Brooklyn Journal of Corporate, Financial & Commercial Law

Volume 2 | Issue 1 Article 5

2007

A European Solution to the Regulation of Cross-Border Markets

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A EUROPEAN SOLUTION TO THE REGULATION OF CROSS-BORDER MARKETS

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INTRODUCTION

An extraordinary change took place when the New York Stock Exchange (NYSE) acquired the electronic trading platform operator Archipelago and went public as a $10 billion company. The NYSE's initial public offering marked the end of the NYSE's comfortable 213-year history as a non-profit, member-owned enterprise and the beginning of a new period of expansion and growth into new markets. As a public company, the NYSE took on the burden of having to pursue profits and please shareholders in return for access to capital—capital it could use to invest in technology and pursue mergers and acquisitions.[1] In acquiring Archipelago, the NYSE obtained an advanced electronic trading platform that would enable it to offer, for the first time, the option to execute trades on the exchange electronically,[2] diminishing the importance of the NYSE's traditional trading floor.[3]

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1. For a discussion of the reasons exchanges have sought to demutualize, see Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?*, 21 NW. J. INT'L L. & BUS. 657, 668–72 (2001). *See also* Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 368 (2002) (discussing demutualization as a response to increased trading volume, technological advancements, and competition).

2. Under the NYSE's "hybrid" system, trades may be executed either through specialists on the trading floor or through an automated matching system. New York Stock Exchange, Products & Services: NYSE Equities, http://www.nyse.com/productservices/nyseequities/1166830723427.html (last visited Nov. 12, 2007). The first test of the hybrid system took place on October 6, 2006 when the NYSE removed automated-trading limits on shares of American Express Co. and Equity Office Properties Trust. On the first day, the response time of the exchange decreased from an average of 9 seconds to 0.3 seconds, and electronic trading represented 97% of the trading volume of American Express and 95% of Equity Office. Gaston F. Ceron, *NYSE's Speed Test Starts Off Well*, WALL ST. J., Oct. 9, 2006, at C2.

3. *See* Aaron Lucchetti, *Boos vs. Moos: NYSE Deal Gets One or the Other*, WALL ST. J., Apr. 6, 2007, at A1; Aaron Lucchetti, *The NYSE: Faster (and Lonelier)*, WALL ST. J., Jan. 24, 2007, at C1; Michael J. de la Merced, *Big Board, Moving Toward Electronic Trading, to Lay Off 500*, N.Y. TIMES, Nov. 9, 2006, at C3. When the London Stock Exchange (LSE) first introduced electronic trading as an alternative to its floor trading system in 1986, the LSE trading floor closed within a few weeks. *See* NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION 45–46 (Little, Brown & Company ed., 1991).

The move to electronic trading has some symbolic implications. Often the scene of frenetic traders swarming from one specialist station to another, the NYSE trading floor has been a highly visible symbol of the strength and vibrancy of the U.S. capital markets, making it a popular destination for foreign heads of state, corporate chiefs and A-list celebrities who seek the honor of ringing the NYSE's opening and closing bell.[4] But beyond symbolism, allowing customer orders to move to the Archipelago platform and away from the trading floor was an acknowledgement by the NYSE that providing for faster and more efficient electronic trading is now necessary to compete against exchanges and alternative trading systems (ATSs) in the United States and Europe.

This competitive pressure has been building for years as other exchanges invested heavily in electronic trading technology.[5] In 2001, The Nasdaq Stock Market (Nasdaq) became a public company, and, in 2005, it acquired the trading business of Instinet, an operator of an advanced electronic trading platform and a major competitor of Archipelago.[6] Regional exchanges, like Philadelphia, Boston and Chicago abandoned floor trading several years earlier. Several brokerage firms have purchased ownership stakes in these regional exchanges or have set up electronic networks to internalize orders.[7] These same firms and others also have launched trading services, such as Liquidnet Inc., Investment Technology Group Inc. and Pipeline Trading Centers LLC, to provide alternative trading venues for large block trades.[8]

Compared to their counterparts in Europe, however, the U.S. exchanges have been playing a game of catch-up. Since the United Kingdom's "Big Bang"[9] reforms in 1986, all major European exchanges have demutualized,

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4. *See* Sunando Sengupta, *The Trading Bell at the New York Stock Exchange* (Jan. 2006) (unpublished article), *available at* http://ssrn.com/abstract=876620 (noting that having company executives ring the opening or closing bell has little impact on a company's share price).

5. *See* Hans R. Stoll, *Electronic Trading in Stock Markets*, 20 J. ECON. PERSP. 153, 153 (2006).

6. *See* Jenny Anderson, *Nasdaq to Acquire Electronic Stock Trader*, N.Y. TIMES, Apr. 23, 2005, at C1.

7. In September 2006, Citigroup, Credit Suisse, Bear Stearns, Merrill Lynch, Bloomberg and Knight Capital purchased over 50% of the National Stock Exchange. In June, Bank of America, Bear Stearns, E*Trade Financial and Goldman Sachs made a combined $20 million equity investment in the Chicago Stock Exchange. And in 2005, Morgan Stanley, Citigroup, UBS, Credit Suisse, Merrill Lynch and Citadel Derivatives each acquired minority stakes in the Philadelphia Stock Exchange. Merrill Lynch, Lehman Brothers, Credit Suisse and Morgan Stanley are also investors in BATS, the third-largest trading center in terms of trading volume after the NYSE and Nasdaq. *See Nasdaq's Nemesis*, THE ECONOMIST, Mar. 17, 2007, at 74.

8. *See* Aaron Lucchetti, *Wall Street Plays the Markets*, WALL ST. J., Aug. 30, 2006, at C1; Aaron Lucchetti, *Wall Street Firms Plan New Service for Block Trades*, WALL ST. J., Sep. 27, 2006, at C4. The NYSE recently announced a new venture to specialize in the handling of block trades. Aaron Lucchetti, *Shhh, NYSE Aims to Bring Back Blocks*, WALL ST. J., Oct. 30, 2007, at C3.

9. *Capital City*, THE ECONOMIST, Oct. 21, 2006, at 83.

consolidated and introduced electronic trading technology. In 1993, the Stockholm Stock Exchange was the first European exchange to demutualize. Helsinki followed Stockholm in 1995, Copenhagen in 1996, Amsterdam and Borse Italiana in 1997, Athens in 1999, and London, Deutsche Börse (Frankfurt) and Euronext (Amsterdam, Brussels and Paris) in 2000.[10]

At the same time, the European exchanges have been competing for cross-border listings, spurring efforts to attract order flow by developing faster and more efficient electronic trading systems.[11] In 1986, the Paris Bourse introduced Cotation Assistée en Continu (CAC), and the London Stock Exchange (LSE) introduced its Stock Exchange Automated Quotations System (SEAQ). Since then, European exchanges have competed for listings and trading volume by developing more advanced trading systems that are designed to lower trading costs and increase the speed of order matching and execution. For example, when the LSE introduced SEAQ International, an automated quotation system for international stocks, and threatened to attract a substantial portion of the trading volume of German company shares, the Deutsche Börse countered with Xetra.[12] When other European exchanges appeared to draw away business from the LSE, the LSE introduced the Stock Exchange Electronic Trading System (SETS) for its Main Market in 1997.[13]

The competition for faster and more efficient trading platforms continues today, especially as hedge funds and other institutional investors use fast-trading computer programs to take advantage of arbitrage opportunities.[14] In 2007, the LSE announced its new trading platform TradElect.[15] TradElect shortens the amount of time to complete a trade to ten milliseconds; this is five times faster than with SETS.[16] Competing on the basis of convenience instead of speed, OMX introduced "Genium," one

10. *See* Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 J. APPLIED CORP. FIN. 105, 105–06 (2002). Several non-European exchanges also demutualized: the Australian Stock Exchange in 1998 and Singapore, Hong Kong and Toronto in 2000. The first U.S. market to demutualize was Nasdaq in 2000. *Id.*

11. *See* Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497 (2001).

12. *See* Cara Schwarz-Schilling & Mark Wahrenburg, *Regulating Competition Between Stock Exchanges* 2 (Universitat Frankfurt Am Main, Working Paper, 2002), *available at* http://wiw.uni-frankfurt.de/schwerpunkte/finance/wp/354.pdf; Marco Pagano, *The Changing Microstructure of European Equity Markets* (Ctr. for Studies in Econ. & Fin., Working Paper No. 4, 1997), *available at* http://ssrn.com/abstract=141048.

13. *See* Poser, *supra* note 11, at 523.

14. *See* Norma Cohen, *Headlong Scramble for Speed*, FIN. TIMES REP., Nov. 28, 2006, at 4.

15. *See* Alistair MacDonald, *LSE Puts Its Stock in Speed*, WALL ST. J., June 19, 2007, at C2.

16. *Id.*

of the few trading platforms that can receive orders for securities, commodities and derivatives.[17]

Demutualization and increased competition has led to a wave of consolidation by the European exchanges. Euronext joined together the Amsterdam, Brussels, Paris and Lisbon exchanges where companies listed on each exchange are traded across the same order book. OMX has gone the furthest, bringing together the Copenhagen, Stockholm, Helsinki, Iceland, Riga, Tallinn and Vilnius exchanges into a single exchange with uniform listing rules.[18] The LSE acquired Borse Italiana.[19] And both Euronext and Deutsche Börse have attempted, albeit unsuccessfully, to merge with the LSE.[20]

Until recently, the U.S. and European markets developed independently of each other. Competition among exchanges and from ATSs, as well as regulatory reforms in each jurisdiction, has driven many of the changes that have taken place. This separation of the U.S. and European markets, however, is ending as both the NYSE and Nasdaq acquire major non-U.S. exchanges. In April 2007, the NYSE and Euronext merged into a single cross-border entity, named NYSE Euronext, to operate exchanges in Europe and the United States. Nasdaq, reviving its own international aspirations,[21] announced in May 2007 that it plans to acquire OMX.[22] The existence of one, and likely two, transatlantic exchanges is putting pressure on Deutsche Börse and other European exchanges to seek new partners.[23]

The merger of the two largest U.S. exchanges with European exchanges (and possibly additional mergers with exchanges in other parts of the

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17. *Id.*

18. *See generally* Alistair MacDonald, *Multiple Markets, One Listing*, WALL ST. J., Oct. 3, 2006, at C14; OMX Corporate, http://www.omxgroup.com (last visited Nov. 12, 2007).

19. Alistair MacDonald, *LSE Snags Borsa Italiana, Beating Out NYSE Euronext*, WALL ST. J., June 23, 2007, at B3.

20. Alistair MacDonald, *For LSE Chief Furse, Takeover-Fighting Skills Could Be Put to the Test*, WALL ST. J., Sept. 21, 2007, at C1.

21. In 2000, Nasdaq entered into a joint venture with the Osaka Stock Exchange to form Nasdaq Japan, and in 2001 Nasdaq acquired Brussels-based exchange Easdaq, renaming it Nasdaq Europe. Both ventures ultimately failed. *See* Silvia Ascarelli, *Nasdaq Confirms its Acquisition of Easdaq Stake*, WALL ST. J., Mar. 28, 2001, at C14; Terzah Ewing & Phred Dvorak, *Japan Gets First Taste of Nasdaq in Latest Push for Global Market*, WALL ST. J., June 20, 2000, at A21; *German Offshoot of Nasdaq Plans to End Operations*, WALL ST. J., Aug. 13, 2003, at C10.

22. *See* Aaron Lucchetti & Alistair MacDonald, *Nasdaq Lands OMX for $3.7 Billion; Are More Merger Deals on the Way?*, WALL ST. J., May 26, 2007, at B3. Nasdaq also attempted unsuccessfully to acquire the LSE in February 2007, but may make another attempt in the future. As of June 2007, Nasdaq owned 30 percent of the LSE, enough to deter a competing bid and to make another serious takeover attempt for the London market. *See* Alistair MacDonald & Jenny Clevstrom, *Moving the Market: Nasdaq, Nordic Exchange Holding Talks - Consolidation Fever Revives Speculation of a Joint LSE Bid*, WALL ST. J., Apr. 13, 2007, at C2.

23. *See Buy, buy, buy*, THE ECONOMIST, May 24, 2007, at 76.

world)[24] poses a problem for U.S. regulators: How should a multi-jurisdictional exchange be regulated?[25] The U.S. regulatory regime tightly controls how exchanges operate, who can conduct business on the exchanges and what are the responsibilities of exchanges to regulate market participants. Unique to the U.S. system, these regulations cannot easily be extended to non-U.S. exchanges. Furthermore, European governments have shown hostility to any prospect of the U.S. Securities and Exchange Commission (SEC) applying its regulations to the European half of a transatlantic exchange.[26]

To win approval for their merger, the NYSE and Euronext announced that they would keep their markets separate, each to be regulated only by its respective home regulator,[27] but it is unlikely NYSE Euronext will be satisfied with this arrangement. The utmost economic benefits of the merger will be realized only if the exchanges are able to consolidate trading into one platform with a single order book, thereby achieving economies of scale and maximizing liquidity. To complete such a consolidation would require unhindered cross-border trading, where broker-dealers in the United States and Europe would have full access to listed shares in each market.

Currently, the United States prevents a foreign exchange from providing services in the United States without registering as an exchange or meeting certain limited registration exemptions set forth by the SEC. Foreign broker-dealers also cannot provide services in the United States without meeting applicable U.S. broker-dealer regulations.[28] These limitations are the result of the SEC's unwillingness to provide greater flexibility in a regulatory system it believes best provides for investor protection and market integrity.[29] In this respect, U.S. regulation conflicts

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24. *See* James Kanter, *Trans-Atlantic Exchange to Be Listed Today*, N.Y. TIMES, Apr. 4, 2007, at C2 (reporting that NYSE Euronext chief executive officer John Thain announced plans to expand operations to Asia).

25. *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

26. *See, e.g.*, Alistair MacDonald, *UK Frets Over LSE Takeover*, WALL ST. J., Sept. 14, 2006, at C12. *See also* Charlie McCreevy, EU Comm'r for Internal Mkt. & Serv., Public Address at The Heyman Center for Corporate Goverance: Building the Transatlantic Marketplace (Mar. 7, 2007), *available at* http://www.heyman-center.org/programs/mccreevy%20speech.pdf.

27. *See* Notice of Filing of Proposed Rule Change Regarding Proposed Combination Between NYSE Group, Inc. and Euronext N.V., Securities and Exchange Commission Release No. 34-55026, 72 Fed. Reg. 814, 817 (Dec. 29, 2006); Press Release, New York Stock Exchange, NYSE Group and Euronext N.V. Agree to a Merger of Equals (June 1, 2006), *available at* http://www.nyse.com/press/1149157439121.html.

28. *See* 17 C.F.R. § 240.15a-6 (2005). *See also A Global View: Examining Cross-Border Exhange Mergers: Hearing Before the Subcomm. on Securities, Insurance and Investment of the S. Comm. on Banking Housing, and Urban Affairs*, 110th Cong. (2007) (written statement of the SEC).

29. *See* Erik R. Sirri, Dir., SEC Div. of Mkt. Regulation, Speech: Trading Foreign Shares, (Mar. 1, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030107ers.htm

with the profit interests of the exchanges. Pressure will build on the SEC to relax its regulatory framework to allow for Euronext-/OMX-listed companies and market participants to have full access to the NYSE/Nasdaq and vice-versa—in short, lower the barriers to the creation of a single market.

This article examines the problem of regulating a transatlantic exchange. This article argues that the most appropriate regulatory strategy is a mutual recognition regime between the United States and European Union. One appropriate model for such a regime is the recently adopted Markets in Financial Instruments Directive (MiFID)—the new EU directive that provides a regulatory structure for European markets to operate in and among the various EU member states.[30] The general MiFID approach can be extended to allow regulated exchanges and alternative trading systems in the United States and European Union to operate in both jurisdictions.

In setting forth the benefits of the MiFID to the regulation of cross-border exchanges, this article argues that consideration of the MiFID as a model for the SEC is not merely an academic exercise. The MiFID's potential to increase the competitiveness of European exchanges compels the SEC to incorporate some of the MiFID's best features in the way it regulates the operation of exchanges and other trading centers in the United States. To this end, this article sets forth and examines three changes in how the SEC regulates exchanges: separation of self-regulatory responsibilities from exchange operations; redefinition of best execution in the trade-through rule to permit exchanges to compete on a variety of services, not only price; and the opening of the U.S. market to foreign financial services providers, which includes allowing foreign exchanges to place trading screens in the United States. Each of these changes will move the U.S. markets closer to the European markets and make it easier for U.S. and European markets to combine and share services across the Atlantic.

This article also considers the advantages and problems associated with a MiFID-style mutual recognition regime between the United States and European Union. To put in place the type of regime envisioned in this article, U.S. regulators will have to reconsider some long-held views about the role and obligations of exchanges in our securities markets. I note the recent proposal of SEC officials Ethiopis Tafara and Robert J. Peterson for the SEC to adopt a policy of "selective substituted compliance." While this article applauds the proposal for its acceptance of the basic principles of mutual recognition, it notes that the proposal does not go far enough to resolve the regulatory differences that exist between the U.S. and European

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[hereinafter Sirri Speech]; Howell E. Jackson et al., *Foreign Trading Screens in the United States*, 1 CAP. MKT. L.J. 54, 68–69 (2006).

30. Council Directive 2004/39, 2004 O.J. (L 145) 1–44 (EC) *amended by* Council Directive 2006/31/EC, 2006 O.J. (L 114) 60–63 [hereinafter MiFID].

markets and the task of coordinating regulation and enforcement between the United States and European Union. Consequently, much can still be learned from following the more ambitious blueprint for the regulation of U.S. and foreign exchanges laid out by the MiFID.

Ultimately, the SEC must actively cooperate with EU regulators and seek a convergence of regulation. The problem of regulating cross-border exchanges should be viewed in the context of the SEC's need to open up the U.S. securities markets to more international competition. By seeking to coordinate regulation with foreign jurisdictions, the SEC can ensure that high standards for the protection of investors are maintained in both the United States and European Union and that the U.S. markets remain the most competitive in the world.

MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MIFID)

How to regulate entities across borders is an old problem for the European Union. One of the European Union's primary objectives since 1960 has been the elimination of national legal and regulatory barriers to create a single European financial market.[31] Just as the SEC is now thinking about the conditions under which it will permit foreign exchanges to access the U.S. market, the European Union has struggled for years with the problem of how to convince its member states to open their markets to financial services firms from other EU member states. Its first attempt at creating a pan-European regulatory regime for financial services was the 1993 Investment Services Directive (ISD).[32] The main achievement of the ISD was to introduce a mutual recognition regime for financial-service firms.[33] This mutual recognition framework raised the prospect of qualified firms operating freely in multiple European countries with the authorization of only one regulator.

Most regulators and market participants, however, found the ISD to be flawed in practice. Despite its promotion of mutual recognition, the ISD did not stop host countries from imposing additional requirements on foreign firms or restricting which firms could apply for mutual recognition treatment.[34] As a result, few firms were able to expand their operations to a foreign country and compete against the already-entrenched home firms.

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31. Eric J. Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a Single European Securities Regulator*, 34 L. & POL'Y INT'L BUS. 499, 499–500 (2003).

32. Council Directive 93/22/EEC, 1993 O.J. (L 141) 27–46 [hereinafter ISD].

33. *See* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999-Part I*, 56 BUS. LAW. 653, 677–78 (2001); Maria Szonert-Binienda, *Passporting Financial Services Throughout the European Union*, 116 BANKING L.J. 456, 457–58 (1999). *See generally* Manning Gilbert Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181 (1994) (describing the impact of the ISD on EU securities regulation).

34. *See* ISD, *supra* note 32.

The ISD only covered a limited number of investment services and products, failing to address the development of new markets like those in derivatives, and quickly became outdated. The ISD also failed to ensure that there was a regulatory framework to take into account both established regulated exchanges and the existence of ATSs.[35] As the ISD covered only "regulated exchanges" (known as the "concentration rule"),[36] its regime prevented trades of listed shares from taking place on ATSs, effectively insulating the main exchanges from any outside competition. Finally, the ISD failed to ensure complete cooperation among the national regulatory authorities. The ISD suffered from inconsistent implementation and did not provide for a means of making technical adjustments to smooth out the wrinkles of implementation once the directive took effect. Thus, firms continued to face different regulations and barriers to operating in multiple European countries without a formal mechanism to bridge regulatory differences. In response to these concerns and a decision to encourage greater competition among financial service firms, the European Union decided to draft an improved version of the ISD. This became the MiFID.[37]

As a model for the SEC, five aspects of the MiFID are worth considering in detail: the passport; scope; definitions of business conduct, investor protection and best execution; provision of pre-trade and post-trade transparency; and recognition of customer categories.

THE PASSPORT: MUTUAL RECOGNITION, MINIMUM STANDARDS AND HOME COUNTRY SUPERVISION

The most important feature of the MiFID is the passport it carried forward from the ISD. Pursuant to the passport, any investment firm or exchange may operate in another EU member state if it has been authorized to conduct business by the competent authority of its home country.[38] The passport itself consists of mutual recognition, minimum standards and home country supervision.[39]

Mutual recognition requires that each country recognize the adequacy of the rules and regulations of another country to permit a regulated entity to do business in both jurisdictions. Mutual recognition depends on an independent determination by each state that the regulatory standards, and the subsequent enforcement of such standards, of a foreign firm's home

35. *See id.*

36. *See, e.g.*, Warren, *supra* note 33.

37. The European Council adopted the MiFID in April 2004. Each EU member state is to implement MiFID no later than November 1, 2007. *See* MiFID, *supra* note 30, at art. 70; Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT'L L.J. 127, 147–50 (2005) (describing the consultation process in preparing MiFID).

38. *See* Niamh Moloney, *Financial Market Regulation in the Post-Financial Services Action Plan Era*, 55 INT'L COMP. L.Q. 982, 987 (2006).

39. *See* MiFID, *supra* note 30, at arts. 31, 32.

state are satisfactory and require no additional oversight and supervision by the host state. If there is true mutual recognition, the host country will not impose additional requirements on the entity regulated by the foreign jurisdiction, and the entity should have complete access to the host country's market. If two jurisdictions recognize each other's market regulations and supervisory competency, there will be a common market even if there is not complete harmonization of regulations.

How a state determines whether another state's regulatory standards are satisfactory must be negotiated. This will be one of the most important tasks in establishing a mutual recognition regime between the United States and the European Union. In the case of the MiFID, EU member states have become more receptive to the principle of mutual recognition because of the Lamfalussy process, a four-level procedural roadmap set forth by the Committee of Wise Men on the Regulation of European Securities Markets.[40] Under the Lamfalussy process, the broad standards agreed to by the member states are set forth in a directive adopted pursuant to the EU legislative process. This exposition of framework principles is considered part of the Level 1 process. This was the same process used to adopt the ISD. Level 2 of the Lamfalussy process provides for promulgation of detailed implementing measures, prepared through consultation with EU officials, the European Securities Committee (ESC) (composed of the finance ministers from each EU member state) and the Committee of European Securities Regulators (CESR) (composed of representatives of each member state's financial regulatory authority).[41] While the passage of a directive must work slowly through EU legislative procedures, the Level 2 process, consisting of permanent committees of expert regulators with direct authority in each EU member state, is designed to encourage more nimble, efficient regulation-making to keep up with market developments.[42] The Level 3 process consists of cooperation among regulators to ensure proper and consistent implementation of the directive and technical implementing measures, and the Level 4 process refers to the monitoring and enforcement of member-state compliance with the directive and technical implementing measures.[43] Consequently, the Lamfalussy process

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40. *See* Eur. Comm'n, Alexandre Lamfalussy et al., *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (2001), *available at* http://europa.eu.int/comm/internal_market/securities/lamfalussy/index_en.htm [hereinafter *Wise Men Report*].

41. European Commission recommendations for certain implementing measures were published on February 6, 2006. The ESC approved these measures in June 2006 with the advice of CESR, and the measures were formally adopted on September 2, 2006. *See* Commission Directive 2006/73/EC, 2006 O.J. (L 241) 26 [hereinafter Implementing Directive]; Commission Regulation 1287/2006, 2006 O.J. (L 241) 1 (EC).

42. *See Wise Men Report*, *supra* note 40, at 28–36.

43. *Id.* at 37–41.

offers an opportunity for national regulators to negotiate and ensure the implementation of certain standards.

A second passport requirement is minimum standards—those common standards that are implemented and enforced in every country participating in the mutual recognition regime. The existence of minimum standards gives confidence to national regulators and market participants that the passport will not result in a regulatory race-to-the-bottom, where market participants engage in regulatory arbitrage to circumvent various host country rules or requirements. The MiFID sets forth the minimum standards that must be in place in all member states.[44] In the case of past EU directives, inconsistencies in how member states implemented the broad, and sometimes vague, terms of directives frustrated the effectiveness of minimum standards.[45] By having national regulators participate in the EU standard-setting process and providing more detailed and technical instructions, the Lamfalussy process should improve how each member state implements the MiFID and ensure compliance with the minimum standards set forth in the directive.

At the same time, the MiFID limits the ability of member states to impose additional requirements on investment firms. Article 4 of the Implementing Directive provides that member states may only impose additional requirements on investment firms if such requirements are justified and proportionate to the relevant risks to investor protection or market integrity.[46] This limitation ensures that foreign investment firms are not denied access to certain markets because some member states attempt to impose additional requirements to protect domestic firms.

The final characteristic of the passport is the principle of home-country supervision. Under the MiFID, each entity that conducts business in the European Union is subject to the supervision of its home country.[47] The principle of home-country supervision is important in defining the regulatory responsibility of each member state. Without an agreement on home-country supervision, a firm may be prevented from conducting its

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44. *See* MiFID, *supra* note 30, at arts. 5–30.

45. *See* Michel Tison, *The Investment Services Directive and Its Implementation in the EU Member States* 21–30 (1999) (Univ. of Ghent Law Sch., Fin. Law Inst., Working Paper No. 1999-17, 1999), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=193270.

46. *See* Implementing Directive, *supra* note 41, at art. 4.

47. *See, e.g.*, MiFID, *supra* note 30, at art. 5 (requiring authorization by home member state authority) and art. 31 (requiring member states to give free access to investment firms regulated by the competent authority of another member state). The one exception in the MiFID to the principle of home country supervision is the regulation of branches. Under the MiFID, firms can establish branches in other states without the authorization of the host state. The firms, however, have to report on the operations of these branches to their home regulator who in turn must pass on information to the host state. In addition, the host state is responsible for ensuring that the branch of the foreign firm complies with all conduct of business, best execution, transaction reporting and pre- and post-trade transparency obligations. *See id.* at art. 32.

operations in more than one jurisdiction because of conflicting regulations imposed by competing regulators. Either inconsistent regulations or the host country's imposition of additional obligations on the foreign firm could deter entry by the firm. By imposing the primacy of the principle of home country supervision, the MiFID resolves uncertainty regarding the applicable regulatory authority and eliminates the regulatory barriers that may stand in the way of cross-border operations.

SCOPE OF THE DIRECTIVE

The MiFID serves as a comprehensive legislative act drafted to cover all areas of the financial services industry, making the MiFID a more ambitious directive than the ISD. The MiFID governs any entity engaged in the selling of securities or investment products, including investment banks, broker-dealers, fund managers, futures and options firms, and some commodities firms.[48] The MiFID requires firms to satisfy certain corporate governance requirements, file reports to the relevant competent authority regarding any changes to management, maintain sufficient regulatory capital (as set forth in the Capital Requirements Directive),[49] manage any conflicts of interest between themselves and their clients, and maintain minimum internal controls, including risk management and outsourcing of critical functions.[50]

The MiFID also covers a broader range of financial instruments than the ISD.[51] The MiFID passport now extends to services pertaining to financial commodity derivatives, credit derivatives and other financial contracts. [52]

Most importantly, the MiFID governs the operation of both exchanges and alternative trading systems.[53] One of the deficiencies of the ISD was that it only extended the mutual recognition passport to "regulated markets," as defined by each member state.[54] This limitation allowed individual member states to deny the passport to ATSs. The MiFID removes this limitation by extending the benefits of the passport to

48. *See* MiFID, *supra* note 30.

49. *See* Council Directive 2006/48/EC, 2006 O.J. (L 177) (relating to the taking up and pursuit of the business of credit institutions); Council Directive 2006/49/EC, 2006 O.J. (L 177) (relating to the capital adequacy of investment firms and credit institutions). Regulated markets, however, are not subject to the Capital Requirements Directive.

50. *See* MiFID, *supra* note 30.

51. The ISD covered transferable securities, money market instruments, units in collective investment undertakings and financial derivatives. *See* ISD, *supra* note 32.

52. *See* MiFID, *supra* note 30, at arts. 31, 32.

53. *See id.*

54. ISD, *supra* note 32, at art. 16.

"multilateral trading facilities" (MTFs), a term that encompasses ATSs.[55] The MiFID requires MTFs to meet many of the same obligations already required of exchanges: presentation of transparent criteria for determining the financial instruments that can be traded on their systems, fair and orderly trading rules and rules to allow for efficient settlement of trades and non-discriminatory rules for access to their systems.[56] Consequently, the MiFID ensures that all markets, whether exchanges or MTFs, are subject to the same market-integrity standards.

BUSINESS CONDUCT; BEST EXECUTION

The MiFID also puts into place new rules of conduct for investment firms in Europe.[57] The MiFID states that firms have to act "honestly, fairly and professionally" and, in accordance with the best interests of their clients, communicate in a way that is fair, clear and not misleading, and provide clients with appropriate information about the firm, its services and the costs, and associated charges.[58] In addition, the MiFID puts a "know-your-client" obligation on firms: They are required to collect information from their clients in order to determine whether a particular service or product is suitable to the client.[59]

One key area where the European Union took a different approach than the one taken by the SEC[60] is in defining the obligation of investment firms to obtain the best possible results for their clients. Under the MiFID, a firm is to take into consideration a range of factors in order to meet its best execution obligation. In addition to price, the firm should consider cost, speed, size, nature of the order and the likelihood of execution, and settlement.[61] The MiFID does not emphasize one factor over another, but rather places the burden on the firms to develop a process for achieving best execution.[62]

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55. Article 4(1)(15) of the MiFID defines a "multilateral trading facility" as a "multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with the provision of Title II." MiFID, *supra* note 30, at art. 4.

56. *See id*. at art. 14.

57. *See* Emilios Avgouleas, *The Harmonisation of Rules of Conduct in EU Financial Markets: Economic Analysis, Subsidiarity and Investor Protection*, 6 EUR. L.J. 72 (2000).

58. *See* MiFID, *supra* note 30, at art. 19.

59. *Id.*

60. *See infra* pp. 153–54.

61. *See* MiFID, *supra* note 30, at art. 21(1).

62. *See id.* at art. 21(2).

PRE-TRADE AND POST-TRADE TRANSPARENCY

The MiFID sets forth several principles to regulate market transparency and integrity. To mitigate concerns about market fragmentation and the migration of order flow to non-regulated internalizers, the MiFID requires public disclosure of certain pre-trade and post-trade information by equity markets and "systematic internalizers" so that customers will know what the best bids and offers for each trade are.[63]

First, the MiFID requires systematic internalizers to publish quotes on a regular and continuous basis during trading hours for shares for which there is a liquid market.[64] The MiFID defines systematic internalizers as investment firms, which, on an organized, frequent and systematic basis, deal on their own accounts by executing client orders outside a regulated market or MTF.[65] Requiring systematic internalizers to disclose bid and offer quotes for shares traded by systematic internalizers benefits customers who wish to ensure they are having their trades executed at the best available prices. As a result, systematic internalizers are forced to meet the same obligations as the exchanges and MTFs, which already provide pre-trade transparency.[66]

Under the MiFID, firms executing trades on a customer's behalf must provide more information to their customers about the terms under which the trade was executed. The MiFID is most concerned with off-exchange trades where the customer has less opportunity to confirm its trade was executed on the best terms. To address this problem, the MiFID requires public disclosure of the terms of a trade if the shares being traded are admitted to trading on a regulated market.[67]

The MiFID imposes additional transparency requirements on MTFs. MTFs must publicly report current bid and offer prices and the depth of trading interests at these prices,[68] which are advertised on their systems in respect of shares admitted to trading on a regulated market. Likewise, after the execution of the trade, an MTF must make public the price, volume and time of the trade executed on its system in respect of shares admitted to trading on a regulated market.[69] Collectively, these transparency requirements encourage the development of a centralized order book where bid and offer information for certain shares, whether it is found on an

63. *Id.* at art. 27.
64. *Id.* at art. 27(1).
65. *Id.* at art. 4(1)(7).
66. *Id.* at art. 27(1).
67. MiFID, *supra* note 30, at art. 28.
68. *Id.* at art. 29.
69. *Id.* at art. 30.

exchange or an MTF, or provided by a systematic internalizer, is made available to the marketplace.[70]

In addition, the MiFID requires regulated markets and MTFs to supervise trading on their markets and report misconduct to the relevant regulator. Investment firms must maintain records of all of their transactions for up to five years so that regulators can monitor on-going transactions and conduct investigations into fraud, insider trading and money laundering.[71]

CUSTOMER CATEGORIES

The MiFID also sets different standards for each customer category. Retail investors benefit from the heaviest protection, and firms are given more freedom to avoid certain MiFID requirements when they conduct business with professional clients or other sophisticated entities. For example, the conduct of business, best execution and client order-handling rules are waived for entities classified as "eligible counterparties."[72] The MiFID considers, among others, investment firms, credit institutions, insurance companies, common funds or unit trusts and pension funds eligible counterparties.[73] These entities are sophisticated enough not to need the benefit of the MiFID's investor protection rules, and it is expected that they will be able to demand or negotiate their own protections as necessary.

The MiFID also allows systematic internalizers to distinguish between retail and professional clients in executing trades in accordance with published quotes. Professional clients include regulated financial service providers, corporate entities of a certain size, governmental bodies and individuals with sufficient investment experience, wealth and/or financial knowledge.[74] The MiFID permits systematic internalizers to execute trades

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70. In its November 2002 Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, amending Council Directives 85/611/EEC, Council Directive 39/6/EEC and European Parliament and Council Directive 2000/12/EC, the European Commission stated:

> The operation of an integrated financial market requires that orders to buy and sell financial instruments interact effectively, freely and instantaneously with each other on a cross-border basis. Requiring investment firms to consider trading conditions on a reasonable range of execution venues, and to route orders to the venues offering the best prices, will ensure that liquidity responds quickly to price differentials.

Commission Proposal for a Directive of the European Parliament and of the Council on Investment Services and Regulated Markets, and Amending Council Directives 85/611/EEC, Council Directive 93/6/EEC and European Parliament and Council Directive 2000/12/EC, at 26, COM (2002) 625 final (Nov. 19, 2002).

71. *See* MiFID, *supra* note 30, at art. 25(2).

72. *Id.* at para. 41.

73. *Id.* at art. 24(2).

74. *See id.* at Annex II.

at prices different from published quotes when the customer is a professional client and the trade involves amounts larger than those normally requested by retail clients.[75]

POLICIES BEHIND MIFID

By all measures, the MiFID creates a comprehensive regulatory framework for the regulation of markets in the European Union and the formation of a single European financial market. Equally notable about the MiFID are the policy principles that underlie many of its provisions.

First, the MiFID establishes a regulatory framework designed to encourage cross-border competition among trading venues. MTFs now can take advantage of the passport to provide services across Europe. Regulated markets and MTFs now have the right to place trading screens in countries outside that in which they are registered without pre-approval of domestic regulatory authorities.[76] At the same time, these trading venues must now provide minimum levels of investor protection and satisfy certain pre- and post-trade transparency requirements.[77] These provisions allow regulated markets, MTFs and systematic internalizers to compete for trading volume on an equal regulatory playing field.

The MiFID also avoids limiting the scope of competition by allowing trading venues to compete in best execution and client-appropriate services. While requiring best execution of trades, the MiFID elects to adopt a broad definition of best execution, providing ample room for trading venues to offer a variety of options to clients.[78] This means some trading venues can provide "better" services for clients seeking price superiority, while others may attract clients seeking execution certainty or lower administration costs. To encourage further market differentiation, the MiFID allows trading venues to offer different services to different types of clients.[79] In so doing, it recognizes that professional clients require less protection than retail clients and may value different services. As a result, trading venues will be able to offer specialized services to retail and professional clients.

Second, the MiFID recognizes the importance of regulatory cooperation in maintaining a mutual recognition regime. The Lamfalussy process lays out a process by which common standards can be agreed upon between member states, but the MiFID also provides that there be sufficient on-

75. *Id.* at art. 27(3).

76. *Id.* at arts. 31(5), (6). *See also* Eur. Comm'n, Comm. of Eur. Sec. Regulators, *The Passport Under MiFID: Recommendations for the Implementation of the Directive 2004/39/EC and Statement on Practical Arrangements Regarding the Late Transposition of MiFID*, para. 52, CESR/07-337b (Oct. 2007).

77. *See* MiFID, *supra* note 30.

78. *Id.* at para. 44.

79. *See id.* at para. 50 and art. 27(3).

going regulatory cooperation to ensure continued relevance of these regulatory standards. Regulatory cooperation consists of information sharing, joint supervision, rights of investigation, consultation and joint enforcement.[80] The MiFID also takes advantage of the new European institutions like CESR to coordinate regulatory responses to changes in the market. [81]

Regulatory cooperation is necessary to facilitate competition. The ISD failed in part because it did not eliminate all of the regulatory barriers preventing cross-operation of investment firms. Certain member states refused to follow the spirit of the mutual recognition regime either because of market-integrity concerns or protectionism.[82] As the MiFID is just being implemented, it is too early to tell if it will suffer from the same fate, but the MiFID has more strongly addressed the need for regulatory cooperation.

Third, the MiFID reflects the European Union's ambition to make the European financial markets competitive with other markets, especially the United States. The European Union drafted the MiFID not only with an eye toward getting its internal markets in order, but also to give it leverage to demand access to other markets. The MiFID explicitly denies branches of investment firms from third countries to establish themselves or provide services in any EU member state without assurances that EU firms will receive reciprocal treatment in return.[83] Article 15 of the MiFID provides that member states are to inform the European Commission of any difficulties faced by their firms when attempting to provide services abroad.[84] The Commission may direct member states to limit or suspend any decision to authorize firms from a third country to conduct business in the member state, and the Commission may continue to stop these non-EU firms from doing business in the European Union until it is satisfied that reciprocal treatment is offered by the third country. Article 15 offers the European Union a potentially powerful tool to seek concessions from the United States, especially with respect to allowing European firms and exchanges direct access to the U.S. market.

RETHINKING THE U.S. SYSTEM

The difference between the EU and U.S. regulatory regimes illustrates one important reason why the European markets demutualized, adopted

80. *See, e.g.*, *id.* at arts. 49, 56, 57, 59.

81. *See id.* at art. 64.

82. *See generally* Eur. Comm'n, Alexandre Lamfalussy et al., *Initial Report of the Committee of Wise Men on the Regulation of European Securities Markets*, at 15–20 (2000), *available at* http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/initial-report-wise-men_en.pdf (discussing the shortcomings of European regulation).

83. *See* MiFID, *supra* note 30, at para. 28.

84. *Id.* at art. 15(1).

electronic trading, and consolidated more than 20 years earlier than their U.S. counterparts. The European markets expanded and competed in a fragmented regulatory environment where each exchange operated in accordance with national laws and regulations. Each EU member state had its own national exchange, and European companies frequently had their primary listings on an exchange located in their home country.[85] After adoption of the ISD in 1993, the various national exchanges in Europe—each still subject to their different local rules—began competing with one another for order flow in European stocks. The introduction of the ISD made it easier for European exchanges to extend their operations to other parts of the European Union and compete with each other. This direct competition eventually led to the combination of national exchanges into multi-jurisdictional-European exchanges like Euronext and OMX and the placement of trading screens across Europe by Deutsche Börse and the LSE.

In contrast, the U.S. regulatory environment, until recently, has shielded U.S. exchanges from similar pressure to innovate and compete. Under the Securities Exchange Act of 1934,[86] and the rules and regulations thereunder, U.S. exchanges are subject to SEC oversight and also serve as regulators of broker-dealers, market makers and listed companies.[87] As self-regulatory organizations (SROs), the established exchanges had little incentive to adopt new trading technology or to be worried about new entrants challenging their dominance of the trading of listed equity securities.

The barriers to entry for new competitors were high, and the SEC prevented foreign competitors from entering the marketplace.[88] A start-up exchange had to register first as an exchange with the SEC and take on the responsibilities (and costs) of being a SRO. Assuming this new exchange could meet the necessary regulatory requirements, it would be difficult for the exchange to challenge the natural monopoly enjoyed by the established exchanges over the trading of existing equity securities.[89] At the same time, the SEC limited the ownership of exchanges to not-for-profit organizations,

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85. *See* Jackson & Pan, *supra* note 33, at 677–78.

86. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2000).

87. For a detailed description of the operation of exchanges as self-regulatory organizations (SROs) and the relevant rules and regulations governing SROs, please see Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069 (2005); Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541 (2006); Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation during the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347 (2004).

88. *See* Jackson et al., *supra* note 29, at 58–59, 68–69.

89. In 1963, the SEC Special Study on the securities markets noted that trading volume was migrating to the primary exchanges at the expense of the smaller regional exchanges. *See* Dombalagian, *supra* note 87, at 1083.

limiting any new exchange's ability to raise money from outside sources.[90] It was not until 1998 in Regulation ATS that the SEC relaxed its position and suggested that in limited cases exchanges could operate as for-profit organizations.[91] The most serious potential competitors were foreign exchanges that had the money, market-depth potential and technology to compete effectively against the NYSE and other established U.S. exchanges, but the SEC refused to grant the necessary regulatory accommodations to allow foreign exchanges to provide services in the United States.[92]

Not surprisingly, the U.S. market continues to be dominated by only two exchanges. In 1936, the NYSE handled the trading of 85% of the market value of all securities on organized exchanges in the United States.[93] The New York Curb Exchange (later known as the American Stock Exchange (Amex)) handled 11%.[94] Today, the NYSE remains the largest stock exchange in the United States. It handles approximately the same share of the market as it had in 1936, and Nasdaq, which came to prominence initially as a quotation system for over-the-counter shares, has assumed Amex's position as the second largest exchange in the United States.[95]

NATIONAL MARKET SYSTEM

Domestic ATSs have supplied the main competitive pressure on the NYSE, Nasdaq and Amex to innovate and lower costs.[96] As the result of the SEC's drive to consolidate the exchanges and ATSs into a national market system, NYSE and Nasdaq have become public companies and sought to merge or acquire ATSs that have developed more advanced electronic trading platforms.[97]

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90. *See* Fleckner, *supra* note 87, at 2556.

91. *See id*.

92. *See* Jackson et al., *supra* note 29, at 58.

93. Seligman, *supra* note 87, at 1352.

94. *Id.*

95. 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2529 (3d ed., rev. vol. 2001) ("As of 1998, the NYSE was responsible for 88 percent of the dollar value of the stocks traded on exchanges and 87 percent of the shares traded." (internal citations omitted)). *See also* WORLD FEDERATION OF EXCHANGES, ANNUAL REPORT AND STATISTICS 2005 66 (2006), *available at* http://www.world-exchanges.org/publications/WFE%202005%20Annual%20Report.pdf.

96. *See* Aaron Lucchetti, *Fast Lane: Firms Seek Edge Through Speed as Computer Trading Expands*, WALL ST. J., Dec. 15, 2006, at A1; Gaston F. Ceron, *Thain Is Confident Offer for Euronext Will Be Attractive*, WALL ST. J., Sept. 29, 2006, at C4. *See also* Greg Ip, *Big Board Opposes SEC Plan to Treat Alternative Trading Systems as Exchanges*, WALL ST. J., Nov. 14, 1997, at B13.

97. Amex also is in the process of becoming a public company. *See* Press Release, American Stock Exchange, American Stock Exchange Appoints the Investment Bank Morgan Stanley to Assist on Demutualization Plan (Jan. 25, 2007), *available at* http://www.amex.com/atamex/news/press/sn_Demutualize_012507.htm. Amex is also introducing

In its 1973 Policy Statement on the Structure of a Central Market System, the SEC stated that "the most important objective of the system is to foster the development of strong competition among its participants."[98] To achieve this goal, Congress passed the Securities Acts Amendments of 1975, authorizing the SEC to establish a "national market system."[99] The SEC required the SROs to disclose trading information in real time and develop electronic linkages to open up trading across markets. The establishment of the Intermarket Trading System made cross-market trading easier.[100] The 1975 amendments also strengthened SEC control over exchanges and placed new obligations on exchanges to regulate broker-dealers and market makers.[101]

Eventually, the SEC had to respond to the movement of trading volume from the registered exchanges to the less regulated ATSs.[102] ATSs allowed investors to trade among themselves while avoiding the disclosure and regulatory obligations imposed on the exchanges. ATSs also permitted investors to trade directly with each other rather than only through registered broker-dealers. When the SEC determined that market makers were able to trade at superior prices on ATSs, creating an arbitrage opportunity between the private ATSs and the more open exchanges, the SEC sought to integrate ATSs into the national market system and make quotations on ATSs publicly available.[103]

In thinking about how to regulate ATSs, the SEC faced a dilemma. On one hand, ATSs were more aggressive than exchanges in investing in new electronic trading platforms.[104] They developed these sophisticated trading systems to attract brokers and institutional investors who appreciated the speed and efficiency in which trades could be executed on ATSs. When the NYSE and Nasdaq recognized that they needed to upgrade their systems to compete more effectively against ATSs, they both acquired the technology through takeovers of the two most prominent ATSs, Archipelago and Instinet.[105]

On the other hand, the SEC recognized that ATSs had certain advantages over the exchanges, stemming from the fact that ATSs did not

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a new electronic trading platform. *See* Aaron Lucchetti, *Forgotten Amex Hopes to Erase Bad Memories*, WALL ST. J., Dec. 14, 2006, at C1.

98. *See* Seligman, *supra* note 87, at 1368.

99. Securities Acts Amendments of 1975, 15 U.S.C. § 78k-1.

100. *See* Dombalagian, *supra* note 87, at 1085–86.

101. *See* Seligman, *supra* note 87, at 1368–69.

102. The SEC defines an ATS as "any organization, association, person, group of persons or systems that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange." 17 C.F.R. § 242.300(a)(1) (2005).

103. *See* Dombalagian, *supra* note 87, at 1087.

104. *See, e.g.*, Lucchetti, *supra* note 96, at A1.

105. *See* Anderson, *supra* note 6, at C1.

have to meet the same regulatory burdens. Because they were not SROs, ATSs did not have to bear the costs of regulating their members and customers, nor did they have to meet the same reporting requirements as exchanges, or make their order books public.[106] These advantages meant that ATSs had lower expenses than the exchanges and investors enjoyed lower trading costs. In addition, orders to ATSs did not have to be routed through a registered broker-dealer, making ATSs even more attractive to investors. Altogether the advantages enjoyed by ATSs allowed ATSs to capture valuable order flow and meant that ATSs sometimes provided better bid and ask prices than the exchanges.[107] The SEC noted that these advantages benefited only those investors that had access to the ATSs—primarily institutional investors—placing smaller investors at a disadvantage.[108]

In response, the SEC promulgated Regulation ATS in 1998.[109] Under Regulation ATS, the SEC required ATSs to elect between being registered as exchanges or being treated as broker-dealers. In order to ensure the soundness of ATSs, the regulation required ATSs to submit to various record-keeping, notice and market surveillance requirements. As an ATS conducted more business, it would assume additional regulatory responsibilities, much like an exchange. In addition, Regulation ATS imposed certain transparency and trading access requirements on ATSs. In the case where an ATS handles a high portion of the trading volume of a particular security, the ATS is required to report its best orders to a central quotation system on a registered exchange.[110]

Regulation ATS reflected the SEC's difficulty in deciding how to incorporate ATSs into the national market system and to define ATSs' relationship to exchanges. The SEC sought to strike a middle path between allowing certain ATSs to continue to operate with light regulation and oversight while imposing additional regulatory oversight requirements on larger ATSs that posed a more direct competitive threat to exchanges. Unfortunately, the degree to which certain ATSs might reach a size where

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106. Fleckner, *supra* note 87, at 2569 ("Stock exchanges face a disadvantage insofar as the Securities Exchange Act compels them to regulate the securities markets, while other market organizers can free ride on the stock exchanges' regulatory expenses.").

107. Dombalagian, *supra* note 87, at 1087–99 (noting that the SEC was concerned that ATSs remained outside the scope of formal regulation).

108. *See id.*

109. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40,760, 63 Fed. Reg. 70,844 (Dec. 22, 1998).

110. 17 C.F.R. § 242.301(b)(3).

they would have to comply with certain additional regulations was a source of great confusion.[111]

The regulation of exchanges and ATSs in the United States culminated in the promulgation of Regulation NMS in 2005.[112] Regulation NMS introduced several significant market reforms to strengthen the national market system. Regulation NMS consisted of four parts: (i) the "trade-through" or Order Protection Rule,[113] (ii) the Access Rule,[114] (iii) the Sub-penny Rule[115] and (iv) the Market Data Rules.[116]

The trade-through rule requires "trading centers" to ensure the execution of a trade at the best price available on any automated trading center. Regulation NMS defines trading centers broadly to include exchanges, national securities associations that operate SRO trading facilities, ATSs, exchange market-makers, over-the-counter market-makers and any broker-dealers that execute orders internally by trading as principal or crossing orders as agent.[117] This definition tracks the MiFID terms MTFs and systematic internalizers.[118] If a trading center receives a bid where the best offer is located at another trading center, the trading center must route the trade to the other trading center. The trade-through rule applies, however, only to automated trading centers. Therefore, trading centers do not have to route trades to a trading center that cannot match a bid within one second of receipt even if that trading center offers a better price.[119] The limitation of the trade-through rule only to automated trading centers was the main reason why both the NYSE and American Stock Exchange moved from exclusively floor-trading systems to hybrid trading systems.

In the SEC's view, the trade-through rule helps accomplish three goals. First, the trade-through rule should increase investor confidence in the markets by ensuring that investor orders are always executed at the best prices.[120] In developing the trade-through rule, the SEC was most concerned about the protection of retail investors, who would be vulnerable to having their trading orders executed at inferior prices. Institutional investors, on the other hand, generally are better informed and have more opportunities to ensure their orders are executed at the best prices. Second, the SEC believed

111. *See* Dale A. 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, 665–66 (2005).

112. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 9, 2005) [hereinafter Regulation NMS Release].

113. 17 C.F.R. § 242.611 (2005).

114. § 242.610.

115. § 242.612.

116. §§ 242.601, .603.

117. § 242.600(b)(78).

118. *See* MiFID, *supra* note 30, at art. 4(1).

119. 17 C.F.R. § 242.611(b)(8) (2005).

120. *See* Regulation NMS Release, *supra* note 112, at 37,498.

that the trade-through rule lowers trading costs and increases market liquidity by encouraging the greater use of limit orders.[121] Finally, the SEC believed the trade-through rule would foster competition among trading centers for orders, since orders have to be directed to whichever trading center has the best prices.[122] The trading center that offers the best price therefore would capture trading volume, and higher trading volume would lead to more revenue from trading fees and enough liquidity to continue to ensure the best prices. Trading centers began complying with the trade-through rule in March 2007.[123]

The access rule aims to ensure non-discriminatory access to quotations displayed by the exchanges (but not other trading centers) by any person seeking to obtain quotations through members, subscribers or customers of the exchanges. Among other rules to make it easier for outsiders to access another trading center's quotations, Regulation NMS limits the fees charged by trading centers for certain quotations to no more than $0.003 per share.[124]

The sub-penny pricing rule prohibits market participants from displaying or otherwise accepting quotations that are priced in units less than $0.01.[125]

Finally, the market data rule changes the formula for how revenues from market data fees are used to support SROs. The main change was to modify the formula to ensure that SROs that provided quotation information received more revenue.[126]

CONFLICTING GOALS OF THE SEC

For nearly seventy-five years, the SEC has attempted to balance three objectives in how it regulates trading markets and broker-dealers: self regulation, protection of retail investors and competition among trading centers. The SEC made the decision early on to delegate regulatory authority to the SROs. Allowing the exchanges and broker-dealers to self-regulate was initially a way of soothing opposition by the exchanges and broker-dealers to the new agency.[127] Quickly, however, the SEC embraced self-regulation as a more *effective* way to regulate the activities of exchanges and broker-dealers, as compared to direct regulation by the SEC.

121. *See id.* A limit order is an order to trade at the best available price, provided that the price is worse than the limit price specified by the trader. *See* LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 73 (2003).

122. *See* Regulation NMS Release, *supra* note 112, at 37,498.

123. *See* Gaston F. Ceron, *New Trading Rules to Launch Days After the Rout, Rollout of First Phase To Bar "Trade Throughs"*, WALL ST. J., Mar. 5, 2007, at C3.

124. *See* 17 C.F.R. § 242.610 (2005).

125. *See* § 242.612.

126. *See* Regulation NMS Release, *supra* note 112, at 37,503.

127. *See* Seligman, *supra* note 87, at 1351–52.

The SEC believed the SROs to be in a superior position to regulate the securities industry because they would be better informed about marketplace activities, be better able to monitor and ensure the compliance of its own members to applicable rules and regulations, and through self-financing of regulatory activities be more capably funded.[128] SROs also had another big advantage over the SEC: SROs would not be bound by due process standards like a government agency and therefore could act faster to stop and punish market actors for fraud or unfairness in the marketplace.[129] In the meantime, the SEC could stand back from the day-to-day regulation of the marketplace and intervene when problems arose—a "shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be."[130] At times when SROs have failed to prevent fraud or abuse, the government has tightened the leash on them,[131] but the SEC remains committed to the ideal of the securities industry regulating itself and all of the ancillary benefits.

The other objective that the SEC has consistently pursued in its rulemaking is the protection of investors, especially retail investors. The focus on retail investors has driven the SEC to seek greater transparency in order books and increase public access to market data. It also led the SEC to adopt the trade-through rule, with the rule's emphasis on always executing trades at the best price. The trade-through rule thus prevents trading centers from providing services that may be especially attractive to institutional investors and less beneficial to retail investors.

Finally, the SEC has sought to encourage greater competition among trading centers. Pursuant to Section 11A of the Securities Exchange Act, the SEC has viewed development of the national market system as the way of linking all of the various U.S. trading centers in a shared order book with cross-market order routing to ensure that trades are always completed at the best available price.[132]

In attempting to create a national market system, however, the SEC has undermined its other objective of increasing competition. Competition can come from three directions. New trading markets can be formed, offering customers better execution technology and charging lower trading fees. To the extent better trading technology and lower fees are not enough, a rival market can try to siphon off order flow by offering superior price discovery

128. *See* Fleckner, *supra* note 87, at 2582.

129. *See* Seligman, *supra* note 87, at 1361.

130. *See id.* (quoting JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 185 (3d ed. 2003).

131. See, for example, the limitations imposed on SROs by the Securities Acts Amendments of 1975 and the reorganization of the NASD in the 1990s. *See* Dombalagian, *supra* note 87, at 1079–82; Seligman, *supra* note 87, at 1369–73.

132. *See* 15 U.S.C. § 78k-1 (2000).

or particular services to institutional customers. Or, to the extent domestic markets cannot provide adequate competition, foreign exchanges with proven technology and better financing could be allowed to provide services in the United States and challenge the NYSE and Nasdaq for listings and order flow. In each case, however, regulatory barriers prevent viable competitive pressure from being exerted from any of these directions.

The SEC's desire to protect the self-regulatory system and promote the interests of retail investors has made it difficult for new entities to challenge the dominance of the large U.S. exchanges. In the United States the NYSE and Nasdaq dominate the trading of equity securities. They attract the highest number of customer orders, which places them in a stronger competitive position relative to other exchanges and ATSs. As noted earlier, this dominance has remained constant for the past century with the exception of Nasdaq, assuming the second-place position once held by Amex.[133]

The attraction of order flow is vital to the business of an exchange. Order flow perpetuates the attractiveness of the exchange. Increased order flow makes the exchange more liquid. Liquidity means not only better prices, but also faster execution of trades.[134]

Order flow also directly affects how much revenue the exchange can generate. An exchange relies primarily on three sources of revenue: trading fees, listing fees and market data fees.[135] Of the three, the biggest source of revenue is trading fees. Trading fees are the fees that an exchange charges customers for each trade. The more order flow, the more trading fees generated. In the year ended December 31, 2006, the NYSE reported $675.9 million in revenue from trading fees compared to $356.1 million from listing fees and $222.5 million from market data fees.[136] Order flow also allows the exchange to generate more listing fees and market data fees. Listing fees are the fees paid by companies to have their securities listed on the exchange. As order flow is a key component of liquidity, an exchange that can attract more order flow will be an attractive exchange for companies on which to seek a listing. Likewise, an exchange that attracts order flow can charge more in market data fees.

It is very difficult for a competitor to dethrone an exchange once that exchange has established itself as the dominant recipient of order flow. A

133. *See supra* p. 150.

134. *See* HARRIS, *supra* note 121, at 394–409.

135. *See* RUBEN LEE, WHAT IS AN EXCHANGE? 51 (1998) (stating that the main sources of income for stock exchanges include fees for transaction-related services, listing, clearing and settlement services, market and company news and information, and membership subscriptions).

136. NYSE Euronext, Annual Report (Form 10-K/A), at 80–81 (May 1, 2007). For a description of trading fees, listing fees and market data fees, see *id.* at 90–92.

competitor faces the classic chicken-and-egg problem: Bid and ask prices superior to those offered on the established exchange may encourage more orders, but without already existing order flow it is difficult for the competitor to offer consistently superior prices.

The need for an exchange to register itself with the SEC is a further hindrance to direct competition between the established exchanges and rising ATSs. Since the 1980s, ATSs like Instinet have been quite popular with brokers and institutional investors that appreciated the faster execution speeds, lower trading costs and anonymity offered by the electronic trading systems.[137] ATSs also did not have to limit membership to registered broker-dealers, giving institutional investors direct access to the trading system and an additional way to minimize trading costs.[138] As ATSs started to handle a greater share of the trading volume for certain securities, the SEC promulgated Regulation ATS.[139] The added regulatory burden of becoming an exchange or taking on exchange-like obligations imposed by Regulation ATS[140] undermines many of the reasons ATSs were attractive to brokers and investors.

The second regulatory challenge to a new exchange stems from its obligation to participate in the national market system and comply with Regulation NMS.[141] The trade-through rule in Regulation NMS has the effect of favoring the dominant exchanges by requiring brokers to execute trades on the exchange offering the best price. The market that handles the greatest amount of order flow will generally be the market that offers the best price.[142] As a result, the trade-through rule perpetuates the dominant position of the largest exchanges. The only opportunity that a new exchange has to challenge the established exchange's dominance is by offering other services to customers beyond price. For example, the exchange could offer faster execution speeds, anonymous trading or better execution certainty. Regulation NMS's trade-through rule, however, denies smaller exchanges this opportunity.

Finally, the SEC has prevented foreign exchanges from offering services directly to U.S. investors without registering as a U.S. exchange.

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137. *See* Stoll, *supra* note 5, at 161; Xiang Cai, Treading Through Trade-Through: A Law and Economics Analysis of SEC Proposed Regulation NMS (Feb. 14, 2005) (unpublished note, Cornell Law Review), *available at* http://ssrn.com/abstract=666962 (citing research that investor preferences may change with market conditions and not always lie with best price).

138. *See generally* Dombalagian, *supra* note 87, at 1087–89 (discussing the consequences of the growth of ATSs in the 1990s).

139. *See* discussion *supra* pp. 151–52.

140. *See supra* p. 152.

141. *See* discussion *supra* pp. 152–54.

142. This point is made by Stavros Gkantinis in *Regulation and Innovation: Comparing U.S. and European Stock Trading Markets* 13–14 (Harvard Law Sch. Student Scholarship Series, Paper No. 13, 2006), *available at* http://ssrn.com/abstract=887645.

While U.S. investors have myriad ways to buy foreign shares abroad on foreign exchanges, foreign exchanges do not yet have the opportunity to place trading terminals in the United States. This would make it easier for U.S. brokers to execute trades on the foreign exchanges.[143] The SEC has the power to exempt foreign exchanges from the registration requirement, but has chosen to do so only if and when the foreign market limits access and trading volume.[144] The result is that the NYSE and Nasdaq are insulated from serious foreign competition.

SUGGESTIONS FOR INCREASING COMPETITION

In order to facilitate greater competition among exchanges, three changes should be made to how U.S. trading markets are regulated. First, the operation of exchanges should be separated from their regulatory functions. It is worth noting again that the self-regulatory obligations of an exchange serve as an entry-barrier to new competitors. New exchanges must build up their regulatory capacities or outsource their SRO responsibilities to another SRO.[145] But, even from the perspective of ensuring sound regulation, it would be wise to remove from exchanges the responsibility of regulating certain market participants. It has been noted by several commentators that there is an inherent contradiction between the SRO duties of an exchange and its for-profit activities.[146] As an SRO, the exchange is responsible for monitoring the activities of brokers, setting and enforcing listing standards and guarding market integrity. As a for-profit enterprise, however, the exchange is trying to attract brokers and issuers. The brokers execute trades on behalf of customers and play an important role in directing order flow to the exchange. Issuers decide where to list. Therefore, tougher regulation of brokers and companies may have a direct impact on the exchange's revenue streams.[147] In addition, exchanges may be in a position of regulating their competitors. ATSs that choose to be regulated as broker-dealers must subject themselves to oversight by an SRO, which may be one of the exchanges.[148]

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143. *See* Jackson et al., *supra* note 29, at 70–72.

144. *See id.* at 59–60 (describing the exemption order granted to Tradepoint Financial Networks plc in 1999); Tafara & Peterson, *supra* note 25, at 64.

145. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78*o*-3 (2000).

146. *See, e.g.*, Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 581–83 (2005); Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP., FIN. & COM. L. 317, 331–35 (2007); Fleckner, *supra* note 87, at 2590–610.

147. *See* Macey & O'Hara, *supra* note 146, at 581–83 (arguing that exchange should only be in charge of guarding market integrity—an area where the interests of the exchange owners correspond with the interests of the public). The NYSE attempted to address this problem by delegating much of its regulatory oversight responsibilities to a not-for-profit subsidiary called NYSE Regulation with a board consisting of a majority of independent directors. *Id.* at 597–98.

148. *See* Fleckner, *supra* note 87, at 2600.

Second, the SEC should revisit the trade-through rule and allow trades to be executed on the basis of criteria other than best price. The SEC chose to define best execution by best price to protect retail investors. The expressed concern was that retail investors would be unable to prevent brokers from executing their trade orders at inferior prices.[149] However, the breadth of the trade-through rule harms those customers who may wish to have their trades executed at inferior prices if it enables them to have their trades executed more quickly or on an anonymous basis.[150]

Finally, the SEC should reconsider its policy regarding the placement of foreign trading screens in the United States. There is ample evidence that U.S. investors already actively invest in foreign securities in foreign markets and that the prohibition on foreign trading screens serves only to increase the cost of investing abroad.[151] Instead, the SEC should consider an alternative to full registration that would allow foreign exchanges that met certain market-integrity and investor-protection requirements to provide services in the United States.[152]

There have been several recent developments that move in the direction suggested by this article. In November 2006, the SEC announced that the NASD and NYSE Regulation will combine their member-regulation functions into a single entity.[153] The new entity, recently named the Financial Industry Regulatory Authority (FINRA),[154] will be completely independent of any exchange.[155] The main purpose of the creation of this combined regulator is to eliminate duplicate regulation of the same brokers that handle orders on both the NYSE and Nasdaq. Also, the shifting of certain regulatory responsibilities away from the NYSE was meant to address concerns about potential conflicts with the exchange's for-profit operations.[156]

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149. *See* Regulation NMS Release, *supra* note 112, at 37,498.

150. *See* discussion *supra* pp. 153–54.

151. *See* Jackson et al., *supra* note 29, at 73–75; Tafara & Peterson, *supra* note 25, at 41–42, 53. *See also* Eric J. Pan, *Why the World No Longer Puts its Stock in Us* 15–16 (Benjamin N. Cardozo Sch. of Law, Jacob Burns Inst. for Advanced Legal Studies, Working Paper No. 176, 2006), *available at* http://ssrn.com/abstract=951705 (discussing the evidence of more U.S. investors buying foreign securities outside of the United States).

152. Another consideration is that the failure to allow European exchanges to place trading screens in the United States may cause the European Union to prevent U.S. exchanges and ATSs from offering services in Europe.

153. *See* Christopher Cox, Chairman, SEC, Statement at News Conference Announcing NYSE-NASD Regulatory Merger (Nov. 28, 2006), *available at* http://www.sec.gov/news/speech/2006/spch112806cc.htm.

154. *See* Order Approving Proposed Rule Change to Amend the By-laws of NASD, SEC Release No. 34-56145, 72 Fed. Reg. 42,169, at 42,170 (July 26, 2007) (noting that the NASD would change its name to the Financial Industry Regulatory Authority).

155. *See id.* at 42,170–72 (describing the governance structure of FINRA).

156. *See Consolidation of NASD with the Member Firm Regulatory Functions of the NYSE: Working Towards Improved Regulation: Hearing Before the Subcomm. on Securities, Insurance*

While the creation of FINRA is a significant regulatory development, it does not fully address all of the concerns about the conflict between an exchange's regulatory activities and its market operations. What remains of NYSE Regulation will continue to oversee the market integrity of the NYSE and ensure that companies on the NYSE comply with NYSE listing standards.[157] There is still the potential that the NYSE will not vigorously enforce its listing standards in the face of other exchanges competing for new listings.

The SEC also is reconsidering its position regarding foreign trading screens. In several public statements, SEC commissioners have stated that under certain circumstances the SEC may allow foreign trading screens to be placed in the United States.[158] The likelihood of the SEC allowing trading screens to come into the United States on a regular basis is dependent on the SEC's implementation of the Tafara and Peterson proposal of substituted compliance.[159]

ADOPTION OF THE MIFID APPROACH

Recent statements by senior SEC officials indicate that the SEC is receptive to rethinking how it regulates exchanges, bringing the prospect of a mutual recognition regime with the European Union, and possibly other jurisdictions, closer to reality.[160] What is less clear from these statements is how the SEC will accomplish this outcome and what the principles guiding a substituted compliance regime between one or more foreign jurisdictions will be. The MiFID offers a possible roadmap for the SEC concerning how it should modify the U.S. regulatory environment for trading markets and open up the U.S. market. While the complete adoption of MiFID provisions by the United States is unwise and does not take into account the legal, political and economic differences between the United States and the European Union, the SEC can and should learn from the regulatory policies effected by the MiFID.

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and Investment of the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. (2007) (statement of Erik R. Sirri, Dir., Div. of Mkt. Regulation, SEC).

157. *See id.* (statement of Richard G. Ketchum, CEO, NYSE Regulation, Inc.).

158. *See, e.g.*, Christopher Cox, Chairman, SEC, Remarks to the N.Y. Soc'y of Sec. Analysts (June 14, 2007), *available at* http://www.sec.gov/news/speech/2007/spch061407cc.htm [hereinafter Cox Speech]; Roel Campos, Comm'r, SEC, Speech: SEC Regulation Outside the U.S. (Mar. 8, 2007), *available at* http://www.sec.gov/news/speech/2007/spch030807rcc.htm [hereinafter Campos Speech].

159. *See* discussion *infra* pp. 162–64.

160. *See, e.g.*, Cox Speech, *supra* note 158; Campos Speech, *supra* note 158; Annette L. Nazareth, Comm'r SEC, Remarks Before the ABA Section of Int'l Law (May 4, 2007), http://www.sec.gov/news/speech/2007/spch050407aln.htm; Sirri Speech, *supra* note 29. *See generally* Tafara & Peterson, *supra* note 25.

In particular, the MiFID offers guidance concerning how to promote competition among trading markets and how to regulate trading markets that operate in multiple jurisdictions. The MiFID does not impose the same types of regulatory barriers to competition as those that exist in the U.S. system. The MiFID does not place registration requirements on trading platforms as does the SEC. In fact, one of the main improvements of the MiFID over the ISD was to expand the mutual recognition passport to all types of trading venues rather than just select regulated markets. By doing so, the MiFID removed the main barrier to the development of competing trading platforms.

The MiFID also avoids the linking of regulatory duties with market operations. An example of this is the MiFID's more flexible definition of best execution.[161] Under the MiFID, trading platforms are permitted to tailor their services according to the sophistication of the investor. Therefore, trading markets have the flexibility to offer services beyond best price to institutional investors, while retail customers still retain the protection of best price. Finally, the mutual recognition passport opened the EU member states to exchanges from other EU member states, allowing various European exchanges to place trading screens and offering services directly to investors across Europe. This openness made it possible for exchanges to compete head-to-head for listings and order flow.[162] This in turn has encouraged the consolidation of European exchanges and the competitive innovations noted above.

The MiFID further offers a blueprint for a mutual recognition regime between the United States and other jurisdictions. The model is the passport concept set forth by the MiFID. In addition to mutual recognition, the passport requires agreement on minimum standards and home country supervision. For there to be minimum standards, there must be harmonization of certain regulatory standards to ensure that all trading markets satisfy and meet the same basic requirements. Only once these minimum standards are set will it be possible to have home-country supervision. This illustrates the need for a robust mechanism for regulatory coordination. The Lamfalussy process offers one example of how institutional links can be set up to provide information sharing and joint rule-making. In this respect, the MiFID passport reflects many decades of experience by the European Union, where aspirations for mutual

161. *See* discussion *supra* p. 144.

162. With the forthcoming implementation of the MiFID, already certain financial institutions have announced their intention to set up new trading facilities to compete against the established European exchanges. *See* Carrick Mollenkamp, *LSE Could Face a New Threat*, WALL ST. J. EUR., Nov. 15, 2006, *available at* http://online.wsj.com/article/SB116355086492523274.html (describing a new trading platform being developed by Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS to trade large blocks of shares of LSE-listed companies).

recognition have been foiled by inconsistent implementation of directives and imposition of special requirements by certain member states. The United States should respect this experience and consider the approach laid out in the MiFID.

SUBSTITUTED COMPLIANCE: CHANGE IN COURSE FOR U.S. MARKET REGULATION?

Recently, SEC officials Ethiopis Tafara and Robert Peterson proposed a new regulatory framework of "substituted compliance" to allow for foreign stock exchanges and broker-dealers to access the U.S. financial market without registering with the SEC.[163] The Tafara and Peterson article has generated a great deal of attention because of the authors' positions at the SEC[164] and the general endorsement of the proposal by other senior SEC officials.[165]

The substituted compliance framework is substantially the same as the mutual recognition passport used in the MiFID and the ISD.[166] As described by Tafara and Peterson, foreign exchanges and broker-dealers would be granted an exemption from U.S. regulation, except from the anti-fraud provisions of U.S. securities law, if the SEC determines that they are adequately regulated by their respective home regulators. The majority of the article is devoted to explaining how the SEC would go about determining whether foreign securities law and regulation is "substantively comparable" to U.S. securities law and regulation and whether the foreign regulator has oversight powers and a regulatory and enforcement philosophy "substantively similar" to the SEC's.[167]

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163. *See* Tafara & Peterson, *supra* note 25, at 25.

164. Tafara is Director of the Office of International Affairs of the SEC, and Peterson is Senior Counsel of the same office. Despite their positions with the SEC, Tafara and Peterson state that the views expressed in their article are their personal views and do not reflect those of the SEC. *See also, e.g.*, Susan Wolburgh Jenah, *Commentary on a Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 69 (2007); Edward F. Greene, *Beyond Borders: Time to Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (2007); George W. Madison & Stewart P. Greene, *TIAA-CREF Response to a Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 99 (2007); Howell E. Jackson, *A System of Selective Substitute Compliance*, 48 HARV. INT'L L.J. 105 (2007); Floyd Norris, *Should U.S. Markets Be Wide Open?*, N.Y. TIMES, Feb. 9, 2007, at C1.

165. *See* Cox Speech, *supra* note 158; Sirri Speech, *supra* note 29; Jeremy Grant, *SEC Could Widen U.S. Investor Access*, FIN. TIMES., Mar. 7, 2007, at 24.

166. In fact, Tafara and Peterson describe their proposal as incorporating a "bilateral mutual recognition approach." Tafara & Peterson, *supra* note 25, at 56. Later, Tafara and Peterson argue that substituted compliance differs from mutual recognition in that it requires "comparability of regulatory requirements and oversight as the basis for mutual recognition." *Id.* at 54 n.78. It is unclear if there is truly a legitimate distinction. Mutual recognition, by its nature, is the product of agreement by different legal jurisdictions and therefore must reflect some belief that the standards of the two jurisdictions are comparable or at least comparable enough to give rise to the agreement.

167. *See id.* at 32.

According to Tafara and Peterson, the foreign exchange or broker-dealer must meet certain "exemption requirements" and, at the same time, its home jurisdiction must meet certain "regulatory preconditions."[168] To ensure that foreign jurisdictions maintain satisfactory regulatory standards and oversight, Tafara and Peterson suggest a comprehensive agreement between the United States and the foreign country.[169] Tafara and Peterson rightfully acknowledge a mutual recognition system must require on-going monitoring of the foreign jurisdiction. Therefore, they also suggest a reassessment of the arrangement every five years.[170] Such a reassessment period would not be a stick that the United States would use to keep other countries in line. Rather, Tafara and Peterson envision that the benefits of access to the U.S. market will incentivize foreign countries to improve their own regulatory standards.[171]

What is striking about the Tafara and Peterson proposal is the degree to which it borrows concepts from the MiFID and the regulatory approach of the European Union. At the same time, the Tafara and Peterson proposal falls short. It fails to note that the United States would need to modify its own regulations to be more consistent with foreign regulatory systems. For example, the separation of stock exchanges' business operations from their self-regulatory activities and the broadening of acceptable execution criteria under the trade-through rule would need to be addressed.

Furthermore, the Tafara and Peterson proposal is vague about the institutional links that must be established between the SEC and foreign regulators. The authors are too modest to suggest that the SEC join, by treaty, CESR or some other multilateral regulatory body[172] where the members are legally obligated to implement any joint decisions or enter into

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168. *See id.* at 54.

169. *See id.* Tafara and Peterson propose the execution of a memorandum of understanding (MOU) between the United States and the foreign jurisdiction modeled after those entered into between the United States and United Kingdom (Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms, U.S.-U.K., Mar. 14, 2006, *available at* http://www.sec.gov/about/offices/oia/oia_multilateral/ukfsa_mou.pdf) and among the members of the International Organization of Securities Commission (International Organization of Securities Commission, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, May 2002, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf). It is puzzling why the authors prefer the use of MOUs, which some countries have argued are non-binding, to provide the legal framework for a permanent cooperative relationship between the SEC and the foreign regulator. *See, e.g.*, John H. McNeil, *International Agreements: Recent U.S.-UK Practice concerning the Memorandum of Understanding*, 88 AM. J. INT'L L. 821 (1994) (discussing the UK position in an arbitration matter that a U.S.-UK MOU was not legally binding).

170. *See* Tafara & Peterson, *supra* note 25, at 56.

171. *See id.* at 56–57.

172. Tafara and Peterson reject a multilateral mutual recognition regime in favor of bilateral arrangements in order to give the SEC greater control over selecting the regimes that are deemed most compatible with the United States. *See id.* at 55–56.

an international legal regime where the rulemaking or legal interpretation happens at the international level.[173] It is more realistic to expect that the SEC will not be able to dictate what standards must be maintained by other countries, but rather will be forced to negotiate and compromise on comparable standards. It is important to note that foreign markets may not decide that market access to the United States is a vital objective, and, as Tafara and Peterson themselves acknowledge, their proposal is driven in part by the willingness of U.S. investors to go abroad and shed the protections afforded by U.S. law.[174]

Additionally, the bilateral agreement program suggested by Tafara and Peterson will most likely not offer the flexibility required to regulate the fast-moving securities markets. International agreements are difficult to draft and negotiate. It is difficult to imagine drafting and negotiating the terms of an agreement specifying the details of how a country regulates its exchanges and broker-dealers. Agreements, if the parties make them binding, also share an unfortunate characteristic with EU directives in that they will most likely not be self-executing and must be implemented into national law and regulation. The European Union learned quite painfully that inconsistent implementation of directives undermines the directives' objectives.[175] Similarly, there is a likely chance that the treaties will offer little comfort to the SEC that the foreign securities law and regulation is "substantively comparable" to U.S. securities law and regulation, and that a given foreign regulator has oversight powers and a regulatory and enforcement philosophy "substantively similar" to that of the SEC.

The solution is to establish an international body that will serve as a focal point for regulatory coordination. This body will be based on treaty law, and its decisions enforced on participating countries. In short, there needs to be a CESR-like entity that can provide the institutional links necessary to implement technical regulation and monitor enforcement efforts at the national level.

CONCLUSION

The need to re-examine how the SEC regulates exchanges and other trading markets is even more apparent in light of recently voiced concerns about the competitiveness of the U.S. financial markets.[176] In light of these

173. *See* Eric J. Pan, *Authoritative Interpretation of Agreements: Developing More Responsive International Administrative Regimes*, 38 HARV. INT'L L.J. 503 (1997) (discussing the need for self-interpreting international administrative bodies).

174. *See* Tafara & Peterson, *supra* note 25, at 53.

175. *See Wise Men Report*, *supra* note 40, at 10 (noting that the development of the European securities market was being held up by inconsistent implantation of EU directives).

176. *See, e.g.*, COMM. ON CAPITAL MKTS., INTERIM REPORT (2006), *available at* http://www.capmktsreg.org/research.html; MCKINSEY & CO. WITH N.Y. CITY ECON. DEV. CORP., SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007),

concerns, the task for the SEC should be two-fold: encourage U.S. stock exchanges to become more competitive and push for greater convergence of regulation with the European Union as well as other major financial jurisdictions. The MiFID serves as a model for how the SEC can achieve these two goals.

To accomplish the first goal, the SEC should expose the U.S. stock exchanges to greater competition, both from foreign markets and other domestic exchanges and ATSs. The SEC should revisit Regulation NMS and to allow execution of trades on a variety of criteria other than merely price. A trade-through rule focused on best price makes it difficult for new trading venues to challenge the dominance of the major stock exchanges and ignores the needs of institutional investors. These are the investors most likely to look to, and are in the best position to take advantage of, marketplaces outside the United States. By revising the trade-through rule, the SEC would encourage the further growth of ATSs and regional exchanges and increase competitive pressure on the larger stock exchanges to innovate and improve their efficiency.

The SEC also should allow the placement of foreign-market trading screens in the United States. The SEC has long resisted the location of foreign trading screens in the United States without foreign exchanges first becoming registered securities markets under SEC rules. The placement of foreign trading screens will make it easier for U.S. investors to buy abroad, but any costs may be outweighed by the beneficial effect on U.S. exchanges to meet more direct foreign competition.

At the same time, introducing foreign trading screens will allow U.S. exchanges to demand reciprocal treatment in Europe and other jurisdictions. As foreign investors become more interested in equity securities, the SEC should eliminate the barriers to foreign investors participating in the U.S. markets.

The SEC also needs to push foreign regulations to converge with those of the United States. In recognizing that U.S. investors are actively participating in the foreign markets, the SEC's goal should be to bring the other markets up to U.S. standards. The SEC can achieve this goal by devoting more resources to reaching out to foreign regulatory authorities and looking more aggressively for ways to encourage the strengthening of foreign rules and regulations. As an incentive to foreign regulators to work

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available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf; COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS (2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm; Stephen Labaton, *Paulson, at Talks on Regulation, Suggests Pendulum Has Swung Too Far*, N.Y. TIMES, Mar. 14, 2007, at C3 (reporting on meeting of business representatives with Treasury Secretary Paulson to discuss regulation of U.S. financial markets).

with the SEC, the SEC can offer the prospect of establishing mutual recognition arrangements where foreign and U.S. companies can participate in each other's capital markets while complying with their home jurisdictions' requirements. Seeking mutual recognition would mark a major shift in SEC policy, but is an example of the type of bold policy that must be pursued in this changing market environment.

The goal of such a project would not be to have foreign countries adopt U.S. securities laws. Rather, the goal would be to ensure that foreign countries adopt the substance of U.S. requirements to provide a level of investor protection acceptable to the SEC. The United States must defend its position as the leading securities market in the world. To do so, it must look outward and embrace the free flow of investor capital across borders through open competition and regulatory cooperation.