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REGULATION NMS: HAS THE SEC EXCEEDED ITS CONGRESSIONAL MANDATE TO FACILITATE A "NATIONAL MARKET SYSTEM" IN SECURITIES TRADING?

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In 1975, after active and far reaching hearings on the nation's securities markets, Congress adopted significant amendments to the Securities and Exchange Act of 1934. The amendments marked a major turning point in the regulation of the securities industry. Congress "directed" the Securities and Exchange Commission to "facilitate the establishment" of a "national market system" for the trading of securities.[1] The mandate still dominates the SEC's regulatory philosophy. The SEC has ceremonially referenced the mandate—abbreviated to the now well known acronym "NMS"—in most all its rule proposals or concept releases on market structure.[2]

What is curiously absent, however, in SEC releases and in the literature in general on market structure is any close analy-

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1. Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(a)(2) (2004).

2. The newest SEC rule-making initiative uses an abbreviation of the Congressional language in its title, proposed "Regulation NMS." *See* Regulation NMS, Exchange Act Release No. 34-50,870, 69 Fed. Reg. 77,424 (Dec. 27, 2004). The first version of the proposal had an extended discussion of the national market system. *See* Regulation NMS, Exchange Act Release No. 34-49,325, 69 Fed. Reg. 11,126 (Mar. 9, 2004). The other major milestones in the SEC's development of the NMS are the creation of the consolidated system from disseminating market information in the 1970s, the incorporation of Nasdaq securities into the NMS in the 1980s, and the adoption of the Order Handing Rules in the 1990s. *Id.*

sis on the contours of the Congressional mandate. The issue is particularly poignant at present, given the SEC's current proposed Regulation NMS, which, if implemented, would effect a major overhaul of the structure of our public trading markets.[3]

The 1975 Congressional amendments vested substantial discretion in the SEC to flesh out and implement Congress's admittedly hazy, inchoate vision of what a national market system ought to be. Congress did indicate unequivocally that it was directing the SEC to make progress on two fronts. First, Congress directed the SEC to encourage better communication among the various markets. Second, Congress directed the SEC to eliminate inappropriate burdens on competition among securities trading market centers.

The SEC was, after its successful attack on fixed brokerage commissions in 1975,[4] very deliberate in pursing the second objective. It waited, for example, until 2000 to eliminate the last vestiges of the New York Stock Exchange's off-board trading restrictions.[5] Critics have, over the years, disparaged the

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3. *See* Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2 (reproposing Exchange Act Release No. 34-49,325.)

4. For a discussion of fixed commission rates, *see, e.g.*, William F. Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675 (1970); G. William Schwert, *Pubic Regulation of the National Securities Exchanges: A Test of the Capture Hypothesis*, 8 BELL J. ECON. 128 (1977). On May 1, 1975, NYSE commission rates became freely negotiable and immediately dropped by about 25%. *See* Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J. L. & ECON. 273, 280 (1983).

5. *See* Order Approving Proposed Rule Change to Rescinded Exchange Rule 390, Exchange Act Release No. 34-42,728, 65 Fed. Reg. 30,175 (May 10, 2000). Prior to 1975, national stock exchanges had rules in place that prohibited their members from trading anywhere but on the exchange. For a discussion of the SEC's slow nibbling away at the prohibition that culminated with the 2000 release, *see* Mark Borrelli, *Market Making in the Electronic Age*, 32 LOY. U. CHI. L. J. 815, 838-840 (2001). Similarly, the NYSE retained a stringent version of Rule 500 governing the delisting of stocks, requiring a 66.6% vote of the outstanding shares and less than a 10% negative vote, until 1997. *See* NYSE Board Approves Revision to Rule 500 (Nov. 6, 1997), *available at* http://www.nyse.com/Frameset.html?displayPage=/Press/1055763411603.html; NYSE Approves Additional Revisions to Rule 500 (Oct. 1, 1998), *available at* http://www.nyse.com/Frameset.html?display Page=/Press/1055763411603.html. There are numerous other examples. It took the SEC 15 years to put in place a system of unlisted trading privileges in Nasdaq securities on the national exchanges. *See* Joint Industry Plan; Order Approving Proposed Reporting Plan for Nasdaq/NMS Securities, Exchange Act Release No. 34-28,146, 55 Fed. Reg. 27,917 (July 6, 1990).There

SEC's caution.[6]

The SEC has, however, been much more aggressive in acting on the first charge, moving quickly to establish market linkage systems and steadily nurturing and growing those linkages over time. Indeed, the SEC has been so active that, in my view, it has exceeded even the wide mandate of the 1975 legislation. Critics have been largely silent here.[7] Many have taken issue with the wisdom of specific SEC decisions, but few have questioned whether the SEC has the authority to do what it has done and is attempting to do.[8] This article develops this position.

The discussion will begin with the history and language of the 1975 amendments, followed by a summary of the highlights of the SEC's application of its power under the amendments. A section on a speculative alternative history concludes the analysis.

Before proceeding with the argument, however, a short note on the important subtleties on the issue of federal agency authorization. This article takes two distinct positions on authorization depending on the SEC regulation. First, the article argues that the SEC was operating outside its statutory authority when it approved the inter-market *order routing and execution* system. The proposed Regulation NMS "trade-through rules," discussed below, fall into this category. Second, the article argues that the SEC may have been operating inside its

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is some academic commentary that Congress and the SEC have miscalculated the costs and benefits of these types of exchange rules. *E.g.*, Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1456 (1997) (suggesting that rules may be consistent with shareholder welfare); Dale Oesterle, *Comments on the SEC's Market 2000 Report*, 19 J. CORP. L. 483 (1994) (discussing, in addition to NYSE Rules 360 and 500, the resistance to decimalization). In any event, this issue is reserved in this article.

6. *See* Borrelli, *supra* note 5; Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 316 (noting exchange rules against delisting and restrictions on off-board trading).

7. There are two important exceptions. *See* Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981); Walter Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233 (1975).

8. *See, e.g.*, 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).

literal grant of authority when it approved inter-market trade *reporting and quote display* systems, but that it has deviated from Congress's expressed hopes and goals when doing so, both in relying on single rather than competitive inter-market systems and in micro-managing the details of trading market structure in running those systems. The Regulation NMS quotation "access rules" and "market data" rules, discussed below, are in this category.

On the first argument, I do not and cannot claim that the federal courts, given their track record of deference to agency authority, will agree.[9] It is highly unlikely that any court will follow, or even listen to, this analysis. Nor will Congress act to bring the SEC into compliance with the '75 mandate, with new hearings and legislation; there is no current political interest in the issue. My claim is that of a resigned academic; in my view the agency has strayed outside its authority and we have come too far to do much about it—it is the proverbial water over the dam.

One could argue that my second claim is technically not an argument over legal authority at all but rather more like simple displeasure by a principal over the direction of decisions made by an authorized agent. The agent, although authorized in its action, has not been sympathetic to, or consistent with the principal's anticipated outcomes or its fundamental hopes and wishes. Congress thought the SEC would take a different approach than the one it took.

One could also take a third, more moderate, position, and simply note that, given the history outlined below, the SEC, although technically authorized to do what is has done, also has the authority to reverse its course. The SEC is not itself bound by its own past policy mistakes given its mandate. That is, the 1975 amendments do not *require* the course of action that the SEC has chosen to undertake. The amendments are open-ended enough to justify an SEC strategy that is much

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9. *See, e.g.*, Domestic Sec. v. SEC, 333 F.3d. 239, 248-249 (D.C. Cir. 2003) (deferring to SEC's approval of the Nasdaq Market Center Trading System, the successor to SuperMontage); NASD v. SEC, 801 F.2d 1415 (D.C. Cir. 1986) (deferring to SEC decision on NASD fees for ECN access to quotes on NMS securities). *See also* U.S. v. Chestman, 947 F.2d 551, 557-58 (2d Cir. 1991) (citing Chevron v. Nat. Resources Def. Council, 467 U.S. 837 (1984)) (deferring to SEC "legislative regulations" unless "arbitrary, capricious or manifestly contrary to the statute").

less market intrusive than the path it has chosen. The Commission is not bound to the past by a doctrine of precedent—*stare decisis*—as are the courts. It would take a very strong, dedicated SEC Chairman to reverse course, however, bucking those with vested interests in the current market structure. Again, this does not appear to be in the cards.

I.
THE HISTORY OF THE 1975 AMENDMENTS

In 1968 and 1969, brokerage houses on Wall Street went through what is now known as the "Back Room Crisis." Trading volume in shares increased exponentially at a time when the mechanism for settling or clearing trades still required the physical transfer of certificates from one place to another, and the creation and transfer of a flood of related papers (among other things, a floor report, a comparison, transfer instructions, contract sheets, and a settlement statement).[10] In the late 19'60s, the cumbersome physical process broke down and trades began to fail in extraordinary numbers.[11] The loss of control over securities also invited massive theft.[12] More than two hundred brokerage houses—some storied old houses—failed.[13]

Congress, looking for a culprit, asked the SEC to study the market activity of institutional investors.[14] The SEC produced its multi-volume 1971 Institutional Investor Study that largely let the institutional investors off the hook.[15] In the SEC's

10. *See* Marshall E. Blume et al., REVOLUTION ON WALL STREET: THE RISE AND DECLINE OF THE NEW YORK STOCK EXCHANGE 116-27 (1993). Professor Werner also attacks the Consolidated Tape Plan. Werner, *supra* note 7, at 1280-82.

11. BLUME, *supra* note 10, at 117 (noting that up to forty percent of trades failed).

12. From 1966 to 1970, the New York City Police estimated that $100 million worth of securities were stolen or just disappeared. The SEC and FBI valued the missing securities at $400 million. *Id.* at 121.

13. *Id.* at 120.

14. Pub. L. No. 90-438, 82 Stat. 453 (amending the Securities Exchange Act of 1934 to authorize an investigation of the effect on the securities markets of the operation of institutional investors).

15. Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, at ix (1971) (stating that institutions had only gradually increased their share of outstanding equity securities over time and their holdings were concentrated in the larger companies). The

transmittal letter to Congress, however, the SEC dropped a bombshell. The SEC came out in favor of "the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime."[16] The SEC sought the creation of an overarching communications system that would include all the existing exchanges and their specialists, over-the-counter market-makers, and anybody else for that matter, and in which dealers would compete with each other for order flow:

> The participation of competing dealers in the central market will . . . reduce the element of monopoly power which has accompanied past efforts to establish a central market and will make it possible for potential abuses of such monopoly power to be controlled not only by regulation but to an increasing degree by competition. An essential characteristic of such a system would be the prompt reporting of all securities trades to the public on a comparable basis . . . [O]ur objective is to see a strong central market system created to which all investors have access, in which, all qualified broker-dealers and existing market institutions may participate in accordance with their respective capabilities, and which is controlled not only by appropriate regulation but also by the forces of competition.[17]

Over the next few years the SEC conducted hearings aimed at defining what later came to be known as the "national market system" concept. The NYSE attempted first to stonewall the initiative,[18] and, when this failed, produced its own recommendation, known as the Martin Report, which called for all trading to be consolidated on one national exchange.[19] The SEC continued its campaign, issuing a State-

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study did ask for increased institutional reporting of securities holdings by institutional investors, however. *Id.* at x-xi.

16. *Id.* at xxii.

17. *Id.* at xxv.

18. BLUME, *supra* note 10, at 164.

19. William M. Martin, Jr., *The Securities Markets, a Report with Recommendations* (Aug. 5, 1971) (report to the NYSE Board of Governors recommending "the creation of a national market system [which] would provide one market for each listed security."). *Id.* at 5-6. The report added that the NYSE and

ment on the Future Structure of the Securities Markets in February, 1972. In the Statement, the SEC defined its goal as:

> A system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together. It also includes a set of rules governing the relationships which will prevail among market participants.[20]

The centerpiece of the SEC proposal was a call for a nationwide system for disclosure of market information designed to make trading price and volume information in all markets universally available. The policy, as announced, was sorely in need of some meat on its bones, so in its Statement the SEC established three advisory committees to report on the best means of implementing its goal.

In 1973, after the advisory committees reported, the SEC issued a detailed plan for the achievement of its central market system goal.[21] The Policy Statement described how a consolidated transaction reporting system would operate and what rules would be necessary to ensure that information disseminated through that system would not be misleading. The Policy Statement also described a national system for disclosing price quotations (bids and offers) on exchange traded securities, a new wrinkle in the proposal that had originally focused only on reporting the prices of actual trades (last sales). Both systems have now been put in place, as detailed below, but two additional proposals in the 1973 report have not.

The Policy Statement also recommended an "auction trading rule" that would provide price priority protections for all public orders entered into a proposed central electronic repository and a "public preference rule" in which public orders entered in the repository would have preferential treatment over orders by professionals acting as principals unless the professionals bettered the public bids or offers. This was a dramatic proposal—the SEC was considering rules that con-

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AMEX "might provide appropriate listing requirements for two such divisions." *Id.* at 6.

20. *See* Statement of Securities & Exchange Commission, *Future Structure of the Securities Markets*, 37 Fed. Reg. 5286 (Mar. 14, 1972).

21. SEC Policy Statement of the Securities and Exchange Commission on the Structure of a Central Market System, Sec. Reg. & L. Rep. (BNA) No. 196, at D-1 (Apr. 4, 1973).

trolled order routing and execution for all the country's markets.

It was the beginning of the SEC's many musings on a perfect national order execution system for securities. The SEC has since pursued the national system with a two-part strategy. Part one of this strategy has consisted of a periodic series of grand scale concept releases on various national execution system proposals that were floated but not adopted.[22] Part two of this strategy consisted of detailed rule-making initiatives that built a national system piece-by-piece, from the bottom up. These latter initiatives have been adopted. Implicit threats came in the grand proposals: "Work with the agency on amending the details or you may get a new centralized trading system you really do not want." In response, the SRO's participated and acquiesced to the SEC's technical rules in the part two proposals.[23] The SEC history of rule making initiatives on market structure is worthy of careful study.

The SEC transmittal letter with the Institutional Investor Study of 1971 and the 1972 Statement set the conceptual stage. But the detail work began in late 1972. When a joint task force of the national and regional exchanges and the National Association of Securities Dealers[24] (which operated the then "over-the-counter" (OTC) market[25]) dissolved in jurisdic-

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22. *See supra* notes 21, 22, 93, 128, and accompanying text. For a discussion of the 1991 and 1994 Reports, *see* Oesterle, *supra* note 5.

23. This creates the SEC's convenient position, often heard at conferences, that the SEC is only "facilitating" not "mandating" or "creating" a national market system; that is, the SEC is working with the trading community in an innocent, public spirited mediator style role to structure the national market. A related position is that the SEC changes are "incremental" and "modest" compared to what the SEC "could do." I am confident that SEC staff, present and past, believe these positions. Given the pace of incremental changes, I would suggest that the number and nature of the incremental changes is rapidly increasing. Viewed as a whole, the SEC role is now controlling.

24. The NASD is a national securities association registered with the SEC. Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(a) (2001). The organization provides, among other things, self-regulation of the OTC market.

25. In 1971, the NASD formed the Nasdaq system, a computerized securities information center. The system rationalized the OTC market by providing up to date quotation information from market-makers on liquid OTC securities. By 1984, the Nasdaq system began to provide automatic execution of some trades. *See* NASD v. SEC, 801 F.2d at 1416-18 (providing a history of Nasdaq).

tional squabbles, the SEC took the bit and, in late 1972, promulgated Rule 17a-5, ordering all exchanges and the NASD to submit proposals for a transaction-reporting plan.[26] The SEC's authority to do so was questionable; the SEC grounded the initiative in the market participant record keeping and reporting requirements of Section 17(a) of the 1934 Act, a real stretch. The only proposal submitted created a "Consolidated Tape Association plan" run by the Securities Industry Automation Corporation ("SIAC"), a subsidiary of the New York and American Stock Exchanges.[27] The Consolidated Tape opened on a limited basis in June, 1975 and was fully operational by 1976.

The Consolidated Tape collected executed trade information for national exchange-listed stocks in all the markets.[28] The NASD's participation in the CTA plan at the time came through the so-called "third market," the trading of national exchange listed securities by NASD market-makers. At the same time, the SEC requested proposals for a consolidated quotation system reporting "quotes"—the prices market-makers were currently offering to potential buyers and sellers. The NYSE, although resigned to the inter-market trade reporting system, resisted the inter-market quotation system proposal vigorously, arguing that the proposal was "beyond the authority of the SEC under the existing provisions of the Securities and Exchange Act of 1934" and that it was an illegal taking of private property in violation of the due process clauses of the Constitution.[29]

The SEC's answer to the NYSE's charges came in the 1975 amendments.[30] Concurrent with the SEC proposals, Congress

26. For the history of Consolidated Tape, *see* Collection and Dissemination of Transition Reports and Last Sale Data, Exchange Act Release No. 16,589, 45 Fed. Reg. 12,377 (Feb. 26, 1980).

27. *See* Notice of Receipt of Plan, Exchange Act Release No. 34-10,026, 38 Fed. Reg. 6,443 (Mar. 9, 1973); Consolidated Tape Plan, Exchange Act. Release No. 34-10,787, 39 Fed. Reg. 17,799 (May 20, 1974).

28. Eligible securities included all those listed on the two largest national exchanges, the NYSE and the AMEX, and those admitted to unlisted trading privileges on a national exchange if they substantially meet the listing requirements of the NYSE and the AMEX.

29. BLUME, *supra* note 10, at 167. The NYSE continues to make the property argument today in various forms.

30. *See* S. Rep. No. 94-75, at 9 (1975) (noting the NYSE's position on the Consolidated Tape plan).

was holding hearings on the structure of the securities markets. Subcommittees of both houses of Congress issued comprehensive reports containing conclusions and recommendations and the SEC had significant influence in the committees.[31] The subcommittee recommendations formed the basis of legislative proposals that were enacted into law as the 1975 amendments.[32]

The 1975 amendments inserted Section 11A into the text of the Securities Exchange Act of 1934. Section 11A contains an explicit statutory commitment to the establishment of a "national market system" and clarified and strengthened the SEC's authority to implement such a system. The 1975 amendments did not, however, define the term "national market system" nor did they mandate the components of such a system.[33] Congress did, however, specify basic underlying principles that were to govern the creation of that system. They were:

1. The economically efficient execution of transactions;
2. Fair competition among broker-dealers, among exchanges, and between exchanges and other markets;
3. The ready availability of quotation and transaction information to broker-dealers and investors;
4. The ability of broker-dealers to execute orders in the best market; and
5. The opportunity, consistent with the other goals, for investors to execute orders without the participation of a dealer.[34]

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31. Subcomm. on Commerce & Finance of the House Comm. on Interstate and Foreign Commerce, Securities Industry Study, 92nd Cong. 2d Sess. (1972); Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, Securities Industry Study, 93rd Cong., 1st Sess. 89-135 (1973).

32. For a history of the 1975 Amendments, *see* Harvey A. Rowen, *The Securities Acts Amendments of 1975: A Legislative History*, 3 SEC. REG. L. J. 329 (1976). An amusing anecdote may aptly describe the reason the legislation did not pass in 1975: a key proponent of the bill had a dentist appointment that he would not miss and the legislation failed in the House Rules Committee, with six yea votes, six no votes, and one member not voting. *Id.* at 343.

33. *See* S. Rep. No. 94-75, at 7 (1975).

34. Securities Exchange Act of 1934, § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (2000).

As noted in the Committee Reports, Congress passed the amendments with a scathing assessment of the condition of the national markets at the time. The House Report, for example, condemned the markets' "stunted and distorted" evolutionary process and technological obsolescence that resulted in "misallocations of capital, widespread inefficiencies, and potentially harmful fragmentation of trading markets."[35] As noted in the House Report, Congress's solution was to "enhance competition [among trading markets] and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations of practices and services."[36] Congress made it very clear that it did not want to pre-determine an outcome for the competition; it did not want to favor one trading market over another:

> Neither the markets themselves nor the broker-dealer participant in these markets themselves should be forced into a single mold. Market centers should compete and evolve according to their own natural genius and all actions to compel uniformity must be measured and justified as necessary to accomplish the salient purposes of the Securities and Exchange Act, assure the maintenance of fair and orderly markets and to provide price protection for the orders of investors.[37]

In the Senate Report there was a similar sense of regulatory humility:

> This is not to suggest that under S. 249 the SEC would have either the responsibility or the power to operate as an "economic czar" for the development of a national market system. Quite the contrary, for a fundamental premise of the bill is that the initiative for the development of the facilities of a national market system must come from private interests and will depend upon the vigor of competition within the securities industry as broadly defined.[38]

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35. H.R. Rep. No. 94-123, at 49 (1975). *See also* S. Rep. No. 94-75, at 1 (1975).
36. H.R. Rep. No. 94-123, at 51 (1975).
37. *Id. See also* S. Rep. No. 94-75, at 7 (1975) ("it is not the intention of the bill to force all markets for all securities into a single mold.").
38. S. Rep. No. 94-75, at 7 (1975).

During the hearings, the NYSE argued that the legislation should include a provision requiring that all trading in exchange listed securities be confined to registered exchanges, statutorily eliminating the third market. The prohibition made it into the Senate version of the bill. The SEC and the Antitrust Division of the Justice Department opposed the provision and carried the day,[39] but only after agreeing to a statutory provision that gave the SEC the power to eliminate the third market on specified factual findings.[40] The SEC, fortunately, has never exercised the power.

Congress anticipated that the core component of a national market system would be through an electronic communication linkage of existing markets.[41] In often-underestimated provisions added in Section 11A by the 1975 amendments—subsections (b), (c)(1) and (2)—Congress empowered the SEC to register and regulate "securities information processor[s]."[42]The subsections on information processors, with numerous divisions, make up over one-half the total

39. *Id.* at 20-21.

40. The SEC had to find that the third market "affected [the fairness or orderliness of the markets in listed securities] contrary to the public interest or the protection of investors"; that no rule on any exchange "impairs the ability of any dealer to solicit or effect transactions . . . or unreasonably restricts competition among dealers" in listed securities, and that "the maintenance or restoration of fair and orderly markets in such securities may not be assured through other lawful means." Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(c)(3)(A) (2000).

41. *See, e.g.*, S. Rep. No. 94-75, at 3 (1975). There was a mild preference for auction-type trading. *See* Development of National Market System, Exchange Act Release No. 34-14,416, 43 Fed. Reg. 4,354, at 4,356 (Feb. 1, 1978). *See also* Securities Exchange Act of 1934, § 11A(c)(3), 15 U.S.C. § 78k-1(c)(3)(A) (empowering the SEC to abolish the third market if such trades are contrary to the "public interest or the protection of investors.").

42. The 1975 amendments added a definition of a securities information processor to Section 3(a)(22)(A) of the 1934 Act. A securities information processor is:

> any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis information with respect to such transactions or quotations.

Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(22)(A) (2004).

statutory language added by the 1975 amendments to the 1934 Act. The comparison of this length and detail with the single sentence in (c)(4) on anticompetitive practices—which attracts the bulk of academic commentary on the legislation—is telling.[43]

In subsection (b), Congress requires securities information processors to register with the SEC unless the processor is not an "exclusive processor of any information with respect to quotations for or transactions in securities" (and the SEC has not found it necessary to register non-exclusive processors).[44] Congress knew, given the SEC version of a Consolidated Tape Plan already in the start up stages when the legislation passed, that there might be only one dominating cross-market information processor. Congress implied in subsection (b), however, that if competing processors did appear on the scene, the SEC could substantially lighten its regulations.

In the reports that accompanied the legislation, Congress referred to an exclusive cross-market information processor as a "public utility" that "should be regulated accordingly."[45] The Senate Report also noted that an exclusive central information processor "should not be "under the control or domination of any particular market center."[46]

Implicit in these comments and the language of the statute itself is an unmistakable Congressional preference for *competing* last sale and quotation inter-market reporting services. This preference has never been realized. Indeed, from what I can tell, competing systems had never been mentioned in any SEC public initiatives or releases until 2004, when it was considered and rejected.[47] We are left today with only one inter-market reporting system for trades, begun in mid 1975, and only one inter-market reporting system for quotations, started in 1978.

The statute's registration provisions on securities information processors also enabled the SEC to gather information

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43. *See, e.g.*, Macey, *supra* note 6.

44. Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(b)(1) (2000).

45. S. Rep. No. 94-75, at 11 (1975); H.R. Conf. Rep. No. 94-229, at 93 (1975).

46. *See* S. Rep. No. 94-75, at 11 (1975); H.R. Conf. Rep. No. 94-229, at 93 (1975).

47. *See infra* notes 78-85 and accompanying text.

necessary for the application, as well as to hear complaints. It directed the SEC to grant the registration if the SEC finds that the processor "is so organized, and has the capacity, to be able to assure the prompt, accurate, and reliable performance of its functions . . . [to] comply with the provisions of this chapter and the rules and regulations thereunder, carry out its functions in a manner consistent with the purposes of this section, and, insofar as it is acting as an exclusive processor, operate fairly and efficiently."[48]

Yet, nowhere in the legislation is there even a mention of an inter-market order routing and execution system.[49] As is evident in the express language of the statute on securities information processors, Congress assumed that the securities information processors would convey only last sale transaction data and market quotations. There is no mention of an order routing or execution function for the information processors. Even the title "securities information processors" conveys the sense that Congress was not sanctioning or encouraging electronic order routing and execution systems. And one can read the various goals stated in subsection (a)(1) consistently: the statutory goal in subsection (a)(1) of "brokers executing investors' orders in the best market" does not require a single centralized market, but only that brokers have public information on all available markets.[50]

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48. Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(b)(3) (2000).

49. There is some evidence against this statement in the text of the legislation. One can find some references in the Congressional Committee Reports to a "centralized" trading mechanism. *See, e.g.*, S. Rep. No. 94-75, at 17 (1975). The Senate Report does not, however, state that the SEC ought to be authorized to develop such a mechanism, and the statute changed the language of "central" market system to "national" market system, a much less intrusive concept. Critics could also note that the statute intends to provide an "opportunity . . . for investor's orders to be executed without the participation of a dealer." 15 U.S.C. § 78k-1(a)(1). Some could argue that this assumes a *centralized* NMS. I disagree. In the statute, the language of a central market system was replaced by a national market system. This change is significant. Moreover, the goal of minimizing the role of intermediaries could be achieved in a system that has multiple market centers, so long as some of the centers are automated ECNs that allow customers to interact directly with each other or some are auction exchanges in which those in the crowd interact with each other.

50. Some claim that a "best execution" obligation, found in the statutory language, is a key concept of the national market system. Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(a)(1)(D) (2000). *See also* Poser, *supra*

The omission of any language on order routing in the 1975 statute is notable in light of the SEC's prior 1973 Policy Statement that had proposed order routing and execution rules. As a result, it is no answer to claim (as some do) that technology was so unsophisticated in 1975 that Congress could not have anticipated an inter-market order routing system similar to what is possible today and, therefore, that new advances in communication technology require the SEC, authorized under the statutes' open-ended grants of authority, to fashion modern and adaptive rules. Order routing proposals were floating around at the time of the legislation, and they were similar to those proposed today. Moreover, the SEC had its first inter-market order routing system in place only three years later, by 1978.

Finally, the change in language from a *central* market system—as proposed in the early 19'70s SEC reports—to a *national* market system as is found in the legislation, is significant. Consistent with the Committee reports, a national market system has room for many competitive trading centers. A central market system concept, on the other hand, could justify an extreme centralization of orders under one universal routing and execution system.

The authorization for the SEC's initiatives on order routing and centralized execution systems[51] seems to depend on the definition of a single term—"linking"—derived from § 11A(a)(1)(D) of the 1975 Amendments. The section calls for the "linking of all markets for qualified securities through communication and data processing facilities" to "foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate offsetting of investor's orders, and contribute to best execution of such orders."[52] Do these provisions empower the SEC to establish

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note 7, at 911. The term refers to the common law duty of an agent to obtain for a customer the best price discoverable in the exercise of reasonable diligence. *See also* Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 676 (S.D.N.Y. 1966), *aff'd*, 367 F.2d 157 (2d Cir. 1966).

51. See *infra* notes 57-64 and accompanying text (discussion of the ITS or its stronger alternatives, a black box, CLOB or common message switch).

52. Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(a)(1)(D) (2000). *See also id.* § 78k-1(c)(1)(e) (empowering the SEC to assure that all exchange members, brokers and dealers "transmit and direct orders . . . consistent with the establishment of a national market system"). The section as-

mandatory order routing and execution systems? If so, it is a slender reed of support.

One could also argue (persuasively, in my view, as it is more consistent with the history and language of the 1975 amendments) that Congress intended for the SEC to link the markets through information processing only—namely, through —exchanges of data on transactions and quotations—and did not intend the SEC to link the markets though government mandated order routing and execution systems. Under this vision, individual markets and market-makers could choose to route orders to each other but their decision to do so and the mechanism of choice for doing so would not be at the government's direction. The decision to "offset . . . orders" and the obligation of "best execution" remains with the local markets and is not a call for an automatic centralized order routing and execution system.[53]

Similarly there is no express direction in the 1975 amendments that the SEC specify and approve the details of an intermarket information processor's operations, nor that they direct how individual markets interact with a central processor. I recognize that a sympathetic court may find such power in other provisions, on the SEC's authority to deal with how information processors interact with the various trading market centers.[54] However, one could read these examples, consis-

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sumes the goals of subsection (a)(1) in defining the concept of a national market system, however.

53. In this regard, note the language that authorizes the SEC to "facilitate" offsetting orders and to "contribute" to best execution. *See id.* § 78k-1(a)(1)(D). This is not a Congressional direction to *establish* a centralized mechanism for *effecting* offsetting orders and best execution.

54. The SEC did get broad rule-making power over processors in subsection (c)(1):

> (A) [to] prevent the use, distribution or publication of fraudulent, deceptive, or manipulative information . . . ; (B) assure the prompt, accurate, reliable, and fair collection, processing, distribution, and publication of information . . . ; (C) assure that all . . . processors may . . . obtain on fair and reasonable terms such information with respect to quotations and transactions in such securities as is collected, processed, or prepared for distribution or publication by any exclusive processor . . . ; (D) assure that all exchange members, brokers, dealers . . . [and] all other persons may obtain on terms which are not unreasonably discriminatory such information . . . ; (E) assure that all exchange members, brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities

tent with the legislative history, to imply a much more modest scope and purpose for the SEC inter-market system regulations.[55]

II.
THE SEC'S EXERCISE OF ITS NEW POWERS UNDER THE 1975 AMENDMENTS

The SEC, in the thirty years since the 1975 amendments were passed, has taken the broad and sweeping grant of authority in the legislation to implement a national market system, and exceeded it.[56] There are three overarching regulatory failures and a host of specific ones. I will focus on the overarching failures and leave the specific ones to other authors.[57]

> in a manner consistent with the establishment and operation of a national market system; and (F) assure equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers . . .

Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(c)(1) (2000). Subsection (c)(2) also empowers the SEC to require any person "to report such purchase or sale to a registered securities information processor, national securities exchange, or registered securities association and require such processor . . . to make appropriate distribution and publication of information with respect to such purchase or sale." *Id.* § 78k-1(c)(2). I view these as anti-fraud and anti-restraint of trade provisions, not as general provisions. In support of my view, note that the Senate report listed as examples of legitimate SEC rules under these sections "the hours of operation of any type or quotation system, trading halts, what and how information is displayed and qualifications for the securities to be included on any tape or within any quotation system." S. Rep. No. 94-75, at 11 (1975).

55. One could, of course, argue that the "what and how information is displayed" language in Senate Report 94-75, for example, justifies detailed SEC rules on each systems interaction with each covered trading market. S. Rep. No. 94-75, at 11 (1975). I believe, however, that the spirit of the passage is to the contrary.

56. admittedly, the federal courts could find statements in the legislative history that justify, effectively, complete deference to the SEC. *See, e.g.*, H.R. Conf. Rep. No. 94-229, at 92 (1975) ("The Senate Bill [which the Conference adopted] relied on an approach designed to provide maximum flexibility to the [SEC] and the securities industry in giving specific content to the general concept of the nation market system."). I submit that the delegation in the 1975 Amendments has some limits, however, inherent in the language and history of the legislation.

57. *See, e.g.*, Borrelli, *supra* note 5; Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399.

The first problem is the SEC's complete lack of effort to facilitate competition among cross-market securities information processors. There is, and has always been, only one exclusive, primary information processor for transaction data (the Consolidated Tape Association) and one for quotation data (the Consolidated Quotation Association). Second, the SEC did not have a mandate from Congress to force the markets to participate in an inter-market trade execution system. Congress did not authorize the creation of an Intermarket Trading System ("ITS") and its potential progeny (a Consolidated Limit Order Book system, for example). And third, Congress did not intend for the SEC to so pervasively micro-manage the details of the behavior of the participant markets in a national market system. Independent computerized markets have been the recent objects here; the SEC is attempting to limit their habitat.

Each of the failures is discussed sequentially below.

The Consolidated Data Dissemination Systems: The CTA, CQ, and Nasdaq UTP Plans

The first part of a national, consolidated information system on the price and volume in actual securities sales, was created by a joint-industry task force in 1972. The Consolidated Tape Association Plan, up and running in its experimental stages even before the passage of the 1975 amendments, has continued and is now registered as an information processor under the amendment's new Section 11A(b)(2) of the Securities Exchange Act.[58] The SEC eventually replaced old Rule 17a-15 with new Rule 11A3-1 in 1980.[59]

The Consolidated Tape, run by the Consolidated Tape Association, continues to collect and disseminate trade information in all exchange-traded stock (including listed stock and stock admitted to unlisted trading privileges). All national and

58. Notice of Application for Registration, Exchange Act Release No. 34-11,779, 40 Fed. Reg. 51,700 (1975); Order Granting Registrations as Securities Information Processors, Exchange Act Release No. 34-12,035, 41 Fed. Reg. 4,372 (Jan. 29, 1976).

59. *See* Collection and Dissemination of Transaction Reports and Last Sale Data, Exchange Act Release No. 16,589, 45 Fed. Reg. 12,377 (Feb. 26, 1980).

regional exchanges and the NASD, as owner of the Nasdaq,[60] participate in the plan. The Consolidated Tape provides "last sale" information, or the price at which the last transaction in a covered stock occurred on participating markets. A separate reporting plan operated by Nasdaq—the "Nasdaq System"—provides transaction data on all Nasdaq securities.

The CT uses technology supplied by the SIAC, a subsidiary of both the New York and American Stock Exchanges. The operations of the CTA are managed by a board 'which until 1980, had six members: the New York and American Stock Exchanges had two votes each, and the other four members—the Chicago, Pacific, and Philadelphia stock exchanges and the NASD—had one vote each.[61] Moreover, until 1980, both the New York and American Stock Exchanges had effective veto power over plan amendments. In 1980, the CTA added two new members, the Boston and Cincinnati Exchanges, and both of the national exchanges lost their extra vote and their exclusive veto power. With the addition of the Chicago Board Options Exchange in 1991,[62] the CTA now has nine members.[63] No amendments are "effective," however, unless executed by each of the Association participants.

The next SEC initiative involved a consolidated system for disseminating quotes, bids and offers for securities by national exchanges. The SEC established a quotation reporting system shortly after the adoption of the 1975 amendments and the implementation of the trade reporting system, the CTA Plan. The SEC adopted Rule 11Ac1-1 in January 1978, requiring the public dissemination of quotations by exchanges and NASD

60. NASD market-makers trading in exchange listed stocks—the "third market"—report under the plan. *See id.*

61. Consolidated Tape Plan, Order Approving Amendments to Plan, SEC Exchange Act Release No. 34-16,983, 45 Fed. Reg. 49,414 (July 16, 1980).

62. Order Approving the Fifteenth Amendment to the Consolidated Tape Association Plan, Exchange Act Release No. 34-28,808, 56 Fed. Reg. 3,124 (Jan. 28, 1991).

63. Current CTA plan participants are AMEX (American Stock Exchange), BSE (Boston Stock Exchange), CBOE (Chicago Board Options Exchange), CHX (Chicago Stock Exchange), NSX (National Stock Exchange), NASD, NYSE (New York Stock Exchange), PCX (Pacific Stock Exchange) and PHLX (Philadelphia Stock Exchange). *See* Consolidated Tape Association; Notice of Filing of the Fifth Substantive Amendment, Exchange Act Release No. 34-48,987, 68 Fed. Reg. 75,661 (Dec. 31, 2003).

market-makers.[64] The NYSE and the AMEX filed a plan for a Consolidated Quotation System ("CQS") with the SEC on July 25.[65] The plan created a Consolidated Quotation Association ("CQA") that while technically separate from the CTA, has the same membership and is the basis for the CQS in place today. The CQS provides quotation information from all participating markets for exchange-listed stocks.[66]

The SEC standardized the trade and quote reporting requirements by system participants in 1980.[67] This standardization gave the SEC control over the minute details of trade and quote reporting requirements. Control over quote reporting, in particular, gave the SEC significant influence over the details of how each market trading center had to structure its basic trading. In the 2004 proposed Regulation NMS, together with the new '"Trade-Through" Rules discussed below,[68] the SEC sought to take power over quotation standardization, and '"dictate dramatic changes in market structure.

In 1981, the SEC adopted Rule 11Aa2-1, introducing the concept of National Market System ("NMS") securities.[69] The initiative extended the consolidated reporting system from exchange-listed securities to a selected segment of heavily traded securities in the over-the-counter market. The Rule, as amended in 1987, identifies a class of securities eligible for inclusion in the national market system. Exchange-traded or NASD-traded securities subject to a "reporting plan" approved by the SEC are designated NMS securities and subject to specifically tailored transaction and quotation reporting rules. In complying with the Rule, the NASD designated securities as Nasdaq/NMS securities and created a distinct national market segment of the Nasdaq.[70] The Nasdaq system now provides

64. Dissemination of Quotations for Reported Securities, Exchange Act Release No. 34-14,415 ,43 Fed. Reg. 4,342 (Feb. 1, 1978).

65. Temporary Order, Exchange Act Release No. 34-15,009, 43 Fed. Reg. 34,851 (Aug. 1, 1978).

66. Network A is for NYSE listed securities; Network B is for securities listed on the AMEX and other national exchanges.

67. Dissemination and Display of Transaction Reports, Exchange Act Release No. 34-16,590, 45 Fed. Reg. 12,391 (Feb. 19, 1980).

68. *See infra* notes 129-38 and accompanying text.

69. Designation of National Market System Securities, Exchange Act Release No. 34-17,549, 46 Fed. Reg. 13,992 (Feb. 25, 1981).

70. Order Approving Proposed Designation Plan for National Market System Securities, Exchange Act Release No. 34-13,899, 47 Fed. Reg. 2,226

quotation information for Nasdaq stocks under a third plan, known as the "Nasdaq UTP Plan."[71] Recently, under an order from the SEC, the NASD also opened an "alternative display facility" for ECNs to provide quotes and report trades on Nasdaq stocks.[72]

There are currently three "Networks" for disseminating market information on NMS stocks: Network A securities are those listed on the NYSE; Network B securities are those listed on AMEX and the regional exchanges; and Network C securities are traded on the Nasdaq.[73] For each security included, the networks offer the national best bid and offer (NBBO) with prices, sizes and market center identification; best bids and offers from each participating market with prices, sizes and market center identification; and consolidated trade reports (last sale information).[74] Each network has a monopoly over the consolidated, national reporting of covered securities.

The CT, CQ and Nasdaq systems all provide for the collection of fees from vendors and subscribers for the dissemination of market data and for the allocation of the revenues among members. Vendors enter into contracts with the networks and pay access and administrative fees. The subscribers—typically broker/dealers or institutional investors—receive information from the vendors in exchange for a fee that the vendor then passes back to the network. The fees and

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(Jan. 14, 1982). Nasdaq SmallCap securities are not covered by the NASD plan and are therefore not considered NMS securities.

71. Under the Nasdaq UTP Plan, NASD administers a CQ, Network C for unlisted but qualified NASD securities, so-called NMS securities. The quotes are included in the CQ Plan data stream. *See* In the Matter of American Stock Exchange, Inc., et al., Exchange Act Release No. 34-16,518, 45 Fed. Reg. 6,521 (Jan. 28, 1980). The Nasdaq System also includes transaction and quotation information for Nasdaq SmallCap securities and other OTC securities that are not NMS.

72. Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Exchange Act Release No. 34-47,663, 68 Fed. Reg. 19,043 (Apr. 7, 2003). The ECNs cannot quote exchange listed stock on the ADF, however.

73. Consolidated Tape Association; Notice of Filing, Exchange Act Release No. 34-44,615, 66 Fed. Reg. 41,058 (Aug. 6, 2001) (discussing Networks A and B.)

74. *See* Regulation NMS, Exchange Act Release No. 43-49,325, *supra* note 3, at 94.

sharing arrangements among members are subject to SEC approval, and are a source of constant attention and tension.[75]

The struggle over fees is a necessary part of the SEC's "public utility" oversight of exclusive securities information processors. Just as a state public utility regulates the fees that electric and gas companies charge retail customers, the SEC regulates the fees the CTA, CQA and Nasdaq charge vendors. With no easy analogies to prices in competitive markets, the SEC has, for years, struggled with a theoretical and practical basis for such fee calculations.[76] The disputes over fees by participants finally led the SEC in 2004 to consider whether or not to break the consolidated network monopolies. Led to the brink of change, the SEC balked. This history is telling.

In 1999, the SEC, seeking to quell intense squabbling among market centers, proposed a "flexible, cost-based" system for regulating market data fees.[77] But the Commission struggled to determine which costs should be included. The NYSE, claiming an ownership interest in the data, argued in response to the initiative that it should be free to set its own fees and that the CTA should be dissolved. Discount brokers argued that the fees were excessive, were used to improperly fund regulatory surveillance costs, greatly exceeded the costs of gathering the information, and discriminated against online firms. Both sides used creative accounting calculations in their arguments.

An advisory committee created in 2000 to develop recommendations on the issues, after eight hearings, ended in 2001 by rejecting the SEC's cost-based initiative with tepid support for status quo standards and calculations.[78] A majority of a

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75. *See, e.g.*, Approval of an Amendment to the Consolidated Tape Plan Establishing Non-Professional Fees, Exchange Act Release No. 34-20,386), 48 Fed. Reg. 53,616 (Nov. 28, 1983); Order Approving the Fifteenth Amendment to the Consolidated Tape Association Plan, Exchange Act Release No. 34-28,808, 56 Fed. Reg. 3,124 (Jan. 28, 1991). *See also* NASD v. SEC, 801 F.2d 1415 (D.C. Cir. 1986) (Instinet contested Nasdaq fees).

76. *See* Borrelli, *supra* note 5, at 903-05.

77. *See, e.g.*, Regulation of Market Information Fees and Revenues, Exchange Act Release No. 34-42,208 at 29, 64 Fed. Reg. 70,613 (Dec. 17, 1999).

78. *See, e.g.*, Mary Schroeder, *Market Data Report Backs Multiple Consolidators*, SEC. INDUS. NEWS, Oct. 1, 2001, at 1. *See also* Securities & Exchange Commission, *Report of the Advisory Committee on Market Information: A Blueprint of Responsible Change* (Sept. 14, 2001), *available at* http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm.

badly split committee, however, supported a dramatic change: a move to "competing information processors," more in line with the 1975 Congress's desires.[79] In the competing consolidators' model, each major market center would be allowed to separately establish its own fees, enter into and administer its own market data contracts, and provide its own data distribution facility. Data vendors (competing consolidators) could purchase data from the individual market centers, consolidate the data, and distribute it to investors and other data users. A minority group of the Committee favored radical change, a deconsolidation model that would eliminate the consolidated data system entirely.[80]

In 2004, the SEC, in proposed Regulation NMS, accepted many of the Advisory Committee's technical recommendations for the three networks but rejected the majority's recommendation for competing consolidators and similarly rejected the minority group's deconsolidation model.

In rejecting the deconsolidation model, the SEC noted that the problem of market power by some market centers such as the NYSE in creating quote and trade information would led to monopoly-like fees. It also worried about the confusion that a lack of standardization would inflict on retail investors.[81] In rejecting the "competing consolidators" model, the SEC projected that the model would cause investors to pay higher fees for lower quality information.[82] The information would be lower quality because of a potential lack of uniform-

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79. *See, e.g.*, Ed. Staff, *Market Data Committee Supports Competition*, SEC. INDUS. NEWS, Oct. 8, 2001, at 46 (also noting two distinct minority views). In 2003, the Nasdaq added fuel to the flame when it petitioned the SEC to recognize surveillance costs as legitimate deductions from data revenue. *See, e.g.*, Isabelle Clary, *Nasdaq Seeks Uniform Rules*, SEC. INDUS. NEWS, May 5, 2003, at 1. The Nasdaq believes that it bears a disproportionately large part of the regulatory costs for the national market in Nasdaq stocks without being adequately compensated, and has asked the SEC to aggregate all markets' regulation costs and to deduct these costs from the data collection revenue. Since the Nasdaq has over $80 million a year in costs—far larger than any other participant—the effect is to increase the Nasdaq's portion of the collected vendor revenues.

80. *See Report of the Advisory Committee*, *supra* note 78, at VII.B.1.

81. Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 13, 69 (citing the discussion in Regulation NMS, Exchange Act Release No. 34-49,325, *supra* note 2, at 96-100.)

82. *Id.*

ity in data presentation among the competing consolidators; the information would cost more because the dominant market centers would raise their fees to all the consolidators unless the SEC intervened.[83] SEC intervention would require the regulation of ten market center fee schedules rather than the three of the networks in the consolidated system.[84]

Reading the legislative history and language of the 1975 amendments and comparing it to the CTA, CQS and Nasdaq plans, one cannot help but be struck by the resistance on the part of the SEC to do what Congress clearly seemed to prefer. Congress had hoped that there would be multiple primary security information processors and that if there was only one, it would not be owned by the major markets that it serviced. The SEC carried out neither of the wishes nor has it even attempted to do so.[85]

One is led to question why there isn't at least one nonmarket center controlled processor that collects and integrates *primary* transaction and quote data from individual market centers and market-makers? There are several new, creative, private *secondary* information services,[86] and the SEC had the power to facilitate such arrangements and the power to require the market centers and market-makers to provide them with the appropriate information.[87]

At the root of the SEC's concerns in rejecting the competing consolidators' model is the market power of the primary market centers—namely, the NYSE and the Nasdaq—to

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83. Regulation NMS, Exchange Act Release No. 34-49,325, *supra* note 2, at 97-8. The SEC also rejected a "hybrid model" in which the networks would continue to disseminate only NBBO information. Other trade and quote information would be disseminated by individual market centers. *See* Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 13, 69-70 (citing the discussion in Regulation NMS, Exchange Act Release No. 34-49,325, *supra* note 2, at 99-100.)

84. *Id.* at 69.

85. A cynic might argue that by creating a "public utility" that had to be closely watched, the SEC augmented its power as a regulator.

86. The successful Lava Trading Inc.'s Colorbook service is an example. *See* Ed. Staff, *Consolidating Fragments*, TRADERS MAG., Apr. 1, 2003 (interview with Rich Korhammer, Lava COS).

87. *See* Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW. 637 (Feb. 2002) (authored by the Chair of the SEC Advisory Committee on Market Information).

charge excessive fees, and the lack of objective standards for the Commission in evaluating fees across the centers. If the SEC can, as it now does, set fees for each of the three networks (step one) and then allocate those fees among individual participating market centers using a complex formula (step two) one should ask why the same fee allocation formula mechanics (a complicated algorithm based on a mix of trading activity and NBBO quotes) could not be used to establish *primary* level fee regulation. Just combine steps one and two, calculate a total fee for data dissemination on any one stock, and allocate the fees among the markets that trade the stock.

The deeper problem, however, is one of antitrust enforcement. The SEC has, as noted below, facilitated the creation and entrenchment of market centers with dominate market power over certain securities. The SEC should have employed more robust antitrust principles long ago in its market regulations and enforcement. But it gets worse. By requiring one or more consolidators to include *all* market centers in their data package—as the SEC now does—and/or by requiring broker/dealers to find the best price across *all* markets for customers—as the SEC wants to do in Regulation NMS[88]—the SEC necessarily exposes retail investors to monopolistic pricing problems from *every* market center, large or small. A mandatory inclusion rule at either the consolidator or broker/dealer level makes each market center a monopolist with respect to the provision of its own trade and quote data.[89] By creating the network monopolies, or ten monopolies under the new proposals (whereby every market center becomes a monopoly), the SEC can claim authority over rigid fee structure control—in our best interest, of course.

The answer may lie in less SEC control—not more. The minority report of the Advisory Committee that recommended a deconsolidation model had a partial answer. The minority recommended suspending the requirement that market centers work together to provide consolidated data and suspending the requirement that data purchasers buy data from all markets, opening up the market' for raw data competition.

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88. *See infra* notes 129-38 and accompanying text (on the SEC's proposed Trade-Through and Access Rules).

89. *Cf.* Bob Greifeld, *Millions of Momentary Monopolies*, WALL. ST. J., Dec. 8, 2004, at A12 (making a similar point on the proposed access rules).

Competitive forces would determine data products, fees, and market center revenues. The other half of the answer is to address the problem of market power by the larger market centers. The SEC, in tandem with a deconsolidation model, would have to loosen its other market structure regulations that limit competition among market centers, using a basic antitrust analysis as its guide to make the model work. Two of these SEC initiatives, for example, would have to loosen the trade-through rule and the regulation of ECNs, as discussed below. A deconsolidation model would work only if it were part of a broader package of proposed rules that open up market competition among market centers in the trading of any given security.

But the SEC, rather than loosening its control over market structure, has proposed in Regulation NMS to tighten it up. And in tightening up control over market structure, the SECs reinforces its claim that it must necessarily control data dissemination and set fees. This argument is circular, and a tightening spiral at that. If and when SEC Regulation NMS is put it place, we will be so far down the road to a government-structured secondary trading market that we may find it virtually impossible to ever turn back.

Trade Execution Among Market Centers: The Inter-market Trading System ("ITS")

After Congress's 1975 amendments to the 1934 Act, the SEC also moved forward on its earlier proposal for some form of an electronic communications network that would "link" the major markets. The word "link"—which could refer only to data exchanges—has come to mean something much more; namely, —that participants in one market can execute orders, and buy and sell securities on another. On January 26, 1978, the SEC issued a statement calling for, among other things, the prompt development of a comprehensive market linkage and order routing system to permit the efficient transmission of orders for qualified securities among the various market centers.[90] In the 1978 release, the SEC floated several propos-

90. *See* Development of a National Market System, Exchange Act Release No. 34-14,416, 43 Fed. Reg. 4,354, at 4,356 (Feb. 1, 1978). *See also* Dale Oesterle, *Securities Markets Regulation: The Time to Move to a Market-Based Approach*, CATO INST. POLICY ANALYSIS, No. 374 (June 21, 2000).

als for a centralized order routing scheme—a central execution system with strict price and time priority for every order (known by some as "the black box")[91] and an alternative Consolidated Limit Order Book (the "CLOB").[92] The SEC wanted to settle, at minimum, for a "common message switch."[93]

Existing trading markets resisted vigorously the proposals, and with the threat of unilateral SEC action in the background, negotiated a compromise. The NYSE, seeking a compromise that would preserve their superior market position, proposed the Inter-market Trading System or ITS.[94] The ITS gives members of the various exchanges reciprocal trading privileges in each other's markets.[95] The system permits a dealer on one market to transmit an order to another when a dealer in the other market is displaying a better price quote. The ITS began on a pilot basis on April 17, 1978, with the NYSE and the Philadelphia Stock Exchanges trading eleven stocks.[96] By mid-1978, four other exchanges had joined the system and gradually more stocks were added.[97] The Cincinnati (now National) Stock Exchange joined in 1981, the NASD in 1982, and the Chicago Board Options Exchange in 1991.[98]

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91. *See* SEC Policy Statement, *supra* note 21. The SEC proposed a central location where all orders for one stock converged. The central computer would automatically match and execute orders when prices matched, giving price and time priority to orders.

92. *See* Composite Central Limit Order Repository, Exchange Act Release No. 34-12,159, 41 Fed. Reg. 19,274 (May 11, 1976). In a CLOB there would be a single national book in which all orders for a given stock at a given price would be entered. A consolidated limit-order book would have created major disruptions in the structure of the trading markets and the NYSE specialists would have lost significant business. *See* Blume, *supra* note 10, at 175.

93. Norman Poser, *Automation of Securities Markets and the European Community's Proposed Investment Services Directive*, 55 LAW & CONTEMP. PROBS. 29, 41 (1992). With a common message switch, a computer would automatically route any order to the market displaying the best prices. *See* BLUME, *supra* note 11, at 177.

94. American Stock Exchange Inc. et al., Exchange Act Release No. 34-14,661, 43 Fed. Reg. 17,419 (Apr. 24, 1978) (initial temporary approval); American Stock Exchange Inc. et al., Intermarket Trading System, Exchange Act Release No. 34-19,456, 48 Fed. Reg. 4,938 (Feb. 3, 1983) (final permanent approval).

95. *See* BLUME, *supra* note 10, at 177.

96. *Id.*

97. *Id.*

98. All national securities exchanges and the NASD are members of the ITS except the new International Securities Exchanges, which trades options

As initially drafted, the ITS did *not* provide for automatic execution of orders across markets. As now operated, however, the ITS requires each plan participant to provide other participants electronic access to its best bid or offer quotes, and to provide an automated mechanism for routing orders ("commitments") to reach the displayed quotes.[99] In 1981, the ITS adopted a rule that changed the essential nature of the ITS system from a voluntary execution system, in which a market-maker in one market could choose to execute trades in other markets, to a mandatory execution system, in which a market marker in one market center, under some circumstances, was forced to execute trades in other markets. The rule, now known as the controversial "trade-through rule,"[100] requires that a market-maker whose price is inferior to the National Best Bid or Offer price—and who has a customer market order—either match the better price or make a "commitment to trade" on the market posting the better price.[101] In other words, it is an illegal "trade-through" when a member of an ITS participant market center initiates a purchase (or sale) on the exchange of a security covered by the ITS at a price that is higher (or lower) than the price at which the security is quoted at the time of the transaction in another ITS participant market center.[102]

Frustrating the SEC's grand plans for the system, the ITS trade volume has always been inconsequential, never rising above three and one-half percent of the total trade volume on the member markets.[103] This should not be a surprise as the

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not covered by the plan. Regulation NMS, Exchange Act Release No. 34-49,325, *supra* note 2, n.17.

99. *Id.*

100. It is really an anti-trade-through rule, as it prohibits dealers from trading through or ignoring posted open orders when executing orders of their own clients.

101. *See* Order Approving Proposed Rule Changes, Exchange Act Release No., 34-17,704, 46 Fed. Reg. 22,520 (Apr. 17, 1981) (national exchanges); Order Granting Accelerated Approval, Exchange Act Release No. 34-19,249, 47 Fed. Reg. 53,552 (Nov. 26, 1982) (NASD).

102. The ITS rule has significant gaps in coverage. It does not, for example, cover large block transactions (10,000 shares or greater).

103. Supporters of the ITS argue that trade volume is not the measure of success. The true measure of success must include all those trades in which a dealer in one market improves her price on execution for a client to match a dealer in another market quoting on the ITS.

rule requires market-makers in one market to give trades to their competitors in another market, with a resultant loss in the first market-maker's' fees and the market's' network fee allocations. Rather that route trades to a competitor, market-makers in one market with inferior quotes to another market usually just match the better prices or refuse the trade. Most of the ITS trades that do occur are in one direction, routed by the smaller markets to the NYSE. There have been constant rumblings over time that markets posting the best prices on ITS get ignored by market-makers located in other competing markets.[104]

The SEC and ITS board has been frequently at odds over how the inter-market system should function. Again, this should not be a surprise. The SEC envisions an expanding role for the ITS as a precursor to an integrated central trading market, and the participating members of the ITS seek to use the body as a classic guild, entrenching historic market segmentation. For example, the SEC and ITS board fought for twenty-five years over the mechanics of the addition of the NASD to the ITS. The Nasdaq had developed an automatic order execution system (the Computer Assisted Execution System ("CAES")), and any linkage of ITS to CAES meant that orders in listed stocks could be automatically executed away from the established exchanges. In 1999, after the ITS board had once again refused to budge on the matter (it operated on a unanimity voting requirement), the SEC ordered the ITS to include a linkage to CAES in all listed securities.[105] This breach threatens to turn into a flood as the ITS has now admitted a computerized electronic facility, Archipelago, and included "remote specialists" on the regional exchanges.[106]

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104. *See, e.g.*, Gretchen Morgenson, *Is the Big Board Getting Creaky?*, N.Y. TIMES, Apr. 27, 2003, at 3.1.

105. Adoption of Amendments to the Intermarket Trading System Plan, Exchange Act Release No. 34-42,212, 64 Fed. Reg. 70,297 (Dec. 16, 1999). The ITS had included only "Rule 19c-3" securities (securities listed on exchanges after 1979) since 1982.

106. Intermarket Trading System: Order Granting Approval of the Eighteenth Amendment, Exchange Act Release No. 34-44,923, 66 Fed. Reg. 53,455 (Oct. 22, 2001); Intermarket Trading System: Order Granting Approval of the Nineteenth Amendment, Exchange Act Release No. 34-46,474,67 Fed. Reg. 58,564 (Sept. 9, 2002). A remote specialist operates off the physical trading floor of a regional exchange, communicating with the

Electronic Communications Networks complain, however, that the NYSE uses the ITS structure and the SEC's rules to effectively block ECNs from executing trades in exchange listed shares.[107] They make two arguments. First, ECNs using CAES must adapt to the outdated technology of CAES and pay a hefty fee to a competitor, the Nasdaq, for the questionable privilege of accessing the ITS system. Second, the ITS trade-through rule disables ECNs from trading listed stocks that are not exempted from the rule. ECNs cannot be programmed to wait for exposure to non-automated auction markets such as the NYSE.[108] As a result, in 2002, several ECNs floated a proposal to allow them to quote listed securities on the NASD's Alternative Display Facility, whose members are not subject to a trade-through rule.[109] Thus many of the ECNs do not trade ITS stocks or do so only if there is a specialized exemption from the rule. ECNs can trade selected high-volume, derivatively priced Exchange Traded Funds—specifically QQQQs, SPDRs and DIAs[110]—or a very small volume in a covered security.[111]

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floor electronically. The Boston Stock Exchange has had remote specialists in place since 1994.

107. *See, e.g.*, Eric Moskowitz & Jenny Anderson, *ECNs Want Piece of Battered Big Board Business*, N.Y. POST, April 25, 2003, at 37.

108. Instinet makes the claim that ECNs, which are automatic, cannot wait on execution by dealers in manual markets that are offering better prices. They have to refuse to trade all stocks in which a specialist in a manual market is offering a better price. Instinet's major market in listed securities is in exchange traded funds, which are subject to a special trade-through rule exemption. *See* Order Pursuant to Section 11A, Exchange Act Release No. 34-46,428, 67 Fed. Reg. 56,607 (Sept. 4, 2002).

109. *See* Isabelle Clary, *SEC Extends ADF Pilot for Nasdaq Stocks Only*, SEC. INDUS. NEWS, Apr. 21, 2003, at 5.

110. *See* Order Pursuant to Section 11A, *supra* note 108. The rule contained a *de minimis* exemption for prices that were within three cents of the NBBO. Many observers thought that a *de minimis* rule would be extended to all exchange traded securities. The SEC chose another tack in Regulation NMS, however, excluding all manual trades from the trade-though rule, which surprised many.

111. ECNs are not required to follow the rule with respect to a covered security until they have 5% or more of the average daily trading volume in that security over a six month period. Regulation ATS, 17 C.F.R. § 242.301(b)(3) (2005).

By contrast, the Nasdaq UTP Plan does not contain a trade-through rule and, despite SEC pressure,[112] there is no intermarket trade-through rule on Nasdaq securities. The result is that ECNs now dominate the trading market in Nasdaq securities. ECNs continue, on the other hand, to have a very minor position in the trading markets for exchange listed securities. In Regulation NMS, the SEC now seeks to impose a trade-through rule on the Nasdaq.[113] In so doing, as discussed in the next section, the SEC had to satisfy the complaints of the ECNs, primarily by applying the rule only to quotations that are immediately accessible through automatic execution.

The history of the evolution of the ITS is sobering, for it is the proverbial nose of the camel under the tent. The SEC is using the ITS as a vehicle to develop, step by step, a full-blown centralized trading system. Regulation NMS is the latest SEC maneuver in this steady progression. Since 1972, the SEC has periodically repeated its preference for strengthening the ITS system by asking for comments on stronger versions of the system. In a 2000 Concept Release,[114] for example, the SEC requested comments on a CLOB, a message switch with price and time priority, and an order exposure rule modification for the ITS. In 2002, I wrote that "[s]ome day the SEC may get its way."[115] In Regulation NMS, the SEC has decided to go for broke with its proposed "Access Rules."[116] With these Access Rules, the SEC has effectively proposed turning the ITS into a surrogate CLOB.

To understand the current SEC proposals one first has to consider the SEC's historical flirtations with market centralization proposals. Advocates of centralized markets tend to favor one of three particular arrangements. First, there are advo-

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112. *See, e.g.*, Unlisted Trading Privileges, Exchange Act Release No. 34-22,412, 50 Fed. Reg. 38,640 (Sept. 24, 1985).

113. Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 7.

114. Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42,450, 65 Fed. Reg. 10,577 (Feb. 28, 2000).

115. *See* Dale A. Oesterle, *Congress's 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?*, AM. ENTERPRISE INST. MONOGRAPH 17 (May 2003).

116. Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 9-11. *See also* Exchange Act Release No. 34-50,870 at 9-11, 69 Fed. Reg. 77,424 (Dec. 27, 2004).

cates of the "black-box" approach. Devotees of this approach envision the single market to be one all-encompassing computer trading system (sometimes referred to as a strict time-priority central limit order book, or "hard CLOB").[117] Second, there are those who favor a stronger overarching ITS with more stocks and more automatic routing and execution.[118] Enthusiasts argue that time priority can also be imposed on competing markets by forcing all trading through a computerized message switch that monitors the timing of quote updates and routes orders accordingly. And third, those in current positions of superior market power—principally the NYSE—urge the SEC to consolidate order flows of selected securities in specified markets. There are several versions of the third position. Historically the NYSE consolidated order flow in listed stocks on its exchange with internal no-compete rules; members of the exchange had to agree not to trade listed shares off the exchange. With the loss of the rules and their remnants, the NYSE now has urged the SEC to terminate the ITS system, recognizing that the NYSE could easily maintain its dominate market position in listed shares if it was not required to integrate with other markets.[119] Modern versions of this proposal include a version that would give corporations the right and power to list their shares on only *one* market, the market of their choice.

Historically, the SEC had flirted with version one, resisted version three, and settled on version two, a growing ITS sys-

117. The most mature of the proposals comes from J.W. Peake. *See* Junius Peake, *Market Center Competition: Order Flow or Listings?*, "Market Microstructure" Conference, Sponsored by the New York Stock Exchange in conjunction with the University of Southern California and the University of California at Los Angeles, (Mar. 26-27, 1992). In his proposal, an issuer would have the exclusive right to determine, for five-year periods, a single exchange for the trading of its securities.

118. Professor Jeremy J. Siegel of the Wharton School of Business argues that the SEC should establish an inter-market trading system on which the highest bid and lowest offer for every stock, no matter where they originate, should be displayed on a screen available to all investors around the clock. Jeremy J. Siegel, *Manager's Journal: The SEC Prepares for a New World of Stock Trading*, WALL ST. J., Sept. 27, 1999, at A34. Professor Siegel's view seems to have piqued the SEC's interest as Regulation NMS makes bid and ask prices for ITS linked stocks available for all investors.

119. Greg Ip, *NYSE, in a Break With Heavyweights, Calls for End to System Linking Markets*, WALL ST. J., Apr. 7, 2000, at C1.

tem. The concept of an overarching ITS does have a certain superficial appeal. But the ITS system shares many of the problems of any self-regulatory organization.[120] The ITS is itself a combination of otherwise independent trading markets.[121] If all exchanges were required to belong to the ITS, and the ITS maintained exclusive rules for membership and a dominant market position, that system could easily become an anti-competitive combination of otherwise independent competitors. One can make a good case for the proposition that in the past the ITS system has been a major tool used by the national exchanges to stifle competition in exchange-listed securities. When the SEC recently announced an initiative to give NASD dealers full access to trading NYSE listed securities over the ITS, the SEC Chairman commented that the change was "long overdue and, frankly, should have been accomplished some time ago through the voluntary efforts" of the ITS membership.[122] Currently, ECNs claim that the ITS's trade-through rules are anti-competitive.[123]

Centralizing trading through a time-priority message switch—that is, a modified ITS—raises all the same issues as centralizing trading in a central limit order book, the CLOB version of the "black box" approach. It requires expensive new infrastructure and bureaucracy, precludes competition and innovation, and leaves the market dependent on government-imposed technology. Moreover, a time-priority rule does not take into account other attributes of the participating markets that are relevant to execution choice. Another concern with time priority is that it prevents competition on factors other than price. In other words, the trading market that is first in line gets the order, regardless of whether other markets offer enhanced liquidity, faster or more reliable systems, lower rates of failed trades, or better credit, to name a few of the many factors on which markets compete today. Under a time-priority rule, the better markets will pressure the SEC to mandate rules that either "shape-up" or eliminate the sloppier mar-

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120. *See generally,* Oesterle, *supra* note 90.

121. For example, under the rules governing the ITS, each exchange has a veto over all ITS rule changes.

122. *Id.*, op. cite (Dec. 9, 1999).

123. *See supra* note 108 and accompanying text.

kets—a sure recipe for ever more intrusive SEC micro-market regulation.

What is the best ITS system? Surely the SEC ought not to be the final arbiter on these critical operation issues—but nor should an exclusive trade association of all the old-line exchanges. It is questionable whether an SEC micro-managing the operating characteristics of a super-ITS system will make the right technical decisions. For example, the overarching ITS system as envisioned by many of its advocates would have the same quote display problems that so bedeviled the SEC in its efforts to promulgate Regulation ATS. Can participants quote different prices for different amounts? Would traders be required to display their entire position or could they dribble out their sales? Would all brokers have ITS access? Should strict time/price priority be enforced through an ITS (option six in the SEC's Concept Release on Market Fragmentation)?[124] Should an order exposure rule be applied through an ITS (option three in the SEC's Concept Release on Market Fragmentation)?[125] If the answers do not accord with the desires of large traders, those traders will go to London or

124. *See* Commission Request for Comment on Issues Relating to Market Fragmentation, *supra* note 116, at 21 ("To assure a high level of interaction of trading interest, the SEC could order the establishment of a national market linkage system that would provide price/time priority for all displayed trading interest. Under this option, the displayed orders and quotations of all market centers would be displayed in the national linkage system (NLS). All NLS orders and quotations would be fully transparent to all market participants, including the public. Orders and quotations displayed in the NLS would be accorded strict price/time priority. Market-makers could execute transactions as principals only if they provided price improvement over the trading interest reflected in the NLS. Trading interest in the NLS could be executed automatically; however, the NLS would not be a market center itself: executions would continue to occur at the level of individual market centers. Public access to the NLS would be provided through self-regulatory organizations, alternative trading systems, and broker-dealers. The NLS could be administered and operated by a governing board made up of representatives from the public and relevant parts of the securities industry.").

125. *See id.* at 19 ("As a means to enhance the interaction of trading interest, the SEC could require that all market centers expose their market and marketable limit orders in an acceptable way to price competition. As one example of acceptable exposure, an order could be exposed in a system that provided price improvement to a specified percentage of similar orders over a specified period of time. As another example of acceptable exposure, a market maker, before executing an order as principal in a security whose quoted spread is greater than one minimum variation, could publish for a

Brussels unless the ITS system has overwhelming market power; that is, a monopoly maintained through government regulations.

The SEC's proposed solution to the potential problems of a strengthened ITS is contained in Regulation NMS. In the Regulation, the SEC offers a dramatic restructuring of the national securities markets, using the ITS. In so doing, the SEC seeks openly to regulate the ITS system as if it were a public utility. (We have already noted above the public utility style regulation favored by the SEC in trade and quote information dissemination.)[126]

Proposed Regulation NMS contains several new initiatives: a new trade-though rule for the ITS, new access rules for the CQ, a prohibition on quotes in fractions of a penny, and a new method of allocating fees collected by consolidated data reporting services.[127] Of the initiatives, the new trade-through and access rules are the most far-reaching. The trade-through rules offer three major changes.[128]: First, trade-through protection is extended to the Nasdaq, covering all NMS stocks, from very large block trades to very small trades (100 share blocks). Second, the trade-through protection is limited to automated trades, excluding quotations in manual markets. Third, the trade-through protections may be extended to depth of book quotations—quotations in any market center that are inferior to the market's best bid and offer—at the choice of individual markets.[129] To protect the integrity of the new trade-though rules, however, the SEC had to open up market access to the protected quotes on controlled fees. The access rules therefore prohibit market centers from controlling their own membership; the centers must accept all private

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specified length of time a bid or offer that is one minimum variation better than the NBBO.").

126. *See* Borrelli, *supra* note 5, at 886-88, 903-04. Borrelli is very critical of the initiative, and states that "[d]irect [SEC] involvement in ratemaking would be unworkable." *Id.* at 903.

127. *See* Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 3.

128. *Id.* at 7-11.

129. The SEC, in the Regulation NMS release, repeatedly underlined the word "voluntarily" to emphasize that the agency is not proposing the markets be required to disseminate their DOB quotations. *Id.* at 32.

links—even from non-members—on "non-discriminatory" terms, at the SEC's proscribed fees ($.003 per share).[130]

These changes, if adopted, will restructure the market, effecting the most dramatic changes since the passage of the New Deal legislation that put the markets under federal regulation.[131] Some changes will be predictable and many will not. There is heavy speculation on who the "winners and losers" will be under the new rules.[132] The SEC Commissioners themselves split on whether to propose the Regulation.[133]

The floor brokers on the New York and American Stock Exchanges would appear to be the big losers, as the traditional open out-cry auction exchanges will be forced to automate a higher percentage of their trades to get the benefit of trade-through rule protection. Moreover, modern ECNs will be able to trade exchange-listed securities on an equal basis with the exchanges for the first time in their young history. It may be the beginning of the end for the manual auction market on these storied exchanges. NYSE seat prices hit a nine year low in January as a result of the anticipated changes.[134] Other losers may include the smaller ECNs trading NMS shares on Nasdaq;[135] they will lose order flow to the larger markets in those shares. Consolidation of the automated markets trading Nasdaq shares appears inevitable. Finally, all traditional market-makers (specialists on the exchanges and manual market-makers on the NASD) will lose privileged access to quote information if the DOB system is widely adopted.

The biggest winner under Regulation NMS will be the SEC, which has made a permanent position of enhanced im-

130. *Id.* at 9-10.

131. The changes will dwarf the effect of the 1996 Order Handling Rules initiative that gave the ECNs room to operate. Order Execution Obligations, Exchange Act Release No. 34-37,619A, 61 Fed. Reg. 48,290 (Sept. 12, 1996).

132. Kate Kelly & Deborah Solomon, *New SEC Rules Create Winners (And Losers)*, WALL ST. J., Dec. 9, 2004, at C1 (NYSE floor brokers, Nasdaq may be losers; institutional investors, small retail investors may be winners).

133. Deborah Solomon, *Changes in the Trade-through Rule Spark Divisions Within the SEC*, WALL ST. J., Dec. 16, 2004, at C3 (the proposal passed 4-1 with Commission Paul Atkins dissenting).

134. Kate Kelly & Jed Horowitz, *NYSE Seat Fetches Only $1 Million, A Nine-Year Low*, WALL ST. J., Jan. 7, 2005, at C1. *See also* Jenny Anderson, *Cheap Seats Provide View of Troubles At Exchange*, N.Y. TIMES, Jan. 10, 2005, at C1.

135. This could include the Nasdaq itself because the larger ECNs, ArcaEx and Instinet, currently have more volume and better prices.

portance for itself; it will be the eight-hundred pound gorilla of our trading markets.[136] The NYSE and Nasdaq will become *de facto* operating branches of the SEC.

The SEC's various centralized order routing proposals, of which Regulation NMS is the most current, share a common problem. A central market would be a government-sponsored monopoly (or in more positive terms, a "public utility") and it would be resistant to innovation.[137] At best, one ought to doubt whether the SEC has the foresight to create a market that would be superior to one created by a more competitive process among private parties. Nobody knows currently which, if any, of the proposed trading market systems will prove best. The SEC is more likely than not to pick the wrong system and trading will be less efficient than if it had been left to market forces.[138] Or, even if the SEC picks the correct system for the moment, it will be the wrong system for tomorrow and difficult to change. At worst, the SEC will be captured and corrupted by the interests behind whatever market manages to establish itself as the only game in town.[139]

Some of the SEC's most ardent critics unwittingly aided the SEC's role as the final arbiter of the market's structure. The SEC's market-structure-by-mandate satisfies few in the industry. Unfortunately, many of the SEC's most vocal critics favor an even more centralized market on which all stock of any issuer can be traded.[140] Those who advocate these solutions bemoan the dangers of "market fragmentation." They

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136. *See* Greifeld, *supra* note 89 (Greifeld, CEO of Nasdaq, recognizing the shift).

137. *See generally* Robert B. Ahdieh, *Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets*, 76 S. CAL. L. REV. 277 (2003) (describing the tendency of trading markets to resist innovation).

138. A new entrant in the market, for example, is Nasdaq's Primex system. Primex is an electronic system that mimics the NYSE's own auction-market process. When an order is sent to Primex, participants bid for it by attempting to better the best price then prevailing in any other market.

139. Such a system would, in the long run, be inherently unstable since overseas markets will develop that offer more attractive venues and prices.

140. Steve Wunsch, in his letter to the Wall Street Journal, seems to be complaining about the SEC not centralizing the market. This makes his letter odd indeed, for it is only through laws that a market will be centralized. Left on its own the market for trading systems will have numerous participants. *See* Steven Wunsch, Letter to the Editor, *SEC is Practicing Divine Intervention*, WALL ST. J., Oct. 29, 1999, at A19.

argue that only such a market will be orderly, liquid, and deep, with narrow price spreads. Moreover, only in a single market will traders know with certainty that they have received the best executions of their orders and that no one else offers a better price.

Advocates of a centralized trading system often note the "tension" between competition for orders and competition among trading market centers. The advocates claim that optimal competition for orders requires that all pending orders interact in one trading market. The argument assumes the SEC can establish and keep current an efficient central market, an unrealistic premise given the inherent problems of government micro-regulation. The so-called tension is a false one: the optimal competition for orders will come pragmatically through an ever-evolving competition among market centers for orders. The 94th Congress recognized this, and the SEC should be more honest to this vision.

The problems of designing an all-inclusive ITS demonstrate why it would be better to have competition not only among trading markets for traders but also among inter-market trading networks for the participation of trading markets. An SEC-mandated ITS would eliminate two aspects of competition: first, how competitors use any given inter-market trading system, and second, how competing inter-market trading systems evolve.

Evidence of the strength of the first form of competition in the market—competition inside a trading network—is seen in the joint venture between Archipelago and the Pacific Stock Exchange's stock trading business.[141] The deal gives Archipelago, an ECN, direct access to the current CQS and ITS as an exchange (ArcaEx).[142] ArcaEx has advertised several ex-

141. In March 2000, Archipelago gave the PCX $40 million in cash and a 10% stake in Archipelago Holdings, creating a joint venture that allowed Archipelago to operate ArcaEx as an equity exchange. Now, Archipelago Holdings is going to purchase the rest of the PCX, including the options trading floor. It plans to close the trading floor and offer traditional equity securities and options on the same all-electronic platform. Jenny Anderson, *Market Owner Agrees to Buy Pacific Exchange*, N.Y. TIMES, Jan. 4, 2005, at C1.

142. The Archipelago joint venture with the Pacific Stock Exchange in 2000 was the first in a series of mergers between ECNs and Exchanges or ECNs with each other. In September 2004, Nasdaq purchased the Brut ECN for $190 million from Sunguard Data Systems. This purchase gave Nasdaq

change innovations. First, members in the current system can execute all incoming orders in-house as long as they match the best price in the system; they do not have to route orders to the market that first displayed the best price. But the Archipelago program promises to automatically route incoming orders to whichever market has first posted an opposite order at the best price. That is, Archipelago may voluntarily offer strict time priority in an effort to woo customers.[143] Second, Archipelago also eliminated the specialist position in favor of competing market-makers on its exchange. Third, traders have more options in how to present their trading positions in the system:[144] reserve orders,[145] discretionary orders,[146] immediate or cancel orders,[147] now orders,[148] and pegged orders[149]—in addition to the standard limit orders, stop orders, and market orders. The SEC did not need to "facilitate" or otherwise order

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access to the full depth of Brut's trading book, a smart-routing system that allows other ECN's to trade on the Nasdaq Market System, and a broker/dealer that will allow it access to ArcaEx, and potentially, the NYSE. Instinet Group purchased the Island ECN in 2002, creating the INET ECN. Instinet Group also owns Instinet, a broker-dealer for institutions. Together these two entities form the most promising ECN in the market today. Instinet Group entertains a variety of mergers, acquisitions, and joint ventures for INET in the current market. Of course, the recent news regarding the NYSE and Archipelago transaction follows this trend. The wave of mergers of ECNs and broker dealers is likely to continue, as proposed Regulation NMS makes automated markets all but necessary to remain viable. *See* Ivy Schmerken, *Making Markets Move: The race to become a fast market may lead exchanges to join forces with ECNs*, WALL ST. & TECH. (July 26, 2004), *at* http://www.wallstreetandtech.com/showArticle.jhtml?articleID=25600563.

143. The exchange risks losing brokerage clients that want payments for order flow but will hope to draw customers based on increases in execution speed, decreases in cost, and increase in execution quality.

144. The order forms are evolving and subdividing in response to traders' requests. For an updated catalogue and description, *see generally* Welcome to Archipelago, *available at* http://www.archipelago.com. Currently, ArcaEx can handle 24 different order types. *Id.*

145. A trader can enter a larger order than he wishes to have displayed in the system. *See id.*

146. A trader can enter a more aggressive price without 'exposing his hand' to the market. *See generally id.*

147. The order is executed immediately if Arca's book has the best insider price; otherwise, it is cancelled. *Id.*

148. "Now orders" are treated like IOC orders with the addition of a pool of pre-qualified market-makers other to Arca's book. *See id.*

149. A trader can enter an order pegged and indexed to quotes or other prices. *Id.*

any of the practices or innovations. The NYSE, otherwise a very cautious innovator, has responded with a new Liquidity Quote of its own.[150] New Regulation NMS would stifle such innovations, borne out of inter-market competition.

Additional evidence of competition inside a trading network is the explosion in trading centers featuring Nasdaq stocks. The NASD system of trade and quotation reporting has, until now, not contained a trade-through rule and, as is noted in the next section, Nasdaq stocks are now traded on the exchanges, through the Nasdaq Market Center, formerly known as the SuperMontage System, and on the NASD's ADF system. The ADF system is an information processor that is separate from the Nasdaq Market Center. Although they are both ruled by the NASD, they are in a sense competitors. As a consequence, there are now three significant trading venues for Nasdaq securities competing head to head for market share—the Nasdaq Market Center, INET, and ArcaEx.[151] Most importantly perhaps, several services directly access the multiple venues for traders[152]—in essence, the ECNs, responding to customer demand, have put in a version of a trade-through rule on their own,[153] all without an SRO or SEC mandate.[154]

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150. Mary Schroeder, *SEC Backs Bloomberg Liquidity Quote View*, SEC. INDUS. NEWS, Apr. 7, 2003, at 1 (traders can now provide quotes of substantial size on the exchange that are executable).

151. Isabelle Clary, *SuperMontage Technology Garners Praise Amid Slump*, SEC. INDUS. NEWS, Apr. 28, 2003, at 1.

152. *See id.* (discussing Track Data Securities); *Consolidating Fragments*, *supra* note 86 (discussing the Lava Colorbook.) ArcaEx also offers to route its trades to the best market under specified order directions. The order routing among ECNs has been the subject of some acrimony, however. *See* Isabelle Clary, *SEC Probes ECN Access, Pricing*, SEC. INDUS. NEWS, Apr. 14, 2003, at 1 (Island sued Archipelago over nonpayment of access fees and Archipelago counterclaimed with an antitrust suit).

153. Indeed, some traders fault the Nasdaq Market Center (successor to the SuperMontage) system for not, on its own, providing a version of a trade-through rule. *See* Amy Baldwin, *Once-hot Nasdaq Fights to Reverse Slide*, CHI. TRIB., April 28, 2003, at Bus. Sec. 6.

154. The proliferation of trading centers in Nasdaq stock has led to an increase in locked and crossed markets, however. In a locked market the bid and offer quotes are the same; in a crossed market the inside bid price is greater than the inside sell price. There is some debate over how harmful such situations are and, if harmful, how to deal with them. *See, e.g.*, Isabelle Clary, *STA: Ban Fees on Locked Markets*, SEC. INDUS. NEWS, Mar. 31, 2003, at 1.

Evidence of the strength of competition among information processors comes from internet businesses that interconnect various retail markets to offer customers the best price alternatives. The travel market, consisting of airline tickets, hotels, rental cars, and tourist event tickets, is the best example. Anyone can log on to one of these popular internet sites and compare prices from a variety of businesses. The securities trading markets can and will develop competing market linkage sites that will not only include American markets but also markets abroad (London, for example) that trade American stocks. Indeed, as noted above, there are several very creative information processors, such as the Lava Colorbook,[155] that combine the quotes from the various trading markets now. The SEC should not retard the development of either of these two forms of competition.

Trading markets are no different from any other service markets: the more competition and the less government intervention the better. The majority of the SEC's critics who demand a black box or CLOB have it upside down.[156] The SEC is too intrusive already, and trying too aggressively to micromanage an order routing linkage of the various trading markets.

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155. *See Consolidating Fragments*, *supra* note 86.

156. There is a recurring proposal to consolidate market trading without the creation of an over-arching linkage system. Called a "competition for listing" proposal, the advocates would have individual firms choose, for five-year periods, the exclusive trading markets for their shares. *E.g.*, Beny, *supra* note 57; Morris Mendelson & Junius W. Peake, *Intermediaries' or Investors': Whose Market Is It Anyway?*, 19 J. Corp. L. 443 (1994). The proposals assume, first, that firms would only list in one market (they could choose to list in several); second, that the intermarket linkage systems would be dismantled; third, that moving from one trading market to another would be easy (the new delisting rules on the NYSE have not encouraged a move off the market); and, fourth, that foreign markets would not take up the slack, trading in unlisted shares in American companies. The first and second problems are interwoven: intermarket linkages would remain an issue if issuers under such a system choose to list in more than one market. There may also be some unintended consequences from such a proposal. Absolute firm control over listing would add another agency problem to the trading markets that does not now exist; or management could abuse the privilege to obtain personal advantage at the expense of their shareholders (e.g. list on a market whose rules prohibit hostile takeovers). There are other corporate governance issues as well, such as whether a firm could opt out of making such a choice.

I argued in the previous section that the concept of a centralized order routing procedure is inconsistent with the intentions of the 94th Congress when it enacted the 1975 amendments; that is, that the SEC is not authorized by the 1975 amendments to create a centralized routing procedure. I also believe that the 94th Congress was correct in its policy preferences. So even if one believes, as the federal courts will undoubtedly find, that the 1975 amendments do authorize the SEC's ITS initiatives, as a fall-back position, I also suggest that the SEC has made a series of policy mistakes and needs to rethink the conceptual paradigm of its program.

The SEC's Micro-Structuring of Individual Market Center Routing and Execution Practices: Case Studies of the Regulation of Quote Form and of ECNs

The SEC is not content to just arbitrate the design of the CTA, CQS and ITS links. The SEC also writes rules on how market participants must use these links. This gives the SEC an open license to micro-structure the internal features of the market centers that are connected by the systems. SEC rules for accessing and using the inter-market links become trading rules for each of the individual trading markets. One of the true innovators of the ECN, Steve Wunsch, the President of the computerized Arizona Stock Exchange, defined the issue well in an October 29, 1999 letter to the Wall Street Journal. Wunsch criticized the SEC for "playing God":

> In pursuit of such nebulous concepts as "transparency," "efficiency" and "fairness," the SEC and its academic advisers have relentlessly intervened to redesign the market structure. But, just as it is difficult to design a better eye or grain, attempts to turn the stock market into a "level playing field". . . have produced only a slew of unintended consequences . . . Why not let the market structure result from competition rather than mandates from on high?[157]

In practice, the SEC reads the 1975 national market system mandate to empower it to craft a plethora of regulations on the operation of the individual markets. There are regula-

157. Steven Wunsch, Letter to the Editor, *SEC is Practicing Divine Intervention*, WALL ST. J., Oct. 29, 1999, at A19.

tions on, among other things, member and subscriber access, price quote and trade display practices, listing requirements, execution fee schedules, best execution obligations of brokers, order routing practices, limit order procedures—in short, regulations on much of the essence of the market structure. It is amazing what rules the SEC justifies in the name of promoting a national market system. And the number and scope of the rules continues to grow. Moreover, with the speed of the changes in the market, the SEC, unless it reverses course, will find itself constantly tinkering with the rules in a struggle to keep structure current with technology and to eliminate what have proven to be past regulatory blunders. The pace of SEC rulemaking is falling behind current market developments.[158]

Examples of the SEC national market system regulations bleeding into the regulation of market center internal structures are numerous. A few significant ones are worthy of discussion.

1. Case Study One: SEC Rules on Quotation Practice

Consider first the SEC's rules on quotation practice. The link between markets provided by the CQS led the SEC to adopt Rule 11Ac1-1 in 1978 on market-makers' quotation practices. The rule requires market-makers' quotes to be "firm"—to obligate the quoting market-maker (or specialist) to execute a transaction at the quoted price. The rule also requires all quotes to include a size for which a price is firm.[159] The rule sounds straightforward, but it is not.

Numerous administrative problems have led to repeated amendments to this rule. The cost burdens of the rule required SEC amendments, for example, that exempted market-makers and exchanges that do less than one percent of the volume in a covered security, and that protected market-makers in periods of usually rapid price movements.[160] There was also a modification for the firm quote obligation when market-makers were executing one order, and a second appeared

158. *See, e.g.*, Isabelle Clary, *Nasdaq Pushes SEC To Rule on Its Status*, SEC. INDUS. NEWS, Mar. 17, 2003, at 1 (Nasdaq has waited over 20 months on its application to be an exchange).

159. This is often the minimum required by each exchange or the NASD.

160. *See* Securities Exchange Act of 1934, 17 C.F.R. § 240.11Ac1-1(a) (25), (b)(1), (b)(3) (2005).

before the market-maker had revised her quote.[161] Exceptions for modern innovative securities such as ETFs were required. More changes were to come.

In September 1996, the SEC promulgated its so-called Order Handling Rules, an initiative it often points to with some pride.[162] The Order Handling Rules, prompted by the SEC's concern over market fragmentation,[163] adopted the Display Rule and the ECN amendment. The Display Rule requires market-makers and specialists to display customer limit orders and their size when the orders are priced better than the market-maker's or specialist's quote.[164] The ECN amendment attempts to eliminate "hidden markets." It requires specialists and market-makers who place orders with an ECN at a price better than her public quotation to either make the better price publicly available, or use an ECN that will publicly disseminate its prices and allow other broker-dealers access to its system.

These rules were successful, illustrating that when the SEC limits itself to straight-forward disclosure (a form of anti-fraud) rules, the agency has a valuable role to play. The Display Rule has had very positive effects for the Nasdaq. The Display Rule forced Nasdaq market-makers to display customer limit orders and that, combined with Nasdaq's new automated trading programs, has caused a significant increase in customer-to-customer transactions—transactions without a dealer as an intermediary.[165] This lowers trading costs and makes the market more attractive to traders. Moreover, the Display Rule put ECNs in direct competition with traditional Nasdaq market-makers in the business of attracting customer limit orders. The competition among markets drove down

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161. *Id.* at (c)(3)(i)(B), (c)(3)(ii)(B).

162. The Order Handling Rules provided a short-term shot in the arm to the business of ECNs.

163. The SEC expression of this concern is always a signal that order routing requirements are in the offing.

164. Securities Exchange Act of 1934, 17 C.F.R. § 240.11Ac1-4 (2005). The Rule applies only to Nasdaq or exchange listed securities. *See* Order Execution Obligations, *supra* note 131.

165. *E.g.*, Gretchen Morgenson, *At Big Board, a Disturbing Investigation Of a Lesser Sin*, N.Y. TIMES, Apr. 24, 2003, at C1 (dealers only involved in 43% of Nasdaq trades).

market making fees and charges and encouraged market structure innovations.

The SEC's regulations on quotation practice also affect the details of the country's more innovative automatic execution systems. By way of illustration, consider the "Small Order Execution System ("SOES") Bandit" problems of the early 1990s. The SOES Bandits proved in the early 1990s that clever traders could beat the SEC's quote rule.[166]

The NASD designed SOES in 1985 to make it easier for small investors to obtain an automated execution of their orders. Participation of a market-maker in SOES was initially voluntary, but once a market-maker chose to participate in the system, it could not withdraw without the consent of the NASD. Later, SOES became mandatory for NMS stocks, and unexcused withdrawals now receive a penalty of a twenty-day suspension.[167]

As a result of the SEC's firm quote rule and the 1988 rule changes to SOES, a group of savvy traders took advantage of the system's automatic execution features to generate huge trading profits at the expense of the market-makers who had trouble updating their quotes fast enough in a volatile market. There followed a five-year tug of war between the NASD—which attempted to protect its market-makers—and the SEC, which worried that the NASD's solutions would stratify the SOES market.[168] In the end, the SEC blocked almost all of the NASD proposed solutions. The NASD now attempts to discourage SOES bandits through disciplinary actions with some continuing resistance by the SEC.[169] One can take sides in the

166. Order Approving Proposed Rule Change, Exchange Act Release No. 34-21,742, 50 Fed. Reg. 7,435 (Feb. 22, 1985). *See also* Order Approving Proposed Rule Change to Define Professional Trader, Exchange Act Release No. 34-26,361, 53 Fed. Reg. 51,605 (Dec. 22, 1988).

167. *See* Order Granting Accelerated Approval to Proposed Rule Change, Exchange Act Release No. 34-25,791, 53 Fed. Reg. 22,594 (June 16, 1988).

168. For a history, *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. 34-37,542 (Aug. 8, 1996) at 213-55. The NASD wanted to ban trades from a "professional trading account" in the SOES system and wanted to give market-makers a fifteen second grace period between executions. The SEC approved the rules but, stung by criticism from the D.C. Circuit, reversed itself and repealed them. In 1994, The SEC approved a one-year pilot program and then refused to renew it in 1995.

169. *Id.*

dispute or just note that the SEC's quote rule inevitably caused some unexpected problems for the creation of a workable automated system.

The NASD has since created a SuperSOES (which became the "SuperMontage" system and now the "Nasdaq Market Center") and the cascade of SEC rules tweaking and tinkering with the NASD automated execution system continues unabated.[170] A recent example was the NYSE's demand that data vendors who want to redisseminate their new Liquidity Quotes not integrate those quotes with other market center's' quotes.[171] The SEC refused the request.[172] Also heavily contested, to the point of litigation, were the SEC rules on removing ECN quotes from the Nasdaq Market Center system to prevent "locked" or "crossed" markets.[173]

In any event, rather than letting individual market centers establish their own quotation procedures, the SEC is now well on its way to the creation and enforcement of a national rule on quotation practice. The SEC first created the CQS, then a firm quote rule, and then exceptions to the rule. Now the agency must deal with the many technical problems associated with the rules. A better practice would be an SEC rule that mandates that continuous trading markets[174] provide quotes to all inter-market systems that will pay for them, and enforces whatever quote practices each market chooses to develop, implement, and advertise. A market that does not itself offer traders some sensible version of quotation practice will not last long.

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

171. *See* Schroeder, *supra* note 150.

172. Although the SEC seems to have permitted the NYSE to require segmented reported of its Openbook (limit order) quotes.

173. *See* Domestic Sec., *supra* note 9 (contesting "decrementation"). A locked market occurs when the highest quoted bid price equals the lowest quoted ask price. A crossed market occurs when the highest bid price is greater than the lowest quoted ask price. Locked or crossed markets temporarily stall market trading until the market is unlocked or uncrossed.

174. A pure non-continuous, periodic auction market should not have to provide open quotes; ITS does not have any.

2. Case Study Two: The SEC Rules and ECNs

My second example of SEC rules that micro-structure trading markets revolves around the SEC's rules for automated (computerized) order execution services. While the problems with the quote rule are distracting, the SEC's regulations on ECNs are serious business. These rules affect the most innovative part of our national securities markets, the part of our markets that will determine whether the United States maintains its international pre-eminence in the world's financial markets. And the SEC has become very aggressive in regulating ECNs. In new regulations for ECNs, the SEC attempted to "regulate the wind;" that is, it took on the task of regulating computerized trading technology.

As noted above, since 1972, the SEC has thought about some form of centralized market. While the SEC has been unable to order the use of a preferred centralized system, it is inching inexorably towards one with a growing package of specialized rules on automated trading. This the central piece of the bottom-up strategy noted above. A top-down strategy would define and enforce a detailed best execution obligation for market participants; but such an obligation is too hard to define with the concreteness necessary for a day-to-day direction of trading practices.[175] A bottom-up strategy, accumulating rules in specific situations, is more politically feasible.

The SEC's bottom-up strategy' on automated execution seems to have two parts. First, the SEC mandates order routing links through the ITS for listed securities and through the Nasdaq National Market Execution System for NMS securities. Second, the SEC imposes individual obligations on market participants to direct their orders through these systems pursuant to a growing body of operating rules. While the first step was discussed above (Regulation NMS is the SEC's boldest step

175. A broker-dealer that receives a customer order has a duty of best execution under the common law of agency and, if the doctrine is still viable, the "shingle theory." A broker-dealer hangs out its shingle when it offers to deal with customers. *See* Charles Huges & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943). *See generally* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995). The duty cannot be confined to obtaining the best price. It also includes other aspects of order handling, such as speed and certainty of execution. *See* Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 34-43,084 at 5-9, 65 Fed. Reg. 48,406 (Aug. 8, 2000).

in this strategy and takes the agency very close to its goal, a centralized national trading market system), the second step means that the SEC must take increasing control over the details of the operating systems of the ITS participants. A discussion of the details of these rules—while difficult to read—is necessary to get a sense of how much involved the SEC has become in the technical side of structuring our markets.

Prior to proposing Regulation NMS in 2004, the SEC had seriously considered rules on internalization,[176] payment for order flow,[177] order exposure,[178] and trade-through.[179] It had adopted none of the proposals and settled for a more traditional SEC approach to confounding regulatory problems—a new detailed public disclosure rule. In November 2000, the SEC adopted a Disclosure Release that requires market-makers and broker-dealers to make extensive public disclosures regarding order routing and execution practices.[180]

Rule 11Ac1-5 requires "market centers" to make specified information available to the public on a monthly basis in electronic form, and Rule 11Ac1-6 requires broker-dealers to disseminate quarterly reports on their routing practices. Rule 11Ac1-6 also requires, among other things, broker-dealers to reveal material aspects of their relationship to market centers, including arrangements of payment for order flow or other profit sharing arrangements. The SEC hopes the disclosure will discipline market-makers with publicity, provide a vehicle for enforcement actions against misbehaving market-mak-

176. The practice of a broker-dealer routing orders to its own market-making desk or to an affiliate for execution.

177. The practice of market-makers providing compensation to broker-dealers that route the order for execution. Payments for order flow may take many forms other than cash. A market-maker may, for example, offer clearing services to the directing broker-dealer.

178. An order exposure rule would require a broker-dealer, before executing an order as a principal, to expose the order to trade interest on another market center. The NYSE has periodically proposed such a rule.

179. A trade-through rule would require broker-dealers executing customer orders to route the order to the market center that is providing the best price. At present in the ITS system, a market-maker has the option of meeting another market's best price rather than routing an order to that market.

180. Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 34-43,590, 65 Fed. Reg. 75,414 (Dec. 1, 2000).

ers,[181] and encourage traders to select market-makers with preferred execution practices.[182]

But the Disclosure Release has been a temporary (although welcome) respite. The SEC has also been piecing together a quilt of very specific order execution practices in selected contexts. The SEC's biggest recent leap in regulating execution practices has been in the regulation of ECNs. In the past decade, entrepreneurs with expertise in telecommunications and computers have developed a variety of alternative securities trading systems that have the potential for becoming substitutes for traditional securities exchanges. These computerized trading systems now handle over fifty percent of the orders in securities listed on the Nasdaq and almost seven percent of the orders in all exchange-listed securities.[183]

The ECN sector has evolved rapidly over the few years in which it has been robust. There were over a dozen ECNs operating in the late 1990s and there are only six ECNs left today. The year 2002 was marked by heavy consolidation. Of the six ECNs left, only three have substantial volume. One of the three ECNs, Archipelago, has joined with the Pacific Stock Exchange to become ArcaEx. The other two ECNs—both divisions of Instinet—operate as quasi-exchanges. Instinet itself is the only major participant on the NASD alternative display facility ("ADF") and its division, INET, is the only big player left on the National Stock Exchange (formerly the Cincinnati Stock Exchange). Nasdaq achieved ECN status by merging with BRUT. As a result of proposed Regulation NMS more consolidations no doubt lay ahead.[184] This is exacerbated by

181. A market-maker who is misbehaving is also likely to lie on the disclosures, and a suit based on lying is easier to bring and prove.

182. The new filings have been a valuable source of information that otherwise might not be public. For example, Rule 11Ac1-5 filings of the NYSE (an exchange that has historically been very parsimonious with its internal operating data) have opened a few eyes.

183. *See generally* Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50,700, 69 Fed. Reg. 235, at 71,275 (Mar. 8, 2005).

184. Before recent news of the impending merger between the NYSE and Archipelago, there were repeated rumors of merger talks between NASD's Nasdaq Market Center (the successor to SuperMontage) and Archipelago. *See, e.g.*, Jeremy Adams, *Nasdaq Sets Sight on Acquisitions*, EFINANCIAL NEWS, Mar. 11, 2003, *available at* 2003 WL 4202650. These rumors ended with Nasdaq's acquisition of the BRUT ECN. INET, the largest and most powerful of the remaining independent ECNs, is likely to file for SRO status, or merge

the fact that several of the major players are reporting operating losses.[185]

The SEC struggled in the late '1990s with the problem of how to regulate the new, emerging ECNs. Traditional market centers, asking the SEC to stifle these dangerous new competitors, complained about market fragmentation and an unequal regulatory playing field. The ECNs just asked the SEC to be left alone; they knew they could compete successfully with traditional market-makers. The only rule holding ECNs up was the ITS trade-through rule on exchange listed securities.

The first big SEC action affecting ECNs, the Order Handling Rules of 1996[186], were not directly aimed at them. The Rules were aimed at traditional market-makers and their refusal to publicly quote limit orders that bettered their displayed quotes. Forcing OTC market-makers to display their BBO limit orders created a temporary boon to ECNs that were used by market-makers to post alternative quotes. Four ECNs registered with the NASD immediately after the release.

The SEC's major directive aimed directly at ECNs came a few years later. After releasing three major series of proposed rules—each over one hundred text pages—the SEC settled on rules that became effective on April 21, 1999.[187] In essence, the SEC gave an ECN two options. First, an ECN could choose to register as a national securities exchange and meet the very expensive licensing requirements of the Securities and Ex-

with one of the other regional exchanges. *See generally* Schmerken, *supra* note 142.

185. In the last quarter of 2002, Instinet reported an operating loss of $10 million. In 2002, Instinet posted a net loss of $735 million, which included at one-time charge of $102 million for the purchase of Island. *See* Isabelle Clary, *Reuters Mulling Instinet's Future,* SEC. INDUS. NEWS, Feb. 17, 2003. Reuters continues to mull over the possibility of selling the Instinet Group, and the combination ECN/broker dealer remains available for the right buyer. Jenny Anderson, *Owner of Big Stock Trading System is Said to Be for Sale,* N.Y. TIMES, Nov. 18, 2004, at C1.AMEX—which had a net loss of $14.3 million from 2001 to 2003—has been spun-off by NASD to its members as of January 2005. *See* Jed Horowitz, *NASD Completes its Sale of Amex to Member Group,* WALL ST. J., Jan. 4, 2005, at C3.

186. *See generally* Order Execution Obligations, *supra* note 131.

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

change Act.[188] Or, second, an ECN could choose to register as a "broker/dealer" and comply with the special licensing re-

188. Consider the operations of a basic ECN. The owner of a large capacity computer writes software to match buyers and sellers, software that the owner believes will appeal to a large number of traders. Traders—both buyers and sellers—subscribe, pay a fee, log on, and place bid and ask orders. The computer matches the trades that it can in a pre-established format. The traders are then notified of the matches. Unmatched traders are either cancelled after a set period of time or forwarded to other markets. The software programs can—and without SEC involvement—would differ from one another in many respects: the type of trader that the program allows to log on; the types of display of the size, price and participant identity for any pending orders; the types of access non-subscribers have to price quotes; the publication of the size, price and identity of participants in any successfully matched trade; and the mechanics of the matching process.

There are many variations of matching processes that might be used to attract traders. A software program could run a call auction at set times (the Arizona Stock Exchange), a continuous matching system with first-in-time priority (INET), or a crossing system that matches unpriced orders at a single price established in another market (Posit), for example. One of the more innovative systems that began with much fanfare and failed was the OptiMark system that allowed traders to post orders for different amounts of securities at different prices. Also, if an ECN chooses to register as an exchange, it must develop a self-regulatory organization side to its business. Consider what this entails. The SRO must include an internal compliance system for its owners and subscribers. The compliance system must include a "fair procedure" for any disciplinary actions. The SRO would also have to develop a package of rules designed, among other things, to prevent fraudulent and manipulative practices, to allocate fees for access to the ECN, and to regulate trading by owners and employees. Why should the SEC require the owner of such a system to form an SRO? There is no traditional exchange membership to discipline. The ECN sells its services to subscribers and should be allowed to terminate subscribers at will or under other conditions set forth in the subscriber contracts. There are far fewer insiders to monitor. An ECN replaces floor brokers and specialists by a machine and technicians. There are minimal listing requirements for the stocks traded. The drastic reduction in manpower at the point of trade in an ECN suggests that there need only be laws that require an ECN to operate free from fraud and to record an audit trail for trades (to detect insider trading and the like.) Such a law might require that any ECN be honestly advertised to subscribers and deliver on its promises. There is no longer a need for complex monitoring and compliance systems on each trading system. If each ECN creates an SRO there will be, at a minimum, excessive duplication among the various regulatory bodies of each ECN and an unnecessary cost burden on each ECN that must be passed on to subscribers in the form of higher fees.

quirements of a new Regulation ATS.[189] Both options came with substantial costs.

Under Regulation ATS, an ECN can participate in the ITS through the NASD/CAES outdated routing platform or through a regional exchange—in both cases paying competitor access fees. An ECN trading in Nasdaq stock can post on the NASD System as a market-maker or list on the new NASD ADF, paying substantial NASD fees in both cases. All but one of the existing ECNs—ArcaEx—has opted for Regulation ATS status rather than register as a securities exchange.[190] The ECNs complain that the NASD access fees add substantial costs to their operations and that the NASD equipment is "old and clunky."[191] As a consequence, one ECN has jumped to the ADF and another posts on a regional exchange. ECNs also attack the ADF system as using "obscure technology."[192]

Despite regulatory burdens, ECNs continue to take Nasdaq market share in trading volume. The NASD first sought regulatory relief, complaining to the SEC of "regulatory arbitrage", and sought to have a uniform set of rules across the various markets trading Nasdaq listed securities.[193] When the SEC balked, the NASD fought back by spending $100 million to develop the SuperMontage System that is its own version of an ECN. In the original NASD proposal, however, the new sys-

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189. If an ECN chooses that alternative, it will fall under the jurisdiction of the NASD's huge SRO, the NASDR, that covers all brokers/dealers in the securities industry. If an ECN attempts to avoid the burdens of creating and maintaining an SRO by not registering as an exchange, then it must register as a broker/dealer and be subject to the NASDR. Yet NASD ran two competing markets, the Nasdaq and the AMEX until January 2005, when the AMEX was spun-off to NASD members. *See* Horowitz, *supra* note 185. To eliminate potential conflicts of interest, the NASD took pains to separate the operation of its trading markets from the operation of its disciplinary arm through a holding company structure. Yet the parent corporation is still run by securities professionals who may have interests in one or more of the trading markets. (The logic of the separation of the divisions is obvious and ought to mature into a total separation of the two functions. NASD ought not to run the NASDR).

190. INET continues to consider the possibility. Schmerken, *supra* note 142.

191. *See, e.g.*, Robert Sales, *ECN Evolution*, WALL ST. & TECH. (Jan. 17, 2003), *at* http://www.wstonline.com/story/supp/WST20030117S0003.

192. *See* Domestic Sec. v. SEC, 333 F.3d 239, 249 (D.C. Cir. 2003).

193. *See* Isabelle Clary, *Track, NexTrade Cut Trading Fees*, SEC. INDUS. NEWS, Jan. 6, 2003, at 1.

tem subordinated executions of large classes of ECN trades.[194] The NASD proposal discriminated against trades submitted to the new system by ECNs that did not accept automatic order executions. The SEC, barraged by angry ECN complaints, responded with a proposal that discriminated against only those ECNs that charged access fees.[195] Tense negotiations ensued with ECNs successfully requesting eight amendments to the SuperMontage proposal before the SEC adopted the new system. The amendment proposals continue post-adoption.[196] As negotiated, the SuperMontage was not the threat to the large ECNs that people thought it would be; it has hurt the smaller ECNs, however.[197]

The final SuperMontage system emerged with a complex labyrinth of trading choices. It was a Solomonic compromise of the highest order. "Directed" orders, sent to specific market centers, have to be oversized to limit dual liability problems. Parties sending "undirected" orders have four choices: (1) the usual order algorithm of the system; (2) the order exposed, successively, with *time* priority to defined market tiers;[198] (3) the order exposed, successively, with *size* priority to defined market tiers; and (4) a reduced priority for ECNs charging separate access fees unless the ECN's quote net of fees is still the best price.

There is much potential mischief in the SEC's role of monitoring ECNs. The SEC cannot resist the temptation to tinker with the operating characteristics of ECNs—all in the name of consumer welfare, of course. For example, in a classic misstep, the SEC required all ECNs registered under Regu-

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194. *See generally* Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Exchange Act Release No. 34-42,166, 64 Fed. Reg. 68,125 (Dec. 6, 1999); Order Approving Proposed Rule Changes, Exchange Act Release No. 34-43,863, 66 Fed. Reg. 8,020 (Jan. 26, 2001).

195. For a history, *see* Borrelli, *supra* note 5, at 869-78.

196. The most recent is Notice of Filing and Immediate Effectiveness of Proposed Rule Change, Exchange Act Release No. 34-47,735, 68 Fed. Reg. 23,787 (May 5, 2003). Another important request is Notice of Filing and Immediate Effectiveness of Proposed Rule Change, Exchange Act Release No. 34-47,621, 68 Fed. Reg. 17,418 (Apr. 9, 2003) (Nasdaq asks lower access fees for reporting internalized orders).

197. *See* Clary, *supra* note 193, at 1.

198. The tiers are: (1) quotes or orders of market-makers and ECNs and UTP agency orders; (2) reserve size of market-makers and ECNs; and (3) principal quotes of UTP (Unlisted Trading Privilege) exchanges.

lation ATS to publicly display the full size of its best buy and sell orders if the ECN volume in a security is five percent or more of the security's average daily volume.[199] Thus if an ECN grows significantly, processing a higher volume of orders, it may have to alter its operating system to allow for such display. Moreover, a five percent volume limits an ECN to using a "reserve system" method of hiding full order size if a trader wants to retain the ability to post single large orders in a way that does not immediately come to the attention of other dealers. The SEC has also required Regulation ATS ECNs to afford non-subscribers execution access to ECN quotes for "fair fees", again at a five percent threshold.[200] But an ECN's control over its subscriber base is a crucial aspect of its overall business strategy.

The SEC, in settling the dispute between NASD and the ECNs, found itself in the too comfortable position of arbitrating a dispute between competitors that, in essence, microstructured the new computerized trading markets. These tortured, nuanced negotiations over the routing practices of the SuperMontage System were just the beginning of a larger negotiation. Just as the basic procedure of the Foreign Corrupt Practices Act of 1977—narrowly applied to control bribery abroad—produced the Sarbanes-Oxley Act of 2002 that broadly applied the same procedure to all internal accounting and disclosure procedures, the SuperMontage rulemaking presaged a much larger negotiation over computerized order routing and execution market wide that emerged in Regulation NMS. The new Regulation may give the SEC the breakthrough precedent it has sought for so long—the opportunity to fashion the creation and operation of an overarching national computerized market system.

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

200. Regulation ATS, 17 C.F.R. § 242.301(b)(4) (2005). An ECN must open its membership if it trades over twenty percent of the average daily volume in a security. 17 C.F.R. § 242.301(b)(5). The SEC has proposed in Regulation NMS to lower the threshold to five percent. Regulation NMS, Exchange Act Release No. 34-50,870, *supra* note 2, at 44.

Regulation Today

So, where are we? The existing structure of the securities markets in the United States is excessively complex and it has been created primarily by, or with the approval of, the SEC. Years of particularized rulemaking have accumulated to encrust our securities markets. Traders and trading centers now engage in regulatory arbitrage, seeking loopholes in the regulatory system to achieve short-term advantages,[201] while the SEC struggles with the cries of injured participants. And yet with each new initiative, the SEC claims it has acted with self-restraint, modestly, only at the margins, and in cooperation with market participants.[202] So the SEC can claim, after having overseen the creation of a cumbersome, overly-regulated system, with multiple tiers and sub-tiers, that with each new rule it will "let the markets work" and act "incrementally."[203]

III.
AN ALTERNATIVE SEC HISTORY

One of my favorite books on the Civil War speculates on the outcome of the Battle of Gettysburg and the War itself given different decisions by Confederate Generals of each major day of the battle.[204] It is a great read—provocative, and, in a way, pointless. In the same vein, one can ask where would we be had there been an alternate SEC after 1975—an SEC that followed a less ambitious path on the creation of a national market system, an SEC that in my view stayed within the outlines of Congress's purpose and intent behind the 1975 Amendments.

Consistent with the analysis above, there would be competing cross-market information processors collecting last sale and other transaction data and collecting quotations from in-

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201. *See, e.g.*, Clary, *supra* note 152 (ECNs reporting on regional exchanges have lower reporting fees, lighter regulatory burdens, and a more permissive short-sale rule.)

202. *See, e.g.*, Regulation NMS, Exchange Act Release No. 34-50,870, at 6 ("Commission has sought to avoid the extremes . . .").

203. *Id.* at 6 ("The Commission . . . [creates] intermarket 'rules of the road' [to] establish a framework within which competition among individual markets can flourish. . .").

204. Brian Thomsen & Martin H. Greenberg, ALTERNATE GETTYSBURGS (Berkeley Books 2002).

dependent trading market centers. The market centers themselves would not have any ownership or management positions in the processors. Individual processors could ask for, process, and package the information from trading centers as they saw fit and negotiate on fees. The SEC would monitor the accuracy of the processors and watch for anti-competitive fee arrangements. The market centers could initially publish their transaction and quotation data themselves or provide it to the processors for initial publication. There would be no discrimination in fees charged to processors by any of the market centers unless based on objective, neutral business-related criteria. If centers did choose to self-publish the data, the SEC would ensure that processors could republish the information.[205]

Order execution systems would depend entirely on market center designed processes, accurately communicated to traders. The SEC would monitor the accuracy of the disclosures and enforce rules against misleading practices or conduct. Order execution systems that were the most efficient would attract the most traders. Each center would be responsible for creating, on its own or with others, an audit trail for surveillance purposes.

All market center rules and practices designed to restrain members, market-makers, broker-dealers, traders, securities, or firms from acting in several markets or from routing trades easily from one market to another or among markets would have been eliminated. Refusals to deal and cartels would be disfavored and subject to traditional antitrust analysis and scrutiny. There could, for example, be no execution discrimination in one market of trades originating in another, or of trades originating with non-members, if not based on some neutral criteria such as price or time priority. Any market center could list and trade any security and could choose to qualify or otherwise classify listed securities under neutral, objective criteria. Mergers among market centers would be subject to a monopolization (Clayton Act) test.

Any order routing procedures between market centers would occur naturally, as market center affiliates could choose to be members of each other—or be negotiated at the market level, the subject of joint venture agreements—both with mini-

205. If done at no charge, this would encourage the centers to negotiate with processors for fees for the data.

mal SEC direction and involvement. Only if a joint venture raised anti-competitive concerns under a traditional anti-trust merger analysis would the SEC intervene.[206] Otherwise traders would be free to route orders to the market of their choice using their own market comparison systems and their own routing procedures. Market-makers and other broker-dealer intermediaries would have to accurately describe to customers and traders their routing practices and preferences.[207] The SEC's primary role would be to enforce the quality and truthfulness of the disclosures.

I suspect that under such a system, several privately-owned computerized execution systems would dominate the trading market,[208] and that they would come and go as technology improves and as traders' preferences change. Customers with sophistication could choose to use a preferred system without resort to financial intermediaries. We would not have open outcry pits or auction floors, nor would we have a geographical convergence in New York or Chicago.

But, as noted above, this speculation is, in a sense, pointless. We are well down another path, one to a quasi-centralized trading market, with very powerful interest groups holding a stake in existing and evolving structures. The SEC having chosen and groomed this path is now committed, ironically, to acting "incrementally." It appears that the SEC is unlikely to retrace its steps.

IV. CONCLUSION

The SEC currently has in its hands an extraordinary array of rule requests and initiatives on essential elements of the

206. The stranglehold of an ITS on trading listed stock would not happen, since market-makers could route orders to markets offering better prices. Moreover, order routing could occur either through an ITS-like system or through a system of diffuse, privately developed communication channels, or both.

207. Pressure from customers would cause intermediaries to establish and advertise their own form of best execution practices.

208. They could be privately held, publicly-traded or not-for-profit trade associations, as the NYSE is now. I suspect that the publicly-traded companies would have a competitive advantage over the other two forms and that the publicly-traded form will dominate.

United States securities market structure.[209] Market participants wait while the SEC ponders.[210] With each new SEC pronouncement, the market participants will adapt; some will get or maintain a step, and some will lose a step in the competition. And there will be a new round of rule requests with affected parties seeking modifications and exemptions, whatever the SEC decision.

The SEC would be well advised to consider the current predicament of the Federal Communications Commission, a federal agency that has made a hash out of regulating the exploding technology in the telecommunications business.[211] Clever regulatory ideas for telecommunications have turned into business straightjackets.[212] Business niches now flourish or dry up with each regulatory pronouncement.[213] No one in the industry is completely satisfied, and yet proposals for sensi-

209. To list some of them: the Nasdaq wants exchange status and has also petitioned for "uniform rules" for all markets trading Nasdaq listed shares; ECNs want rules rewritten to enable them to trade listed shares; market centers want a new division of data revenue fees and market participants want lower market access fees; ECNs are contesting each other's access fees; Nasdaq is becoming an ECN and competing with other ECNs over which its parent NASD regulates and provides reporting services; Nasdaq's declining market share in its listed stock; mergers among the few remaining ECNs; the NYSE seems to want to eliminate the intermarket links, the CTA, CQS, and ITS; problems with locked and crossed markets of Nasdaq stocks; problems with specialists behavior on the NYSE; questions about the governance procedures of the NYSE and other exchanges; requests to modify the trade-through rule on the ITS; and the ongoing recommendations of academics for one centralized, automated trading market.

210. Proposed Regulation NMS attempts to answer several of the questions. If the Regulation is implemented, however, there will be more questions to ask.

211. *See, e.g.*, David C. McCourt, *The Telecom (Better Later Than Never) Revolution*, WALL ST. J., Jan. 4, 2005, at B8.

212. Steven Rosenbush et al., *What Hath the FCC Wrought?*, BUS. WK., Mar. 10, 2003, at 38.

213. *See* Health of the Telecommunications Sector: A Perspective from Investors and Economists, Hearing Before the Subcomm. on Telecommunications and the Internet of the Comm. on Energy and Commerce, 108th Cong. 108-3 (2003), *available at* 2003 WL 253986 (F.D.C.H.) (statement of Robert C. Atkinson, Director of Policy Research-CITI, Columbia University, describing the "legal gridlock" effects on the telecom sector).

ble regulatory changes create nothing but logjams as offsetting powerful, vested interests square off in the political arena.[214]

At issue is whether the SEC will stumble into a similar thicket.

Professor Walter Werner wrote in exasperation on the debate over the 1975 amendments that "[t]he best thing that can be said about government's past regulation of market structure is that the market survived it . . . But the markets may not continue to be so durable."[215] His words ring true today.

Recent Developments

As this article goes to press, historic developments on the structure of the national securities trading markets continue to unfold. On April 6, 2005, the SEC voted to adopt Regulation NMS.[216] The vote was three to two; the chair, a Republican nominee, voted with two Democratic commissioners and two Republican commissioners opposed. The Regulation adopted had last been rewritten and re-proposed on December 15, 2004. The new Regulation will be phased in next year. The press featured the new "trade through" rule that would now apply to Nasdaq securities and would no longer necessarily apply to NYSE listed securities that were traded manually (only electronically traded NYSE securities would be covered).[217] The "depth of book" proposal, applying a trade through rule for every order on any market's books (not just for each market's best price) was not adopted.

The effect of the SEC's action was dramatic. On April 21, 2005, the NYSE announced plans to acquire electronic-trading firm Archipelago Holdings, Inc.[218] Structured as a reverse merger, the surviving entity would be a publicly traded NYSE. Members of the NYSE would receive $300,000 per seat and a seventy percent stake in the surviving company. Stockholders

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214. *See, e.g.*, Steve Rosenbush & Peter Elstrom, *8 Lessons from the Telecom Mess*, BUS. WK., Aug. 13, 2001, at 60.

215. Werner, *supra* note 7, at 1297.

216. Securities & Exchange Commission, *SEC Adopts Regulation NMS*, SEC Press Release 2005-48 (Apr. 7, 2005), *available at* http://www.sec.gov/news/press/2005-48.htm.

217. *See, e.g.*, Aaron Lucchetti, *Big Board Still Carries a Big Stick*, WALL ST. J., Apr. 5, 2005, at C1.

218. *NYSE to Acquire Electronic Trader and Go Public*, WALL ST. J., Apr. 21, 2005, at A1.

of Archipelago would receive the remaining thirty percent of the stock.

The proponents of the deal valued the new company at $3.5 billion, which would give Archipelago shareholders a thirty percent premium over pre-announcement prices. The market traders disagree and have bid Archipelago shares to over double their pre-announcement prices. A former NYSE director and the owner of one seat on the NYSE, Kenneth Langone, threatened a hostile bid for the NYSE claiming that the members of the exchange should get a larger share of the surviving company.[219]

In response, the Nasdaq announced on April 22, 2005, an agreement to acquire Instinet Group Inc. for $934.5 billion in cash.[220] The SEC has to approve both acquisitions. The press speculated that the ultimate effect of Regulation NMS would be to create a two player stock market, with the NYSE and the Nasdaq fighting for superiority.[221] If there is only one victor, the SEC will finally have the single centralized, automated trading system that it dreamed about in 1972. And we will all be the worse off for it.

All major trading market innovations in the last twenty years have come from outside the major incumbent trading markets, the NYSE and the Nasdaq. The incumbents have fought them tooth and nail. A consolidated trading market is a market inherently resistant to innovation and change. And a supervisory government regulatory authority is not bright enough to decide on, let alone force, needed changes. The proof is in the markets' recent history. Most recent innovations came from electronic trading networks that emerged as competitors of the Nasdaq, a market that did not have a "trade through" rule. The NYSE maintained an 80% market share in its listed securities with a "trade through" rule in place even though the Exchange sported an obsolete manual trading system.

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219. Aaron Lucchetti & Gregory Zuckerman, *The Ultimate Mark to Market*, WALL ST. J., Apr. 27, 2005 at C1.

220. *Nasdaq to Acquire Instinet*, Nasdaq Press Release, Apr. 22, 2005, *available at* http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_044.stm.

221. Floyd Norris, *After Market's Merger Mania, Is Oligopoly Next?*, N.Y. TIMES, April 22, 2005, at C1; Jenny Anderson, *Let the Battle Begin: Big Board v. Nasdaq*, N.Y. TIMES, Apr. 22, 2005 at C1.

So what does the SEC do? Propose a Regulation that will, in effect, consolidate the markets in the hands of incumbents and attempt to impose a universal "trade through" rule—the opposite of what recent events have taught us is the best way to go.

In any event, more people should be asking whether the SEC has the foresight to micro-structure the country's securities markets. With Regulation NMS we are entering into the treatment of the nation's securities markets as one of the most heavily regulated industries in the nation's history in a peacetime economy. We are only a half step away from the government's acting like a public utility commission, controlling the activities of a single surviving gas or electric company operating in a given geographic area.