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Turning Seats Into Shares: Cause and Implications of Demutualization of Stock and Futures Exchange

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Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges

by
ROBERTA S. KARMEL*

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Introduction

A dramatic shift in the economic and power structure of the securities industry is currently in progress. Although competition to traditional markets from electronic trading markets may be the precipitating cause of this upheaval, more than technology is driving these changes. The worldwide rise in stock exchange trading volume, global integration of the capital markets and competition for trading profits have triggered a disintermediation comparable to the unfixing of commission rates. Decimalization has cut the conventional trading increment, formerly twelve and a half cents, to a penny or less. Futures exchanges similarly have been buffeted by technological change, global competition and resulting cost pressures.

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

Demutualization by some key foreign exchanges has proceeded at a faster pace. This trend is recent. The first exchange to demutualize was the Stockholm Stock Exchange in 1993, but by the middle of the year 2001 numerous additional stock and futures exchanges had demutualized, including the Amsterdam Stock Exchange, the London Stock Exchange, the Paris Bourse, the CME and the Deutsche Börse. The Stockholm and Australian Stock Exchanges immediately went public and listed on their own boards.¹

1. See Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, Draft #2 (Oct. 17, 2000), at http://papers.ssrn.com/paper.taf?abstract_id=246789.

The Deutsche Börse went public in February 2001.² Public offerings and listings before the end of 2001 are planned by other demutualized exchanges including the London Stock Exchange, Euronext (a fusion of the Paris, Amsterdam and Brussels exchanges) and Nasdaq.³

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

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

This article will argue that the SEC is attempting to re-regulate market structure under a command and control model pursuant to the national market system (NMS) provisions injected into the Exchange Act in 1975 at a time when the monopoly trading regime which led to the national market system mandate is breaking down. An interesting and relevant question is whether current trading technologies and the competition these technologies have engendered should lead to a reduction of SEC market regulation, rather than the increase in regulation envisioned by current SEC concept and

2. See *Deutsche Börse Shares Jump*, N.Y. TIMES, Feb. 6, 2001, at W1.

3. See Alan Cowell, *The London Stock Exchange Says It Will Go Public in July*, N.Y. TIMES, May 25, 2001, at W1.

rulemaking releases, so that competition rather than regulation can determine outcomes. Further, once trading spreads have been reduced, the pressures for market structure changes may abate, rendering new SEC regulatory initiatives unnecessary. The CFTC model of regulation of exchanges is in the process of changing to permit exchanges to engage in a greater degree of self-regulation in order to compete with foreign exchanges.

This Article will also inquire into the future of self-regulation and stock exchange governance in a world where stock exchanges are not mutual organizations. Some argue for SRO consolidation. It is possible that demutualization may lead to a transfer of some regulation from exchanges to government regulators. A countervailing trend could be that national regulators will be unable to engage in effective regulation of trading markets in a trading environment that moves across boundaries with the click of a mouse. Therefore, more self-regulation and less government regulation may be required to assure that global markets are fair and honest. Self-regulatory organizations may have to be restructured, however, because of the conflicts of interest demutualization and changing trading platforms entail.

Part I of this Article will discuss the impetuses for demutualization, the trend toward replacing exchange floors with electronic trading markets and the SEC's response in the form of Regulation ATS. Part II of this Article will summarize the antitrust problems inherent in exchange trading practices and then Part III will describe the national market system (NMS) mandate given to the SEC in 1975 and current issues the SEC is addressing pursuant to this mandate relevant to the changing nature of stock exchange trading. The future of self-regulation for both securities and commodities exchanges after demutualization will be discussed in Parts IV and V.

I. The Development of ECNs, ATs, and Their Regulation

A. Drivers for Electronic Exchanges and Demutualization

ATs are proprietary trading systems, sometimes referred to as the "fourth market." They are operated by NASD members or NASD-member affiliates and are similar to exchanges because they allow two participants to meet directly on the system and are maintained by a third party who also serves a limited regulatory function by imposing requirements on each subscriber.⁴ ECNs are a

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

special class of ATSS used to disseminate firm commitments to trade to participants, or subscribers. ECNs may be linked into the Nasdaq marketplace.⁵ Many broker-dealers have internal systems to automate the firm's execution of customer orders, particularly firms that internalize or purchase order flow. These systems are not generally considered ATSS because all trades effected on internal systems involve only the operator of the system and no external parties.⁶

Although some ATSS and ECNs have been in operation for many years, technological advances, trading volume increases and pressures on trading profits have enabled some ECNs to become serious competitors to Nasdaq and exchanges. Similarly, in order to compete with foreign derivatives exchanges ECNs have developed for financial futures. ECNs also are being developed for the bond markets, and the trading of bonds may therefore become more efficient. Trading efficiency necessarily means a reduction in trading spreads and is therefore inevitably resisted by traditional traders. Whether government regulators have any public interest justification for either impeding or mandating a reduction of trading spreads pursuant to the statutes under which they operate is a good question. They have been doing so indirectly through new regulations for ATSS and other initiatives. The SEC is inclined to equate cheaper executions with better executions, but if spreads were reduced to zero, there would be no market makers and liquidity would evaporate.

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

It can be argued that electronic trading networks are likely to destroy an exchange's natural monopoly and, therefore, the benefits

5. *Id.*

6. *Id.*

of mutual governance may no longer be as valuable as before. A related argument is that electronic exchanges and their competitors are compelled to become for-profit corporations in order to be efficient and to compete effectively. Another important driver for demutualization of some exchanges has been the perceived need to shift power within exchanges from one group of members to another and to afford institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to effect such a shift and resolve conflicts of interest between exchange members as well as between exchanges and their members.

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

Under the federal securities laws as currently drafted and interpreted by the SEC in Regulation ATS,⁷ no registered exchange may have institutional or individual investor members, but may only have broker-dealer members. However, institutions and retail customers could become shareholders of a demutualized exchange. A separation of membership from ownership could then realign the interests of investors, who are providing trading interest and liquidity to an exchange pricing mechanism, and exchange members. It should be noted, however, that exchange demutualizations in countries outside the United States have thus far not generated the institutional investor shareholding interest that was hoped for by some exchange officials. Rather, the primary shareowners are former members.

In the late 1970s some believed that the trading markets would and should become an electronic "black box," but this did not happen. Buyers and sellers of securities want efficiency and liquidity

7. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40,760, 63 Fed. Reg. 70,844, at 70,852 (Dec. 22, 1998) [hereinafter Adopting ATS Release].

and, if they are intermediaries, they need to obtain best execution. They also are concerned about market impact so they want anonymity. Further, they are concerned about the financial ability of counterparties to settle trades. Exchanges have historically provided these functions with the exception of anonymity. But the pressure on intermediary profits is undermining the acquiescence of those who provide liquidity to support a continuation of past practices. Commodities exchanges have been experiencing similar pressures. The CBOT is no longer the world's biggest futures exchange, but has been eclipsed by an electronic derivatives marketplace in Europe.⁸ Further, the CBOT's largest customers are going into competition with the exchange. Accordingly, the CBOT determined to split in two, and offer its customers side by side electronic trading and open outcry floor trading, and at the same time, demutualize.⁹ The CME has become an entirely electronic, demutualized for-profit exchange.¹⁰

Whatever new governance structures or trading systems replace the traditional trading systems, there is a danger that demutualization of exchanges will cause order flow to move away from exchanges to competitive ATSS. Exchanges can be expected to fight to retain order flow as Nasdaq has done by developing the SuperMontage.¹¹ But as ATSS proliferate, member firms will no longer have the same stake in an exchange's viability and success, and there will be competition between exchanges and their members. As for-profit exchanges expand, they may also begin to compete with their listed companies. These developments have significant implications for exchange governance and exchange self-regulation.

B. Decimalization

Traditionally, there was a one-eighth increment in the trading of stocks in the United States. Not only were both exchange and over-the-counter trading conducted in eighths, but the transactions were reported in eighths. This trading convention was destroyed by an antitrust investigation of Nasdaq, which will be discussed below. The

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

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

10. See Peter A. McKay, *CME's New CEO Devises a Five-Year Strategy*, WALL ST. J., Feb. 24, 2000, at C17.

11. See Order Approving Proposed Rule Changes by the NASD and Amendment Nos. 1, 2, 3, 4, 5, 6, 7 and 8 thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 9 Relating to the Establishment of the Nasdaq Order Display Facility and Order Collector Facility and Modifications of the Nasdaq Trading Platform, Exchange Act Release No. 43,863, 66 Fed. Reg. 8020 (Jan. 26, 2001) [hereinafter SuperMontage Adopting Release].

destruction of the one-eighth trading convention was comparable to the unfixing of stock exchange minimum commission rates in its effect on the profitability of certain segments of the securities industry, as well as in the market structure issues it triggered.

Nasdaq began trading in one-sixteenth-point increments on June 2, 1997.¹² At the same time as trading spreads were being compressed, there was a government prompted move to change trading conventions to decimals. The Common Sense Pricing Act of 1997 would have required stocks to be traded in dollars and cents within a year of its enactment.¹³ While Congressional pressures to effect such a change were frequently justified as lowering trading costs and modernizing trading, they were resisted by the securities industry, and to some extent the SEC, for two reasons. First, it was anticipated that the move to decimalization would be costly and would greatly increase stock market volume. This was one effect of the unfixing of commission rates, and it had disastrous results because securities firms were unable to adjust their systems to deal with this increased volume. Second, there was a threat that trading increments could drop to a penny or less. As the unfixing of commission rates also demonstrated, once charges for the trading of stocks are deregulated it is difficult to predict how low such charges will descend or what collateral consequences will ensue.

Accordingly, the move to decimalization was slow due to worries about operational capabilities. Although the NYSE voted to trade stocks in decimals in June 1997, such trading did not begin until January 2001, and Nasdaq did not change over to decimals until April 2001.¹⁴ Contrary to expectations, the change to decimal pricing strengthened the position of the NYSE as a central marketplace but had some adverse consequences with respect to liquidity. ECNs have not reached the critical mass necessary to become a genuine source of pricing discovery rather than a derivative pricing mechanism.¹⁵ Institutional investors have complained, however, that the shift to decimals has permitted specialists to step in front of large orders and

12. Deborah Lohse, *Nasdaq to Start Trading All Stocks in Sixteenths*, WALL ST. J., May 29, 1997, at C1.

13. Common Sense Pricing Act, H.R. 1053, 105th Cong. (1997). This bill never became law.

14. See Kate Kelly & Jeff D. Opdyke, *Nasdaq to Complete Its Shift to Decimals With All Stocks Priced in Dollars, Cents*, WALL ST. J., Apr. 9, 2001, at C9; Vanessa O'Connell, *Conversion to Decimal System in Stocks Could Prove a Boon to Small Investors*, WALL ST. J., June 6, 1997, at C1; Jeff D. Opdyke, *NYSE Adds Decimals, Subtracts Fractions*, WALL ST. J., Jan. 29, 2001, at C1.

15. See Greg Ip, *If Big Board Specialists Are an Anachronism, They're a Profitable One*, WALL ST. J., Mar. 12, 2001, at A1 (commenting concerning NYSE specialists, "Dinosaurs should be so hardy.").

therefore has reduced liquidity.¹⁶ Although government pressures forced the U.S. exchanges to convert to decimal trading, it does not appear that this change has enhanced competition between the NYSE, Nasdaq and ATSS.

C. Regulation ATS

SEC concern about ATSS dates back to the 1960s when the NASD-developed Nasdaq and Instinet Corp. (Instinet) developed a computer-based facility for trading equities that allowed institutional investors to trade directly with one another. In response, the SEC proposed Rule 15c2-10 under the Exchange Act in order effectively to create a new nonstatutory classification for the regulation of automated trading systems.¹⁷ However, this rule was subsequently withdrawn,¹⁸ and the SEC permitted Instinet and other ATSS to do business as registered broker-dealers.¹⁹ As a result, the SEC defined the term "exchange" very narrowly as a system that utilizes the capital of specialists to buffer price swings and add liquidity to a marketplace "generally understood" to be an exchange.²⁰

In its Market 2000 Study the SEC examined the development of alternative markets and services for equity trading in the context of market fragmentation and competition. The staff noted that alternative markets had been developing for 20 years, that they produced improved trading services and enhancements and had put pressure on the primary markets to operate more efficiently.²¹ However, the staff also recognized that markets can fragment to the point where price discovery is impaired and maintenance of fair and orderly markets is difficult.²² The Report noted that almost all ATSS were regulated as broker-dealers, but the proliferation of such systems could have effects on the NMS that should be closely

16. Jeff D. Opdyke & Gregory Zuckerman, *Decimal Move Brings Points Of Contention From Traders*, WALL ST. J., Feb. 12, 2001, at C1; Unger, *Exchange Officials Testify Decimals Have Affected Depth, Liquidity of Trading*, 33 Sec. Reg. & L. Rep. (BNA), at 803 (May 28, 2001).

17. Notice of Proposal to Adopt Rule 15c2-10 under the Securities Exchange Act of 1934, Exchange Act Release No. 34-8661, 34 Fed. Reg. 12,952 (Aug. 4, 1969).

18. Notice of Adoption of Rule 11Ab2-1, Exchange Act Release No. 34-11,673, 40 Fed. Reg. 45,422 (Sept. 23, 1975).

19. Instinet Corp., SEC No-Action Letter, Fed. Sec. L. Rep. CCH ¶ 78,997 (Sept. 8, 1986), 1986 WL 67657 (SEC).

20. Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27,611, 55 Fed. Reg. 1890 (Jan. 12, 1990). This interpretation was upheld by the Seventh Circuit. *Bd. of Trade of the City of Chi. v. SEC*, 923 F.2d 1270, 1272 (7th Cir. 1991).

21. DIV. OF MKT. REGULATION, SEC, MARKET 2000, AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS III-2 (Jan. 1994).

22. *Id.*

monitored to determine whether additional regulation was warranted.²³ Therefore more enhanced recordkeeping and reporting was required.²⁴

The rulemaking proceeding resulting in Regulation ATS began with a Concept Release, in which the SEC defined the term ATS as "automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not currently registered with the Commission as national securities exchanges or operated by a registered securities association."²⁵ The Concept Release proposed a new regulatory regime that would either require ATSS to register with the SEC as exchanges or would impose new obligations that would permit ATSS to continue to be regulated as broker-dealers but would require them to comply with rules designed to improve their transparency and surveillance, as well as their systems capacity, integrity and security.²⁶

The SEC asserted that ATSS were handling almost twenty percent of orders in OTC stocks and four percent of orders in NYSE listed securities and, therefore, they needed to be better integrated into the national market system.²⁷ The particular concerns highlighted by the Concept Release as a justification for increased regulation of ATSS were market access and fairness, market transparency and coordination, market surveillance and market stability and systemic risks.²⁸ In general, commenters opposed the "exchange-lite" concept and suggested that ATSS be permitted to remain registered as broker-dealers.

The SEC then proposed rules and requested comment on a framework that would allow ATSS to choose whether to be a market participant and register as a broker-dealer, or to be a separate market and register as an exchange.²⁹ The thrust of these proposals was to integrate ATSS into the NMS.³⁰ Although the proposals were controversial and generated a fair amount of negative comment, the

23. *Id.* at III-11.

24. *Id.* at III-13. The SEC then promulgated Rule 17a-23 under the Exchange Act. Recordkeeping and Reporting Requirements for Trading Systems Operated by Brokers and Dealers, Exchange Act Release No. 34-35,124, 59 Fed. Reg. 66,702 (Dec. 28, 1994). In connection with adopting Regulation ATS, the SEC moved these requirements into rules 17a-23 and 17a-24, 17 C.F.R. § 240.17a-23 and 17a-24 (1999). Adopting ATS Release, *supra* note 7, at 70,891.

25. Regulation of Exchanges, Exchange Act Release No. 34-38,672, 62 Fed. Reg. 30,485, at 30,486 n.1 (June 4, 1997).

26. *Id.* at 30,487.

27. *Id.* at 30,486.

28. *Id.*

29. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-39,884, 63 Fed. Reg. 23,504 (April 29, 1998) [hereinafter Proposing ATS Release].

30. *Id.* at 23,504.

SEC adopted its proposed framework with only minor modifications on December 2, 1998. The purpose of the new regulation was to level the playing field for ATSs, Nasdaq, and the registered exchanges.³¹ SEC Chairman Levitt commented that he was "committed to promoting the competitiveness and viability of exchanges." Thus, the rule was designed to create "flexibility" for existing exchanges.³²

The SEC's objective of bringing ATSs into the NMS was accomplished by a new and expanded definition of the term "exchange" that captured most ATSs and by a rule exempting ATSs from exchange registration if they chose to register pursuant to Regulation ATS and undertake certain new obligations as to the transparency of their quotes and trades, fair access and systems capacity. Although the SEC extolled the benefits of exchange registration for an ATS, it refused to adjust any obligations of an exchange, and it therefore discouraged most ATSs from choosing exchange registration. The impact of the regulation on smaller ATSs was minimal. It merely required a filing with the SEC regarding the ATS's operations methods, quarterly filings and maintenance of an audit trail.³³ It also mandated oversight by an SRO, presumably NASD Regulation, Inc. (NASDR).³⁴ Larger ATSs became more heavily regulated under the new regulation.³⁵

Exchange Act Rule 3b-16 reinterpreted the term "exchange" to include "any organization, association or group of persons that: (1) Brings together the orders of multiple buyers and sellers; and (2) uses established, nondiscretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade."³⁶ The SEC justified its revised interpretation on various grounds, particularly the broad statutory grant of exemptive authority the SEC obtained in 1996³⁷ permitting the SEC to craft a flexible regulatory framework for markets.³⁸ More fundamentally, the SEC asserted that although traditional exchanges still provide liquidity through two-sided quotations and raise an expectation of liquidity at the quoted price, this is no longer the

31. *Id.* See also, Adopting ATS Release, *supra* note 7.

32. Neil Hare, *Levitt Reminds NYSE, NASDAQ of SRO Rule as Exchanges Consider Demutualization Plans*, 31 Sec. Reg. & L. Rep. (BNA), at 1002 (July 30, 1999).

33. See *Alternate Trading Systems; SEC Will Allow ATSs to Choose Registration as Brokerage or Exchange*, 30 Sec. Reg. & L. Rep. (BNA), at 1686 (Dec. 4, 1998).

34. *Id.*

35. *Id.*

36. Adopting ATS Release, *supra* note 7, at 70,847.

37. National Securities Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3424 (codified at Exchange Act § 36, 15 U.S.C. § 78mm (1999)).

38. Adopting ATS Release, *supra* note 7, at 70,899.

essential characteristic of a securities market. Today's technology enables markets participants to tap simultaneous and multiple sources of liquidity from remote locations.³⁹

Using its exemptive authority under Section 36 of the Exchange Act, the SEC adopted Exchange Act Rule 3a1-1 exempting from the definition of an "exchange" any ATS that registers as a broker-dealer and complies with Regulation ATS.⁴⁰ The term "alternative trading system" was defined as any system that "constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange" and that does not "set rules governing the conduct of subscribers other than the conduct of such subscribers' trading" on such system or "discipline subscribers other than by exclusion from trading."⁴¹ This definition was intended to preclude any SRO from opting to register as a broker-dealer rather than an exchange or association unless it decides to give up its self-regulatory functions and complies with Regulation ATS.⁴² An ATS subject to Regulation ATS must be a member of an SRO.⁴³

Various requirements as to quote and trade transparency and access are imposed upon any ATS that has five percent or more of the trading volume of any exchange listed, Nasdaq NMS or Nasdaq SmallCap Security.⁴⁴ Any such ATS must publicly disseminate its best priced orders in such securities for inclusion in the quotation data made available to quotation vendors by exchanges and the

39. *Id.*

40. *Id.* at 70,859.

41. 17 C.F.R. § 242.300(a) (1999). Although European exchanges have not yet faced serious competition from ATSS, the Forum of European Securities Commissions (FESCO) has noted that in the debt and standardized OTC derivative markets electronic trading systems are replacing bilateral telephone trading and in equity markets ATSS have signaled additional competition for exchanges with near monopolies. FESCO therefore has outlined potential risks posed by ATSS and formulated standards for their regulation. See Proposed Standards for Alternative Trading Systems, Consultative Paper, at <http://www.europefesco.org/Documents/Consultative/01-035b.pdf> (last visited June 14, 2001). FESCO's definition of an ATS is very broad and defines a qualifying system as "an entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interests—in the system and according to rules set by the system's operator—in a way that forms, or results in, an irrevocable contract." *Id.* at 6.

42. Adopting ATS Release, *supra* note 7, at 70,859. Any ATS that trades only government securities is excluded from the scope of Regulation ATS, but other ATSS that trade other debt securities are subject to the Regulation. The SEC expressed its view that its concerns about trading equity securities on ATSS, especially as to capacity, integrity and fair access, apply to trading of fixed income securities in ATSS. *Id.* at 70,861-62, 70,902.

43. *Id.* at 70,863.

44. *Id.* at 70,870; see also *id.* at 70,866 n.191-92.

NASD. Any ATS required to publicly display its best priced orders must also provide to members of the SRO with which it is linked the ability to effect a transaction with those orders. Further, fees cannot be set that are inconsistent with the principle of equivalent access.⁴⁵ If an ATS accounts for more than twenty percent of trading volume in any equity security, or twenty percent or more of the volume in any category of corporate debt or municipal security, during four of the preceding six months, under Exchange Act Rule 301(b)(5) it must establish standards for access to its system and apply those standards fairly to all prospective subscribers.⁴⁶

Exchange Act Rule 301(b)(6) applies to any ATS that trades twenty percent or more of the volume in any equity security or any category of corporate debt or municipal securities during four of the preceding six months. Any such ATS, among other things, is required to: (1) Establish reasonable current and future capacity estimates; (2) conduct periodic capacity stress tests of critical systems; (3) develop and implement reasonable procedures to monitor systems development and testing methodology; (4) review the vulnerability of systems and data center computer operations to internal and external threats, physical hazards and natural disasters; and (5) establish adequate contingency and disaster recovery plans.⁴⁷

Any ATS that falls within the registration rule, Rule 3b-16, can choose to register as a national securities exchange. But the SEC declined to give any relief from the obligations of an exchange under the Exchange Act.⁴⁸ Therefore, any ATS choosing to register as an exchange must be able to enforce compliance by its members and associated persons with the federal securities laws and rules of the exchange.⁴⁹ Further, such an ATS must comply with corporate governance requirements. At least one director must be representative of issuers and investors and not associated with any member or broker-dealer. There must be fair representation of an exchange's members.⁵⁰ The customers of many ATSs are institutions. This is one reason the SEC previously declined to extend the definition of an exchange to include them.⁵¹ Nevertheless, in its rulemaking package, the SEC determined not to grant any relief from

45. *Id.* at 70,870.

46. *Id.* at 70,923. The Proposing Release included a right of appeal to the SEC of any denial of limitation of access. This appeal right was not included in the final rules. *Id.* at 70,874.

47. *Id.* at 70,924.

48. *Id.* at 70,880.

49. *Id.* at 70,881.

50. *Id.* at 70,882-84.

51. *See Bd. of Trade of the City of Chi. v. SEC*, 923 F.2d 1270, 1273 (7th Cir. 1991).

the requirement that all exchange members be registered broker-dealers.⁵²

In addition, any ATS choosing to register as an exchange, must provide fair access for members, sufficient systems capacity to handle foreseeable trading volume, participate in NMS quotation and reporting systems and establish trading halt and circuit breaker rules.⁵³ For example, a newly registered exchange would be required to halt trading when neither quotation nor transaction information could be disseminated. Any securities traded on a registered exchange must be registered with the SEC and approved for listing on the exchange. Therefore systems that trade privately placed or unregistered foreign securities could not register as exchanges.⁵⁴

In order to level the playing field between registered ATSS and registered exchanges, and to further innovation, Exchange Act Rule 19b-5 permits pilot systems to operate for two years before filing and approval by the SEC.⁵⁵ A pilot trading system is, essentially, a low volume system operated independently of any other SRO system.

No ATS has yet been able to register as an exchange. The most serious effort to do so has been that of Archipelago LLC (Archipelago), an ECN that offers investors anonymous access to the markets.⁵⁶ Archipelago filed an application to become an exchange in August 1999, but this application languished.⁵⁷ Then in August 2000 Archipelago and the Pacific Stock Exchange (PCX) created the Archipelago Exchange (Arca) for the purpose of trading NYSE, Nasdaq and American Stock Exchange, Inc. (Amex) stocks in a fully electronic system.⁵⁸ PCX submitted proposed rules for Arca, which would be operated by Archipelago under PCX's SRO umbrella, but these rules were opposed by Nasdaq.⁵⁹ In fact, ATSS cannot operate and be regulated like traditional exchanges and for ATSS and exchanges to compete effectively, either ATSS or exchanges would have to change their governance and the way they are regulated. But the SEC seems determined to force all marketplaces into bureaucratic pigeonholes.

52. Adopting ATS Release, *supra* note 7, at 70,884.

53. *Id.* at 70,885-88.

54. *Id.* at 70,886.

55. *Id.* at 70,892-93.

56. See Rachel Witmer, *Archipelago Begins Trading NYSE, AMEX Stocks on NASDAQ Intermarket*, 32 Sec. Reg. & L. Rep. (BNA), at 1100 (Aug. 14, 2000).

57. See Rachel Witmer, *SEC Seeks to Foster Innovation, Unger Says, Responding to Criticism of Market Regulation*, 32 Sec. Reg. & L. Rep. (BNA), at 178 (Feb. 14, 2000).

58. See Archipelago, *Pacific Exchange Close Deal, Create First Fully Automated U.S. Exchange*, 32 Sec. Reg. & L. Rep. (BNA), at 945 (July 17, 2000).

59. *Proposed PCX/Arca Exchange Lacks Adequate Integration into NMS*, Nasdaq Says, 33 Sec. Reg. & L. Rep. (BNA), at 249 (Feb. 19, 2001).

Regulation ATS is a significant NMS initiative, but like many of the SEC's past programs in this area, it is unclear what will really be accomplished. Although the SEC expanded the definition of an exchange from its prior narrow interpretations, it did so to force ATSs with substantial volume into NMS quotation and transaction reporting rules, not to change the way in which exchanges operate or are governed. Although the SEC has long believed that market transparency is a keystone of the NMS, the argument can be made that transparency has costs, especially for efficiency and liquidity and that it may benefit the retail investor, but burden the institutional investor.⁶⁰ In fact, the SEC has not integrated broker-dealer block trading desks or single market maker or dealer systems into the ATS-NMS framework, thus permitting institutional investors some leeway in keeping their strategies and orders from the marketplace.⁶¹

D. SuperMontage and NYSE Direct

The NASD's response to competitive changes in the marketplace, especially those changes which have been precipitated by new technologies was the SuperMontage. The NASD claims that the SuperMontage will improve market transparency, maintain liquidity, and thwart any threats of fragmentation.⁶² The NASD also believes that the SuperMontage will ultimately benefit investors by providing them with more market information, reduced spreads and better executions. Several market makers believe the SuperMontage is an appropriate response to the ever growing competition among ECNs, ATSs and traditional exchanges and will create a central order book for Nasdaq securities.⁶³ Yet ECN giants Archipelago and Instinet fiercely oppose the proposal, claiming it will stifle competition and seeks to maintain the NASD's monopolistic power over the OTC marketplace while Nasdaq is evolving into a for-profit entity.

It is within this framework that the SEC, after nine amendments, approved the NASD's SuperMontage Proposal.⁶⁴ Then SEC Chairman Levitt stated that the proposal was an adequate response to

60. Letter from Ruben Lee to Jonathan Katz, Secretary, SEC (July 28, 1998).

61. Adopting ATS Release, *supra* note 7, at 70,851. The reason is that the customers of a broker-dealer generally keep control over their own orders so the broker-dealer is unlikely to be viewed as using discretionary methods in handling the order. *Id.* at 70,850-51.

62. Richard G. Ketchum, NASD, Inc., Testimony before the House Subcommittee on Finance and Hazardous Materials on Competition in the New Electronic Market (May 11, 2000).

63. Randal Smith & Greg Ip, *Exchanges, Firms Wrestle Over Structure*, WALL ST. J., Mar. 1, 2000, at C1.

64. SuperMontage Adopting Release, *supra* note 11.

increased domestic and global competition, providing better and faster execution and greater market transparency.⁶⁵ While Chairman Levitt admitted that the SuperMontage does not meet all competitive challenges, and "would be an easier matter if we were at a different stage in our market's evolution, with the issues of demutualization and market data dissemination behind us," he also concluded that it was not the SEC's role to structure markets.⁶⁶

In general, SuperMontage will turn Nasdaq into more of a conventional stock exchange as opposed to a network of market makers by centralizing and displaying more stock quotes.⁶⁷ SuperMontage will modify three areas of the Nasdaq quotation system: 1) Quote/order collection; 2) quote/order display; and 3) execution services.⁶⁸ First, the new system will eliminate the distinction between quotes and orders by allowing participants to enter multiple quotes/orders at the same or different prices. Second, SuperMontage will aggregate the system's best priced quotes to create a participant's best quote as well as display three additional quotes/orders.⁶⁹ Entry of multiple quotes is voluntary. Additional entries may also be made anonymously. Third, SuperMontage will automatically execute orders according to a default price/time algorithm. Participants may also opt for one of three different algorithms (price/time, price/size/time, or price/time which account for fees) and may direct their orders to a particular market participant.⁷⁰

The SuperMontage proposal was very controversial. It encountered three core criticisms. First, it was asserted that the auto-execution mechanism was discriminatory because it prioritizes ECN quotes which charge access fees and UTP Exchange quotes lower than quotes from other dealers. Second, it was argued that inherent conflicts of interest exist between the NASD, as regulator, and Nasdaq, an evolving for-profit entity. And third, critics claimed that the SuperMontage would have an anticompetitive effect on ATSs.

The price/time algorithm gives lower priority to ECN quotes/orders which charge access fees for their services, and last priority for UTP Exchanges. Many ECNs claim that the execution process ought to ignore access fees because "statistically the price improvement provided by certain ECNs exceeded the cost of their

65. SEC Chairman Arthur Levitt, Opening Statement on NASD's Proposed SuperMontage and Streamlining the SEC Review Process for SRO Filings (Jan. 10, 2001).

66. *Id.*

67. Michael Schroeder & Greg Ip, *Plan to Upgrade Nasdaq Trading Passes the SEC*, WALL ST. J., Jan. 11, 2001, at C1.

68. *Id.*

69. *Id.*

70. *Id.*

fees.”⁷¹ The SEC conceded that these priority issues were irreconcilable, but that price priority should trump time priority and that it was reasonable for an investor to choose an execution method that gives lower priority to quotes that require access fees.⁷² Moreover, the amended proposal provides investors with the option of directing orders to the ECN or market maker of their choice, regardless of the fees charged. Therefore, if speed is a priority, investors will request that ECN access fees not be taken into account. ECNs believe that this model will impede price competition and investors will not receive the best execution since even the best priced quotes (minus access fees) would receive lower priorities.

Whether SuperMontage will recapture for Nasdaq trades lost to ATSS remains to be seen. It is worth noting that despite vociferous howls from some established ECNs, and a disclaimer by the SEC that it was using its powers under the NMS provisions of the Exchange Act to approve SRO rules to structure markets, the SEC approved a Nasdaq effort to better compete with ATSS. Further, as this Article will demonstrate, neither Nasdaq nor the NYSE nor ATSS are free to establish new systems or embark on new business initiatives without the acquiescence of the SEC. This regulatory power by a government agency makes it questionable that exchanges can demutualize and become for-profit public companies without changes in their regulation by the SEC. But if exchanges become free of the shackles imposed upon their operations by the NMS provisions of the Exchange Act, they may no longer be able to operate as SROs.

The NYSE response to the threat of competition from ECNs has been greater automation. Over ninety percent of NYSE trades are now handled electronically.⁷³ NYSE Direct+ is a fully electronic connection to the point of sale and offers rapid, automatic execution of limit orders up to 1,099 shares.⁷⁴ Plans to automate the execution of anonymous institutional orders will further the NYSE's claim that it is the biggest ECN in the world.⁷⁵ Although these initiatives would appear to cut into the profitability of specialist firms, these firms have been doing well. Some large securities firms that invested in ECNs a few years ago are now buying specialist firms.⁷⁶

71. SuperMontage Adopting Release, *supra* note 11, at 7.

72. *Id.*

73. See EXCHANGE PLACES, ECONOMIST GLOBAL MARKETS EQUITY SURVEY, May 5, 2001, at 13.

74. See NETWORK NYSE, at <http://www.nyse.com/pdfs/nydirect.pdf> (last visited June 14, 2001).

75. See INSTITUTIONAL XPRESS, at <http://www.nyse.com/pdfs/ixpress3.pdf> (last visited June 14, 2001); Exchange Places, *supra*, note 73.

76. See Ip, *supra* note 15, at A1; Jeff D. Opdyke, *Goldman Boosts Clout In Trading*, WALL ST. J., Jan. 30, 2001, at C1.

The SEC has paid lip service to competition between and among marketplaces and it is required to do so when implementing the NMS provisions of the Exchange Act. Its reaction to the development of ATSS as marketplaces competing with the NYSE and Nasdaq, however, has been to design complicated new regulations to force ATSS into existing market structures. Further, the SEC is too concerned about fragmentation of the pricing mechanism for equities to permit unregulated competition between market centers. This may well be appropriate as a matter of policy, but the model that is emerging is that of two dominant market centers with ATSS gaining just enough market share to keep the NYSE and Nasdaq innovative and honest. This long was the SEC model for the NYSE and regional exchanges, with Nasdaq as an aggressive interloper. What will happen to regional exchanges in the new trading markets that are emerging remains to be seen, but the PLX-Archipelago joint venture may prove telling. In any event, the SEC's approval of the SuperMontage and the NYSE's in house ECN experiments suggest that ATSS will not supplant Nasdaq or the NYSE in the immediate future.

II. Antitrust Issues

There have long been serious conflicts between competition and regulation in the securities field. The seminal case attempting to reconcile these conflicts, *Silver v. New York Stock Exchange*,⁷⁷ set forth a test for reconciling antitrust laws with securities regulation as follows: "Repeal [of the antitrust laws] is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."⁷⁸ In this case a nonmember broker sued the New York Stock Exchange, Inc. (NYSE) under the Sherman Act after the NYSE ordered the discontinuance of his wire connections with the offices of NYSE members without notice, explanation or a hearing. The Court held that no policy of the Exchange Act was served by this conduct and therefore the NYSE had acted in violation of the Sherman Act. In the context of the unfixing of commission rates and a restructuring of the securities industry over a decade later the Supreme Court broadened the area in which the antitrust laws may be impliedly repealed by the securities laws.

In *Gordon v. New York Stock Exchange, Inc.*⁷⁹ the Court held that the antitrust laws did not apply to the system of fixed commission rates then utilized by the stock exchanges because the SEC had

77. 373 U.S. 341 (1963).

78. *Id.* at 357.

79. 422 U.S. 659 (1975).

authority to do away with fixed commissions had it found them inconsistent with the regulatory structure. Direct and active supervision by the SEC over rate-fixing by securities exchanges negated the possibility of antitrust liability for fixed commissions. In a second case decided the same year the Court found that the SEC had not exercised the same degree of supervision with regard to the secondary trading of mutual funds, but read the applicable legislative history as granting to the SEC the informed administrative judgement to do so.⁸⁰ The 1975 Act amendments, passed in the same year as these cases, made clear that the SEC's role in passing on exchange or other SRO rules must include an evaluation of the anti-competitive aspect of such rules. Several new powers for and limitations on the SEC were added to the Exchange Act with respect to the consideration of competitive questions.

Within one year after the effective date of the statute, the SEC was required to determine whether the rules of any national securities exchange or registered securities association complied with the Exchange Act. Thereafter, proposed rule changes of exchanges and associations were required to be subjected to prior rulemaking procedures by the SEC and could not take effect without an SEC finding that such rule was consistent with the Exchange Act.⁸¹ These provisions effectively required the SEC to take competition into consideration in reviewing all existing and any new exchange or association rules. In addition, fixed commission rates were effectively outlawed although the SEC was given the authority to allow "reasonable" fixed rates prior to November 1, 1976 if found to be in the public interest.⁸² The SEC was also instructed to review and presumably eliminate off board trading bans of the exchanges, but as will be explained below, these rules were not finally eliminated until May 2000.

Although the SEC pushed for multiple trading of equities for many years, and believed multiple trading was endorsed by the 1975 Act amendments, in the mid-1970s, the SEC nevertheless discouraged multiple trading of options on more than one exchange because of concerns over manipulative activity.⁸³ However, in 1989 the SEC

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

81. Exchange Act § 19(b), 15 U.S.C. § 78s (2000). See also Notice of Rulemaking Proceeding, Exchange Act Release No. 34-11,628, 40 Fed. Reg. 41,808 (Sept. 9, 1975).

82. Announcement of the Adoption of Rule 19b-3 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-11,203, 40 Fed. Reg. 7394 (Jan. 23, 1975). See also Announcement of the Adoption of Rule 17a-20 and Related Form X-17A-20 Under the Securities Exchange Act of 1934, Exchange Act Release No. 34-11,395, 40 Fed. Reg. 20,073 (May 8, 1975).

83. See *SEC Proposal Would End Prohibition on Multiple Exchange Trading of Options*, 19 Sec. Reg. & L. Rep. (BNA), at 906 (June 19, 1987).

permitted multiple options trading.⁸⁴ Some years later the Department of Justice investigated and brought a class action charging price-fixing in the options markets. This case was against exchanges that had exclusive options and certain of the specialists, market makers and floor brokers which allegedly entered into an unlawful conspiracy to refrain from the multiple trading of options and to refuse to integrate the options markets leading to spreads at excessive levels.⁸⁵ This case and a companion SEC case have since been settled.⁸⁶ A companion private class action case was also settled as to some parties, but on a motion for summary judgment by the remaining parties, was dismissed on the basis of implicit repeal due to SEC regulation of the options-listing arena.⁸⁷ This decision left the question of whether options exchanges should enjoy a monopoly with respect to the listing of a particular option or be permitted or required to compete in the trading of the same options squarely in the lap of the SEC.

Of much greater importance to the future shape of the securities markets was a Department of Justice and SEC investigation into market maker spreads on Nasdaq. A pricing convention by which most Nasdaq stocks were quoted in even eighths was declared illegal.⁸⁸ As a result, stocks began to be quoted and traded on stock exchanges and Nasdaq in smaller increments. Furthermore, this proved but a prelude to decimalization in which stocks could be traded in much smaller increments.⁸⁹ Just as prodding by the Department of Justice was necessary to unfix commission rates, action by the Department of Justice was necessary to narrow trading spreads. This process of unfixing trading spreads is ongoing.

84. 17 C.F.R. § 240 (1999). See *Multiple Trading of Standardized Options*, Exchange Act Release No. 34-26,870, 54 Fed. Reg. 23,963 (June 5, 1989).

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

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

87. See *In re: Stock Exch. Option Trading Antitrust Litig.*, 2001 WL 128325 (S.D.N.Y. Feb. 15, 2001). See also, *In re: Stock Exch. Options Trading Antitrust Litig.*, 2001 WL 423039 (S.D.N.Y. Apr. 24, 2001). This case is of interest now that the SEC will also regulate single stock futures which will compete with exchange traded options. See *SEC, CFTC Propose Joint Rules For Trading of New 'Security Futures'*, 33 Sec. Reg. & L. Rep. (BNA), at 742 (May 14, 2001).

88. See Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market, Exchange Act Release No. 37,542, 62 S.E.C. Doc. 1385 (Aug. 8, 1996).

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

Furthermore, ECNs are generating an onslaught of competitive threats to the former monopoly type powers of exchanges.

Among these monopoly type powers was the trading of securities in issuers that determined to list on the exchange. Although as far back as the Multiple Trading Case in 1941⁹⁰ the SEC attempted to prevent exchanges from exercising a monopoly in the trading of an issuer's securities, the NYSE's off-board trading rule, Rules 390,⁹¹ effectively prevented serious competition among exchanges in dually listed stocks. The first significant attack on the monopolization of trading in the stock of a listed issuer was Exchange Act Rule 19c-3 which permitted exchange members to trade off-board as agent for customers, except in agency crosses, and abolished off-board trading restrictions as to stocks listed after April 26, 1979.⁹² In recent years, competition to exchange trading monopolies has come from ECNs or ATSS. The proliferation of these electronic marketplaces has forced the SEC to confront numerous market structure issues.

III. The NMS Mandate

A. The Securities Acts Amendments of 1975

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

(a)(1) The Congress finds that-

(A) The securities markets are an important national asset which must be preserved and strengthened.

(B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.

(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure-

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

91. Order Approving Proposed Change To Rescind Exchange Rule 390 Exchange Act Release No. 34-42,758, 65 Fed. Reg. 30,175 (May 10, 2000).

92. Off-Board Trading Restrictions, Exchange Act Release No. 34-16888, 45 Fed. Reg. 41125 (June 8, 1980); Off-Board Trading Restrictions, Exchange Act Release No. 34-16889, 45 Fed. Reg. 41156 (June 8, 1980).

- (i) economically efficient execution of securities transactions;
- (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
- (iv) the practicability of brokers executing investors' orders in the best market; and
- (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers and investors, facilitate the offsetting of investors' orders and contribute to best execution of such orders.⁹³

The 1975 Act amendments were precipitated by the unfixing of commission rates and the back office paperwork crisis and disintermediation that resulted from the onset of freely negotiated rates. Competitive challenges to the hegemony of the NYSE were fragmenting the markets and so there were concerns about the integrity of the pricing mechanism for equities and the best execution of customers' orders. This background is important to an understanding of current market structure issues because current issues are arising from a similar disintermediation.

B. NMS Policy Statements

A recent book advocates that governments withdraw from the task of mandatory securities market structure and let market forces shape trading platforms.⁹⁴ While the SEC is unlikely to accede to this advice, and probably could not do so given the NMS provisions of the Exchange Act, the SEC's record of accomplishments is skimpy in realizing its vision of a NMS articulated in 1978.

93. 15 U.S.C. § 78k-1 (a). See generally Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 VA. L. REV. 785 (1984); Milton Cohen, *The National Market System—A Modest Proposal*, 46 GEO. WASH. L. REV. 743 (1978); Norman Poser, *Restructuring the Stock Market: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981); Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17 (1986).

94. RUBEN LEE, WHAT IS AN EXCHANGE? THE AUTOMATION, MANAGEMENT, AND REGULATION OF FINANCIAL MARKETS 260-61, 264-65, 308-09 (1998).

In a 1978 Policy Statement, the SEC asserted that Congress supported three major principles when directing the SEC to facilitate the development of the NMS. These were: (1) Creating an ideal auction type market by implementing a nationwide system according to price and time priority for all limit orders of public investors over all professional orders; (2) the types of securities qualified to be included in a national market system should depend primarily on their characteristics rather than where they were traded; and (3) a refusal to achieve a nationwide centralized auction-type market for qualified securities involving abolition of over-the-counter trading in listed securities.⁹⁵ Competitive forces, to the extent feasible, were to shape the markets.⁹⁶ The major problems to which the ideas of the NMS were addressed were those arising from market fragmentation or "the existence of multiple, geographically separated forums in which trading in the same security occurs and from institutionalization of the markets."⁹⁷

In a Notice of Intent to engage in rulemaking, the SEC expressed views as to those initiatives which it believed had to be taken over the next year (that is, before January 1979) to facilitate the establishment of a national market system. The first initiative was taken simultaneously with the SEC's National Market System Release, namely the adoption of Rule 11Ac-1-1, designed to facilitate the prompt development of a composite quotation system by improving the quality and reliability of quotation information made available to securities information vendors by exchanges and third market makers.⁹⁸

The second initiative was the development of comprehensive market linkage and order routing systems. This linkage was created by the Intermarket Trading System (ITS), which initially was a quotation link between all national securities exchanges, and was then linked to the NASD's Computer Assisted Execution System (CAES).⁹⁹ The SEC has expressed the view that ITS has become anticompetitive and that quotes of electronic communications networks (ECNs) should be included in a consolidated quote.¹⁰⁰

95. Development of a National Market System, Exchange Act Release No. 14,416, 43 Fed. Reg. 4354 (Feb. 1, 1978).

96. *Id.* at 17.

97. *Id.*

98. See Dissemination of Quotations for Reported Securities, Exchange Act Release No. 14,415, 43 Fed. Reg. 4342 (Feb. 1, 1978) [hereinafter Dissemination of Quotations Release].

99. See Intermarket Trading System, Exchange Act Release No. 18,713, 47 Fed. Reg. 20,413 (May 12, 1982); In the matter of American Stock Exchange, Inc., et. al., Exchange Act Release No. 19,456, 48 Fed. Reg. 4938 (Jan. 27, 1983).

100. See Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 43,084, 65 Fed. Reg. 48,406, at 48,420 (Aug. 6, 2000) [hereinafter Disclosure Rules

ATSs and ECNs that are not exchanges do not have access to the ITS.¹⁰¹ This raises a concern about price discovery efficiency and an argument that every exchange, ATS and ECN should be playing by the same rules.¹⁰² Frustrated critics of the current system note that the United States is the only major country without an electronic stock exchange.¹⁰³ Instinet's CEO, recommends following Europe's lead and opening access to prevent fragmentation.¹⁰⁴

A White Paper issued by several large NYSE member firms in February 2000 asserted that in order to make the ITS a "super national market system (NMS), much must be done, including: opening access to all qualified market participants; making governance more democratic and streamlined; updating technology, ensuring efficient order-routing; and providing an effective dispute resolution mechanism.¹⁰⁵ Also, mandatory price-time priority to ensure automatic execution must be built into the system.¹⁰⁶

The third basic principle upon which the 1978 SEC believed an NMS must be based was the assurance that all agency orders in NMS securities, regardless of location, receive the benefit of auction-type trading protections. To that end, the SEC recommended that concerned self-regulatory organizations develop and implement a central limit order book (CLOB) for public agency orders. To this day, no such CLOB has been developed and it remains a controversial idea. Some, including SEC Chairman Levitt, have advocated a CLOB for all customer orders.¹⁰⁷ A CLOB is a "central repository" that allows *all* market participants to see prices for a

Release]. See Deborah Lose & Greg Ip, *SEC Demands Rule Changes for System That Links Nation's Stock Exchanges*, WALL ST. J., May 29, 1997, at C22. The SEC also proposed that the ITS Plan be changed to require a two-thirds supermajority vote for amendments to the plan instead of a unanimous vote. Proposed Rules to Amend the Intermarket Trading System Plan to Expand the ITS Computer Assisted Execution System Linkage to All Listed Securities and to Eliminate Unanimous Vote Provision, Exchange Act Release No. 40,260 (July 24, 1998).

101. Rachel Witmer, *SEC Seeks to Foster Innovation Unger Says, Responding to Criticism of Market Regulation*, 32 Sec. Reg. & L. Rep. (BNA), at 178 (Feb. 14, 2000).

102. *Id.*

103. *Id.*

104. *Id.*

105. *Responding to Chairman Levitt's Call: A Plan for Achieving a True National Market System* (Feb. 29, 2000), at <http://interactive.wsj.com/articles/SB951781063229264679.htm> [hereinafter Large Firm White Paper]; see Michael Schroeder & Randall Smith, *Sweeping Change in Market Structure Sought—Major Firms Propose Central Order System and Single Regulator*, WALL ST. J., Feb. 29, 2000, at C1; *Five Wall Street Firms' Vision Of A Centralized Market*, 32 Sec. Reg. & L. Rep. (BNA), at 277 (March 6, 2000).

106. Large Firm White Paper, *supra* note 105.

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

security simultaneously. This proposal thwarts price fragmentation and promotes price transparency.¹⁰⁸ There is a vigorous debate as to whether a CLOB is the answer to this issue. Many oppose the CLOB although it would improve broker dealer and ATSS market positions.¹⁰⁹ The SEC has not taken an official current position on whether the CLOB would better serve the interest of investor protection.¹¹⁰

In 1979, the SEC next proposed that a decision was required concerning off-board trading prohibitions. Thereafter, in 1980, the SEC amended Exchange Act Rule 19c-1 and adopted Rule 19c-3, which permitted exchange members to trade off-board as agent for customers, except in agency crosses, and abolished off-board trading restrictions as to stocks listed after April 26, 1979.¹¹¹ However, remaining off-board trading restrictions were not removed until May 2000.

The fifth pillar of the SEC's vision of a national market system in 1979 was a consolidated transaction reporting system. This pillar was then constructed pursuant to a variety of national market system plans pursuant to Exchange Act Rules 11A3-1, 11Ac1-1, 11Ac1-2 and 11A3-2 by the Consolidated Tape Association (CTA) and related committees.¹¹²

Finally, the SEC explained that it was necessary to define securities qualified to trade in the national market system and it then proceeded to do so.¹¹³ A variety of other matters were also briefly addressed in the 1979 National Market System Release including institutional trading prohibitions, self-regulatory organization governance and surveillance of national market system facilities, and clearance and settlement issues. Of overriding policy concern, however, was the problem of fostering competition without fragmentation of the market due to internalization by member firms.

108. *Id.*

109. See Witmer, *supra* note 107, at 241.

110. *Id.*

111. *Id.*

112. Dissemination and Display of Transaction Reports, Last Sale Data and Quotation Information, Exchange Act Release No. 16-590, 45 Fed. Reg. 12,391 (Feb. 26, 1980); Dissemination of Quotations Release, *supra* note 98. See Regulation of Market Information Fees and Revenues, Exchange Act Release No. 42-208, 64 Fed. Reg. 70,613 (Dec. 17, 1999) [hereinafter SEC Concept Release on Fees].

113. Designation of National Market System Securities, Exchange Act Release No. 17,549, 46 Fed. Reg. 13,992 (Feb. 17, 1981). For the potential this gave the SEC to impose governance standard on listed issues, see Roberta S. Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. UNIV. L. REV. 809 (1987); but see *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (this potential did not pan out).

C. Fragmentation

The most significant of the many complex market issues currently under consideration is resolution of the tension between trading competition and centrality of the price setting mechanism for equities. The SEC set forth this issue and the many sub-issues involved in its Request for Comment on Issues Relating to Market Fragmentation (SEC Request for Comments).¹¹⁴ After reviewing the comments submitted in response to this release, the SEC recently proposed two new rules to improve public disclosure of order routing and execution practices.¹¹⁵

Another important market structure issue is resolution of the tension between liquidity and transparency. This issue, among others, was addressed in the Report of the Special Committee on Market Structure, Governance and Ownership of the New York Stock Exchange, Inc. (NYSE Report).¹¹⁶ To some extent, this NYSE Report was a response to the Large Firm White Paper concerning the issue of market fragmentation.¹¹⁷ The NYSE Report also was prompted by the SEC's Concept Release on Market Information Fees and Revenues.¹¹⁸ In a further effort to come to grips with the issues of price transparency and consolidated market information and determining how market information fees should be determined, the SEC established an Advisory Committee on Market Information on July 25, 2000.¹¹⁹

Fragmentation occurs when investor order flow is directed to different markets that are not connected or are ineffectively connected.¹²⁰ Internalization and payment for order flow are among the causes of fragmentation. These questionable practices have been under SEC scrutiny for some time, but the SEC has been reluctant to outlaw them because they have exerted pressure on the NYSE and Nasdaq to reduce trading costs. Whether fragmentation is a serious current problem in the securities markets is a subject of some debate. The Large Firm White Paper asserted that fragmentation is a reality

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

115. Disclosure Rules Release, *supra* note 100.

116. SPECIAL COMMITTEE ON MARKET STRUCTURE, GOVERNANCE AND OWNERSHIP, MARKET STRUCTURE REPORT OF THE NYSE (March 23, 2000), available at <http://www.nyse.com/pdfs/marketstructure.pdf> [hereinafter NYSE Report].

117. See Large Firm White Paper, *supra* note 105.

118. SEC Concept Release on Fees, *supra* note 112.

119. See *Law School Dean to Chair Advisory Panel on Market Information*, 32 Sec. Reg. & L. Rep. (BNA), at 1331 (Oct. 2, 2000).

120. See Large Firm White Paper, *supra* note 105, at 3.

and that it will worsen when ENCs register as exchanges and when NYSE off-board trading restrictions are removed.¹²¹ The NYSE also claimed that the rescission of Rule 390 would exacerbate fragmentation to the detriment of investors.¹²² Both the Large Firm White Paper and the NYSE Report blamed inadequacies in the ITS for some market structure problems, but their solutions were quite different.

The Large Firm White Paper urged a completely reformed market linkage system, which would include all qualifying ECNs and would have a new governance structure including representatives from all industry participants so that the NYSE and Nasdaq would no longer be in a position to regulate their ECN competitors.¹²³ The Large Firm White Paper also recommended the adoption of a CLOB, that is an automatic price/time priority rule.¹²⁴ These reforms would help to connect fragmented liquidity pools while preserving the ability of the large firms to internalize retail executions. The NASD has asserted that the SuperMontage is an alternative solution to fragmentation, and better than a CLOB. Critics of SuperMontage claim it is a CLOB.¹²⁵

The NYSE Report asserted that developments in communications technology have eliminated the need for an intermarket order-routing system such as ITS and suggested that ITS be abolished.¹²⁶ Recognizing, however, that the SEC was unlikely to agree, the NYSE Report argued that the ITS should continue to require that participants be SROs.¹²⁷ This would compel broker-dealers, including ECNs that do not register as exchanges pursuant to Regulation ATS, to link to ITS only through an SRO participating in the ITS plan. Further, the NYSE Report opposed the adoption of a CLOB, which it defined as a "single, national, order-driven intermarket linkage requiring submission of all customer limit orders for automatic matching based upon price-time priority."¹²⁸ The NYSE Report argued that a CLOB eliminates, without replacing, the price discovery that occurs in the crowd on the NYSE floor and questioned whether a CLOB would attract meaningful institutional order flow. The NYSE Report also recommended that the NYSE not facilitate internationalization of customer orders in the absence of

121. *Id.* at 3-4.

122. See SEC Request for Comment on Fragmentation, *supra* note 114, at 10,578.

123. Large Firm White Paper *supra* note 105, at 11-15.

124. *Id.* at 15-25.

125. See, e.g., Congressional Testimony of Kevin Foley, President and CEO, Tradebook LLC, March 22, 2000.

126. See NYSE Report, *supra* note 116, at 42.

127. *Id.* at 43.

128. *Id.* at 27.

opportunities for price improvement.¹²⁹ Recently, the SEC reiterated its concern about the potential for internalization and payment for order flow arrangements to interfere with order interaction and the display of aggressively priced quotations.¹³⁰

ECNs and their defenders argue that the equity markets are not fragmented and that competition between market centers—ECNs and exchanges—should make the pricing mechanisms efficient and fair.¹³¹ Both ECNs and the regional stock exchanges (which may have the most to lose in the competition for order flow and executions) oppose a CLOB as anticompetitive and likewise opposed the SuperMontage.¹³² This debate has pitted the interests of the large wire houses wishing to internalize order flow against the interests of exchanges and other markets. The effect decimalization will have on execution costs and profits as well as the continued popularity of limit orders is unknown. Accordingly, the timing has not been propitious for the SEC to mandate a CLOB that is opposed by large segments of the securities industry, and the SEC has so concluded.¹³³

The adoption of a CLOB was not the only idea put forth by the SEC in its Request for Comment on market fragmentation. Other options suggested by the SEC were greater disclosure by market centers and brokers concerning trade execution and order routing; restrictions on internalization and payment for order flow; requirements for exposure of market orders to price competition; and intermarket prohibitions against market makers trading ahead of previously displayed and accessible investor limit orders.¹³⁴ The SEC is now following up on all of these ideas.

Rule 11Ac1-5, adopted at the end of 2000, requires market centers that trade national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis.¹³⁵ Rule 11Ac1-6 requires broker-dealers that route orders on behalf of customers to make publicly available quarterly reports that describe their order routing practices and disclose the venues to

129. *Id.* at 36-40.

130. Disclosure Rules Release, *supra* note 100, at 48,407.

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

132. See *Market Fragmentation Issue Reduced to CLOB Comments*, 3 Securities Regulatory Update (CCH), at 1 (June 12, 2000).

133. Disclosure Rules Release, *supra* note 100, at 48,407.

134. SEC Request for Comment on Fragmentation, *supra* note 114, at 10,586.

135. 17 C.F.R. § 240.11Ac1-5.

which customer orders are routed for execution.¹³⁶ There is an ongoing staff study on order execution quality which could serve as a basis for restricting internalization and payment for order flow arrangements.¹³⁷

Industry focus on the merits of a CLOB rather than the SEC's other suggestions for reducing fragmentation is understandable since currently two-thirds of all orders on Nasdaq and system orders on the NYSE are limit orders.¹³⁸ The SEC believes that limit orders narrow spreads, increase liquidity and promote the ability of investors to trade without the intervention of a dealer.¹³⁹ However, the increased chances of missing limit order executions after decimalization may change investor behavior and make the debate over a CLOB irrelevant. The SEC has suggested that after decimalization it may prevent market makers from stepping ahead of customer limit orders at a penny in order to continue to encourage limit orders.¹⁴⁰ However, the already complicated regulations for limit order display and handling perhaps defy compliance.¹⁴¹

D. Market Data

Current and contemplated changes in market structure also have thrown into question arrangements for disseminating and charging for market information. In 1999, the SEC issued a Concept Release on Market Information Fees and Revenues which indicated that the SEC was considering effecting serious changes in the way in which exchanges and other markets could charge for market information. The SEC seemed to envision cost-based accounting with respect to the production of market information in order to determine whether the fees for the provision of such information are reasonable.

Although the SEC Concept Release on Fees set forth the SEC's belief that market information fees are an appropriate part of SRO funding, it questioned whether the cost of member regulation should be included in the computation of what market information costs.¹⁴² Further, the SEC suggested that conversion of exchanges to for-profit companies and the proliferation of alternative trading markets may require greater government interference in the way in which SRO

136. 17 C.F.R. § 240.11Ac1-6.

137. Disclosure Rules Release, *supra* note 100, at 48,407. On the other hand, decimalization may lead to the demise of payment for order flow.

138. *SEC Special Study: Report Concerning Display of Customer Limit Orders*, Fed. Sec. L. REP. (CCH) ¶ 86,306, at 83,401 (May 4, 2000) [hereinafter *Special Study*].

139. *Id.*

140. Disclosure Rules Release, *supra* note 100, at 48,420.

141. See *Special Study*, *supra* note 138.

142. SEC Concept Release on Fees, *supra* note 112, at 70,627.

information processors are governed as well as how they charge for market information.

It seems curious that at a time when there are more, rather than fewer, competing markets for equity trading the SEC is considering the imposition of utility rate style regulation for market information. In response to the SEC Concept Release, the NYSE determined to withdraw from the CTA and lambasted the idea of cost-based rate regulation for market data fees.¹⁴³ Further, the NYSE expressed the view that if it charged more for its data, it could charge less for listings and transactions.¹⁴⁴ Because of the complexity of the issues, the SEC set up an Advisory Committee on Market Information to deal with numerous contentious issues.¹⁴⁵

Under its charter, the Advisory Committee was asked to address the value of transparency to the markets; the impact of decimalization and electronic quotes on transparency; the merits of consolidated market information; alternative models for collecting and distributing market information; the determination and evaluation of market data feed; and the administration and governance of joint market information plans.¹⁴⁶

Prior to the 1970s, there was no systematic or government regulated arrangement concerning the dissemination of market information and little, if any, market information was accessible. Relying on the so called "ticker" cases (early Supreme Court cases which examined an exchange's interest and right to control and sell market information), exchanges and exchange members claimed that because they had a proprietary right in the market information their services generated, they could control what information would be generated, to whom it was generated, and at what cost.¹⁴⁷ The NYSE, for example, "severely restricted public access to market information, particularly its quotations."¹⁴⁸ Thus, prior to the 1970s, "market information, to the extent it was disseminated, was not consolidated, and the largest market[s] refused to provide public access to its quotations."¹⁴⁹

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

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

145. See, *supra* note 119.

146. REPORT OF THE ADVISORY COMMITTEE ON MARKET INFORMATION 2 (Sept. 14, 2001), available at <http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm> [hereinafter REPORT ON MARKET INFORMATION].

147. SEC Concept Release on Fees, *supra* note 112.

148. *Id.*

149. *Id.* See also Amex Statement, "It is long-standing and clearly established that the Exchange has a proprietary right in its transaction data and quotation information. It is not clear from the terms of the proposed Rules whether or to the extent to which they might impinge on the Exchange's right." *Id.* at 70,620. See also NYSE Statement, "It has

One aim of the NMS provisions of the Exchange Act was to influence greater dissemination of consolidated market information and unrestricted public access to such information.¹⁵⁰ In 1972 the Commission adopted rules to provide for the consolidated reporting of transactions and quotations by SROs.¹⁵¹ The Commission found SROs to be in the best position to disseminate this information because of their concurrent status as regulators. The rule did not prevent exchanges from charging reasonable fees for their market data and “[i]n this regard, revenues derived from market information fees already were an important source of SRO funding.”¹⁵²

The statutory standard under the 1975 Amendments mandates that the terms under which market information is available must be fair, reasonable and nondiscriminatory.¹⁵³ Congress envisioned that exclusive processors of market information would function as a public utility—a completely neutral party among all market participants—under SEC oversight and regulation.¹⁵⁴ In contrast to the Commission’s policies regarding fixed commission rates, Congress did not adopt a cost of service or “ratemaking” approach to the fees charged for market data. Instead, the 1975 Amendments give the SEC considerable flexibility in determining the reasonableness and fairness of market fees. This flexibility, coupled with a radically changing market structure, however, spurred recent SEC inquiries into what is fair and reasonable.¹⁵⁵

always been the position of the Exchange that NYSE bid-asked quotations on a continuous basis are a prerogative of Exchange membership.” *Id.* at 70,620.

150. SEC Concept Release on Fees, *supra* note 112.

151. *Id.* The NYSE claimed that the Commission had exceeded their rule making authority under Section 17(a) and 23(a) of the Securities Exchange Act and deprived them of their property.

152. *Id.*

153. Sections 11A(c)(1)(C), 11A(c)(1)(D), and 6(b)(4) and 15A(b)(5); SEC Concept Release on Fees, *supra* note 112.

154. SEC Concept Release on Fees, *supra* note 112. Any securities information processor (SIP) which is an exclusive processor must be registered with the Commission. Section 11A(b)(1).

155. The Commission has reviewed market information fee structures on two occasions. First, in 1978, the Commission reviewed OPRA’s proposal to institute an access fee on vendors based on costs associated with its new consolidated reporting system. SEC Concept Release on Fees, *supra* note 112. Nevertheless, the Commission refused to evaluate the reasonableness of the fee, simply finding that some form of access fee may be charged. Second, in 1984, in a dispute involving the NASD and Instinet, the Commission found that a “proposed NASD fee for quotation information represented an unwarranted denial of access, primarily because the NASD had failed to submit an adequate cost-based justification for its proposed fee.” *Id.* at 70,622. However, the Commission emphasized “that it was the peculiar competitive context of the proceedings that led to its decision to require a strict, cost-based justification.” *Id.* at 70,623. The Commission stated the following:

Because Instinet seeks to distribute certain NASDAQ quotation information in

The Report on Market Data endorsed transparency and consolidated market data as core elements of the NMS, and a majority of the Advisory Committee favored retention of the Display Rule, Rule 11Ac1-2, which requires vendors and broker-dealers to provide a consolidated display of last sale transaction reports and quotations from all reporting market centers.¹⁵⁶ The SEC's proposal for a cost based rate making standard for market data fees was emphatically rejected, but no alternative new system for reviewing rates was recommended.¹⁵⁷

Initially, Nasdaq and the NYSE had very different visions concerning the future of market data fees. Nasdaq proposed two alternatives to the current consolidation structure.¹⁵⁸ Under a "market choice" alternative, participants could choose whether to participate in any NMS plan and submit data to the plan's exclusive processor. Otherwise, each exchange and SRO could make its data available to nonexclusive or competing processors, or other market data vendors independently. Additionally, "exchanges could negotiate separately for the sale of that information *plus* enhanced information to market data vendors, broker-dealers, and subscribers." The second alternative, a "single consolidator", would operate as a public utility, jointly administered, and subject to SEC oversight. Although participants would be required to make its last sale and BBO information available, each exchange and SRO could independently sell their enhanced market information. Under a "single consolidator" alternative, Nasdaq also recommended amending the rule requiring unanimous consent for *all* NMS plan amendments. The NYSE announced plans to withdraw from the Consolidated Tape Association (CTA), objecting to the CTA as a "single-source monopoly" as well as to the SEC's plans to engage in rate making with respect to market data.¹⁵⁹

competition with the NASD, which is an exclusive processor of that information, the proposed fees must be cost-based and calculated by allocating the percentage of system use of each quotation service offered by the NASD, to ensure the neutrality and reasonableness of the NASD's charged to Instinet and its subscribers. *Id.* at 70,623.

156. SEC Concept Release on Fees, *supra* note 112, at 70,613, 70,618-23.

157. *Id.* at 70,628.

158. THE NASDAQ STOCK MARKET, NEW APPROACHES TO MARKET INFORMATION, SUBMISSION TO SEC MARKET DATA ADVISORY COMMITTEE (Nasdaq White Paper) (Feb. 19, 2001), available at http://www.fisd.net/news/sec_nasdaq0022101sub.pdf.

159. See Greg Ip, *NYSE Tells Regulators It Wants to Quit Stock-Data Distribution Organization*, WALL ST. J., Apr. 12, 2000, at C8. See also Memorandum from the New York Stock Exchange, Recommendation for an Alternative Model, submitted to the Federal Advisory Committee on Market Information (Dec. 1, 2000), available at <http://www.sec.gov/divisions/marketreg/marketinfo/nysemi.htm>.

The Report on Market Data recommended that the SEC should permit a new system of competing consolidators to evolve from the current unitary model of the CTA, so that each market center would be permitted to sell its market information to any number of competing consolidators, which in turn could sell to vendors and subscribers.¹⁶⁰ Further, if the SEC does not adopt a competing consolidator model, the Report on Market Data recommends that an information processor be selected by competitive bidding and governance be broadened through a nonvoting advisory committee.¹⁶¹

E. The Future of the NMS

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

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

160. REPORT ON MARKET INFORMATION, *supra* note 146, at 2-3. A minority of the Advisory Committee, including the Amex, voted to retain the existing model and another minority composed of ECNs viewed the elimination of the Display Rule, Rule 11Ac1-2, necessary for a system of competing consolidators. *Id.* at 49 nn. 237-38.

161. *Id.* at 54-55.

rather, has preferred regulation to ensure that the markets are transparent and fair, but not limited to a single monopoly marketplace.

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

IV. Background and History of Self-Regulation

A. Stock Exchanges

A major market structure issue currently confronting the SEC is the future of self-regulation, which has been addressed by a special committee of the Securities Industry Association (SIA).¹⁶² Prior to the enactment of the Exchange Act stock exchanges were private membership organizations under state law. When the federal securities laws were passed, stock exchanges were required to register with the SEC.¹⁶³ The SEC thus obtained oversight authority over stock exchanges, but the stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies.

Before 1934 no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed the Maloney Act to establish a framework for an OTC self-regulatory organization (SRO).¹⁶⁴ Only one such association, the NASD exists for OTC brokers and dealers. Although the NASD is for all intents and purposes a stock exchange,¹⁶⁵ it continues to be called and

162. SIA, REINVENTING SELF-REGULATION: WHITE PAPER FOR THE SECURITIES INDUSTRY ASSOCIATION'S AD HOC COMMITTEE ON REGULATORY IMPLICATIONS OF DE-MUTUALIZATION 5 (Jan. 5, 2000) [hereinafter SIA WHITE PAPER].

163. Exchange Act § 6, 15 U.S.C. § 78f (1994).

164. Exchange Act § 15A.

165. See Adopting ATS Release, *supra* note 7, at 70,852. Nasdaq, the subsidiary of the NASD that functions as an exchange marketplace, is registered as a securities information processor. *Id.* It intends to register as a stock exchange in the future. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Amending the Nasdaq By-laws and Restated Certificate of Incorporation, Exchange Act Release No. 42,983, 65 Fed. Reg. 41,116 (June 26, 2000) [hereinafter Approval of Nasdaq By-Laws]. Pursuant to Rule 3a1-1, 17 C.F.R. § 240.3a1-1, an organization, association, or group of persons are exempt from the definition of an

regulated as an "association" under the securities laws. All broker-dealers registered with the SEC, except those doing business exclusively on a securities exchange, are required to join the NASD.¹⁶⁶

Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,¹⁶⁷ that Study concluded that self-regulation should be maintained and strengthened.¹⁶⁸ Nevertheless, in 1964 the SEC obtained greater direct authority over the continuous disclosures made by public companies.¹⁶⁹ Previously, the SEC was given power to regulate financial disclosure by issuers making initial public offerings,¹⁷⁰ but after 1964 the SEC also was given responsibility for regulating annual and periodic reports.¹⁷¹ Stock exchange listing requirements maintained their importance as to certain shareholder rights issues, however, because the SEC does not have the statutory authority to dictate the corporate governance of listed companies.¹⁷²

The Securities Acts Amendments of 1975¹⁷³ further strengthened the SEC's oversight role over the stock exchanges and the NASD by, among other things, giving the SEC the power to initiate as well as approve SRO rulemaking,¹⁷⁴ expanding the SEC's role in SRO enforcement and discipline,¹⁷⁵ and by allowing the SEC to play an active role in structuring the market.¹⁷⁶ Also, formulation and enforcement of the net capital rule became a direct SEC responsibility instead of a regulation of the SROs.¹⁷⁷ For the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors.¹⁷⁸ Additionally, the 1975 Act gave new SROs, such as clearing and transfer agents and information processors, a statutory foundation.¹⁷⁹

The 1975 Act sought to preserve and reinforce the concept of industry self-regulation with SEC oversight. However, by directing

"exchange" if it is operated by a national securities association. Therefore, Nasdaq's registration as an exchange must occur before it can become an independent corporation.

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

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

168. *Id.* at 83,414-15.

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

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

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

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

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

174. Exchange Act § 19(c), 15 U.S.C. § 78s(c) (1994).

175. Exchange Act §§ 19(c), (d), (g).

176. Exchange Act § 11A.

177. Exchange Act § 15(c)(3).

178. Exchange Act § 6(a)(3), 15A (b)(4).

179. Exchange Act § 17A.

the SEC to facilitate the creation of a national market system, injecting competition as a statutory goal and giving the SEC greater authority over SRO rulemaking, disciplinary activities and other matters, the SEC became able to exert more leverage over exchange corporate governance than in the past.

B. Commodities Exchanges

The CFTC has had to address the problems of conflicts of interest in SRO functions in connection with approving the demutualization of the CME.¹⁸⁰ Prior to 1974 commodity futures trading was regulated by the Commodity Exchange Authority within the Department of Agriculture.¹⁸¹ Then Congress created the CFTC as an independent agency and gave it exclusive jurisdiction over future and commodity options trading pursuant to the Commodity Futures Trading Commission Act of 1974 (Commodity Futures Act).¹⁸² The next year, on October 20, 1975, the CBOT introduced the first futures contract on a security.¹⁸³ Since then, jurisdictional battles regarding regulation of financial futures have raged between the SEC and the CFTC.¹⁸⁴ These battles have been temporarily resolved by the Commodity Futures Modernization Act of 2000 (CFMA), permitting the commodities exchanges to trade single stock futures.¹⁸⁵

To a large extent the CFTC is an analogue to the SEC with respect to the regulation of futures exchanges. The CFTC has deferred to rulemaking and self-regulation by commodities exchanges.¹⁸⁶ Such self-regulation by commodities exchanges has a long history.¹⁸⁷ Initially, the organizational and governing structure of a commodity exchange was not subject to CFTC regulation.¹⁸⁸ In addition to self-regulation by commodities exchanges, the National Futures Association (NFA) is a free standing self-regulator that was

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

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

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

183. Dan Glickman & Thomas A. Russo, *Look Beyond the "Pits" for Directors*, N.Y. TIMES, Oct. 28, 1984, at F3.

184. See Markham, *supra* note 181 at 985-87.

185. Pub. L. No. 106-554, 114 Stat. 2763 (2000).

186. 114 Stat. 1004-05.

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

188. THOMAS A. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS § 1.03, at 1-9 (1983).

granted registration by the CFTC in 1982 as a futures association.¹⁸⁹ The NFA works with the CFTC to set standards for ethics training of industry professionals, the review of disclosure documents and issues concerning statutory disqualification of registered persons and entities.¹⁹⁰ Also, the NFA audits any commodities firms not a member of any commodities exchange.¹⁹¹

C. Federal Involvement in Exchange Governance

(1) General

Stock and futures exchanges in the United States traditionally were organized under not-for-profit incorporation laws of a particular state. Unlike charities or educational institutions, they pay taxes. For example, the NYSE is incorporated under a New York law that existed prior to the exchange's incorporation.¹⁹² Further, exchanges have been mutual organizations, owned by their members, and profits have been returned to members in the form of lower access fees or other benefits. The members vote for the exchange boards of directors (sometimes called governors).

Recently, however, electronic exchanges have posed the question of whether nonmember, for-profit entities may operate as exchanges. The SEC has determined that a for-profit corporation may register as a stock exchange.¹⁹³ But the Exchange Act limits exchange membership to registered broker-dealers.¹⁹⁴ The SEC has stated that it will not grant relief from this requirement to alternative trading systems (ATSS) wishing to register as exchanges which include institutions among their members.¹⁹⁵ The commodities laws, by contrast, have been amended to give the CFTC authority to regulate different types of marketplaces in different ways.¹⁹⁶

189. See U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION HOW INVESTORS FARE, REP. TO CONG. REQUESTERS, GAO/GGD-92-74 (May 1992).

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

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

192. N.Y. BUS. CORP. § 402.

193. Adopting ATS Release, *supra* note 7, at 70,848, 70,883. One big electronic network, Island ECN Inc., is moving to raise capital and register as a stock exchange. Rebecca Buckman, *Island ECN Raises Capital to Become a Stock Exchange*, WALL ST. J., May 11, 1999 at C20.

194. Exchange Act § 6(c)(1), 15 U.S.C. § 78f(c)(1) (1994).

195. Adopting ATS Release, *supra* note 7, at 70,884-85.

196. As the result of CFMA, the Commodity Exchange Act now provides for two tiers of markets, or "multilateral transaction execution facilities."

Floor based exchanges, such as the NYSE and the CBOT have a limited number of members or seat holders. Traditionally, this gave the members monopoly powers with respect to the stocks or futures contracts traded on the exchanges. Concern about the abuse of such power gave rise to government interest in exchange governance. Examinations of governance issues have tended to focus on power struggles between seat holders, professional exchange managers and upstairs firms. More recently, conflicts have emerged between seat holders and clearing members. In the view of Congress, exchanges are affected with a national public interest, requiring their regulation to insure the maintenance of fair and honest markets.¹⁹⁷

(2) *Stock Exchanges*

When the Exchange Act was passed, Congress expressed concern about the rules of exchanges concerning the classification of members, method of election of officers and committees, and disciplining of members. Congress therefore directed the SEC to study and report on these matters.¹⁹⁸ Before the NYSE's governance could be changed in accordance with SEC recommendations, the Conway Committee was appointed by the NYSE to study its reorganization. This committee recommended a more representative composition of the board, limits on consecutive service and the creation of a full time paid president and professional staff.¹⁹⁹ A scandal involving Richard Whitney, a former NYSE president, interrupted these reforms but did lead to the appointment of the NYSE's first full time president, William McChesney Martin.²⁰⁰ In 1949-50 further governance changes were made in response to proposals by a group of floor members to try to eliminate self-perpetuation by a control group. The board was expanded and consecutive service was limited.²⁰¹

In the SEC's 1963 Special Study, exchange governance was again focused upon. The Study noted that self-perpetuation had not been eliminated and recommended making the board "more sensitive to the public character of the exchange and more cognizant of the needs of public investors"²⁰² by separating voting rights from the concept of seats, and by giving firms doing business with the public increased

197. See Exchange Act § 2, 15 U.S.C. § 78b (1994).

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

199. SIA WHITE PAPER PT. 4, *supra* note 162, at 507-08

200. *Id.*

201. *Id.* at 571.

202. *Id.* at 572.

representation.²⁰³ No changes resulted from these recommendations, however.

From that time and until 1972, the NYSE Constitution consisted of thirty-three members, composed of the chairman, the president, three representatives of the public and twenty-eight members' representatives.²⁰⁴ Specialist firms dominated the governance structure. Of the twenty-nine members' representatives (including the chairman), seventeen were required to be seat holders and to spend a substantial part of their time on the floor. Members of the board could not serve more than two consecutive terms, except after an interval of two years. Nominations to the board were made by an elected committee of eight members, five of whom were required to be seat holders; at least four of whom were required to spend substantial time on the floor.²⁰⁵

Significant changes were made to the NYSE Constitution in 1972 as a result of the Martin Report released in 1971 and its implementation by the Owens Committee. These changes occurred in the context of uncertainty about the immunity of stock exchanges from the antitrust laws,²⁰⁶ pressures to unfix commission rates²⁰⁷ and the financial and operational back office crisis of the securities industry.²⁰⁸ These developments ultimately led to the enactment of the 1975 Act that restructured the regulatory relationship between the SEC and SROs and stripped stock exchanges of some of their former autonomy.

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

1. To give proper recognition in the governing board of the Exchange to its quasi-public nature and the respective interests of the public, the companies listed on the Exchange and the members of the securities industry involved.
2. To provide broad access to the public auction market for all brokerage firms which meet necessary standards and will be subject to equal regulation.
3. To create an organization which, through the public representation on its governing board and the authority and

203. *Id.* at 576.

204. *Id.* at 510.

205. *Id.*

206. HOUSE SUBCOMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG, 1ST SESS., SECURITIES INDUSTRY STUDY, Fed. Sec. L. Rep. (CCH) Spec. Rep. 438, at 155-68 (Aug. 25, 1972) [hereinafter SECURITIES INDUSTRY STUDY].

207. *Id.* at 131-46.

208. *Id.* at 3-13.

independence of its management, will strengthen self-regulation and answer the prevalent criticism that member firms of the New York Stock Exchange cannot be expected to discipline themselves.

4. To permit and encourage the principal officers and partners within the member firms to serve on the governing board without respect to business background, e.g., the floor, the back office or the New York metropolitan area.

5. To transfer voting power from the individual members to the member firms and to provide a means for its redistribution so that each member firm could have voting power more closely related to its investment and its share of exchange transactions.

6. To change the present seats into shares, without destroying their market value.²⁰⁹

More specific steps recommended that the NYSE board should be reduced from thirty-three to twenty-one—ten directors from member firms, ten from the public and a full time, paid chairman; public directors should include representatives of listed companies and all segments of the investing public, including institutional investors; the ten member firm directors should be principal officers, partners and proprietors; public directors should have staggered three-year terms and member firm directors one-year terms; member firm directors should nominate themselves, but nominations from the floor should be allowed and cumulative voting would prevail; public directors should elect their successors; the board should have power comparable to the board of a business organization, with authority to amend its constitution and rules, subject to member override; all directors should be reimbursed for their expenses and public directors should be compensated for their time and responsibility; existing seats should be converted into one share, with one vote per share, but ten shares would be required to enable a firm to place a representative on the board or be a clearing member and share ownership for voting purposes limited in proportion to the amount of business done with the public.²¹⁰

In 1971, the NYSE was incorporated and it adopted a new constitution. Its new governance structure, which essentially has been maintained, was adopted in response to the Martin Report, but it did not adopt all of the Martin Report's recommendations. It fell short of doing so because votes remained tied to seats; public directors were nominated by a joint-industry-public committee and there was no requirement that the board include representatives of all segments of the investing public; continuous service was not limited; and the board was not given the power to amend the constitution.²¹¹ When

209. *Id.* at 103.

210. *Id.* at 103-05.

211. *Id.* at 105-06.

the NYSE was incorporated in 1971, the SEC expressed some doubts as to whether this step would impair the effectiveness of the exchange as a self-regulator.²¹² In 1972, the House Subcommittee on Commerce and Finance recommended that the NYSE and the American Stock Exchange (Amex) and the NASD reorganize their boards in conformity with the principles laid down in the Martin Report.²¹³

By the time the 1975 Act was passed Congress was not inclined to put rigorous corporate governance standards into the Exchange Act. In part, this was not necessary because the term "member" of an exchange was defined in such a way as to divorce it from the concept of a "seat,"²¹⁴ and the SEC was given plenary control over specialists' activities.²¹⁵ In addition, the SEC was given the power to abrogate, amend or add to the rules of any SRO.²¹⁶ Although self-regulation was preserved, and in some ways strengthened, a new emphasis on competition, investor protection and fair procedures changed the manner in which exchanges and associations could operate. Access to the market was opened up²¹⁷ and standards were put in place for the design of exchange and NASD rules and disciplinary proceedings.²¹⁸

With specific reference to exchange boards of directors, the Exchange Act was amended in 1975 to provide that the rules of an exchange must "assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer."²¹⁹ A corresponding provision was inserted for associations.²²⁰ The House bill had required that exchanges and associations include public representatives and further required that these SROs appropriate sums for use of public directors to employ staff independent of the exchange or association, but such provisions were dropped in the conference committee.²²¹

212. See SEC Comments on NYSE Incorporation, Exchange Act Release No. 9112, 1971 WL 1717 (SEC) (Mar. 17, 1971).

213. SECURITIES INDUSTRY STUDY, *supra* note 206, at 107.

214. Exchange Act §§ 3(a)(3), 3(a)(9), 3(a)(19), 15 U.S.C. §§ 78c(a)(3), (a)(9), (a)(19) (1994).

215. Exchange Act § 11(b). Previously exempt specialists, floor traders and floor brokers were required to register with the SEC.

216. Exchange Act § 19(c).

217. Exchange Act §§ 11A(b)(5)(A), 19(f).

218. Exchange Act §§ 6(b)(7), 15A(b)(8), 19(b).

219. Exchange Act, § 6(a)(3).

220. Exchange Act § 15A(b)(4) (1994).

221. REPORT OF THE SENATE-HOUSE CONFERENCE COMMITTEE, H.R. CONF. REPT. NO. 94-229 (1975).

(3) *Futures Exchanges*

Scrutiny of and debates concerning the governance of futures exchanges occurred in connection with amendments to the Commodity Futures Act.²²² Because the Commodity Futures Act gives commodity exchanges a monopoly over the trading of futures, the perception of conflicts of interest on the part of exchanges was examined in the early 1990s. Commodity exchanges were traditionally governed by their floor members, consisting of "locals" and "independent" floor brokers, who used their leverage to control exchange appointments and policy.²²³

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

The public had only token representation on futures exchanges in the form of outside public directors.²²⁴ Candidates for the board generally were selected by their predecessors.²²⁵ Floor members could select their own candidates by petition and could circulate petitions on the floor demanding that proposals be adopted by the exchange boards.²²⁶ Although exchanges had professional staffs, they were governed by exchange committees composed of exchange members.²²⁷ The House of Representatives approved a bill in 1989 that would have required at least twenty percent of the members of the board of a futures exchange to be public representatives with no exchange affiliations, but this proposed law failed to pass.²²⁸

In 1989 there were undercover FBI sting operations at the CME and CBOT that resulted in the indictment of forty-eight individuals for various trading practice violations on commodity exchange floors.²²⁹ These criminal indictments were upheld, although the trials had mixed results.²³⁰ In response to the sting operation Congress passed legislation to strengthen regulation of the trading pits. Among other things, audit trails were strengthened, there was increased regulation of floor broker associations, and more outsiders were

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

223. Markham, *supra* note 181, at 1009.

224. *Id.* at 1010.

225. *Id.* at 1009.

226. *Id.* at 1011.

227. *Id.*

228. H.R. REP. NO. 101-236, at 6 (1989); *see also* Markham, *supra* note 181, at 1013.

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

230. *Id.*

required to be included on exchange boards and disciplinary committees.²³¹

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

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

- (i) futures commission merchants;
- (ii) producers of, and consumers, processors, distributors, or merchandisers of, principal commodities traded on the board of trade;
- (iii) floor brokers and traders; and
- (iv) participants in a variety of pits or principal groups of commodities traded on the exchange.

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

- (i) expertise in futures trading, or the regulation thereof, or in commodities traded through contracts on the board of trade; or
- (ii) other eminent qualifications making such person capable of participating in and contributing to board deliberations.

(C) provide that no less than 10 percent of the regular voting members of such board be comprised where applicable of farmers, producers, merchants, or exporters of principal commodities traded on the exchange;²³²

Furthermore, such exchanges were required to provide on all major disciplinary committees a diversity of membership sufficient to ensure fairness and to prevent special treatment or preference for any person in the conduct of disciplinary proceedings and the assessment of penalties.²³³

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

A. Stock Exchanges

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

231. *Id.*

232. 7 U.S.C. § 7a(14) (1994), *added by* Pub. L. 102-546, title II, § 206(a)(1), 106 Stat. 3590, 3601 (1992).

233. Commodity Futures Act § 7a(15).

associated is a constituency board. There are requirements for industry directors from firms that have substantial direct contact with securities customers, for specialist members and nonspecialist floor members and geographical specifications.²³⁴ The NYSE has 1,366 members who have physical access to the trading floor and who are the owners of the exchange.²³⁵ However, the NYSE also has up to twenty-four physical access members, electronic access members and lessee members.²³⁶ The lessee members are a significant factor in governance issues because they can contract for the right to vote.²³⁷ Moreover, at the end of 1999, 863 of the NYSE's 1,366 regular seats were leased.²³⁸

The NYSE Chairman has explained that the diversity of interest among NYSE members is a continuous source of tension and conflict. Members are only able to realize economic value from their right to trade on the NYSE floor, but member firms compete with one another in a variety of businesses, including OTC market making in listed securities. Demutualization offers greater commonality among equity owners and avoids concentration of ownership power in a particular group of exchange participants. Also, a demutualized exchange can raise capital for strategic affiliations, technological improvements or new systems.²³⁹ Nevertheless, the NYSE has yet to move forward with a demutualization plan.

The NASD does not have "seats" since it has never had a floor. Rather, its membership is composed of broker-dealers. The NASD's job of self-regulation has always been difficult because its membership is nationwide, large and diverse and not pre-selected.²⁴⁰ Further, its emphasis in the past was on members regulating and disciplining themselves, as distinguished from regulation by a hired staff, and in promoting voluntary compliance with ethical standards.²⁴¹

234. See NYSE CONST., art. IV, § 2(a)-(b), 2 N. Y. S. E. GUIDE (CCH), at ¶ 1151.

235. See *id.*, art. II, § 1(a), at ¶ 1051.

236. See *id.*, §§ 1(b)-(c), 2.

237. *Id.* Electronic access members (who have access to the DOT system) initially had ½ the vote, but new electronic access members after 1986 do not vote. See Order Approving Proposed Rule Change, Exchange Act Release No. 22,959, 51 Fed. Reg. 8060, 8063 (Mar. 7, 1986).

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

239. Grasso Testimony, *supra* note 228.

240. See SPECIAL STUDY, *supra* note 138, at 83,416.

241. *Id.* at 83,414.

Principles emanating from the Maloney Act and guiding the NASD were democratic organization, business person's judgment and local autonomy.²⁴²

The NASD was completely reorganized in 1996 in the aftermath of a Department of Justice and SEC investigation into anticompetitive practices by OTC market makers.²⁴³ The SEC criticized the NASD for its regulatory deficiencies in failing to uncover these practices or discipline its members, and found that the NASD was unduly influenced by Nasdaq market making firms with respect to rulemaking, the disciplinary process and the admission of new members.²⁴⁴ In a settlement of these matters, the NASD agreed, among other things, to achieve greater diversity of representation on its board and its policy making committees, to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters, to create an enhanced audit trail, and to improve its surveillance and examination of order handling and the reliability of trade reporting.²⁴⁵

The 1996 NASD reorganization resulted in the creation of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc. (NASDR). Thereafter, NASD purchased the American Stock Exchange, Inc. (Amex), which operated as a subsidiary. All four boards are constituency boards that are required to have a majority of nonindustry members.²⁴⁶ NASD governance is again in a state of flux because of a restructuring that will result in the sale of seventy-eight percent of Nasdaq to issuers and NASD members and lead to the registration of Nasdaq as a stock exchange with the SEC.²⁴⁷

On April 14, 2000 the membership of the NASD voted overwhelmingly to turn Nasdaq into a for-profit company and alter its ownership structure.²⁴⁸ This ongoing transformation is being accomplished in two stages. In the first stage, up to forty-nine percent of Nasdaq's common stock was offered in a private placement to NASD members, Nasdaq issuers, institutional investors, and strategic partners. After a further sale of Nasdaq stock in the second phase,

242. Grasso Testimony, *supra* note 228.

243. See In the Matter of Nat'l Ass'n of Securities Dealers, Exchange Act Release No. 37,542 (Aug. 8, 1996), 1996 WL 452691, at *1.

244. See *id.* at *2.

245. See *id.* at *2-3.

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

247. See NASDAQ, FACT SHEET ON THE PROPOSED NASD RESTRUCTURING, available at <http://www.nasdaqnews.com/news/pr2000/fact313.html>. See *supra* note 165.

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

the NASD will own only a minority stake of approximately twenty-two percent of Nasdaq.²⁴⁹ A future public offering is contemplated.

In connection with the first phase of the restructuring, the NASD separated Amex from The Nasdaq-Amex Market Group, a holding company that was a wholly-owned subsidiary of the NASD, and the Group was then merged with and into Nasdaq. Nasdaq then effected a 49,999-for-one stock dividend creating 100 million shares of Common Stock outstanding (all of which were initially owned by the NASD), and authorized the issuance of an additional 30.9 million in new shares of Common Stock to be offered for sale by Nasdaq as part of the Restructuring.²⁵⁰ On June 28, 2000, Nasdaq sold an aggregate of 23,663,746 shares of common stock for an aggregate consideration of \$260,301,206. The NASD sold an aggregate of 6,415,049 Warrants to purchase an aggregate amount of 25,660,196 shares of common stock and an aggregate of 323,196 shares of Common Stock owned by the NASD for an aggregate consideration of \$74,120,695.²⁵¹

In the second phase of the restructuring, on January 18, 2001, Nasdaq sold an aggregate of 5,028,797 shares of Common Stock for an aggregate consideration of \$65,374,361. The NASD sold an aggregate of 4,392,345 Warrants to purchase an aggregate amount of 17,569,380 shares of Common Stock and an aggregate of 4,222,295 shares of Common Stock owned by the NASD for an aggregate consideration of \$116,382,665.²⁵² Investors in both phases of this restructuring consisted of NASD members, Nasdaq market participants, issuers with securities quoted on Nasdaq, and other strategic partners.

On May 3, 2001, Nasdaq issued and sold \$240,000,000 in aggregate principal amount of its four percent convertible subordinated debentures due 2006 to Hellman & Friedman Capital Partners IV, L.P. and certain of its affiliated limited partnerships (collectively, "Hellman & Friedman"). The subordinated debentures are convertible at any time into an aggregate of 12,000,000 shares of Common Stock, subject to adjustment. Hellman & Friedman owns approximately 9.8% of Nasdaq on an as-converted basis. In

249. See Press Release, NASD, NASD Restructuring Wins in Landslide Vote of the Members (Apr. 14, 2000), available at http://www.nasdaqnews.com/news/pr2000/ne_section00_091.html; see also Terzah Ewing, *NASD Members Vote to Sell Nasdaq, Paving the Way for Private Ownership*, WALL ST. J., Apr. 17, 2000, at C21. The NASD will continue to control Nasdaq until Nasdaq's registration as a stock exchange becomes effective.

250. See Nasdaq 10-12G/A Registration Statement, June 29, 2001, available at <http://www.sec.gov/Archives/edgar/data/1120193/000095017201500449/0000950172-01-500449.txt>.

251. *Id.*

252. *Id.*

connection with the transaction, Nasdaq has agreed to use its best efforts to seek stockholder approval of a charter amendment that would provide for voting debt in order to permit Hellman & Friedman to vote on an as-converted basis on all matters on which common stockholders have the right to vote, subject to a five percent voting limitation in Nasdaq's Restated Certificate of Incorporation.²⁵³ In May 2001, Warren Hellman of Hellman & Friedman went on the Nasdaq board.²⁵⁴

On May 3, 2001, Nasdaq used the net proceeds from the sale of the subordinated debentures to purchase 18,461,538 shares of Common Stock from the NASD for \$13 per share for an aggregate purchase price of \$239,999,994. These repurchased shares have been cancelled and are no longer outstanding. As of May 4, 2001, NASD owns thirty-one percent of Nasdaq assuming all warrants are fully exercised.

Among the purposes of the demutualization of Nasdaq are to permit the NASD to focus more intently on its original mission of being a membership-focused organization; to streamline corporate governance; and to create a financially stronger Nasdaq better able to address competitive challenges and invest in new technology.²⁵⁵ The Nasdaq board will be restructured prior to its registration as an exchange. Currently, all ten members of the Nasdaq board sit on the NASD board. It is contemplated that the Nasdaq board will be increased by four members who will not serve on the NASD board, two of whom will be industry members and two of whom will be nonindustry members.²⁵⁶

B. Futures Exchanges

(1) CBOT

The CBOT was established in 1848 and is the world's oldest derivatives exchange.²⁵⁷ It was the world's largest futures exchange, until its volume was eclipsed by Eurex in 1999.²⁵⁸ At its inception, the CBOT traded only agricultural futures contracts, but in 1975 it expanded to include financial futures, including the U.S. Treasury

253. *Id.*

254. *Nasdaq Expands Board—Positioning For Its Anticipated IPO and Nasdaq's Global Expansion*, PR Newswire, May 2, 2001.

255. See Ewing, *supra* note 249.

256. See *id.*

257. ABOUT CBOT, CBOT TODAY, ORGANIZATIONAL PROFILE, available at <http://www.cbot.com/cbot/www/page/0,1398,10+10+83,00.html> (last visited Nov. 2, 2000) [hereinafter ORGANIZATIONAL PROFILE].

258. See Silvia Ascarelli & Peter A. McKay, *CBOT Directors Agree to a Eurex Partnership*, WALL ST. J., May 19, 1999, at C21.

Bond futures contract and in 1997 it launched futures and futures-options contracts based on the Dow Jones Industrial Average.²⁵⁹ For decades, the primary method of trading at the CBOT was open outcry where traders meet face to face in trading pits.²⁶⁰ In 1994, the CBOT launched an electronic trading system called Project A, and in August 2000 replaced Project A with a/c/e electronic trading platform (alliance/CBOT/Eurex).²⁶¹

The CBOT is a membership Association which has over 3,600 individual members.²⁶² The eighteen director Board includes nine elected directors who are full members of the CBOT, of whom two are nonresidents of the Chicago area; four nonmember directors nominated by the President and approved by the Board; and two associate members.²⁶³ However, under a new for-profit structure, the board will be reduced to nine members, two of whom will be independent.²⁶⁴

In recent years there have been some severe governance upheavals at the CBOT as a reaction to competition and technological changes. The precipitating cause of these upheavals is competition to the CBOT's floor based, open outcry trading system coming from electronic exchanges, including new trading systems designed by CBOT's members. In 1998 there were merger talks between the CBOT and the CME, but the CBOT pulled out.²⁶⁵ Then in early 1998, Eurex, the all-electronic German/Swiss derivatives exchange, began talks with the CBOT regarding a joint venture creating a single global electronic trading system to replace Project A (the CBOT's then interactive computerized trading system).²⁶⁶ Two years later, CBOT members voted to discontinue the proposed alliance only to reconsider it six months later. Finally, on August 28, 2000, the CBOT Eurex Alliance was launched.²⁶⁷ The alliance

259. ORGANIZATIONAL PROFILE, *supra* note 257.

260. *Id.*

261. *Id.*

262. Of these, 1,402 are full members. There also are associate members, which have fractional membership participations. See Amendment No. 4, Form S-4 CBOT Registration Statement, available at <http://www.sec.gov/Archives/edgar/data/117463/00009501310501062/0000950131-01-501062.txt>, at 124 [hereinafter CBOT S-4].

263. *Id.* at 97.

264. *Id.*

265. See Terzah Ewing, *Idea of Merging CBOT, CME Gains Support*, WALL ST. J., July 13, 1998, at C1; Jim Kharouf, *Merger Talks For Real This Time?*, FUTURES (Oster), Sept. 1, 1998; *Board of CBOT Calls Off CME Back-Office Alliance*, WALL ST. J., Sept. 3, 1998, at C20.

266. ABOUT CBOT ANNUAL REPORT THE 1999 ANNUAL MESSAGE FROM THE CHICAGO BOARD OF TRADE CHAIRMAN AND PRESIDENT, available at <http://www.cbota.com/annual/main.html> [hereinafter 1999 ANNUAL MESSAGE].

267. CBOT Eurex Successfully Launch a/c/e—alliance/cbot/eurex, Aug. 28, 2000, available at http://www.cbota.com/cbot/www/cont_detail/0,1493,11+24+108+863,000.html.

provides investors with the "opportunity to trade the most active futures and options products in the world from a single screen."²⁶⁸ While the exchanges share technology and operating costs, the CBOT and Eurex will remain completely separate entities and each will receive all profits generated by its products.²⁶⁹ In connection with the close vote on the initial rejection of a joint venture between the CBOT and Eurex (450 to 390),²⁷⁰ there was a contested election for the CBOT chairmanship. David Brennan ("Brennan"), a soybean trader who wanted to retain open outcry trading in the pits won this election.²⁷¹ Then, there was an effort by Brennan to oust the President, Thomas Donovan ("Donovan"), a career employee, which was not immediately successful, but Donovan retired thereafter.²⁷² At the end of 2000, Brennan lost the CBOT chairmanship in another contested election (in a vote of 557-5/6 to 550) to Nikolas J. Neubauer.²⁷³ Thereafter, David J. Vitale, a long time Chicago bank executive, was appointed President and CEO.²⁷⁴

Competitive threats from Eurex and other electronic futures exchanges led to proposals for restructuring the CBOT with a view toward its demutualization. According to the CBOT, "institutional investors are demanding greater liquidity, lower cost and more efficient trade execution, enhanced access and a sophisticated supporting infrastructure."²⁷⁵ Further, new electronic markets are delivering such services in a more nimble and focused way than traditional open outcry exchanges.²⁷⁶ Therefore, a restructuring of the CBOT to transform it into a demutualized publicly traded company is ongoing.

The restructuring initiatives are designed to accomplish several objectives. First, the CBOT will be demutualized by converting it

268. 1999 ANNUAL MESSAGE, *supra* note 266.

269. *Id.*

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

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

272. See Greg Burns, *Talk of Move to Oust Donovan Rocks the CBOT*, CHI. TRIB., Apr. 15, 1999, at 1; Peter A. McKay, *Donovan Resigns as CBOT President and CEO*, WALL ST. J., Apr. 17, 2000, at C19.

273. *Nickolas J. Neubauer Elected Chairman of the CBOT*, available at http://www.cbpt.com/cbot/www/cont_detail/0,1493,11+24+108_1811,00.html (last visited June 15, 2001).

274. *CBOT Announces Appointment of David Vitale as President and CEO*, Feb. 20, 2000, available at http://www.cbpt.com/cbot/www/cont_detail/0,1493,11+24+108+2410,00.html (last visited June 15, 2001).

275. CBOT S-4, *supra* note 262, at 37.

276. *Id.*

from a nonstock, not-for-profit corporation into a stock, for-profit corporation and distributing shares of common stock of the for-profit CBOT to the current CBOT members. Second, the CBOT's corporate governance structure will be modernized by substantially eliminating the membership petition process, streamlining the Board of Directors and making certain other changes to improve the efficiency of the CBOT's corporate decision-making process while creating certain "core rights" including a member fee preference and trading pit preservation measures which cannot be altered without member approval. Finally, the CBOT's electronic trading business will be reorganized and consolidated.²⁷⁷

Following a period of review, it is expected that the SEC will declare the CBOT's Registration Statement effective and the CBOT will submit the restructuring transactions detailed therein to a member vote. Once the approval of the membership has been obtained and other conditions have been satisfied, the CBOT will convert to a for-profit corporation and shares of stock in that corporation will be distributed to CBOT members. Shortly thereafter, the Board of Directors of the CBOT will be reduced from eighteen members to nine members as the result of a shareholder election. In mid-2000, the CBOT reincorporated in Delaware in order to enhance its corporate flexibility, with a view toward pursuing its restructuring initiative.²⁷⁸

(2) CME

The CME is an outgrowth of the Chicago Produce Exchange which was established in 1874 to provide an organized market for butter, eggs, poultry and other farm products.²⁷⁹ In 1898 a division of the Produce Exchange formed The Chicago Butter and Egg Board, and in 1919 the name of this Board was changed to the Chicago Mercantile Exchange.²⁸⁰ In 1969 the Chicago Mercantile Exchange Trust was established to provide discretionary financial assistance to customers of any clearing firm which should become insolvent.²⁸¹ In 1972 the International Monetary Market (IMM) was created with the trading of seven foreign currencies.²⁸² This trading followed the demise of the Bretton Woods Agreement fixing international

277. Letter from Nikolas Neubauer, CBOT, to CBOT Members, *available at* http://www.cbtc.com/cbot/www/cont_detail_0,1493,11+24+108+2175,00.html (last visited June 15, 2001).

278. *Id.*

279. CHI. MERCANTILE EXCHANGE, HISTORY OF INNOVATION, *available at* http://www.cme.com/about_cme/about_history.cfm (last visited Nov. 2, 2000).

280. *Id.*

281. *Id.*

282. *Id.*

exchange rates, and transformed the CME into the first major futures exchange to apply to financial instruments the principles of futures markets.²⁸³ A decade later, in 1981, cash settlement of futures contracts, instead of physical delivery, was inaugurated.²⁸⁴ In 1982 the Index and Option Market (IOM) division was formed for the purpose of listing index and options contracts.²⁸⁵ The first contract traded on the IOM was the Standard & Poor's 500 (S&P 500) futures contract.²⁸⁶

In 1984, the CME and Singapore Monetary Exchange (SIMEX) instituted their mutual offset system, the first international linkage between exchanges.²⁸⁷ In 1987, in conjunction with Reuters Holdings PLC, the CME pioneered GLOBEX, the first worldwide after hours electronic trading system.²⁸⁸ In 1995, the CME launched the Growth and Emerging Markets (GEM) division to provide access to investment in emerging market countries.²⁸⁹ In 1998, the CME launched GLOBEX2 based on a technology swap with the Paris Bourse and MATIF.

Until its recent demutualization, the CME was an Illinois Corporation, incorporated as a not-for-profit company, and owned by its members who had purchased exchange seats.²⁹⁰ There were four categories of memberships: full CME seats; IMM seats; IOM seats and GEM seats. Board membership was required by the CME's Rules to be composed of twelve CME members elected by CME members; eight IMM members elected by IMM members; four IOM members elected by IOM members and up to ten persons appointed by the Chairman and approved by the Board.²⁹¹

Further, the CME Board was required to have a meaningful diversity of interests, including: floor brokers; floor traders; futures commission merchants; producers, consumers, processors, distributors, and merchandisers of commodities traded on the CME; participants in a variety of pits or principal groups of commodities traded on the CME; and other market users or participants. To the extent that no elected director represented one of the interests listed

283. CHI. MERCANTILE EXCH., ABOUT THE EXCHANGE, BACKGROUND ON CME, ITS MEMBERSHIP AND ITS PRODUCTS, *available at* <http://www.cme.com/exchange/back2000.html> (visited Nov. 26, 2000).

284. *Id.*

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

289. *Id.*

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

291. CME Rule 210. *See also* CHI. MERCANTILE EXCH. CME RULEBOOK (2001), *available at* <http://www.cmerulebook.com> (last visited Oct. 26, 2001).

above, a person representing such interest was required to be appointed to the Board. At least ten percent of the regular voting members of the Board were required to be comprised, where applicable, of persons representing farmers, producers, merchants or exporters of principal commodities underlying contracts traded on the CME. In addition, at least twenty percent of the regular voting members of the Board were required to be comprised of persons who were not members of the CME, currently salaried employees of the CME, primarily performing services for the CME in a capacity other than a member of the Board, or officers, principals or employees of a firm which holds a membership at the CME either in its own name or through an employee on behalf of the firm.²⁹²

On November 13, 2000 the CME became the first U.S. futures exchanges to demutualize, in a restructuring designed to streamline its decision-making processes and change its financial model by converting memberships into shares with trading rights in CME products, as well as into shares representing pure equity.²⁹³ CME converted itself into a publicly held, for-profit corporation in several steps. The original Illinois not-for-profit corporation initially was merged into a new Delaware nonstock corporation and immediately thereafter into a stockholder-owned, for-profit Delaware corporation. In a final step, CME then issued Class A and Class B shares. Both classes of stock have the traditional features of common stock; however, the primary purpose of the Class B stock is to confer trading privileges associated with exchange membership. The transaction did not represent an initial public offering (IPO).

As a result of the demutualization, 25,855,200 shares of Class A common stock were allocated on a 3-2-1 basis to members of the CME, International Monetary Market (IMM) and Index and Option Market (IOM) divisions. In addition, 4,722 shares of Class B common stock were issued to exchange members in series corresponding to the former membership divisions. Each CME member received a B-1 share, each IMM member received a B-2 share, each IOM member received a B-3 share, each member of the Growth and Emerging Market (GEM) division received a B-4 share, and those holding a fractional interest in a GEM seat received a B-5 share. Each B series share confers the trading privileges associated with the membership interests that are converted into that series, along with the traditional features of common stock.

292. *Id.*

293. Press Release, CME, CME Becomes a For-Profit Corporation, Nov. 13, 2000, available at http://www.cme.com/shownews.cfm?NewsItem=002AB00-EA20_IA54_B30D80C59A2800 (visited Nov. 20, 2000).

Class B shares are traded much the way memberships or "seats" on the exchange were traditionally bought and sold. CME's Membership Department posts bids and offers. The value of Class B shares, as determined by the market, are based on the value of the trading right and of the A share equivalents bundled with the trading right. Class A shares are subject to trading restrictions which will be lifted gradually over a period of fifteen months after the demutualization transaction. For example, after six months, shareholders can trade twenty-five percent of their initially allocated Class A shares. For the first six months following demutualization, Class A shares can be sold only in conjunction with a sale of the related Class B share. Such sales will occur through a process substantially the same as the process for selling existing membership interests (i.e., through the Membership Department). After six months, increasing portions of the Class A shares can be transferred independently of the associated Class B shares.²⁹⁴

The CME demutualization proceeded with over ninety-eight percent of the membership in favor under the direction of a new CEO, hired by the board rather than chosen by the members. It accomplished the transformation of the CME into a for-profit corporation headed in the direction of becoming a public company. In accordance with the restructuring, the existing thirty-nine-member board of directors will be reduced to nineteen members over a two-year phased reduction period. Following the 2002 election, the Board will be composed of nineteen directors: thirteen directors known as "equity directors" and six directors known as "Class B directors". The thirteen equity directors (consisting of one nonmember and six members or nonmembers, all serving two year terms) will be elected by the Class A and Class B shareholders from a slate proposed by the Board Nominating Committee. The six divisional directors (three CME, two IMM, and one IOM) will be voted by the Class B divisional shareholders from a slate proposed by the Divisional Nominating Committees.²⁹⁵ Class B shareholders will have rights to change certain "core rights," rights associated with trading privileges conferred by those shares, while Class A will not have this right. Therefore, although Class B shareholders will represent only

294. See QUESTIONS & ANSWERS ON THE DEMUTUALIZATION OF THE CHICAGO MERCANTILE EXCHANGE INTO CHICAGO MERCANTILE EXCHANGE INC., available at <http://www.cme.com/exchange/demutualizequestions.html>.

295. Memorandum from Ann M. Cresce, Corporate Secretary, CME, to All CME Members (Oct. 10, 2000), available at <http://www.cme.com/allaire/spectra/system/securemediastore/20001010ELECTION.pdf>. The GEM division will not elect any Class B director. Finally, after the 2002 election, there will be no "appointed directors."

approximately ten percent of the overall equity interest, such voting rights offer Class B shareholders some ability to block changes.²⁹⁶

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

C. Models for Self-Regulation

(1) *Conflicts of Interest*

One of the more contentious questions under discussion concerning exchange demutualization is the future of self-regulation. The issue is whether a commercial entity carrying on the business of running an exchange and seeking to protect and promote its business can continue to support the integrity and efficiency of the trading markets by setting and enforcing appropriate regulations in the public interest.²⁹⁷ It can be argued that there would be conflicts of interests between shareholders and members in a demutualized exchange environment that would diminish the ability of exchanges to engage in effective self-regulation. A potentially serious conflict is the regulation of an ATS market by the NYSE or NASD. These conflicts could become manifest in discrimination through sanctions imposed in disciplinary proceedings, unfairness in not being permitted to participate in particular activities or discrimination with respect to fees charged.²⁹⁸ This is perhaps a more serious problem at the NASD than the NYSE because all broker-dealers are compelled to join the NASD. Further, securities firms are concerned about the costs of multiple SROs, especially if several ATSS become exchanges and begin to engage in self-regulation. Therefore, some industry members argue in favor of a single SRO for exchanges and member firms.

The NYSE and NASD engage in self-regulation in four areas: listed company governance and disclosure; surveillance and discipline of their markets and specialists, floor brokers and market makers; member firm financial and operational compliance; and fair and equitable treatment of customers. Commodities exchanges are not

296. Annual Meeting and Board Election Set for April 18, 2001, CFTC, Memorandum from the Division of Trading and Markets Re: The Chicago Mercantile Exchange's Proposed Demutualization Plan, to the Commission, *available at* http://www.cftc.gov/tm/tmce_demutualization_memo.html (visited Nov. 14, 2000).

297. See INT'L ORG. OF SEC. COMM'NS TECHNICAL COMM., DISCUSSION PAPER ON STOCK EXCHANGE DEMUTUALIZATION 3-4 (Dec. 2000), *available at* http://www.iosco.org/docs-public-2000/2000-stock_exchange_demutualization.html [hereinafter IOSCO DISCUSSION PAPER].

298. *Id.* at 19.

engaged in issuer corporate governance regulation, but they regulate their markets and members. Also, both the NYSE and NASD run arbitration facilities for disputes between members and disputes between members and customers, but customer reparations proceedings against commodities intermediaries can be prosecuted before the CFTC.

The NASD membership has always been more diverse than the NYSE and is not pre-selected. Further, it has a nationwide organization with some local autonomy. At the NYSE's New York location, more exclusive membership and domination by the industry's largest firms has given its inspection and regulatory operations a different cast than that of the NASD. Further, in a financial crisis, the NYSE's ties to the New York Federal Reserve Bank have been important.²⁹⁹

NYSE listing requirements go back to the nineteenth century and stem from a concern about the quality of the securities sold on the exchange. These requirements were intended to facilitate an efficient, continuous auction market by setting minimum numerical standards for capitalization, number of shares and shareholders, by establishing disclosure requirements and by specifying certain shareholder protection or corporate governance mechanisms.³⁰⁰ The NYSE developed these requirements because it recognized that standards were good for its business and could give the exchange a competitive advantage.³⁰¹ When Nasdaq was organized as an electronic market, it also established listing qualifications in order to preserve and improve the quality of and public confidence in its market.³⁰²

If the NYSE and Nasdaq become public companies it will perhaps be anomalous for them to negotiate listing agreements with themselves and then supervise continuing compliance with such agreements. For this reason, when the Stockholm and Australian Stock Exchanges went public, government regulators were assigned the task of overseeing exchange disclosure to shareholders.³⁰³ On the other hand, the NYSE and Nasdaq will continue to have a motivation to market their exchanges as lists of quality issuers. At least one commentator has argued that the benefits of increased capital mobility would be better realized through regulatory decentralization

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

300. See Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. LAW 1461, 1465 (1992).

301. *Id.*

302. See NASD RULES 4300, 4310, NASD MANUAL (CCH) at 5271-79.

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

than greater centralization. Under a decentralized model, exchanges should be the primary writers and enforcers of rules relating to disclosure by listed companies, standards of conduct for member broker-dealers and for market structure.³⁰⁴

When an exchange becomes a for-profit public company there are some new conflicts that could call into question its regulatory role with regard to issuer corporate governance. If an exchange enters or considering entering into a joint venture with a listed company, it might be tempted to under regulate that company. Conversely, an exchange could behave in a discriminatory way toward a competitor. For example, Instinet, a direct competitor of the NYSE and NASDAQ is now a public issuer.³⁰⁵ It may well wonder if it will be treated on an equal footing with other listed companies.

Many corporate governance listing standard questions arise in the context of contests for corporate control. Demutualized exchanges tend to have corporate governance provisions to prevent any shareholder from having more than a specified percentage stock ownership, thus insulating them from being taken over.³⁰⁶ Would such an issuer continue vigorously to enforce corporate governance standards preventing companies from adopting certain poison pills in response to a hostile takeover bid without shareholder approval?³⁰⁷

Broker-dealer regulation by exchanges has its roots in efforts to assure the credit worthiness of exchange members. This continues to

304. See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997). The author has examined this aspect of exchange demutualization at greater length in Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325 (2001).

305. On May 9, 2001 Instinet, a Delaware limited liability company, converted into a Delaware corporation, Instinet Group Incorporated. Shortly thereafter, on May 18, 2001, Instinet Group Incorporated announced that its shares commenced trading on the Nasdaq stock market under the symbol "INET" after its registration statement relating to the initial public offering of 32,000,000 newly issued shares of common stock was declared effective by the SEC. The underwriters have an option to purchase an additional 4,800,000 shares to cover over-allotments. Instinet used approximately \$150 million of the IPO proceeds to repay its indebtedness to Reuters Group PLC ("Reuters") for an advance used in May 2001 to fund a simultaneous return of capital to Reuters. Following completion of the IPO, Reuters will hold 86.6% of Instinet's share capital (approximately eighty-five percent if the underwriters exercise their over-allotment option). INSTINET GROUP INC., 2001 PROSPECTUS (May 18, 2001), available at <http://www.investor.instinet.com/edgar.cfm>.

306. Nasdaq has a five percent voting limit in its certificate of incorporation. See *supra* note 253. The CME now has limits on shareholder transfers. See *supra* note 294. The purpose of such limits are, in part, to prevent an exchange from falling into the wrong hands. Because exchange members were licensed prior to demutualization, there are not statutory restrictions limiting controlling persons of exchanges to persons meeting regulatory approval standards, but this is a likely future probability.

307. See NYSE LISTED COMPANY MANUAL, §§ 308, 312.03 (1999), available at <http://www.nyse.com/listed/listed.html>.

be a significant issue and an important aspect of NYSE and NASD regulation. In that regard, the NYSE has developed a competence in examining and assuring the financial viability of its large member firms that would not easily be duplicated by a single SRO, located in Washington, D.C., and indirectly run by the SEC. Moreover, now that securities firms, banks and insurance companies can operate in a single holding company, the Federal Reserve Board, as an umbrella regulator, will be weighing in heavily on securities industry capital adequacy questions.³⁰⁸ When the NYSE or NASDAQ go public, it is likely that clearing member firms will be large stockholders. This will give them an incentive to maintain high standards of financial and operational capabilities for member firms. The changing nature of ownership may create some new conflicts of interest, but others will be resolved because market makers and floor members will have a diminished role in exchange governance. This is also true for demutualized commodities exchanges. The creation of a single SRO would not solve conflicts among members regarding appropriate capital adequacy rules.

What could call into question continued capital adequacy regulation is the changing structure of financial services regulation. Functional regulation is now the prevailing mode of developing and enforcing capital adequacy regulations. Although the SEC adopts net capital rules for securities firms, it relies upon the NYSE and NASD to conduct broker-dealer examinations and enforce capital requirements. But the emergence of huge financial conglomerates may raise questions as to the effectiveness and adequacy of this scheme. Financial holding companies need to manage complicated risk on a global basis. Whether the wide array of financial regulators for these holding companies will be able to cooperatively develop new standards for measuring risks on a global basis and then garner the talent to examine firms and enforce financial regulations is an open question.

The incentive of the NYSE and Nasdaq to police their markets for manipulation, and their effectiveness in doing so, would probably be greater following a public offering than it is today. There should be fewer conflicts of interest in policing the markets if ownership of these SROs is spread beyond those concerned with making markets. Since Nasdaq is a dealer market and the NYSE is a specialist system, the creation of a single SRO to oversee these two markets is unlikely to create any economies of scale and could well be counterproductive. Even if the SEC succeeds in mandating or fostering the creation of

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

new mechanisms for linking exchange and OTC markets,³⁰⁹ it is unlikely that these markets will lose their particular characteristics.

The changing structure of the securities trading markets have raised a host of issues detailed in Parts II—IV of this article that competing SROs will be unable to solve. Although a single SRO might be better able to develop inter-market solutions to problems that cut across markets, joint SRO plans, like the CTA, are now unraveling. The real issue is whether regulatory solutions to these issues are needed or their resolution should be left to the market. This depends, in part, on whether the price discovery mechanism for equities is a natural monopoly in the sense that however many orders and intermediaries are formed into pools of liquidity, there is a public interest need to consolidate orders in a transparent system. Alternatively, can the trading markets be fragmented and still function in a fair and efficient manner?

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

(2) *Competing Models*

The Securities Industry Association's (SIA) Ad Hoc Committee on the Regulatory Implications of De-Mutualization has determined guiding principles for analyzing an appropriate SRO structure and has suggested six different models for future regulation of the securities industry.³¹⁰ The SIA's Ad Hoc Committee's guidelines for evaluating regulatory options state that any regulatory structure should foster investor protection; preserve fair competition; eliminate inefficiencies; encourage expert regulation; promote reasonable and fair regulatory costs; foster due process; and encourage industry participation and self-regulation.³¹¹ The five models the Committee

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

310. SIA WHITE PAPER, *supra* note 162.

311. See *id.* at 1.

put forward are, in addition to status quo, (1) Multiple Exchanges with Separate Boards and Information Barriers for Their Regulatory Arms (NASDR Model); (2) Multiple SROs with Firms Designated to a Single SRO for Examination Purposes (DEA Model); (3) One SRO for Member Firms; Markets Regulate Their Own Trading (Hybrid Model); (4) All Purpose Single SRO (Single SRO Model); and (5) Single Regulatory Organization (SEC-Only Model).³¹²

The SIA's Ad Hoc Committee endorsed the Hybrid Model in which there would be a central SRO responsible for firm oversight and cross market issues, including rules generally applicable to all markets.³¹³ Individual market SROs would then be responsible for market-specific rules, including rules regarding trading and listing.³¹⁴ Cross-market rules would include front running, manipulation, free-riding and withholding rules, sales practice regulation, industry admission standards, financial responsibility requirements, training and supervision and recordkeeping.³¹⁵ Arguments in favor of the Hybrid Model are that this model would improve regulation, decrease regulatory costs, preserve the synergy between markets and market-specific oversight, foster competition and continue self-regulation.³¹⁶ On March 22, 2000 the SIA board of directors endorsed the Hybrid Model.³¹⁷ One reason for this endorsement is that the securities industry would like to avoid duplication of examinations and inconsistent regulation. In that connection, the White Paper advocates a single, independent arbitration forum.

The NASD has been pushing for a Single SRO model and the Chairman of the SEC briefly embraced this model.³¹⁸ One of the problems with this model is that the NYSE opposes it.³¹⁹ Another problem is that the SEC does not have the statutory authority to impose corporate governance requirements on listed companies and

312. *See id.* at 5.

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

314. *See id.* at 2.

315. *See id.* at 3.

316. *See id.* at 5.

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

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

319. See Lisa L. Fried, *Plans Debated for Stock Markets' For-Profit Conversion*, N.Y.L.J., Sept. 30, 1999, at 5; Richard A. Grasso, Testimony before the Sen. Banking Comm. (Sept. 28, 1999), available at <http://www.nyse.com/speech/NT000245.html>.

neither would a free standing Single SRO.³²⁰ Further, although the SEC might find it convenient to oversee a sole self-regulator, the SEC might be tempted to make it an arm of the government, rather than a true self regulator. Yet, SROs do not afford those they discipline the protections of persons who are investigated or prosecuted by government officials.³²¹

One of the goals of the Exchange Act is "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."³²² For the SEC to suppress or eliminate competition among SROs could be contrary to this goal because an important function of an exchange is self-regulation.³²³ On the other hand, an ATS regulated as a member of an exchange could complain of unfair competition, and yet find it uneconomical to become a full service SRO. Further, although the benefits of regulatory competition are often touted, regulatory competition can be unseemly and destructive of public confidence in the regulators. Given the serious fissures within the securities industry at the present time, the Hybrid Model seems the most likely solution to self-regulation after demutualization if the NYSE can be persuaded to endorse some version of this model.

One of the many difficulties with any new SRO structure is adequate funding. Currently, SROs rely on four primary sources for their funding: (1) Regulatory fees and assessments paid by SRO members; (2) transaction services fees; (3) listing fees; and (4) market information fees.³²⁴ The continued viability of all of these fees in rapidly changing market conditions is unclear. The SEC has issued a complex and provocative release on some of these fees, and however uncomfortable the SEC may be with establishing fees for market users, this is an issue that will not disappear.³²⁵ Clearly, rigorous, expert and fair regulation is not possible unless SRO regulation is adequately funded. But after demutualization, subsidizing general broker-dealer enforcement activities through fees other than regulatory assessments of members may prove difficult. On the other hand, the exchanges could try to make fines and penalties a profit stream and this would raise a variety of new questions and problems. This suggests that the securities industry is likely to focus on the costs of duplicative self-regulation.

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

321. See, e.g., In the matter of Stephen J. Gluckman, Exchange Act Release No. 41,628, 70 SEC DOC. 323 (July 20, 1999).

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

323. See *id.*, § 6(b).

324. See SIA WHITE PAPER, *supra* note 162, at 35.

325. See Exchange Act Release No. 42,208, 64 Fed. Reg. 70,613 (Dec. 17, 1999).

The futures industry could perhaps move more easily to a sole self-regulator than the securities industry because the NFA already exists and has statutory recognition. But neither the CME or CBOT have determined to contract out their regulatory functions. Further, such a contracting out raises issues regarding the exchange's continuing responsibility over its contractor and the relationship of both entities to a government regulator.³²⁶ Demutualization of futures exchanges and their need to face competition from electronic exchanges has highlighted another problem — the need to level the playing field between traditional exchanges and ATSs by decreasing government regulation of exchanges.³²⁷ The SEC has recognized this challenge in fashioning Regulation ATS,³²⁸ but it has not dealt with the need to significantly change its regulation of traditional exchanges. Yet, if exchanges no longer enjoy a monopoly (or near monopoly) of trading the stocks of their listed issuers, or trading other financial products, much less government regulation is needed because competition can substitute for government regulation. The CFTC has been pushed in the direction of turning more front line regulation over to exchanges, but the SEC has been engaged in more intrusive market regulation. One possible regulatory model that could result from the demutualization of exchanges is the transfer of regulation from SROs to the SEC. But self-regulation is so enshrined in U.S. securities regulation it is unlikely and probably not in the public interest for it to be supplanted by government regulation. Indeed, greater devolution of regulatory responsibilities from the SEC to exchanges, as is happening in commodities regulation, could be more in tune with political realities in a global capital market.

Conclusion

Today's markets are changing so rapidly that it is impossible to predict tomorrow's market structure or its regulation. New exchange governance and regulatory structures generally have been precipitated by scandals or a financial crisis, so reform of existing exchange models is likely to be shaped by political and economic problems as much as by strategic business planning. Although the diversification of exchange boards has strengthened them, those who make markets still have the greatest interest in maintaining efficient, fair and liquid pricing mechanisms. Much of the competition to the NYSE and Nasdaq in recent years has come from new electronic marketplaces that have taken advantage of uneconomical spreads by

326. See IOSCO DISCUSSION PAPER, *supra* note 297, at 8.

327. See *Oversight Function for CFTC Emerging as Congress Seeks to Renew Mandate*, 32 Sec. Reg. & L. Rep. (BNA), at 92 (Jan. 24, 2000).

328. See Adopting ATS Release, *supra* note 7, at 70,846.

the primary markets. Now that trading costs have declined due to decimalization, some of these competitors will not survive. A similar dynamic is at play concerning the trading of financial futures. In time it is likely that the NYSE and CBOT will move to electronic trading systems and their floors will disappear. But this is not a decision that should be made or forced by government regulators. Further, it does not follow that the NYSE and CBOT will cease to be primary markets.

There seems to be a general assumption that the market structure changes rocking the security industry are harbingers of an inevitable cataclysm that will swallow up the NYSE floor-based specialist system and the NASD market maker system. Further, demutualization seems to be, at least in part, a cover for shifting the power structure of the NYSE and Nasdaq further away from the specialists and market makers to the large securities firms. This does not mean that the markets of the future will be a "black box" that does not require dealer intervention or that demutualization will solve the economic and power struggles taking place in the financial services industry.

The ATS electronic systems have not yet become primary markets and therefore their successful operation as price setting mechanisms is uncertain. In that connection, the SEC is unlikely to allow the market for U.S. equities to seriously fragment to the detriment of retail investors.³²⁹ Also, the success of ATSs in the OTC market is due in part to a shift in the ratio of dealer to agency transactions, and this shift may not be necessary to achieve optimal efficiency in the NYSE market.³³⁰ In addition, the viability of ATS electronic markets have not yet been tested by a violent market break or a serious and prolonged bear market. In volatile markets, the need for the negative and affirmative obligations imposed upon specialists is significant, and it is unclear how markets will be held to a fair and orderly standard in the absence of such dealer intervention. If traders can no longer make money on spreads they will make money by exploiting time and place advantages, and such unfair and inequitable conduct will sooner or later attract the attention of regulators.³³¹

For all of these reasons it is hard to predict the future structure of the securities markets and the future governance and regulation of

329. See NYSE Rulemaking: Notice of Filing of Proposed Rule Change By the New York Stock Exchange, Inc To Rescind Exchange Rule 390, Exchange Act Release No. 42,450 (Feb. 23, 2000) available at 2000 WL 202094.

330. See GUY MOSZKOWSKI ET AL., SOLOMON SMITH BARNEY EQUITY RESEARCH: UNITED STATES, TRADING UP—THE EQUITY MARKETS AND THE NEW WORLD OF ELECTRONIC TRADING 20-21 (Oct. 5, 1999).

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

stock exchanges. While writing this article, the author has been challenged to set forth a vision of the future structure of the trading markets and appropriate new SRO models. But at this time, when markets, financial intermediaries and regulators are all being buffeted by vigorous economic and political forces of change, it is difficult enough to formulate regulatory issues and impossible for any one person to have the answers to the questions being raised.

Issues about exchange governance probably do not have to be fully resolved prior to demutualization because one of the objectives of demutualization is to streamline governance and base it upon stock ownership rather than constituency representation of member firms. A period of trial and error can be expected and should be welcomed. Issues concerning the balance between government regulation and self-regulation and the regulatory implications of demutualization may be more urgent because the SEC may not allow the exchanges to demutualize unless it is satisfied with the securities industry's new self-regulatory structure.³³² It would be a mistake, however, for the SEC or CFTC to force a new system of self-regulation on evolving exchange markets. If a demutualized NASD operates by separating its SRO and market functions and other exchanges do not, time will judge which system produces better markets and better regulations. The form of tomorrow's trading markets should be permitted to evolve before the existing SRO structure is endorsed, dismantled or otherwise adjusted to compliment a new market structure.

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

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

takeover targets, and what lines of business they should be allowed to enter.

During the 1990s, for political and economic reasons, business enjoyed the public's respect and entrepreneurship was fashionable. If there is a prolonged stock market decline and an economic recession, public perceptions might shift. A nonprofit organization enjoys a greater aura of acting in the public interest than does a for-profit corporation.

There is a risk that turning exchanges into ordinary public companies will undermine public confidence in these symbols of capitalism. Yet, this is the price exchanges may have to pay to assure their future survival.