

CAUTIOUS EVOLUTION OR PERENNIAL
IRRESOLUTION: SELF-REGULATION
AND MARKET STRUCTURE
DURING THE FIRST 70 YEARS OF THE
SECURITIES AND EXCHANGE COMMISSION

by

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In revising my history of Securities and Exchange Commission,¹ I was struck by the perennial nature of self-regulation and market structure issues. Literally about 40 percent of *The Transformation of Wall Street* involves market structure issues of one sort or another. These are addressed during each historical period of the SEC; new approaches are considered and often pursued; compromises wrought; and then similar or identical issues frequently later recur. Market structure remains an area of perennial irresolution for the SEC.

It is typical for the Commission and its commentators not to be deeply troubled by this. Our securities markets are, in fact, the most successful in the world. Legal or regulatory irresolution masks profoundly significant evolution in the investor community; information technology; globalization of securities trading; and investment theory and practice.²

¹ Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Aspen Pub. N.Y. 3d ed. 2003).

² See, e.g., Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 Mich. L. Rev. 649, 657-672 (1995).

In these remarks I want to urge that the caution of the SEC is not without cost. It is not simply that issues are not resolved, but rather that our markets remain less efficient; more beset by conflicts of interest; and ultimately, more vulnerable to international competition than they need to.

Let me also highlight three themes that emerge from a historical review of the Commission and market structure:

First, for all the risks and uncertainties of working with Congress, resolution of key market structure issues is most likely to occur when Congress adopts laws, rather than through SEC regulation or SRO rules.

Second, Congress is most likely to act thoughtfully after a period of serious study by the Commission or Congress. Absent detailed public data, the quality of Congressional action tends to be less effective.

Third, SRO conflicts of interest have been a serious and unrelenting problem for the stock exchanges and NASD. These have all too frequently called into question the ability of the SROs to regulate themselves or the SEC to supervise the SROs.

I. Historical Outline of Securities

Market Structure Issues (1934-2003).

A. Origin of Market Structure Issues in Securities Exchange Act of 1934.

1. Market manipulation evidence before Senate Stock Exchange Practice Hearings.

- a. LaGuardia “touting” in leading newspapers.³
- b. Pool operations.⁴
- c. New York Stock Exchange (NYSE) discipline unable to deter pools.⁵

2. Market manipulation was one of many issues for Roosevelt in the 1932 campaign. Emphasis was on stock promotion and full disclosure. E.g., Columbus, Ohio speech in fall 1932:

Roosevelt pledged himself to a comprehensive program of securities law reform. “First . . . to inspire truth telling, I propose that every effort be made to prevent the issue of manufactured and unnecessary securities of all kinds which are brought out merely for the purpose of enriching those who handled their sale to the public.” Second, he proposed federal regulation of securities exchanges and holding companies that sell securities in interstate commerce. Third, he urged the complete divorce of investment and commercial banking. And finally, the candidate recommended prevention of Federal Reserve funds from being used for speculative enterprises.⁶

3. Similarly Democratic Party platform in 1932 did not emphasize stock market

³ SELIGMAN, *supra* n. 1, at 16-17.

⁴ *Ibid.* at 17, 87-88.

⁵ *Ibid.* at 87-88.

⁶ *Ibid.* at 19.

structure issues. The platform called for “regulation to the full extent of federal power of holding companies which sell securities in interstate commerce. . . and Exchanges in securities.” “the divorce of the investment banking business from commercial banks,” and “protection of the investing public by requiring to be filed with the government and carried in advertisements of all offerings of foreign and domestic stocks and bonds true information as to bonuses, commissions, principal invested, and interests of the sellers.”⁷

B. In 1932, there were 34 stock exchanges, led by the New York Stock Exchange (NYSE) which accounted for 90 percent of all issued securities transactions. The NYSE then had 1375 members, governance tended to be dominated by specialists, 170 floor traders, and floor brokers.⁸

C. Initial Roosevelt administration drafts of 1934 Act would have provided:

- 1) Each securities exchange would be registered with the Federal Trade Commission (FTC), which could approve or disapprove exchange rules.
- 2) Nine types of manipulation would be forbidden.
- 3) Margin levels would be set by FTC.
- 4) Floor traders were to be abolished.
- 5) Specialists was to be replaced by exchange personnel who would have no right to trade for own accounts.
- 6) Brokerage houses segregated into a) brokers and b) underwriters and

⁷ Ibid. at 19.

⁸ Ibid at 73-75.

dealers.⁹

D. NYSE effective lobbying response, unified broker-dealers and regional exchanges in opposition and received support from Roosevelt's Treasury and Commerce Departments, Federal Reserve Board, Twentieth Century Fund.¹⁰

E. The 1934 Act was a compromise:

- 1) Federal Reserve Board empowered to set margin levels.
- 2) Broker-dealer segregation transformed to study.
- 3) SEC replaced FTC as enforcement agency – but no SEC member required to be stock exchange member.
- 4) Stock exchanges register with SEC – which approved their rules.
- 5) Floor traders and specialists continued subject to SEC rules.¹¹

B. Joseph Kennedy (1934-1935) “Cooperative Regulation.”

1) Kennedy approach: Before each of the SEC's initial regulations was issued, conferences were held with representatives of the affected industry.¹²

2) During first year of SEC, 12 minor stock exchanges put out of business.¹³ A total of 2300 possible securities fraud cases investigated – but not one major member of NYSE.¹⁴

⁹ Ibid at 85-86.

¹⁰ Ibid. at 89-92.

¹¹ Ibid. at 93-100.

¹² Ibid. at 112.

¹³ Ibid. at 112-113.

¹⁴ Ibid. at 113.

3) In 1934 bare bones registration for stock exchanges – 24 exchanges led by NYSE registered; by 1935, 3345 securities registered; 1948 securities registrations being processed.¹⁵

4) Only modest challenge to NYSE floor community dominance of governance. Brokerage firms publicly owned 52 percent of NYSE 1375 seats but held only one-third of governors or governing committee. Brokers increased from 14 of 40 to 22 of 48 governing committee members.¹⁶

5) SEC negotiated 16 limited trading rules outlawing such practices as manipulation of stock prices through pool operations.¹⁷

6) Kennedy deferred study of segregation of brokers and dealers and specialist reform.¹⁸

C. James Landis (1935-1937): “An Evolutionary Approach”

1) Unlisted Securities – subject to §12(f) of original 1934 Act, calling for study by 1936. Initially 1934 draft bill had sought to abolish unlisted trading because of lack of financial reports. Landis, Report on Trading in Unlisted Securities upon Exchanges reformulated issue into regional stock exchange competition with NYSE.¹⁹

2) Over-the-counter (OTC) securities – by 1936, 6260 securities traded on all

¹⁵ Ibid. at 113-114.

¹⁶ Ibid. at 119-120.

¹⁷ Ibid. at 121.

¹⁸ Ibid.

¹⁹ Ibid. at 139-140, 143-144.

registered exchanges; as many as 90,000 issues quoted in OTC market. But over-the-counter trading did not occur on a discrete number of exchange floors. Each of the nation's 5000 to 6000 OTC dealers could become a "marketmaker" in a designated security merely by signifying to other over-the-counter traders an intent to deal in particular securities. No seat on an exchange needed to be purchased. No exchange disciplinary rules needed to be obeyed. The principal over-the-counter firms were unified only by "a nationwide web of telephone and telegraph wires." The very informality of the over-the-counter markets invited sharp dealing, particularly in small, local common stock trading. No effective quotation system on a real time basis; inside versus outside quotes: often high markups.²⁰

3) Landis two fold approach to OTC markets:

- a) Continue registration of brokers and dealers in OTC market.
- b) Create SRO similar to exchanges for discipline.²¹

4) SEC 1936 Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker: John T. Flynn and Ben Cohen favored strict prohibition of broker dealer activities.²²

a) Kemper Simpson and Willis Ballenger prepared first draft of segregation study that proposed:

- Prohibition on floor trading for member accounts.

²⁰ Ibid. at 140-142.

²¹ Ibid. at 143.

²² Ibid. at 144-145.

- Prohibition of brokerage houses from underwriting.²³

b) Landis caused segregation report to be rewritten. Landis version also critical of floor member trading for their own accounts.²⁴ But because there was insufficient evidence to predict likely effects of segregation, the Report recommended “an evolutionary approach”:

1. No legislation calling for complete segregation
2. Favored SEC rules to achieve partial segregation of NYSE floor community, other than specialists – e.g., brokers could not act as dealers.
3. Intense exchange opposition led to partial segregation largely not being achieved.²⁵

D. William O. Douglas (1937-1939): “Divide and Conquer”

1) NYSE Governance: Charles Gay, allied with Richard Whitney, elected NYSE Chair in 1935. In 1937 Gay attacked Landis SEC for the proposal to partially segregate floor community. Commission brokers led by Paul Shields and E. A. Pierce broke with Gay because “grass was growing on Wall Street”; only cooperation with SEC likely to revive investor confidence and trading volume. Douglas, Roosevelt, full SEC backed brokers. Douglas sought:

- a) Paid NYSE President with professional staff.
- b) NYSE reorganization of Board of Governors to lessen floor

²³ Ibid. at 145-146.

²⁴ Ibid. at 146.

²⁵ Ibid. at 146-148.

community dominance.

- c) Acknowledgment that SEC had not been responsible for 1937 market break.²⁶

2) When NYSE governance negotiations collapsed on November 22, 1937, Douglas, with the unanimous approval of the Commission, issued a press release strongly implying the nature of new trading rules that the SEC would issue unless the New York Stock Exchange committed itself to reorganization.

The Commission had reached a point where it had to decide whether to continue “the past policy of leaving to the Exchanges much of the regulation of their own business” or to seek “an immediate and more pervasive administration directly by the Commission of all phases of Exchange business coming within the purview of the Securities Exchange Act of 1934”:

Operating as private-membership associations, exchanges have always administered their affairs in much the same manner as private clubs. For a business so vested with the public interest, this traditional method has become archaic. . . . And it may also be that there would be greater public confidence in exchanges (and the prices made thereon) which recognized that their management should not be in the hands of professional traders but in fact, as well as nominally, in charge of those who have a clearer public responsibility.²⁷

- 3) Simultaneous publication of SEC NY regional office study of short selling on

²⁶ Ibid. at 160-162.

²⁷ Ibid. at 162-163.

NYSE found that up to 46 percent of trading in five leading stocks had been done by members for their own accounts. Douglas memorably concluded:

In a market in which there is such an enormous public interest – in which not only 300,000 small traders but 10,000,000 investors have a stake, it is essential that no element of the casino be allowed to intrude and that all such elements be obliterated.

Douglas's November press release achieved its desired effect of shocking the New York Stock Exchange into reorganization. This was not the consequence of Douglas's tough words alone. Tough words can always be answered in kind. Rather, President Gay and most of the Old Guard realized how much more financially expensive SEC-imposed trading rules and a public feud with the Commission would be than reorganization.²⁸

4) The NYSE subsequent reorganization adopted SEC Proposals:

a) New Board of Governors with 32 members – 12 brokerage firm representing; 3, public; NYSE Chair and President; floor community could seek election to remaining 15 seats. Brokers majority of nominating committee.

b) Full time paid presidents with professional staff. William McChesney Martin, later selected.

c) Official acknowledgment: "Neither the Stock Exchange nor the SEC can be held responsible for major fluctuations in price of security."²⁹

²⁸ Ibid. at 163.

²⁹ Ibid. at 164-167; regarding Martin, see ibid at 174-176.

5) Subsequently in March 1938 did Richard Whitney embezzlement scandal break. The immediate effect of the Whitney scandal was momentous. It was as if the floor had dropped out from under Wall Street.³⁰

a) Whitney convicted of embezzling from exchange and trust fund securities; sentenced to Sing Sing.³¹

b) SEC public investigation “of all phases of the circumstances which resulted in the insolvency of Richard Whitney & Co. and the indictments of Richard Whitney.”³² Ultimately 14 public hearing days, 52 witnesses.³³

c) Douglas and successor Jerome Frank bargained with William McChesney Martin with respect to two issues:

1) Central depository for securities – not achieved then.

2) Complete segregation of all Exchange floor members resulted in elaborate 13 point compromise: Exchange audit of member firms; 15 to 1 net capital rule.³⁴

d) Douglas period changes in NYSE governance to broker-dominated Board of Governors did not last. Within a few years floor community again dominated.³⁵

³⁰ Ibid. at 168.

³¹ Ibid. at 169.

³² Ibid. at 169-170.

³³ Ibid. at 170.

³⁴ Ibid. at 177-178.

³⁵ Ibid. at 178-179.

6) But Douglas “revolution in financial morality” had consequences. In the market structure arena, the Maloney Act of 1938 achieved Landis’ goal of creating an SRO for OTC Market. Douglas contributions to the Maloney Act were philosophical. Douglas memorably emphasized to a Congressional committee that if effective self-regulation of the securities exchanges was to succeed, the SEC could not compromise its enforcement role, but should play a residual role: “Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.” Amplifying this theme in a January 7, 1938, address to the Hartford Bond Club, Douglas urged self-regulation would have “unquestioned advantages” over direct SEC enforcement: “By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.”³⁶

Douglas compromised and supported an exemption for municipal dealers that led to enactment of the Maloney Act in 1938 and creation of the National Association of Securities Dealers (NASD) in 1939.³⁷

E. Holding Operations (1939-1961). For over 20 years after the Douglas SEC, market structure issues were in abeyance as the Commission focused on the Public Utility

³⁶ Ibid. at 183-186.

³⁷ Ibid. at 188-189.

Holding Company Act and declined in staff size from 1678 in 1941 to 667 in 1955.

1) In 1939-1940 the Commission rejected an NYSE effort to suspend members who traded on a regional exchange as inimical to the fair competition required by the 1934 Act and supported multiple trading of the NYSE list on the regional exchanges.³⁸

2) A 1945 SEC initiative to abolish floor trading was quashed when the White House ordered the SEC to rescind a rule abolishing floor trading.³⁹

3) Specialist domination of the American Stock Exchange (AMEX or before 1953, the New York Curb Exchange) led to a series of market manipulations and other trading scandals that slowly came to light in the late 1950s. Only in 1961 would an SEC investigation of two specialists, Jerry and Gerald Re, lead the Commission to bemoan the “prostitution of the specialists’ important role [which] resulted in many millions of dollars of harm to thousands of unsuspecting investors.” But the Re scandal was most shocking because it occurred nearly thirty years after the creation of the SEC.⁴⁰

F. Revival under William Cary (1961-1964).

1) In May 1961 the SEC authorized a comprehensive staff investigation of the breakdown of self-regulation at the AMEX. Here Cary, with little support in either Congress or the White House, a veritable “stepchild” avoided public hearings and used NYSE members notably Gustave Levy, who chaired the reform committee, to clean house. The Levy Committee urged that the Board of Governors be the sole policy-

³⁸ Ibid. at 231-235.

³⁹ Ibid. at 238-239.

⁴⁰ Ibid. at 281-286.

making body of the Amex, with specialists limited to a small minority of its membership. Administrative responsibility for the management of the exchange would repose in a president and a professional staff, rather than in specialist-dominated standing committees.⁴¹

2) Cary's Chairmanship is particularly well known for the 1961-1963 Special Study of Securities Markets directed by Milton Cohen. Ideally, the investigation should have been conducted by Congress. Any investigation of the securities markets in 1961 had to focus to a considerable degree on the Commission. Such matters as the breakdown of self-regulation of the American Stock Exchange and the revival of securities speculation raised questions about the quality of the SEC's performance.

House Speaker Sam Rayburn, the "father of the securities acts," however, was unwilling to permit the House Commerce Committee to conduct a comprehensive investigation of the SEC and the securities markets. To ensure the independence of the Special Study group, Director Milton Cohen insisted on an unusual procedure. Cohen took the position that he would not head up the study if its work had to be formally approved by the five SEC commissioners. Instead, the SEC agreed with Cohen that the findings of the Special Study would be a report to the SEC from a quasi-independent group within the Commission. Cohen regarded this arrangement as "absolutely essential to the quality of the study," since it obviated the inevitable compromises that would have occurred if the entire report had to secure the official

⁴¹ Ibid. at 288-289, 305-308.

support of the SEC.⁴²

a) Cary in his transmittal letter memorably concluded: “neither the fundamental structure of the securities markets nor the regulatory pattern of the securities acts requires dramatic reconstruction.”⁴³

b) In fact, the text of the Special Study Report, insofar as it focused on the growing role of institutional investors, the need to automate the securities industry, and the anticompetitive practices associated with the New York Stock Exchange’s fixed-commission-rate structure, suggested that the fundamental structure of the securities markets did, or soon would, require dramatic reconstruction.⁴⁴

c) The Special Study, report undoubtedly was the single most influential document published in the history of the SEC; it provided a foundation for most of the reforms that occurred in the securities industry during the ensuing 15 years. In large measure, the *Special Study* was factual documentation of the limits of self-regulation in the securities industry. The Report’s findings illustrated that without the “pointed stimuli” of the SEC, securities industry self-regulation consistently had been self-interested and self-protective, often failing to produce standards of conduct superior to those that existed before the enactment of the securities laws. Significantly, in most of the principal areas covered by the report – for example, entry requirements, selling practices, backoffice problems, exchange floor members, fixed commission rates,

⁴² Ibid. at 296.

⁴³ Ibid. at 297.

⁴⁴ Ibid. at 298.

mutual fund selling practices, and exchange disciplinary procedures – similar disadvantages of securities industry self-regulation were found. In several instances, like floor-trading regulation, the SEC's postwar passivity had, in fact, permitted a deterioration of standards.⁴⁵

d) The Special Study also marked a return in the SEC's focus from fiduciary issues, which had been its major concern during the past 20 years, to market structure issues.

e) Memorably the Special Study criticized SEC review of fixed commission rates in 1947, 1953, and 1958.

By the time of the Special Study, lack of rate competition among New York Stock Exchange members encouraged four major types of anticompetitive practice in the securities industry. First, it had become common for the large brokerage houses to engage in non-rate competition, usually through such ancillary services as investment research, safekeeping of customers' securities, or collection and delivery of investor dividends, rights, and warrants.

Second, institutional and other investors who purchased large blocks of securities formally were prohibited from negotiating volume discounts in spite of the lower per-share cost of large-volume purchases.

Third, in the mutual fund field, the absence of volume discounts regularly resulted in practice known as "give-ups." Although 'exchange members were prohibited from rebating commissions to nonmembers, they were permitted to give up portions of

⁴⁵ Ibid. at 299.

their commissions to other Exchange members. Thus, a mutual fund could arrange for a broker to give up part of the commission to a second Exchange member, who, typically, benefitted the fund by selling the mutual fund's shares. In practice, give-ups were running as high as 60 percent of commission rates by the time of the Special Study.

Fourth, the Exchange's rate structure encouraged Exchange members to raise investors' costs through reciprocal trading and service arrangements.⁴⁶

f) The Special Study also memorably criticized floor member dominance of NYSE governors and determination of Exchange discipline. Soon after Douglas's departure from the SEC, the reforms in the New York Stock Exchange's governance structure, negotiated in 1938 began to erode. The Exchange's floor leaders, led by Robert Stott and John Coleman, first secured a formal expansion of their power in 1941 with the creation of an Advisory Committee, to which the Board of Governors delegated certain disciplinary questions and the power to recommend the allocation of securities to specialists. The Advisory Committee generally followed the recommendations of the floor leaders. In the 1949-1950 period, a so-called Committee of 17 negotiated a series of amendments to the New York Stock Exchange's constitution that changed the power of the NYSE floor members, including a new provision requiring that ten of the Board of Governors 33 members spend "a substantial part of their time on the floor of the Exchange." By the time the Special Study was undertaken, the floor governors also held a majority of seats on the Exchange's Nominating Committee and had restructured

⁴⁶ Ibid. at 301-303.

the Exchange's governance so that discipline of floor members was dominated by the floor governors. The *Special Study* pointedly criticized the floor governors' informal procedures for the disposition of specialist and floor-trader violations, specifically noting that the Exchange's system of specialist surveillance was "not generally geared to the detection of cases of major improprieties." The *Special Study* further found "an apparent reluctance . . . to impose disciplinary sanction on floor traders, despite repeated violations of the floor-trading rules."⁴⁷

g) Under Cary:

1) Modest, but non-majority, increase in broker firm power;⁴⁸

2) Partial success in effect to abolish floor trading, which by the 1960s, had declined in significance. By 1964, before SEC effort floor trading accounted for 2.48 percent of all NYSE transactions; by 1965, floor trading had been reduced to 0.66 percent.⁴⁹ Cary was disappointed: "we waffled and wound up with a series of rules that did not achieve much."⁵⁰

3) More significantly new rules, adopted by the NYSE, did require specialists to observe affirmative and negative trading obligations.⁵¹

4) The Special Study and the Cary SEC, however, did not directly address

⁴⁷ Ibid. at 324.

⁴⁸ Ibid. at 325-327.

⁴⁹ Ibid. at 327-334.

⁵⁰ Ibid. at 335.

⁵¹ Ibid. at 335-343.

the decline in competition among specialists units. By 1967, in fact, there were no longer any NYSE-listed securities traded by competing NYSE specialists.⁵² Cary later would recount that he informally proposed the earlier idea of succeeding specialists with NYSE employees to eliminate the conflict between the specialists broker and dealer roles.⁵³

G. The Road to the Securities Acts Amendments of 1975 (1964-1975)

1) Subsequent SEC studies such as a 1970 staff investigation emphasized deficiencies in specialist regulation⁵⁴ and the need to emphasize greater competition for listed stock marketmaking.

In 1971 and 1972, the SEC emphasized, both in the transmittal letter accompanying its *Institutional Investor Study* and in its “Policy Statement on the Future Structure of the Securities Markets,” that the creation of competition among securities marketmakers should be a key tool for the regulation of specialists. That this decision in part was made because of perceived inadequacies of the SEC’s previous regulation was implied by the 1972 “Future Structure Statement,” which said:

The Commission believes that the liquidity needs of individual and institutional investors can best be provided by policies fostering the development of competition among dealers who are specialists, marketmakers, and block positioners. Such competition will mitigate the very

⁵² Ibid. at 338.

⁵³ Ibid. at 341.

⁵⁴ Ibid. at 343.

difficult problem which now exists of developing and enforcing rules designed not only to prevent specialists from abusing their privileged position, but also to motivate them to perform satisfactorily under widely differing circumstances and in the light of varying risks and pressures.⁵⁵

2) Manuel Cohen's Chairmanship (1964-1969) saw a significant growth in institutional trading and new computerized trading systems led by Instinet designed to create a "third market" by which institutions could trade outside the stock exchange and OTC markets.⁵⁶

3) Similarly, during Cohen's chairmanship, the first step toward the Nasdaq Market and Douglas's central certificate service were taken.⁵⁷

4) Securities legislation is largely a response to perceived crisis. No cluster of issues moved the securities markets faster towards the 1975 Act than resistance to undoing brokerage commission rates. No issue did more to bring into question the historic reputation of the SEC as "an outstanding example of the independent commission at its best" than the Commission's handling of a related cluster of stock exchange commission-rate and membership rules in the 1963-1973 period.

To Paul Samuelson, the SEC's historic indifference to efficient competition in the securities industry was "sad, if not scandalous."⁵⁸

⁵⁵ Ibid. at 344.

⁵⁶ Ibid. at 352-353.

⁵⁷ Ibid. at 353.

⁵⁸ Ibid. at 358.

a) In 1963 the Supreme Court raised the possibility that SEC regulation of Exchange commissions might *not* be exempt from the antitrust laws in *Silver v. New York Stock Exchange*.⁵⁹

b) Subsequently Exchange member Morris Schapiro began a challenge to NYSE Rule 394, later Rule 390, which in effect prohibited NYSE members from trading NYSE issued stocks in the OTC market. A 1965 SEC Staff Study emphasized the anticompetitive effects of Rule 394. The staff proposed allowing NYSE members to buy or sell off the NYSE floor when OTC quotes were superior.⁶⁰

The SEC's response to its staff's Rule 394 report represented the rockbottom low point of the Cohen Commission. The NYSE, as its president, Keith Funston insisted: "Rule 394 is one of the pillars of the Exchange and we cannot, and will not, budge on this issue."

Believing that further negotiation with the Exchange would not be fruitful, "unless we advise the Exchange of the intention to release the report," Trading and Markets Division director Irving Pollack and his staff soon recommended that the SEC "publish the report in order to invite comments and alternative solutions."

The full SEC refused to publish the report. Indeed, it was not to be made public for six years, until Morris Schapiro successfully sued the Commission to gain access to it under the Freedom of Information Act.⁶¹

⁵⁹ Ibid. at 384-385.

⁶⁰ Ibid. at 387-394.

⁶¹ Ibid. at 393-394.

c) Separately a challenge was made to the NYSE rule that restricted its membership to person and firms who devoted the major portion of their time to securities trading. If institutions could become Exchange members their preference for unlisted commissions or volume discounts would have abated.⁶²

d) Lacking a majority in favor of unlisting Commission rates, the Cohen SEC sought to hold public hearings which focused on the extent giveups and reciprocal trading arrangements distorted the NYSE rate structure.⁶³ In 1968 the SEC published proposed Rule 10b-10 which would have prohibited mutual funds from providing giveups.⁶⁴

e) The Rule 10b-10 proposal prompted in Justice Department to file a 67-page brief urging that fixed commission rates were not necessary to make the 1934 Act work and accordingly not impliedly exempt from the antitrust laws.⁶⁵

To the Justice Department, there were two principal defects of the New York Stock Exchange fixed-commission-rate system and related exclusionary practices, such as Rule 394 and the prohibition on institutional membership. First, the failure of the commission-rate schedule to reflect actual brokerage costs had resulted in excessive or monopolistic profits. Paul Samuelson testified: "The true incremental or marginal costs of transacting five hundred shares of a listed stock in much less than

⁶² Ibid. at 395-397.

⁶³ Ibid. at 397-401.

⁶⁴ Ibid. at 401-403.

⁶⁵ Ibid. at 404-414.

five times that of transacting a hundred shares.” In dollars-and-cents terms, fixed commission rates had resulted in a greater than sixfold increase in brokerage income in the 1961-1968 period, with aggregate securities commission income of New York Stock Exchange members increasing from \$613 million to \$3.245 billion, making Wall Street, *Forbes* magazine stated in June 1968, “perhaps the greatest growth industry in the U.S.”⁶⁶

Second, both the economists and leading third-market dealers recognized that far from fragmenting trading in New York Stock Exchange-listed securities, lower commission rates likely would recapture volume lost to the regional exchanges and the third market. The practical consequence of eliminating fixed rates was accurately predicted to centralize more fully the market in NYSE-listed securities while reducing the profits of the securities brokerage industry to competitive levels.⁶⁷

f) While the Justice Department brief was nearly controverted by the NYSE, it did set the stage for the unfixing of brokerage commission rates which began under SEC Chair William Casey with securities transactions over \$500,000 and culminated in 1975 with an SEC rule and the Securities Acts Amendments.⁶⁸

g) By 1975 other issues also had become prominent. The 1967-1970 broker-dealer firm back-office crisis was the most serious failure of securities industry self-regulation in the Commission’s history, a collapse of industry regulatory controls so

⁶⁶ Ibid. at 411.

⁶⁷ Ibid. at 412.

⁶⁸ Ibid. at 445, 449-450, 466-486.

complete that it permitted, in the agency's retrospective view, "the most prolonged and severe crisis in the securities industry in forty years."

The back-office crisis effectively occurred in two phases. During the period from 1967 to early 1969, as SEC chairman Budge testified, "brokerage firms [found] themselves in the paradox of being forced out of business by having too much business." Average daily reported volume on the New York Stock Exchange grew by 265 percent between 1964 and 1968, from 4.89 million shares per average day in 1964 to 12.97 million shares in 1968, reaching a high of 14.9 million shares per average day during the month of December 1968.

Back-office inefficiency in processing the increasing number of securities transactions increased concurrently.

The operational crisis in the securities industry first reached major dimensions in August of 1967 [the SEC subsequently reported].

Newspaper reports of that period recall the feverish efforts of the Wall Street community to keep up with each day's business: Stock certificates and related documents were piled "halfway to the ceiling" in some offices; clerical personnel were working overtime, six and seven days a week, with some firms using a second or even a third shift to process each day's transactions.

To alleviate the back-office paper crunch, the exchanges and the NASD shortened the trading day for a brief period in August 1967 and for about six weeks beginning in January 1968.

These palliatives had little effect. Total complaints to the SEC concerning

broker-dealers jumped from 3991 in the 1968 fiscal year to 12,494 in 1969, with nine out of ten complaints describing back-office problems, “particularly the failure to deliver customer funds and securities” in a timely manner. In April 1968, the first month during which the New York Stock Exchange gathered relevant statistics, member firms’ “fails” (that is, failure to deliver securities by the official settlement day) came to \$2.67 billion, subsequently rising to \$4.12 billion in December 1968. Throughout 1969 and 1970 the dollar value of fails declined, but as late as July 1969, SEC chairman Budge reported, “One out of every 8.4 transactions was a fail.”

The rising number of securities customer complaints and fails was symptomatic of an industrywide loss of control or recordkeeping procedures. In the four-year period 1967-1970, the New York Stock Exchange would find it necessary to intervene directly in the affairs of nearly 200 member organizations, over half of the Exchange member firms that dealt with the public, because of firms’ operational deficiencies.⁶⁹ Then, between May 14, 1969 and May 26, 1970, the Dow Jones Industrial Average fell 35 percent from a high of 968.85 to a low of 631.16, precipitating a decline in New York Stock Exchange volume from a 1968 daily average of nearly 13 million shares to a 1969-1970 daily average of approximately 11 million shares. The volume decline resulted in industrywide losses.

The securities industry’s prolonged unprofitability, coupled with the financial losses created by the 1967-1968 back-office operations breakdown, set in motion the greatest rash of broker-dealer firm failures in Wall Street’s history. Approximately 160

⁶⁹ Ibid. at 450-451.

New York Stock Exchange member organizations went out of business in 1969 and 1970.⁷⁰

h) The securities industry 1967-1970 back-office crisis powerfully suggested that there were limits to the extent to which investors and the SEC could rely on securities industry self-regulation. Consistently during the four-year crisis the SEC did not have reliable data on the seriousness of individual broker-dealer back-office or financial problems until it was too late for the Commission to prevent firm failures. Nor until it was too late did the SEC appreciate the weaknesses in New York Stock Exchange audit procedures or the extent to which the Exchange's unwarranted optimism endangered investors.⁷¹

i) In the aftermath of the back-office crisis, several reforms were adopted. Most significantly, in December 1970, Congress enacted the Securities Investors Protection Act, creating the Securities Investor Protection Corporation (SIPC) to administer a fund providing \$50,000 of insurance protection to each customer of virtually all broker-dealers registered with the SEC.⁷²

j) The period immediately after the 1975 Act amendments saw the first serious effort to develop a national market system. Four different reasons propelled interest in a new system of stock trading:

1) The NYSE Specialist System was no longer able to adequately

⁷⁰ Ibid. at 452-453.

⁷¹ Ibid. at 458-464.

⁷² Ibid. at 465.

process many block trades (10,000 is more shares), which by 1971 had grown to 35 percent of NYSE volume.⁷³

2) A growing belief at the SEC and in Congress that marketmaker competition was more likely to provide better execution for investors than SEC or NYSE regulation of specialists.⁷⁴

3) The back office crisis had subverted confidence that the existing system of securities order, clearance, transfer, and settlement was effective. With 33 documents necessary for a typical manual transaction, the SEC Study of Unsafe and Unsound Practices of Brokers and Dealers called the system “positively archaic.”⁷⁵

4) Nasdaq, begun in February 1971, suggested the potentialities of a comprehensive electronic system and lowered spreads on OTC securities between 1970 and 1972 by about 17 percent.⁷⁶ Between 1974 and 1981 Nasdaq volume grew from 32 to 63 percent of NYSE volume.⁷⁷

5) In 1971 the NYSE published a report by William McChesney Martin which criticized competition among markets “because it has depended upon unequal regulation.” Martin proposed ending third market (or OTC) trading of Exchange listed securities.⁷⁸

⁷³ Ibid. at 487-488.

⁷⁴ Ibid. at 488.

⁷⁵ Ibid, at 488-489.

⁷⁶ Ibid. at 490.

⁷⁷ Ibid. at 491.

⁷⁸ Ibid. at 497-499.

6) In 1972 the SEC published a Statement on the Future Structure of the Securities Markets:

The central market system we look toward to. . . would entail, among other things . . . : 1. Implementation of a nationwide disclosure or market information system to make universally available price and volume in all markets and quotations from all market makers. 2. Elimination of artificial impediments, created by exchange rules or otherwise, to dealing in the best available market. 3. Establishment of terms and conditions upon which any qualified broker-dealer can attain access to all exchanges . . . [and] 4. Integration of third-market firms into the central market system.⁷⁹

7) Similarly in 1973 the SEC published a Policy Statement on the Structure of a Central Market System which envisioned three broad projects. First, creation of a systemwide communications system. Second, since “the most important objective of the system is to foster the development of strong competition among its participants,” the statement called for the elimination of unjustifiable impediments to market-maker competition. Specifically the statement noted that “restrictions such as Rule 394, regardless of their past appropriateness, are incompatible with a central market system and will have to be rescinded by the time the quotation system is in operation.” Finally, the statement anticipated creation of a systemwide specialist limit-order book and, apparently also an electronic execution system.⁸⁰

⁷⁹ Ibid. at 499.

⁸⁰ Ibid.

8) The Securities Acts Amendments of 1975 authorized the SEC to “facilitate the establishment of a National Market System for securities” but did not direct in detail how this should be done.⁸¹ Subsection 11A(a)(1) of the 1934 Act provides in part:

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

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers,

⁸¹ Ibid. at 500-501.

dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

These goals, as Milton Cohen recognized, are partially conflicting.⁸²

9) The SEC, particularly under Chairman Harold Williams, proceeded quite cautiously.

a) A composite last sale price and consolidated quotation system was implemented between 1971 and 1978 to make possible simultaneous review of sales reports and quotes from all exchange and the OTC market for the NYSE list and the list of other exchanges.⁸³

b) Rule 394, by then renumbered Rule 390 was not rescinded in full as was proposed in Rule 19c-2 but only for securities listed after April 26, 1979 by Rule 19c-3.⁸⁴

c) Rather than adopt a Composite Limit Order Book (CLOB) to provide systemwide linkage of trading through price and time priority,⁸⁵ the Commission approved the Intermarket Trading System (ITS) which preserved the Exchange's central role. ITS was essentially a communications system allowing specialists and floor brokers on one exchange floor to transmit buy or sell orders to marketmakers on another exchange floor. If a specialist or floor broker saw a better price on the

⁸² Ibid. at 513-514.

⁸³ Ibid. at 503-508.

⁸⁴ Ibid. at 509-520.

⁸⁵ Ibid. at 520-523, 525-529.

composite quotations system available on another exchange, the ITS system allowed him to transmit a “commitment to trade” to the appropriate marketmaker on that exchange. The marketmaker there would either accept the commitment or he could decline. If there was no response to the initial commitment to trade, the commitment would automatically expire after a designated time period.⁸⁶

The ITS system never achieved much volume. A 1981 SEC staff report found ITS accounted for 3.1 percent of total NYSE volume in 871 ITS stocks during November 1980.⁸⁷

j) The SEC also approved a Designated Order Turnover (DOT) system, now SuperDOT, to electronically route orders from brokers directly to specialist posts without a floor broker.⁸⁸

H. The 1987 Stock Market Break

1) On October 19, 1987 the Dow Jones Industrial Average fell 22.6 percent, the largest one day drop since the creation of the SEC. A number of fundamental factors such as rising interest rates, persistent United States trade and budget deficits, and declines in the value of the United States dollar relative to other currencies were responsible, in a general sense, for the broad stock market price decline between August and October 1987. But the extraordinarily sharp stock price break also appeared to implicate several “market mechanisms” collectively responsible

⁸⁶ Ibid. at 523-525, 530.

⁸⁷ Ibid. at 533.

⁸⁸ Ibid. at 531.

for extraordinary periods of order imbalances. These included the following: (1) Trading strategies involving stock index futures (such as index arbitrage and portfolio insurance) that were responsible at various times on October 19 and 20 for significant percentages of NYSE trading volume. (2) The breakdown of linkages among stock, options, and futures markets. (3) The overwhelming of the capacities of stock exchange specialists and over-the-counter dealers to absorb the huge influx of sell orders and provide price continuity; for example, order imbalances were so severe that one hour after the opening on October 19, more than one-third of the stock in the Dow Jones Industrial Average (including IBM, Sears, and Exxon) had yet to begin trading. (4) Ultimately, volume overwhelmed trade processing capacity, with many market participants generating sell orders out of fear or panic because of uncertainty about factors such as (a) the accuracy and timeliness of quotation and last sale information, (b) counterparty solvency, (c) credit availability, and (d) concern that entire markets would be closed or substantially disrupted.⁸⁹

2) The October 19, 1987, stock market crash, however, prompted a plethora of ambitious regulatory proposals, including:

1. appointment of a single regulatory agency to coordinate intermarket activities;
2. transfer of jurisdiction over financial futures from the CFTC to the SEC;
3. empowerment of the Federal Reserve Board to set margin levels

⁸⁹ Ibid. at 589-592.

- on financial futures (as it did on stocks);
4. abolition of such derivative instruments as financial index futures or index options;
 5. adoption of circuit breakers such as price or volume trading halts, or investor position limits;
 6. creation of a single stock market trading post for trading of “baskets” of stock underlying index futures or options;
 7. improvements in stock, options, and futures operational systems—including improved program trading reporting;
 8. changes in stock exchange specialist capital and stock allocation rules;
 9. changes in stock exchange short sales rules;
 10. improvements in stock and futures exchange enforcement of rules against such forms of manipulation as “front running”; and
 11. further automation of stock, options, and futures exchanges—with the ultimate object of creating a national computerized trading system.

Throughout the balance of the 1980s and into the 1990s, the SEC played a role in the study and resolution of several of these proposals.⁹⁰

For example, circuit breaker mechanisms were adopted in 1988⁹¹ and The

⁹⁰ Ibid. at 593.

⁹¹ Ibid. at 603.

Market Reform Act of 1990 enhanced the SEC's ability to suspend trading in emergencies.⁹²

I. The Levitt Chairmanship (1993-2001).

1) Throughout the Commission's history no cluster of issues has proven more complex and more rapidly changing than those involving stock market structure and self regulation. Since the New Deal, the basic policy of the SEC with respect to the market structure of stock trading on national securities exchanges has been to favor "multiple" trading of the NYSE list on an unlisted basis on regional exchanges. Underlying this policy were three pivotal assumptions: (i) The NYSE dominates stock trading on the national securities exchanges, as distinct from the OTC market. This continued to be true throughout the Levitt Chairmanship. In 1998, for example, the NYSE was responsible for 88 percent of the dollar value of stock trades on national securities exchanges and 87 percent of the shares traded. (ii) The principal competition limiting the market power of the NYSE came from the "regional" exchanges such as the Boston, Chicago, Cincinnati, Pacific, and Philadelphia stock exchange, which in 1998 generated slightly under 10 percent of share volume in the NYSE list. (iii) The principal basis of stock exchange competition was through competitive quotes. This time honored policy had been responsible for Congressional and Commission policy favoring unlisted trading of NYSE securities on rival regional exchanges.

By the time of Levitt's Chairmanship the SEC market structure policy was

⁹² Ibid. at 603-604.

question begging in two if its three basic assumptions. While the NYSE endured as the dominant national securities exchange, competition to the NYSE was increasingly more likely to come from electronic communications networks (ECNs) and potentially the Nasdaq, rather than the regional stock exchanges. Moreover, competition to the NYSE came increasingly from payment for order flow or internalization of order flow rather than from competitive securities quotes.⁹³

2) The SEC Division of Market Regulation Study, Market 2000: An Examination of Current Equity Developments (1994), echoed the fundamental conclusion of the 1961-1963 Special Study in concluding: "No major revision of equity market regulation is needed."⁹⁴ The Report did *not* propose rescission of Rule 390, except during little used after hours trading,⁹⁵ notably did initiate the movement towards decimalization of securities trading by proposing reducing the price variation for stocks from one-eighth to one-sixteenth as soon as possible,⁹⁶ criticized payment for order flow but did not propose termination of payment for order flow and related practices.⁹⁷

3) Early in the Levitt period the SEC approved shortening the settlement period to three days (T+3) and theorized that ultimately the settlement period could be reduced

⁹³ Ibid. at 688-689.

⁹⁴ Ibid. at 690.

⁹⁵ Ibid.

⁹⁶ Ibid.

⁹⁷ Ibid. at 690-693.

to T+0.⁹⁸

4) During Levitt's Chairmanship, Commission Wallman took the lead in a successful effort to transform securities trading from one-eighth point intervals to pennies when fully implemented in 2001, decimalization appeared to have materially narrowed spreads (estimates ranged from 37 to 50 percent) and saved investors tens of millions of dollars per day.⁹⁹

5) The most significant market structure issues during the Levitt Chairmanship concerned the Nasdaq. In 1994 after a study by Professors William Christie and Paul Schultz entitled "Why Do Nasdaq Market Makers Avoid Odd-Eighth Quotes," the Justice Department and SEC found evidence of pervasive price fixing by some Nasdaq marketmakers and a long standing inability of the NASD and SEC Division of Market Regulation to prevent these practices.¹⁰⁰

6) There was considerable SEC follow through. Before a 1997 consent settlement, with NASD, in 1994, the NASD had appointed former Senator Warren Rudman to head a Select Committee to review NASD structure and governance.

In 1995 the Rudman Select Committee on Structure and Governance concluded that "[f]undamental change is required." Specifically the Committee would report:

The NASD's existing governance structure . . . blurs the distinction between regulating the broker-dealer profession and overseeing the

⁹⁸ Ibid. at 693-695.

⁹⁹ Ibid. at 695-696.

¹⁰⁰ Ibid. at 698-701.

Nasdaq stock market. Both missions are thereby disserved.

The Rudman Report most significantly will lead to a separation of regulation (today via the NASD) from stock market operations (through Nasdaq) to address the conflict of interest of one entity providing both regulation and market operations.¹⁰¹

7) The SEC also adopted new order handling rules in 1996. The Commission in 1996 amended Rule 11Ac1-1, popularly known as the Quote Rule. As amended, Rule 11Ac1-1 requires a specialist or OTC marketmaker to make publicly available the price of any order it places in an ECN *if* the ECN price is better than the specialist's or OTC marketmaker's public quotation. OTC marketmakers and specialists could comply with this ENC amendment by changing their public quote to reflect an ECN order or by using an ECN that facilitates their compliance with the amended Rule 11Ac1-1.

Simultaneously the Commission adopted Rule 11Ac1-4, the Display Rule, to require OTC marketmakers and specialists to display any customer limit order when the order was placed at a price superior to the marketmaker's or specialist's quotation.

The two Order Handling rules had a surprising impact. Within a few years Nasdaq spreads had narrowed by approximately one-third "savings investors," Levitt later would report, "\$25 billion in the first year."¹⁰²

8) In the late 1990s the NASD, which was initially after the Rudman Report, a holding company owning the Nasdaq stock market began steps to sell its

¹⁰¹ Ibid. at 701-702.

¹⁰² Ibid. at 703.

stake in Nasdaq, which would become a for-profit stock exchange. The NYSE also announced plan to sell stock to the public and become for-profit. Levitt took the position that the NYSE could not operate the self-regulatory functions in a for-profit corporation but would have to separate them as the Nasdaq stock market was to be from the NASD. The NYSE subsequently shelved this plan.¹⁰³

9) In 2001 the SEC approved the Nasdaq SuperMontage proposal:

The SuperMontage proposal is designed to modify Nasdaq's systems in three principal areas: (1) quote/order collection; (2) quote/order display; and (3) execution services.

1. Quote/Order Collection

SuperMontage will partially eliminate the distinction between quotes and orders and expand the ability of Nasdaq Quoting Market Participants and UTP (Unlisted Trading Privilege) Exchanges to represent quotes/orders in the Nasdaq market. It will permit, but not require, Nasdaq Quoting Market Participants and UTP Exchanges to enter multiple quotes/orders at the same time or at different prices. . . .

2. Display of Quotes/Orders

. . . [T]o the extent Nasdaq Quoting Market Participants and UTP Exchanges voluntarily enter their "near the market" quotes/orders, investors and market professionals will be able to see the aggregate of this interest at three price levels in widely available displays.

¹⁰³ Ibid. at 703-704.

3. Execution Services

SuperMontage will replace Nasdaq's current SOES and SelectNet services with two new processes: a directed order process and a non-directed order process. . . .

The directed order process . . . will allow a Nasdaq participant to direct an order to a particular Nasdaq Quoting Market Participant or UTP Exchange. . . .

The non-directed order process will be default execution process for marketable orders entered by a Nasdaq participant into Nasdaq's order collection facility. A marketable order entered into the non-directed order process will be matched with the highest ranked quotes/orders of Nasdaq Quoting Market Participants and UTP Exchanges on the opposite side of the market, and either will be executed automatically or delivered (on a liability basis) to the matched Nasdaq Quoting Participants and UTP Exchanges, depending upon how such participants participate in the non-directed order process.¹⁰⁴

10) In 2000 Levitt persuaded the NYSE to rescind Rule 390, which by then, Levitt asserted "may very well be on its ninth life." After Rule 390 was rescinded the SEC adopted Rules 11Ac1-5 and 6 to improve public disclosure of order routing and executions practices.¹⁰⁵

¹⁰⁴ Ibid. at 705-708.

¹⁰⁵ Ibid. at 708, 713.

II. The 2002 Reed Proposal to Reorganize the NASD

A) In 2003 Richard Grasso's resigned as NYSE Chair after revelations that his annual compensation had increased from \$2 to over \$30 million between 1995 and 2001 and his retirement benefits were at least \$140 million.¹⁰⁶ Subsequently a series of NYSE and SEC investigations regarding specialists raised other questions about NYSE self regulation.

B) Former Citigroup Chair John Reed subsequently was named NYSE interim Chair.

C) In November 2003 Reed proposed and the NYSE membership approved several proposals to change NYSE governance as well as eight candidates for elections to a reconstituted Board: Madeleine K. Albright, Herbert M. Allison, Jr., Euan D. Baird, Marshall N. Carter, Shirley Ann Jackson, James S. McDonald, Robert B. Shapiro and Sir Dennis Weatherstone. These new members were intended to serve until June 2004 after which the entire board would stand for election each June.

The Reed proposals to amend the NYSE Constitution envisioned both a streamlined Board of Directors with 6 to 12 directors and a Board of Executives, appointed by the Board of Directors, comprised of approximately 20 constituent representatives, balanced among the major broker-dealer firms, the floor community, lessor members, institutional investors, large public funds, and listed companies. The

¹⁰⁶ Letter to SEC Chair William Donaldson from Carl McCall, Sept. 9, 2003.

Board of Directors would elect the Chairman and the CEO each June, although the Reed proposal did not resolve whether this would be one or two persons. The Board of Directors was empowered to delegate specified powers to committees or the Board of Executives. Art. IV §14. The Board of Directors would have ultimate authority for rulemaking, supervisory, and listing of securities. Art. VIII.

The Board of Directors and Board of Executives were authorized to meet in joint sessions several times a year.

The Chairman of the Board of Directors would also be Chairman of the Board of Executives. If there is a separate Chief Executive Officer he or she would also be a member of the Board of Executives.

D) The initial SEC response, before officially receiving the proposal, was to issue a November 5, 2003 Press Release (2003-151), which concluded:

The Commission will continue to consider further market-wide reforms, including governance and regulatory reforms, in the coming months as it proceeds with its broad review of market structure issues. Additional reforms beyond the proposal put forth today will likely be considered.

III. Analysis of Reed Proposal

What ultimately was most striking about the NYSE Reed reorganization are the number of fundamental issues it did *not* address.

A) Narrowly with respect to the proposed NYSE governance Reed did

persuade highly qualified persons to be members of the proposed Board of Directors and empowered the independent board to select the NYSE Chair and CEO, with clear authority for NYSE rulemaking, supervision, and discipline.

B) By its own term, the proposal did not resolve several pivotal governance issues such as whether the Chair and CEO should be one or two persons.

C) More significantly the Reed proposal raised profound process questions. Typically a stock market or NASD reorganization after dysfunction occurs after a public report on what went wrong and analysis of why a particular reorganization was preferable to reasonable alternatives. To date, there has been no published analysis by the NYSE of why the Reed proposed structure is preferable to a separation of regulation from exchange operations such as occurred at the NASD or whether a single industry-wide SRO should be created to supervise all exchanges, all securities associations, and all ECNs.

D) For the SEC self-regulation has long been linked to securities market structure issues. Today there are several market structure issues long overdue for serious examination. Let me highlight certain of these issues:

1) Which market centers should be subject to the Securities Exchange Act of 1934?

Underlying the SEC approach to consolidated market information, order routing, order extension, and linkages, has been the emphasis on national securities exchanges (that is, stock and options exchanges) and securities associations as the primary

means of regulation and the primary recipients of rights.¹⁰⁷

Until relatively recently, this was a time honored and stable approach. For decades there were a small number of registered stock exchanges dominated by the NYSE, and one securities association, the NASD, which, in turn, owned the Nasdaq.

This stable framework for securities markets is now eroding. The key dynamic has been the rapid emergence of ECNs. An ECN is not obviously a securities exchange, a “facility of an exchange,” or a member of an exchange or securities association. While ECN trading volume was small, the SEC issued no-action letters permitting ECNs to avoid exchange registration even though ECNs then were performing at least some of the functions of an exchange.

Between 1994 and 1998, ECNs were subjected to recordkeeping and reporting regulation under former Rule 17a-23.

In 1998, the Commission adopted a comprehensive new approach to ECNs, allowing them to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with additional requirements under a new Regulation ATS (Alternative Trading System), depending on activity and trading volume.

From the perspective of attempting to harmonize the new technology of the ECNs with a 1934 statute, the Commission should be lauded for its resourcefulness and sensitivity.

¹⁰⁷ See generally Joel Seligman, Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System, 57 Bus. Law. 637, 671-676 (2002).

Periodically, however, Congress or the SEC should step back and question whether the conceptual structure of the Exchange Act continues to be appropriate. Should exchanges continue to be the basic securities markets of the Securities Exchange Act or should a more capacious concept including, for example, ECNs succeed the earlier statutory role performed by exchanges?

The answer to this inquiry is neither obvious nor simple. Increasing the number of market centers and combining this increase with more effective order execution systems could prove to be a significant stimulant to enhanced quote competition. On the other hand, ECNs that operate as broker-dealers or alternative trading systems do not comply with significant obligations currently imposed on exchanges or their members, notably including an exchange specialist's duty to be a buyer of last resort in a declining market.

A thoughtful study of what market centers should compete necessarily must consider what rules should be applicable to market centers. Only within the context of applicable rules, are differences between types of markets or market participants meaningful.

2) How Should Quote Competition Be Conducted?

Underlying the Securities Act Amendments of 1975 to the Securities Exchange Act is a general preference for competition as a means to best protect investors.¹⁰⁸

¹⁰⁸ Ibid. at 601-607.

Lack of brokerage rate competition before 1975 was often criticized for encouraging anticompetitive practices in the securities markets.

The initial five years of experience with unfixed rates demonstrated a wide array of economic advantages concomitant with negotiated or competitive brokerage commission rates. SEC studies during the 1975 to 1980 period reported significant diminution in brokerage commission rates, the emergence of new competition through discount brokers, and enhanced securities industry profitability.

There was an important exception to the general preference of the 1975 Act for brokerage rate competition. In the same 1975 Securities Act Amendments that required negotiated commission rates, Congress enacted §28(e) of the Securities Exchange Act, which created a safe harbor for institutional investors that purchased brokerage and research for a higher commission than they could have expended to only purchase brokerage.

Although the wisdom or scope of §28(e) has been and should continue to be debated, one pivotal point is clear. Section 28(e) was not intended to provide a safe harbor for a different and practice called payment for order flow, by which OTC marketmakers or regional exchange specialists pay a rebate to customer's brokers for directing transactions to it rather than to another exchange which is usually the NYSE.

Few practices are more likely to subvert quote competition. Payment for order flow can not be justified as providing bona fide service to investors who pay a higher than competitive price for brokerage but also receive securities research. Payment for order flow is instead an extra payment to a broker to divert a customer's order to a particular exchange or OTC marketmaker. Any advantage to the investor that might

occur because of payment for order flow is coincidental. The broker has a fiduciary duty to seek best execution of orders.

To be sure payment for order flow can be harmonized with a broker's best execution obligations. It does support regional stock exchanges and, in theory, strengthens competition with the NYSE. Decimal stock trading with narrower price spreads appears to have reduced the magnitude of payment for order flow.

That said, the practice of allowing regional stock exchanges or OTC marketmakers to tinker with price competition is anathema to the competitive policy objectives of the Securities Acts Amendments of 1975 and to the general approach to competition taken by our antitrust laws.

The policy question that deserves serious study today is whether the practice of payment for order flow should be prohibited altogether. A key impediment to prohibition has been the ineffectuality of quote competition. A second impediment has been the Commission's tolerance of a number of similar anticompetitive practices such as reciprocal trading arrangements. Logically, each of these should also be reviewed.

3) How Should Securities Trading Be Routed and Executed?

As the Commission's Division of Market Regulation Market 2000 Study recognized in 1994, "payment for the order flow exists, in part, because it is difficult for markets to compete for order flow on the basis of quotations."¹⁰⁹ Must this be so?

¹⁰⁹ Ibid. at 667-671.

Because it is at least theoretically practicable to design a broker-dealer to market center linkage that in a single step directs orders to the market center with the superior quote, the existing two step approach of SuperDot-ITS begs the question, why does a one step process not operate today?

In 1999, nine markets – the NYSE, AMEX, Boston, Chicago, Cincinnati, Pacific, and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, and the NASD participated in ITS. At the end of 1999, 5056 issues were eligible for trading on ITS, representing most of the stocks that were multiply traded. In 1999, ITS share volume was 5.4 billion shares or approximately two percent of aggregate consolidated tape volume.

In 1999, Chairman Levitt termed the ITS “archaic.” A Market Structure Report published in 2000 by the New York Stock Exchange Special Committee on Market Structure, Governance and Ownership similarly proposed elimination of intermarket order routing linkages.¹¹⁰

A thoughtful SEC review of securities market order routing and order linkage is long overdue. Such a review should itself be linked to other issues such as the quotation system and payment for order flow. A quite different environment today exists than existed in 1978, because decimalization has improved quotation spreads; and because a significantly larger number of orders today are routed electronically to specialists and marketmakers.

With SuperDot currently being enhanced to handle market and limit orders up to

¹¹⁰ See *ibid.* at 670-671.

three million shares per order, the argument, for example, that orders must be forwarded to stock exchange floors to allow floor brokers the opportunity to provide superior quotations is an increasingly debatable one.

IV. CONCLUSION: The Future of Self-Regulation

One of the most significant concepts in securities regulation is that of SEC supervision of industry self-regulation. SEC supervision of industry self-regulation is a thread that unites several aspects of the Commission's broad jurisdiction. As articulated during the New Deal chairmanships of Landis, Douglas, and Frank, the necessity for SEC supervision of industry self-regulation stemmed from two quite distinct bases. First, the impracticality of direct SEC regulation of the several thousand broker-dealers and business corporations subject to its jurisdiction. Second, a preference for business, with its greater practical knowledge of its own affairs, to participate in the application of SEC rules and thus reduce the likelihood of unnecessary disruption or inefficiency.

Far from being a panacea, SEC supervision of industry self-regulation generally has been effective in its major applications only when the Commission has been willing to threaten or actually use its regulatory authority to create incentives for industrial self-regulation.

As a 1973 report of the Senate Subcommittee on Securities aptly stated:

The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the

group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.¹¹¹

At the end of the SEC's first 70 years, two particularly significant lessons are suggested by history.

First, unless meaningful steps are taken to ensure the independence of the SRO from those that it regulates, the quality of SRO regulation tends to deteriorate. Both the SEC appointment of members of the Public Company Accounting Oversight Board and the separation of the NASD from the Nasdaq highlight how significantly avoiding conflicts of interest has become in modern SRO design.

Second, it is not sufficient for the leadership of an SRO to be independent of those that it requires, the SRO itself also must have an assured source of revenue. Perhaps the most significant reform in the auditing profession was the replacement of a Public Oversight Board reliant on industries it regulates for funding with a PCAOB which can assess fees subject to SEC oversight.¹¹²

¹¹¹ SELIGMAN, *supra* n. 1, at 439-440.

¹¹² *Ibid.* at 739.