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Demutualization - Implications for the Regulation and Governance of Securities Exchanges

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DEMUTUALIZATION—IMPLICATIONS FOR THE REGULATION AND GOVERNANCE OF SECURITIES EXCHANGES

By Roberta S. Karmel*

I. INTRODUCTION

Traditionally, stock exchanges have operated in the form of non-profit mutual or membership organizations, although the legal form of stock exchanges has differed from country to country, in accordance with national legal and corporate finance systems.[1] Nevertheless, the essential governance structure of stock exchanges has been more similar than different around the world in that exchange members controlled an exchange with trading members as a dominant force. Although this governance structure continues to be the norm, this model is changing rapidly.

To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or market maker members of an exchange control of the price, quality and range of services produced by the exchange. Exchange profits were returned to broker and dealer members in the form of lower access fees or trading profits. Further, exchanges have long operated as self-regulatory organizations (SROs) with members contributing their time to governance and self-regulation to make exchanges more effective and more profitable. Self-regulation gave exchanges more credibility as quasi-public institutions and also protected their monopoly powers.

Today, the world's exchanges are demutualizing. The first exchange to do so was the Stockholm Stock Exchange in 1993, followed by the Helsinki Stock Exchange in 1995, the Copenhagen Stock Exchange in 1996, the Amsterdam Stock Exchange and the Borsa Italiana in 1997, and the Australian Stock Exchange in 1998. By the end of the year 2000 many more exchanges will have joined this group, including the Paris Bourse, the Toronto Stock Exchange and

the London Stock Exchange, and possibly The Nasdaq Stock Market (Nasdaq), the New York Stock Exchange (NYSE) and the Chicago Board of Trade (CBOT).[2] So far only the Stockholm and Australian Stock Exchanges have gone public and listed on their own boards.[3]

This dramatic shift in the power structure of stock exchanges generally has followed or has been accompanied by a shift from a floor trading market to an electronic trading market. Yet more than technology is driving these changes. The worldwide rise in stock exchange trading volume, global integration of the capital markets and competition for trading profits are leading to disintermediation at a rate that the securities markets have not experienced since the unfixing of commission rates.

It seems that this disintermediation is raising many market structure issues—regulation of alternative trading systems (ATSs); market fragmentation; market information fees and other exchange revenues; side by side trading of equities and derivatives; linkages; and the fair treatment of retail customer orders—to name the most significant matters occupying regulators. All of these issues seem new, but they all were considered, and temporarily resolved, by the Securities and Exchange Commission (SEC) in the late 1970s, when commission rates were unfixed in the United States, and the SEC began to implement the Securities Act Amendments of 1975 (1975 Act) to the Securities Exchange Act of 1934 (Exchange Act).[4] The difference today, if there is a difference, is that technology has accelerated the rate of change, and resolution of the issues transcends national boundaries.

This paper will address the implications of demutualization for the governance and regulation of securities exchanges. I will focus primarily on U.S. law and practice because that is what I know best, but the market and regulatory forces being exerted upon U.S. exchanges are affecting exchanges everywhere. Although I will concentrate primarily on securities laws and

securities exchanges, I will also refer briefly to commodities law and commodities exchanges as a related regulatory model. First, I will discuss some of the causes for stock exchange demutualization, and then I will describe exchange governance and self-regulation in the United States. Finally, I will outline likely models for self-regulation in the future.

II. DRIVERS FOR DEMUTUALIZATION

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

Economists argue that electronic trading networks are likely to destroy an exchange's natural monopoly and, therefore, the benefits of mutual governance may no longer be as valuable as previously was the case. Different exchange members are likely to benefit or suffer from ATS competition unevenly. A related argument is that electronic exchanges and their competitors are compelled to become for-profit corporations in order to be efficient and to compete effectively.

Another important driver for demutualization of some exchanges has been the perceived need to shift power within exchanges from one group of members to another and to afford institutional customers direct access to exchange facilities. Separating exchange membership from ownership may be a politically and economically feasible way to effect such a shift and resolve conflicts of interest between exchange members and between exchanges and their members.

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

Under the federal securities laws as currently drafted and interpreted by the SEC in Regulation ATS,[5] no registered exchange may have institutional or individual investor members, but may only have broker-dealer members. However, institutions and retail customers could become shareholders of a demutualized exchange. A separation of membership from ownership could then realign the interests of investors, who are providing trading interest and liquidity to an exchange pricing mechanism, and exchange members. It should be noted, however, that exchange

demutualizations in countries outside the United States have thus far not generated the institutional investor shareholding interest that was hoped for by some exchange officials. Rather, the primary shareowners are former members.

In the late 1970s when I was a Commissioner of the SEC, some SEC Commissioners and others believed that the trading markets would and should become an electronic "black box," but this did not happen. Buyers and sellers of securities want efficiency and liquidity and, if they are intermediaries, they need to obtain best execution. They also are concerned about market impact so they want anonymity. Further, they are concerned about the financial ability of counterparties to settle trades. Exchanges have historically provided these functions with the exception of anonymity. But the pressure on intermediary profits is undermining the acquiescence of those who provide liquidity to support a continuation of past practices. Commodities exchanges have been experiencing similar pressures. The CBOT is no longer the world's biggest futures exchange, but has been eclipsed by an electronic derivatives marketplace in Europe.[6] Further, the CBOT's largest customers are going into competition with the exchange. Accordingly, the CBOT is planning to split in two and offer its customers side by side electronic trading and open outcry floor trading and at the same time, demutualize.[7] The Chicago Mercantile Exchange (CME) is demutualizing and becoming a for-profit exchange.[8]

Whatever new governance structure or trading system replaces the current trading systems, there is a danger that demutualization of exchanges will cause order flow to move away from exchanges to competitive ATSs. Member firms will no longer have the same stake in an exchange's viability and success, and there will be competition between exchanges and their members. As for-profit exchanges expand, they may also begin to compete with their listed

companies. These developments have significant implications for exchange governance and exchange self-regulation.

III. EXCHANGE GOVERNANCE AND SELF-REGULATION IN THE UNITED STATES

Prior to the enactment of the Exchange Act, stock exchanges were private membership organizations under state law. When the federal securities laws were passed, stock exchanges were required to register with the SEC.[9] The SEC thus obtained oversight authority over stock exchanges, but the stock exchanges continued to have rulemaking and regulatory authority with respect to their members, their trading markets and their listed companies.

Before 1934 no analogue to stock exchanges for the over-the-counter (OTC) market existed, but in 1938 Congress passed the Maloney Act to establish a framework for an OTC SRO.[10] Only one such association, the National Association of Securities Dealers, Inc. (NASD) exists for OTC brokers and dealers. All broker-dealers registered with the SEC, except those doing business exclusively on a securities exchange, are required to join the NASD.[11]

Although the efficacy of self-regulation was called into question by stock market abuses reported in the 1963 SEC Special Study,[12] that Study concluded that self-regulation should be maintained and strengthened.[13] Nevertheless, in 1964 the SEC obtained greater direct authority over the continuous disclosures made by public companies.[14] Previously, the SEC was given power to regulate financial disclosure by issuers making initial public offerings,[15] but after 1964 the SEC also was given responsibility for regulating annual and periodic reports.[16] Stock exchange listing requirements continued to have importance for certain shareholder rights issues, however, because the SEC did not have statutory authority to dictate the corporate governance of listed companies.[17]

The 1975 Act further strengthened the SEC's oversight role over the stock exchanges and the NASD by, among other things, giving the SEC the power to initiate and approve SRO rulemaking,[18] thus expanding the SEC's role in SRO enforcement and discipline[19] by allowing the SEC to play an active role in structuring the market.[20] Also, formulation and enforcement of the net capital rule became a direct SEC responsibility instead of a regulation of the SROs.[21] For the first time, the statute set forth requirements with respect to the composition of exchange and association boards of directors.[22] The 1975 Act sought to preserve and reinforce the concept of industry self-regulation with SEC oversight. However, by directing the SEC to facilitate the creation of a national market system, injecting competition as a statutory goal and giving the SEC greater authority over SRO rulemaking, disciplinary activities and other matters, the SEC became able to exert more leverage over exchange self-regulation and corporate governance than in the past.

Prior to 1974 commodity futures trading was regulated by the Commodity Exchange Authority within the Department of Agriculture.[23] Then Congress created the Commodity Futures Trading Commission (CFTC) as an independent agency and gave it exclusive jurisdiction over future and commodity options trading pursuant to the Commodity Futures Trading Commission Act of 1974 (Commodity Futures Act).[24] To a large extent the CFTC is an analogue to the SEC with respect to the regulation of futures exchanges. The CFTC has deferred to rulemaking and self-regulation by commodities exchanges.[25] Such self-regulation by commodities exchanges has a long history.[26] Initially, the organizational and governing structure of a commodity exchange was not even subject to CFTC regulation.[27]

In addition to self-regulation by commodities exchanges, the National Futures Association (NFA) is a free standing self-regulator that was granted registration by the CFTC in

1982 as a futures association.[28] The NFA works with the CFTC to set standards with regard to ethics training for industry professionals, the review of disclosure documents and issues concerning statutory disqualification of registered persons and entities.[29] Also, the NFA audits any commodities firms not a member of any commodities exchange.[30]

Stock and futures exchanges in the United States traditionally have been organized under not-for-profit incorporation laws of a particular state as mutual organizations, owned by their members.[31] The members vote for the exchange boards of directors (sometimes called governors). For-profit ATSs and plans by the NYSE and Nasdaq to demutualize have posed the question of whether non-member, for-profit entities may operate as exchanges. The SEC has determined that a for-profit corporation may register as a stock exchange.[32] Indeed, ATSs must now register as ATSs with the SEC or, alternatively, they may register as stock exchanges, and some have applied to do so.[33]

Floor based exchanges, such as the NYSE and the CBOT have a limited number of members or seatholders. Traditionally, this has given the members monopoly powers with respect to the stocks or futures contracts traded on the exchanges. Concern about the abuse of monopoly power gave rise to government interest in exchange governance. Examinations of governance issues have tended to focus on power struggles between seatholders, professional exchange managers and upstairs trading firms. More recently, conflicts have emerged between seatholders and wire houses and clearing members. In the view of Congress, exchanges are affected with a national public interest, requiring their regulation to insure the maintenance of fair and honest markets.[34]

The dominance of exchange governance by the floor and of NASD governance by market makers has long been both an advantage and a disadvantage. The advantage, sometimes

overlooked, is that the specialists and market makers have contributed to the success of the NYSE and NASD and have devoted their time and talent to make their markets and self-regulation work. With respect to the NYSE, prior to 1972, specialist firms numerically dominated the board of governors, even though the 1963 SEC Special Study recommended that voting rights should be separated from the ownership of seats and the public should be given increased representation.[35] The 1971 Martin Report, written in the context of uncertainty about the immunity of exchanges from the antitrust laws, pressures to unfix commission rates and the financial and operational back office crisis of the securities industry, also recommended that NYSE seats be changed into shares, without destroying their value.[36] This recommendation was part of an objective to transform the Exchange from a private club to a quasi-public organization that would give proper recognition in its governing board to the respective interests of the public, the companies listed on the NYSE, and to member firms, in addition to specialists. Public representation on the board and a greater independence of the exchange management was also intended to strengthen self-regulation and answer criticisms that member firms could not discipline themselves.

In 1971 the NYSE incorporated and in 1972 the NYSE Constitution was changed to adopt many of the reforms advocated in the Martin Report. In 1975 commission rates were unfixed by the 1975 Act, which also strengthened the SEC's oversight role over stock exchanges, and for the first time set requirements for the composition of exchange members and boards of directors. The Exchange Act was amended to provide that the rules of an exchange must assure a fair representation of its members in the selection of its directors and administration of its affairs. It also provides that one or more directors must be a representative of issuers and investors and not be associated with a member of the Exchange, or with any broker or dealer.[37] The 1975 Act further prohibited institutional membership on exchanges.

The NYSE has gone considerably beyond the requirements of the Exchange Act. Half its board is composed of public directors not associated with the securities industry, while the half that is so associated is a constituency board. There are requirements for industry directors from firms that have substantial direct contact with securities customers, for specialist members and non-specialist floor members and geographical specifications.[38] The NYSE has 1,366 members who have physical access to the trading floor and who are the owners of the exchange.[39] However, the NYSE also has up to 24 physical access members, electronic access members and lessee members.[40] The lessee members are a significant factor in governance issues because they can contract for the right to vote.[41] Moreover, at the end of 1999, 863 of the NYSE's 1,366 regular seats were leased.[42] In addition to voting for members of the board of directors of the NYSE and its chairman, regular members are entitled to one vote on "any sale, lease or exchange or other disposition of all, or substantially all of the assets of the exchange; any merger or consolidation in which the exchange is a constituent corporation; or any dissolution or final liquidation of the Exchange."[43]

The NASD does not have "seats" since it has never had a floor. Rather, its membership is composed of broker-dealers. The NASD's job of self-regulation has always been difficult because its membership is nationwide, large and diverse and not pre-selected.[44] Further, its emphasis in the past was on members regulating and disciplining themselves, as distinguished from regulation by a hired staff, and in promoting voluntary compliance with ethical standards.[45] Principles emanating from the Maloney Act and guiding the NASD were democratic organization, business person's judgment and local autonomy.[46]

The NASD was completely reorganized in 1996 in the aftermath of a Department of Justice and SEC investigation into anticompetitive practices by OTC market makers.[47] The SEC

criticized the NASD for its regulatory deficiencies in failing to uncover these practices or discipline its members, and found that the NASD was unduly influenced by Nasdaq market making firms with respect to rulemaking, the disciplinary process and the admission of new members.[48] In a settlement of these matters, the NASD agreed, among other things, to achieve greater diversity of representation on its board and its policy making committees, to provide for the autonomy and independence of its staff with respect to disciplinary and regulatory matters, to create an enhanced audit trail, and to improve its surveillance and examination of order handling and the reliability of trade reporting.[49]

The 1996 NASD reorganization resulted in the creation of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc. (NASDR). All three boards are constituency boards that are required to have a majority of non-industry members.[50] NASD governance is again in a state of flux because of a restructuring that would result in the sale of 78% of Nasdaq to issuers and NASD members and would lead to the registration of Nasdaq as a stock exchange with the SEC.[51]

On April 14, 2000 the membership of the NASD voted overwhelmingly to turn Nasdaq into a for-profit company and alter its ownership structure.[52] This transformation will be accomplished in two stages. In the first stage, up to 49% of Nasdaq's common stock will be offered in a private placement to NASD members, Nasdaq issuers, institutional investors, and strategic partners. After a further sale of Nasdaq stock in the second phase, either by way of a public offering or private placement, the NASD will own only a minority stake of approximately 22% of Nasdaq.[53]

Among the purposes of the demutualization of Nasdaq are to permit the NASD to focus more intently on its original mission of being a membership-focused organization; to

streamline corporate governance; and to create a financially stronger Nasdaq better able to address competitive challenges and invest in new technology.[54] The Nasdaq board will be restructured prior to its registration as an exchange. Currently, all 10 members of the Nasdaq board sit on the NASD board. It is contemplated that the Nasdaq board will be increased by four members who will not serve on the NASD board, two of whom will be industry members and two of whom will be non-industry members.[55]

The Commodity Futures Act, like the Exchange Act, requires diversity on commodity exchange boards. This requirement also was occasioned by market scandals. In 1989 there were FBI sting operations at the CME and CBOT that resulted in criminal indictments and convictions.[56] As a result, Congress passed legislation to strengthen regulation of the trading pits. These 1992 amendments to the Commodity Futures Act require diversity of membership on exchange boards and disciplinary committees to ensure fairness and to mitigate against preferential treatment.[57] Futures exchanges have had no ban on institutional membership so banks and large agricultural interests traditionally have owned memberships. Because of the enforced monopoly futures exchanges have on the trading of particular contracts, the fear of disintermediation that led to the ban on stock exchange institutional membership in the 1975 Act was not relevant to futures exchanges.

The mutual governance structure of stock exchanges served the securities industry reasonably well when the interests of specialists, market makers and other floor members were aligned with the interests of the wire houses and clearing firms. The threat of disintermediation coming from electronic trading systems is now pitting the interests of floor and other trading members against upstairs members and also the interests of the wire houses against the exchanges.[58] Decimalization will put a further squeeze on trading profits not only because it will

decrease trading spreads, but also because it will increase trading volume and require a costly investment in technology.[59]

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

My doubts are based on a number of factors. First, the ATS electronic systems have not yet become primary markets and therefore their successful operation as price setting mechanisms is uncertain. In that connection, the SEC is unlikely to allow the market for U.S. equities to seriously fragment to the detriment of retail investors.[60] Second, the success of ATSs in the OTC market is due in part to a shift in the ratio of dealer to agency transactions, and this shift may not be necessary to achieve optimal efficiency in the NYSE market.[61] Third, the viability of ATS electronic markets have not yet been tested by a market break followed by a serious bear market. In volatile markets, the need for the negative and affirmative obligations imposed upon specialists is significant, and it is unclear how markets will be held to a fair and orderly standard in the absence of such dealer intervention. Fourth, if traders can no longer make money on spreads they will make money by exploiting time and place advantages, and such unfair and inequitable conduct will sooner or later attract the attention of regulators.[62] Finally, listed companies have not

yet had much input into the discussion about the future of the securities markets and the governance of exchanges.[63]

For all of these reasons it is hard to predict the future structure of the securities markets and the future governance and regulation of stock exchanges. Issues about exchange governance probably do not have to be fully resolved prior to demutualization because one of the objectives of demutualization is to streamline governance and base it upon stock ownership rather than constituency representation of member firms. However, issues concerning the balance between government regulation and self-regulation and the regulatory implications of demutualization are more urgent because the SEC is unlikely to allow the exchanges to demutualize unless it is satisfied with the securities industry's new self-regulatory structure.[64]

IV. MODELS FOR SELF-REGULATION

One of the more contentious questions under discussion concerning exchange demutualization is the future of self-regulation. There are several issues that have been raised. First, some have argued that there would be conflicts of interests between shareholders and members in a demutualized exchange environment that would diminish the ability of exchanges to engage in effective self-regulation. A potentially more serious conflict is the regulation of an ATS market by the NYSE or NASD. Second, securities firms are concerned about the costs of multiple SROs, especially if several ATSs become exchanges and begin to engage in self-regulation. Therefore, some industry members are arguing in favor of a single SRO for exchanges and member firms. Third, there are ongoing power struggles between the SROs and between the SROs and the SEC. Resolving these issues will require leadership and forbearance. In my opinion, regardless

of how these issues are resolved in the near term, a shift away from self-regulation to greater government regulation is inevitable over time.

The NYSE and NASD engage in self-regulation in four areas: listed company governance and disclosure; surveillance and discipline of their markets and specialists, floor brokers and market makers; member firm financial and operational compliance; and fair and equitable treatment of customers. Also, both the NYSE and NASD run arbitration facilities for disputes between members and disputes between members and customers. The NASD membership has always been more diverse than the NYSE and is not pre-selected. Further, it has a nationwide organization with some local autonomy. The NYSE's New York location, more exclusive membership and domination by the industry's largest firms has given its inspection and regulatory operations a different cast than that of the NASD. Further, in a financial crisis, the NYSE's ties to the New York Federal Reserve Bank have been important.[65]

NYSE listing requirements go back to the nineteenth century and stem from a concern about the quality of the securities sold on the exchange. These requirements were intended to facilitate an efficient, continuous auction market by setting minimum numerical standards for capitalization, number of shares and shareholders, by establishing disclosure requirements and by specifying certain shareholder protection or corporate governance mechanisms.[66] The NYSE developed these requirements because it recognized that standards were good for its business and could give the exchange a competitive advantage.[67] When Nasdaq was organized as an electronic market, it also established listing qualifications in order to preserve and improve the quality of and public confidence in its market.[68]

If the NYSE and Nasdaq become public companies it will perhaps be anomalous for them to negotiate listing agreements with themselves and then supervise continuing compliance

with such agreements. For this reason, when the Stockholm and Australian Stock Exchanges went public, government regulators were assigned the task of overseeing exchange disclosure to shareholders.[69] On the other hand, the NYSE and Nasdaq will continue to have a motivation to market their exchanges as lists of quality issuers. At least one commentator has argued that the benefits of increased capital mobility would be better realized through regulatory decentralization than greater centralization. Under a decentralized model, exchanges should be the primary writers and enforcers of rules relating to disclosure by listed companies, standards of conduct for member broker-dealers and for market structure.[70]

Broker-dealer regulation by exchanges has its roots in efforts to assure the credit worthiness of exchange members. This continues to be a significant issue and an important aspect of NYSE and NASD regulation. In that regard, the NYSE has developed a competence in examining and assuring the financial viability of its large member firms that would not easily be duplicated by a single SRO, located in Washington, D.C., and indirectly run by the SEC. Moreover, now that securities firms, banks and insurance companies can operate in a single holding company, the Federal Reserve Board, as an umbrella regulator, will be weighing in heavily on securities industry capital adequacy questions.[71] If the NYSE or NASD go public, it is likely that clearing member firms will be large stockholders. This will give them an incentive to maintain high standards of financial and operational capabilities for member firms. It may create some new conflicts of interest, but the creation of a single SRO would not solve these conflicts.

The incentive of the NYSE and Nasdaq to police their markets for manipulation, and their effectiveness in doing so, would probably be greater following a public offering than it is today. There should be fewer conflicts of interest in policing the markets if ownership of these SROs is spread beyond those concerned with making markets. Since Nasdaq is a dealer market

and the NYSE is a specialist system, the creation of a single SRO to oversee these two markets is unlikely to create any economies of scale and could well be counterproductive. Even if the SEC succeeds in mandating or fostering the creation of new mechanisms for linking exchange and OTC markets,[72] it is unlikely that these markets will lose their particular characteristics.

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

The Securities Industry Association's (SIA) Ad Hoc Committee on the Regulatory Implications of De-Mutualization has determined guiding principles for analyzing an appropriate SRO structure and has suggested six different models for future regulation of the securities industry.[73] The SIA's Ad Hoc Committee's guidelines for evaluating regulatory options state that any regulatory structure should foster investor protection; preserve fair competition; eliminate inefficiencies; encourage expert regulation; promote reasonable and fair regulatory costs; foster due process; and encourage industry participation and self-regulation.[74] The five models the Committee put forward are: (1) Status Quo; (2) Multiple Exchanges with Separate Boards and Information Barriers for Their Regulatory Arms (NASDR Model); (3) Multiple SROs with Firms Designated to a Single SRO for Examination Purposes (DEA Model); (4) One SRO for Member

Firms; Markets Regulate Their Own Trading (Hybrid Model); (5) All Purpose Single SRO (Single SRO Model); and (6) Single Regulatory Organization (SEC-Only Model).[75]

The SIA's Ad Hoc Committee endorsed the Hybrid Model in which there would be a central SRO responsible for firm oversight and cross market issues, including rules generally applicable to all markets.[76] Individual market SROs would then be responsible for market-specific rules, including rules regarding trading and listing.[77] Cross-market rules would include front running, manipulation, free-riding and withholding rules, sales practice regulation, industry admission standards, financial responsibility requirements, training and supervision and recordkeeping.[78] Arguments in favor of the Hybrid Model are that this model would improve regulation, decrease regulatory costs, preserve the synergy between markets and market-specific oversight, foster competition and continue self-regulation.[79] On March 22, 2000 the SIA board of directors endorsed the Hybrid Model.[80] One reason for this endorsement is that the securities industry would like to avoid duplication of examinations and inconsistent regulation. In that connection, the White Paper advocates a single, independent arbitration forum.

The NASD has been pushing for a Single SRO model and the Chairman of the SEC briefly embraced this model.[81] One of the problems with this model is that the NYSE opposes it.[82] Another problem is that the SEC does not have the statutory authority to impose corporate governance requirements on listed companies and neither would a free standing Single SRO.[83] Further, although the SEC might find it convenient to oversee a sole self-regulator, I believe the SEC would be tempted to make it an arm of the government, rather than a true self regulator. Yet, SROs do not afford those they discipline the protections of persons who are investigated or prosecuted by government officials.[84]

One of the goals of the Exchange Act is “fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.”[85] For the SEC to suppress or eliminate competition among SROs could be contrary to this goal because an important function of an exchange is self-regulation.[86] On the other hand, an ATS regulated as a member of an exchange could complain of unfair competition, and yet find it uneconomical to become a full service SRO. Further, although the benefits of regulatory competition are often touted, regulatory competition can be unseemly and destructive of public confidence in the regulators. Given the serious fissures within the securities industry at the present time, the Hybrid Model seems the most likely solution to self-regulation after demutualization if the NYSE can be persuaded to endorse some version of this model.

One of the many difficulties with any new SRO structure is adequate funding. Currently, SROs rely on four primary sources for their funding: (1) regulatory fees and assessments paid by SRO members; (2) transaction services fees; (3) listing fees; and (4) market information fees.[87] The continued viability of all of these fees in rapidly changing market conditions is unclear. The SEC has issued a complex and provocative release on some of these fees, and however uncomfortable the SEC may be with establishing fees for market users, this is an issue that will not disappear.[88] Clearly, rigorous, expert and fair regulation is not possible unless SRO regulation is adequately funded. But after demutualization, subsidizing general broker-dealer enforcement activities through fees other than regulatory assessments of members may prove difficult. This suggests that the securities industry is likely to focus on the costs of duplicative self-regulation.

The futures industry could perhaps move more easily to a sole self-regulator than the securities industry because the NFA already exists and has statutory recognition.

Demutualization of futures exchanges and their need to face competition from electronic exchanges has highlighted another problem — the need to level the playing field between traditional exchanges and ATSs by decreasing government regulation of exchanges.[89] The SEC has recognized this challenge in fashioning Regulation ATS,[90] but it has not dealt with the need to significantly change its regulation of traditional exchanges. Yet, if exchanges no longer enjoy a monopoly (or near monopoly) of trading the stocks of their listed issuers, or trading other financial products, much less government regulation is needed because competition can substitute for government regulation.

V. CONCLUSION

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

Demutualization of exchanges will shift the power structures within exchanges, but public offerings of exchanges will change them much more. By raising new capital, exchanges will be able to implement new business strategies. But the freedom of public ownership will add burdens to exchange operations. New disclosure and reporting duties will affect cultures of confidentiality and even (from the public's viewpoint) mystery. To the extent that broker-dealer regulation is subsidized by listed companies, these issuers may object to this use of listing fees. Exchange executives will have to learn to deal with security analysts and plaintiff securities

lawyers. Stock market corrections may adversely affect the stock of exchanges disproportionately to general indices.

During the 1990s, for political and economic reasons, business has enjoyed the public's respect and entrepreneurship has been fashionable. If there is a prolonged stock market decline and an economic recession, public perceptions might shift. A non-profit organization enjoys a greater aura of acting in the public interest than does a for-profit corporation. There is a risk that turning exchanges into ordinary public companies, likely to have much smaller capitalizations than their listed companies, will undermine public confidence in these symbols of capitalism.

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[1] For example, in continental Europe stock exchanges were often established by royal decree and operated by a Chamber of Commerce. In some common law countries, like Australia, they were companies limited by guarantee, a business form the United States does not have. *See* Hogan, Stokes Pty. Limited, *Report on the Future Governance of the Australian Stock Exchange*, July 1996.

[2] *See Exchange Demutualization Trend Sweeps World Markets*, INT'L SEC. OUTLOOK (CCH), Oct. 18, 1999, at 4.

[3] *See* Gwen Robinson, *ASX Shares Likely to Start Above A$3.50,* FIN. TIMES. Oct. 14, 1998, at 18; Bengt Ryden, *The Privatization of Stock Exchanges: The Case of Stockholm Stock Exchange*, ISE REVIEW, July-Sept. 1997, at 1, 10-11 (1997).

[4] Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified in various sections of 15 U.S.C. § 78a *et seq.*).

[5] Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 40760, 63 Fed. Reg. 70844, 70852 (Dec. 22, 1998) (Adopting ATS Release).

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

[7] *See* David Barboza, *Chicago Faces the Future, Reluctantly,* N.Y. TIMES, Nov. 23, 1999, at C1.

[8] *See* Peter A. McKay, *New CEO Devises Five-Year Strategy To Restructure For-Profit Chicago Merc,* WALL ST. J., Feb. 24, 2000, at C17.

[9] Exchange Act, § 6, 15 U.S.C. § 78f (1999).

[10] *See id*. § 15A.

[11] *See id*. § 15(b)(8). Before 1983, the NASD did not have this kind of an SRO monopoly. *See* § 3, Pub. L. 98-38, 97 Stat. 206 (1983).

[12] *See* SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 4, at 502 (1963) (Special Study).

[13] *Id.* Pt. 5, at 201-02.

[14] *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964).

[15] *See* Securities Act of 1933, § 5, 15 U.S.C. § 77e (1999).

[16] *See* Exchange Act, §§ 12(g), 14(a), 15 U.S.C. §§ 78l(g), 78n(a).

[17] *See* Business Roundtable v. SEC, 905 F.2d 406, 407 (D.C. Cir. 1990).

[18] *See* Exchange Act, § 19(c), 15 U.S.C. § 78s(c) (1994).

[19] *Id.*, §§ 19(c), (d), (g).

[20] *See id.,* § 11A.

[21] *See id.*, § 15(c)(3).

[22] *See id.*, § 6(a)(3), 15A (b)(4).

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

[24] Pub. L. No. 93-463, 88 Stat. 1389 (1974).

[25] *See* Markham, *supra* note 23, at 1004-05.

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

[27] *See* THOMAS A. RUSSO, REGULATION OF THE COMMODITIES FUTURES AND OPTIONS MARKETS § 1.03, at 1-9 (1983).

[28] *See* U.S. GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION HOW INVESTORS FARE, (PLI Corp. L. & Practice Course Handbook Series No. B4-7006, at 19, 1992).

[29] *See* CFTC, *Visions and Strategies for the Future: Facing the Challenges of 1997 through 2000* (last modified Sept. 1997) <http://www.cftc.gov/strplan97/home.html>.

[30] *See Regulation of Investment Companies and Investment Advisers,* in THE SEC SPEAKS IN 1995, (PLI Corp. L. & Practice Course Handbook Series No. B4-7080, at 119, 188 n.88, 1995).

[31] Stock exchanges and futures exchanges, unlike charities or educational institutions, they pay taxes. For example, the NYSE is incorporated under a New York law that existed prior to the

exchange's incorporation. N.Y. BUS. CORP. L. § 402 (McKinney 1999). The State of Illinois passed a special law to facilitate incorporation by the CBOT. *See* Chicago Board of Trade, *About the Exchange* (visited Apr. 1, 2000) <http://www.cbot.com>.

[32] *See* Adopting ATS Release, *supra* note 5, at 70848, 70883.

[33] *See id*. Island ECN Inc., is moving to raise capital and register as a stock exchange. *See* Rebecca Buckman, *Island ECN Raises Capital to Become a Stock Exchange*, WALL ST. J., May 11, 1999, at C20. Archipelago applied for exchange status in July 1999. *See* Guy Moszkowski *et al*. *Trading Up–The Equity Markets and the New World of Electronic Trading*, Solomon Smith Barney Equity Research: United States, Oct. 5, 1999, at 51 (Trading Up).

[34] *See* Exchange Act, § 2, 15 U.S.C. § 78b (1999).

[35] *See* Special Study Pt. 4, *supra* note 12, at 576.

[36] *See id*. at 103-05.

[37] *See* Exchange Act, § 6(a) (3), 15 U.S.C. 78f(a)(3).

[38] *See* NYSE Constitution, art. IV, § 2(a)-(b), NYSE Guide (CCH), ¶ 1151.

[39] *See id.*, art. 13; NYSE Constitution, Art. II, § 1(a), 2 NYSE GUIDE (CCH), at 1053.

[40] *See id.,* §§ 1(b)-(c), 2.

[41] *Id.* Electronic access members (who have access to the DOT system) initially had ½ the vote, but new electronic access members after 1986 do not vote. *See* Order Approving Proposed Rule Change, Exchange Act Release No. 22959, 51 Fed. Reg. 8060 (Mar. 7, 1986).

[42] *See* Richard A. Grasso, CEO, NYSE, *Public Ownership of the U.S. Stock Markets*, Testimony Before the Sen. Comm. on Banking, Housing and Urban Affairs, Sept. 28, 1999, at 10.

[43] *See* NYSE Constitution, art. 3, § 9(a), 2 NYSE Guide (CCH), ¶ 1109.

[44] *See* Special Study, Pt. 4 *supra* note 12, at 679.

[45] *Id.*

[46] *See id.* at 606-07.

[47] *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. 37542 (Aug. 8, 1996) *available in* 1996 WL 452691.

[48] *See id.* at *2.

[49] *See id.* at *2-3.

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

[51] *See* Nasdaq, *Fact Sheet on the Proposed NASD Restructuring* (visited Apr. 1, 2000) <http://www.nasdaqnews.com/news/per2000/fact313.html>. Today, Nasdaq is registered as an exclusive information processor. *See* Adopting ATS Release, *supra* note 5, at 70852.

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

[53] *See* NASD, Press Release, *NASD Restructuring Wins in landslide Vote of the Members* (last modified Apr. 14, 2000) <**Error! Bookmark not defined.**>*; see also* Terzah Ewing, *Deals & Deal Makers NASD Members Vote to Sell Nasdaq, Paving the Way for Private Ownership,* WALL STREET J., Apr. 17, 2000, at C21.

[54] *See id.*

[55] *See id.*.

[56] *See* JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION AND OTHER CLAIMS § 14.10 (1998).

[57] 7 U.S.C. § 7a(14)-(15) (1999).

[58] NYSE member firms are heavily involved in electronic communication network development and have invested in the major ATSs. *See* Trading Up, *supra* note 33 ST. J., July 30, 1999, at C11.

[59] *See* Deborah Lohse, *Nasdaq to Start Trading All Stock in Sixteenths,* WALL ST. J., May 29, 1997, at C1.

[60] *See* NYSE Rulemaking: Notice of Filing of Proposed Rule Change To Rescind Exchange Rule 390, Exchange Act Release No. 42450 (Feb. 23, 2000) *available in* 2000 WL 202094.

[61] See Trading Up, *supra* note 33, at 20-21.

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

[63] *But see* Greg Ip, *NYSE Panel to Study Market Structure In Addition to Governance, Ownership,* WALL ST. J., Oct. 12, 1999, at C9.

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

[65] *See* TIM METZ, BLACK MONDAY 160-61, 195, 212-14, 234 (1988).

[66] *See* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 Bus. Law 1461 (1992).

[67] *Id.*

[68] *See* NASD Rules 4300, 4310, NASD Manual (CCH) at 5271-79.

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

[70] *See* Paul G. Mahoney, *The Exchange as Regulator,* 83 VA. L. REV. 1453 (1997).

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

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

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

[74] *See id.* at 1.

[75] *See id.* at 5.

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

[77] *See id.* at 2.

[78] *See id*. at 3.

[79] *See id*. at 5.

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

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

[82] *See* Lisa L. Fried, *Plans Debated for Stock Markets' For-Profit Conversion*, N.Y.L.J., Sept. 30, 1999, at 5; Grasso, *supra* note 42.

[83] *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

[84] *See, e.g.,* In Re Stephen J. Gluckman, Exchange Act Release No. 41628 (July 20,1999).

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

[86] *See id.,* § 6(b).

[87] *See* SIA White Paper, *supra* note 73, at 35.

[88] *See* Exchange Act Release No. 42208, 64 Fed. Reg. 70613 (Dec. 9, 1999).

[89] *See Oversight Function for CFTC Emerging as Congress Seeks to Renew Mandate*, 32 SEC. REG. & L. REP., Jan. 24, 2000, at 92.

[90] *See* Adopting ATS Release, *supra* note 5, at 70846.