January 14, 2005
Princeton University
Woodrow Wilson School
Princeton, NJ 08544

Jonathan G. Katz
Secretary, Securities and Exchange Commission
450 Fifth Street, NW.,Washington, DC
20459-0609

Re: File No. S7-40-04, Release No. 34-50700 (November 18, 2004)
Concept Release Concerning Self-Regulation

Dear Secretary Katz,

This fall a Princeton University undergraduate task force in the Woodrow Wilson School of Public Policy examined the regulation of publicly traded securities. The task force consisted of eight third-year policy students who were led by two fourth-year policy students and were advised by Harvard Law School Professor and Visiting Princeton Professor Hal S. Scott. Each of the eight students investigated a different area of securities regulation, and arrived at their own individual conclusions. The task force discussed each of the topics and eventually arrived at a collective set of recommendations summarized in the attached task force report. The comments and the recommendations the students have produced are the result of objective and extensive independent work and their opinions are entirely their own. The recommendations in this report are not necessarily the views of the senior commissioners or Professor Scott.

The students investigated many of the issues within proposed Regulation NMS and its Reproposal: in addition, there were additional aspects of market structure the task force felt needed to be addressed. One of these was the regulation of the NYSE, Nasdaq and electronic communication networks (ECNs), the subject of the Concept Release on Self Regulation. This filing includes the overall Task Force Report as well as well as an appendix with the paper on SROs. We are filing the entire report because our approach to SROs must be understood in the context of the entire task force report. The collective judgment of the task force on SROs is expressed in the task force report. Our comment consists only of the task force recommendations on SROs. The individual paper is included only for background.

The Princeton students discussed these issues amongst themselves and with distinguished industry professionals over twelve weeks.[1] The students' lack of bias regarding the securities industry combined with the depth of knowledge they have about each topic makes their work unique and invaluable. We are looking forward to having an impact on improving the efficiency of American financial markets. Thank you for your consideration of this comment.

Best Regards,

Jayda Dagdelen
Senior Task Force Commissioner

Mara Tchalakov
Senior Task Force Commissioner

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
Robert L. D. Colby, Deputy Director, Division of Market Regulation

[1] Over the course of the semester, the task force met with Annette Nazareth, Director, Division of Market Regulation, Securities and Exchange Commission; John Thain, Chief Executive Officer, NYSE; Robert Britz, President and Chief Operating Officer, NYSE; Richard Ketchum, Chief Regulatory Officer, NYSE; David Shuler, Chief of Staff, NYSE; Richard Bernard, General Counsel, NYSE; Robert McCooey, Member of the Board of Executives, NYSE; Cameron Smith, General Counsel, The Island ECN; Peter Wallison, American Enterprise Institute; Douglas Shulman, President, Markets, Services and Information, NASD; Benn Steil, Council on Foreign Relations; Eric Roiter, General Counsel, Fidelity Investments.

PRINCETON UNIVERSITY

Woodrow Wilson School of

Public and International Affairs

POLICY TASK FORCE REPORT*

THE REGULATION OF PUBLICLY TRADED SECURITIES

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January 2005

*** This report represents the views of the Task Force Members but not necessarily those of Professor Scott or the senior commissioners.**

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I. INTRODUCTION

A Brief Overview of the Task Force

The monumental task facing the Securities and Exchange Commission (SEC) and United States policymakers today is how to administer rules and reforms that facilitate a more globally efficient and competitive marketplace, while maintaining the nation's commitment to a high level of individual investor protection. This Woodrow Wilson School report sets forth a set of policy recommendations on the aspects of securities regulation relevant to the SEC's recent Regulation National Market System Proposal (Reg NMS),[2] its proposal on Self-Regulatory Organizations, especially regarding Fair Administration and Governance of Self-Regulatory Organizations, [3] its Concept Release Concerning Self-Regulation,[4] and other securities regulation issues: the topics addressed are the trade-through rule, data distribution fees and market access fees, payment for order flow, corporate governance of the exchanges, regulation of the NYSE, Nasdaq and electronic communication networks (ECNs), the role of the federal government in securities market regulation, the regulation of short sales (Reg SHO), and the integration of international securities markets with a focus on transatlantic trading.

Advised by Harvard Law Professor and Visiting Princeton Professor Hal Scott, the task force brought together eight third-year public policy students and two fourth-year students known as "senior commissioners" for a semester of intense study of the policies regulating publicly traded securities under rapidly changing market conditions. The report is comprised of an introduction and background context, a summary of the task force recommendations and findings, a conclusion and an appendix on self-regulation, written by one of the task force members. Before presenting the task force's recommendations, a brief exploration of the context of the regulation of publicly traded securities follows. This context is intended to provide the background for a larger discussion of the task force recommendations and arguments for why the SEC's approach to market regulation may no longer be appropriate.

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2 Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, December 16, 2004, http://www.sec.gov/rules/proposed/34-50870.pdf

3 Securities and Exchange Commission, *Self-Regulatory Organizations-Various Amendments, Proposed Rule,* File No. S7-39-04, November 18, 2004 http://www.sec.gov/rules/proposed/34-50699.pdf

4 Securities and Exchange Commission, *Concept Release Concerning Self-Regulation*, File No. S7-40-04, November 18, 2004, http://www.sec.gov/rules/concept/34-50700.pdf

The Evolving Context of Domestic Securities Regulation and Reg NMS

On February 26, 2004 the Securities and Exchange Commission (hereafter denoted SEC) proposed Regulation National Market System (Reg NMS). The proposal's intention to modernize existing and possibly outdated regulations concerning domestic equity markets represents the culmination of a long tradition of attempts by the SEC to integrate securities markets. The National Market System concept was originally enacted in the 1970s (through the congressionally mandated 1975 Exchange Act amendments) under Section 11A of the Securities Exchange Act (1934) in an attempt to ensure equal regulation of all markets for NMS securities.[5]

In the more than thirty years that have since passed, market conditions have changed rapidly in response to higher trading volume, lower trading costs and the evolving technology that has facilitated both trends. The National Market System now comprises the stocks of over 5000 listed companies that collectively represent more than $14 trillion in U.S. market capitalization.[6] Intense competition now exists between very different market centers (including automated electronic communication networks as well as traditional exchanges, regional exchanges, and other market-making securities dealers) resulting in a greater fragmentation of the marketplace. Computerized trading systems now handle close to forty-five percent of the orders in securities listed on the Nasdaq and almost seven percent of the orders in all exchange-listed securities.[7] The SEC's proposals stem in large part from a growing discrepancy between "fast" and "slow" markets—prompted by innovative trading technologies (ECNs, smart-order routers, direct access technology) and new market centers.

Reg NMS is an attempt by the SEC to update the existing National Market System through four proposals. Respectively, these include a uniform trade-through rule for exchange and Nasdaq-listed securities (the Reproposal eliminates any opt-out exemption for institutional investors and applies only to automated quotes under Rule 611), a uniform market access rule (barring lock and cross quotations and establishing prohibitions on ECN access fees),

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[5] Freeman, David, Zambrowicz, Kevin and Eunice Yang. "The SEC's Proposed Regulation NMS." *Banking and Financial Services Policy Report*, Volume 23, No. 6, June 2004.

[6] Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, February 26, 2004, <http://www.sec.gov/rules/proposed/34-49325.htm>

[7] Oesterle, Dale A. *Congress's 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?* Public Law and Legal Theory Working Paper Series, No. 11, May 2004.

prohibitions on displaying sub-penny quotes, and a modified method of allocating and pricing market data. After the February 26th, 2004 initial proposal of Reg NMS, on May 20, 2004, the SEC extended its comment period[8] so as to reflect the results of the hearing on Reg NMS held on April 21, 2004. On December 16, 2004, after having received comments, the SEC amended and reproposed the Reg NMS.[9] The December Reproposal contains two alternatives for the scope of quotations protected, one protecting the NBBOs of the nine SROs and Nasdaq whose members trade NMS stocks, and the other protecting NBBOs of these same organizations but would secure additional protection for a market's depth-of-book quotations. The Reproposal additionally attempts to simplify the formulas in Reg NMS for allocating revenues generated by market data fees and authorizes markets to distribute their own data independently. The Reproposal intended to perfect the NMS, and promote equal regulation of different markets and stocks and greater order interaction and displayed depth. However, this task force views Reg NMS as one more step down a path towards an anti-competitive and inefficient trading market.

The birth of the national market system in 1975 consisted of a proposal for an electronic communication linkage of existing markets[10] (referring primarily to listed stocks on the registered exchanges of NYSE and AMEX) to which Congress referred to as a "public utility" that "should be regulated accordingly." This initiative developed into the set of semi-centralized order routing procedures for listed securities known as the Intermarket Trading System (ITS). Once almost exclusively the domain of the NYSE, ECNs have rapidly been encroaching on the market for trading exchange-listed stocks (the ITS most recently admitted a computerized electronic facility Archipelago).[11] Currently the SEC mandates order routing links through the ITS for listed securities and through the NASD system or Alternative Display Facility (ADF) for NMS securities. The SEC now appears to be in favor of moving towards an over-arching national computerized market trading system.

A Tale of Two Markets

8 Securities and Exchange Commission, *Proposed Regulation NMS: Request for Additional Comment*, May 26, 2004, http://www.sec.gov/rules/proposed/34-49749.htm

9 Securities and Exchange Commission, *Regulation NMS*, File No. S7-10-04, December 16, 2004, http://www.sec.gov/rules/proposed/34-50870.pdf

10 Oesterle, Dale A. *Congress's 1975 Directions to the SEC for the Creation of a National Market System: Is the SEC Operating Outside the Mandate?* Public Law and Legal Theory Working Paper Series, No. 11, May 2004. .

11 Ibid Oesterle.

The essential policy debate that faces securities regulators today is a clash between the forces of centralization and competition. Contemporary U.S. securities markets in the new millennium are characterized by two entirely different trading structures—floor-based auction markets in the form of NYSE and AMEX, registered exchanges where a predominantly centralized venue accounts for the majority of trading in NYSE and AMEX securities, and electronic trading venues vying for a dominant share of Nasdaq securities.[12] The fragmentation in trading of Nasdaq securities among different venues appears to offer a more competitive, and less centralized market in these securities. Both the nature of the NYSE's auction exchange and its restrictions on competition (most prominently the trade-through rule) have contributed to the centralization in trading of NYSE-listed stocks (on the NYSE) versus Nasdaq stocks. Despite these restrictions, over the last five years increased competition from ECNs has diminished the NYSE's market share in the trading of its own stock (as of 2004 the NYSE only had 80% of the market in its own stock). In 2004 Nasdaq began to cross-list shares that are listed on the NYSE which resulted in direct competition for the trading of NYSE stocks. Intense speculation has emerged as to which system provides a better market structure for investors (in terms of execution, spread, speed, and total costs), and the SEC has been criticized for not taking a strong public stance. As Peter Wallison of the American Enterprise Institute notes, "What is unusual in the heavily regulated securities market is that government regulation seems to be preventing competition, perpetuating support for two different market structures so that competition between them cannot resolve the question of which is best for investors and public companies. It is as though the Federal Communications Commission were fostering two different and incompatible telephone systems, so that users of one system could not place calls to users of the other."[13] This incompatibility poses significant challenges: Are centralized markets better for investors in the long-term? Could ECNs out-compete the NYSE if competitive markets became the dominant strategy? This task force report attempts to address some of these significant policy issues.

[12] Wallison, Peter J. "The SEC and Market Structure Reform: No Data, No Analysis, No Vision (July 2004)." American Enterprise Institute for Public Policy Research.
[13] Ibid Wallison.

Task Force Policy Recommendations: An Overview

Balancing Deregulation with Investor Protection

The task force has determined that most of the SEC's recent proposals to modernize the regulatory structure of the U.S. equities environment (Reg NMS and recently its December 15th 2004 Reproposal) unnecessarily interfere with competitive, market-based efficiency to the detriment of investors. After examining the effects of existing trading rules, the task force has concluded that the SEC continues to over-complicate and micro-manage market trading structure, creating burdensome and potentially harmful trading rules, and fixing prices (particularly in the arena of access fees and market data distribution where the SEC, in effect, sets price ceilings) that are better left determined by market forces. The task force focuses the majority of its recommendations on a deregulatory approach to the securities industry, keeping in mind the paramount importance of investor protection. Thus, in arenas such as corporate governance the task force decided to opt for a greater degree of federal oversight. In many other areas like trade-through and market data distribution however, the task force suggests the SEC significantly scale back its intervention in the market.

The Role of the SEC and the Future of US Capital Market Structure

The United States continues to compete among the world's exchanges for listings and liquidity. In examining the future of U.S. capital market structure, this task force has promoted a set of recommendations in tune with an increasingly global securities marketplace. To that end, this report recommends the SEC adopt a more European-styled approach to securities regulation. On a conceptual level, the European Union has demonstrated a much greater commitment than the United States to harmonization of worldwide accounting standards. It has also managed to maintain an optimal level of investor protection without sacrificing the liberalization of markets necessary for a healthy, competitive marketplace. The EU has fostered both electronic trading and competition among trading venues to a much greater degree than has the United States. The European Union currently has no Intermarket Trading System (ITS), and no such restrictions on competition as a trade-through rule or price-fixing of data fees. The EU's Directive on Financial Instruments Markets adopts a "best-execution" rule that allows for the consideration of factors such as time and size of the order in addition to price. The SEC's position on these issues in the name of investor protection and "best price" priority will significantly impede progress towards an internationally integrated market. The SEC should reconsider its position by overhauling its restrictive trading regulations that stifle competition among markets, and refrain from protecting the NYSE's near-monopoly on trading in NYSE-listed stocks.

The task force reevaluates the proper boundaries of the SEC's regulatory jurisdiction. The criticism of Reg NMS suggests the possible need for a new non-SEC review of these issues. To that end, the task force has recommended the formation of a Presidential Commission to evaluate current trading rules and regulations. Based on the findings of the Commission, it may even be appropriate for a congressional reevaluation of the National Market System a generation after its inception in 1975.   Free markets and a competitive environment between market centers should determine the structure of US capital markets.

II. Summary of Task Force Recommendations

The Trade-Through Rule

The task force examined the trade-through rule for securities listed on the NYSE or the AMEX and considered options for reforming it. The rule prohibits trading at a price other than the best one posted on any market in a security. A number of market centers and institutional investors have called for the rule to be repealed or for there to be exceptions. The New York Stock Exchange has called for the rule to be extended to Nasdaq securities. In proposed Regulation NMS, the Securities and Exchange Commission seeks to expand the regulation to all securities (thereby making the trading rules consistent for all securities) but to apply the rule only to automated quotes. This is a change from the original SEC proposal that extended the trade-through rule to all quotes for NMS securities but permitted trade-throughs of manual markets and permitted institutional investors to opt-out of the rule. The Commission believes the trade-through rule protects consumers and encourages the posting of aggressive limit orders.

The SEC's December Reproposal on the trade-through rule considers whether the rule should be extended to each market's depth-of-book or whether it should apply only to the market's best bid or offer. The proposed depth-of-book trade-through rule is intended by the Commission to provide investors with an incentive to display additional limit orders and to improve the execution quality of larger limit orders. Considering the task force's position generally on the trade-through rule, it does not recommend extending the rule in this manner—the Reproposal represents another step down a regulatory path towards an artificial centralization of the market in NYSE-listed stocks and restricts the fierce competition and technological innovation that characterizes trading in the Nasdaq markets which up until now have functioned successfully without it.

Neither does the SEC address the issue of internalization with respect to this reproposed new rule, particularly since the rule only requires that orders entered into the market be routed to the best-priced quotations. Internalization is allowed to continue as long as internalizers match the best prices displayed in the market.[14] To address this problem, the SEC may, in the future, be tempted to prevent "free-riding" of such internalizers off the prices established by the displayed

[14] SEC remarks. http://www.sec.gov/news/speech/spch121504psa.htm

limit orders, rather than relying on market forces. This could provide the foundation for the creation of a future nationalized central limit order book. As Commissioner Paul Atkins remarks, “Market participants' order routing decisions that are now based upon fiduciary duties and competitive pressures would be replaced with a government mandate to route orders based on its own rigid definition of what constitutes the best price.”[15]

The debate about the trade-through rule is closely tied to the question of what constitutes the best execution for investors. If the best posted-price is the sole factor in determining execution quality, then the trade-through rule is an effective way of protecting investors. But if other factors such as speed, certainty of execution and minimal market impact are important to execution quality, then the trade-through rule is unduly simplistic and makes it harder for some investors to obtain best execution. If the number of trade-throughs that currently occur in domestic securities markets is any indication of how reliant investors are on the rule to protect best price execution quality, the rule is unnecessary. The number of trade-throughs that occur in both the NYSE and Nasdaq amounts to only 2-3% of the total number of trades.[16] In its concept release, the SEC estimated that the absence of a stronger trade-through rule cost American investors roughly $326 million in 2003. This amounts to only .002% of the $17 trillion in total dollar share volume that traded in both the NYSE and Nasdaq markets in that same year.

The specific question this task force considers also involves the larger issue of market structure. What types of markets are best for investors? The NYSE presently dominates the market in securities listed there, whereas the market for OTC volume is much more competitive. This competition has led to innovation in market technology and increased responsiveness to investors’ demands. As primarily a floor-based auction market, the NYSE operates slowly compared to Nasdaq and ECNs such as INET. The prices posted on the NYSE are sometimes superior to prices posted elsewhere, but they are also prices at which there is little depth and at which execution is far from certain. The difference between a posted price and a price at which one can execute a trade immediately is critical. For many investors, particularly institutions trading in large blocks, it can be difficult to complete an order and the overall price for the order may move against the institution as it is filled. This experience suggests that there is more to best execution than price alone.

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[15] SEC remarks December 15, 2004.
[16] Ibid. SEC remarks December 15, 2004.

Applying the trade-through rule only to automated quotes is problematic. It raises questions about how to define an automated quote. The SEC has tried to provide this definition, but the proposed definition is complicated and requires several exceptions. It may also adversely affect the incentives for further innovation once the minimal requirements for being “automated” have been satisfied. Furthermore, it is unclear why a fast quote at which someone could execute immediately would ever be traded through, making a rule superfluous.

Therefore, this task force recommends that the Commission repeal the trade-through rule for NYSE securities and take no action with respect to non-listed securities. Experience with non-listed securities suggests that liquidity has been adequate and trade-throughs have not affected the confidence of investors nor discouraged them from posting limit orders. There is no compelling empirical data that shows otherwise. The trade-through rule has restricted competition for trading volume in listed securities and stalled innovation in those markets. It has also harmed investors whose overall execution quality has been negatively impacted by delays and market impact. Repeal of the trade-through rule would eliminate the regulatory protection the NYSE has enjoyed for decades. Though a venerable institution and powerful franchise, the NYSE should not enjoy special status compared to other securities markets. Competition based on execution quality should be encouraged. The NYSE has already shown itself to be capable of reform by developing and proposing to expand the NYSE Direct+ system and turn itself into a hybrid market. Volume and liquidity will flow to the market center that most effectively serves the needs of all investors.

Without a trade-through rule to define best execution simply on the basis of one factor, price, the best execution obligation under which brokers operate will be increasingly important. It must be enforced either by the SEC or alternatively the courts. This standard is a sounder basis for regulating the execution of trades and affords investors important protection.

Payment for Order Flow

At the core of the payment for order flow controversy is the principal-agent problem that arises between investors and their brokers. Solving the principal agent problem requires either aligning broker-investor incentives with those of their customers or obtaining complete price transparency in the market. Due to the difficulty of obtaining the latter, this task force recommends regulatory measures that compel agents to act in the best interest of their customers. The task force concludes that a deregulatory approach will most effectively solve the principal-agent problem. Specifically, it recommends the removal of the brokers' requirement to credit their clients' accounts based on the price at which the trade was ultimately executed and instead allow brokers to promise to give their customer the national best bid or offer, even if the broker were to obtain a better price. The benefits the brokers receive from getting a better price would be passed on in whole or in part to customers in the form of lower brokerage commissions. The commission-only pricing option would eliminate the principal-agent problem by creating incentives for brokers to minimize costs – a goal that matches the desires of investors. Retail customers would have the choice to either have the broker credit their account with the NBBO or at the price at which the trade was executed.

The rule would allow investors to cheaply audit the quality of their brokers' services by looking to commission fees, thereby eliminating the incentive to remain rationally ignorant. Brokers would likely find the commission-only pricing option attractive because it would enable them to reduce their commissions – the variable to which customers are most attune – while not necessarily decreasing their profit per trade. Institutional investors however would not take this option because of their ability to monitor and their desire to capture all price improvement. Taken together, these factors would standardize fee structures while retaining the benefits of a competitively fragmented marketplace.

Regulation of the NYSE, Nasdaq and ECNs

A registration system that categorizes and regulates trading venues by operational differences and ownership obligations is preferable to one that relies on arbitrary definitions. Nasdaq's application to be an exchange has been pending before the SEC since 2000 and the SEC has granted itself an indefinite period to act on the application. The major stumbling block to approval is an asserted barrier regarding the central limit order book (CLOB). Until now, the SEC has required that every exchange possess a CLOB, which Nasdaq officially does not possess. The SEC has required exchanges to operate a CLOB honoring time/price priority. Rule 3b-16 of the Regulation ATS act release specifies that a CLOB brings together orders of multiple buyers and sellers and displays this information on screens.[17] Furthermore, a CLOB allows the orders to interact in the system before execution.

Nasdaq's Supermontage, implemented in 1997, has features pursuant to a CLOB, but the SEC is concerned with Nasdaq's internalized trades.[18] Supermontage collects quotes posted by market makers and ECNs. It displays bid and ask prices five levels deep on the Level II screens (which are viewed by institutional investors).[19] However, financial intermediaries off the primary market execute Nasdaq's internalized trades when Nasdaq dealers route orders.[20] Nasdaq's system allows orders to be executed without interaction with out other Nasdaq market makers on the condition that trades are reported within 90 seconds.[21] Furthermore, orders do not necessarily follow the time/price priority by allowing preferenced customers while neglecting price displays on Supermontage. The SEC is concerned about these internalized trades which do not go through Supermontage. The task force does not believe exchange status, as described below, should depend on having a CLOB.

Furthermore, an inherent conflict of interest lies in Nasdaq's affiliation with NASD, so it is undesirable for the SEC to, in effect, require Nasdaq to continue to be affiliated with NASD because it is unwilling to grant Nasdaq separate exchange status. Therefore, the task force believes the SEC should approve Nasdaq's application to be an exchange to minimize conflicts of interest and avoid anti-competitiveness.

The task force would adopt a two-tier system of regulation—under which an exchange would be defined as, "a venue that provides a facility through which, or sets material conditions under which, participants entering such orders may agree to terms of a trade" (modified from SEC Concept Release). "Facility" in this instance does not have to be a physical place. This new definition of an exchange will include traditional exchanges and ECNs. Tier 1 is any exchange (under the new definition) without members. Tier 2 is any exchange (under the new definition) with members (persons having the right to trade in the venue). Tier 1 exchanges would be regulated by NASD and Tier 2 exchanges would be regulated by themselves.

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[17] Securities and Exchange Commission, Rule Release No. 34-40760
[18] Interview with Stephanie Dumont, December 13, 2004.
[19] Biais, B., Davydoff, D. "Internalization, Investor Protection and Market Quality." 2002. Retrieved on December 14, 2004 from http://www.oee.fr/pdf/oeefree_pdf/361_10.pdf
[20] Ibid.
[21] Brown, J. Cincinnati Stock Exchange's Comments to SEC on Nasdaq's application to be an exchange. 2001. Retrieved on December 14, 2004 from http://www.sec.gov/rules/other/10-131/brown1.htm

The main differentiation between the trading venues is the presence or absence of members. Members entail significantly more regulatory and enforcement responsibilities. Therefore exchanges with members should be recognized as functionally different from venues without members. As set forth later in this summary, the task force recommends that all trading venues should be able to sell their own data. Thus the ability to charge data fees will no longer determine the status of exchanges. Similarly the charging of listing fees should not be used to determine whether an entity is an exchange. Under this system, ECN's are formally acknowledged as exchanges. ECNs meeting the definition of an exchange should not have the option of registering as broker-dealers since ECNs should be held to a higher degree of responsibility for enforcing anti-fraud practices and anti-manipulation practices. Likewise, ECNs should be responsible for efficient operating systems, such as adequate software.

Governance of the Stock Exchanges

The SEC (as opposed to states or the Congress) is the appropriate body to oversee the regulation of the corporate governance of stock exchanges. First, the SEC currently is the authority that exchanges must report to when they change their rules. The SEC approves the rules submitted by self-regulatory organizations (SROs) and maintains its authority through its enforcement of the SRO rules. Because governance of exchanges can effect how they discharge their SRO function, the SEC should oversee exchange governance standards. Second, the SEC as a federal agency can oversee all exchanges, wherever they might be incorporated, and is thus able to ensure that investors in all states receive adequate protection. Given the highly technical nature of exchange regulation and the consequent transaction costs of individual investors examining various state regulatory regimes and then deciding to do business with exchanges in states with investor-friendly regulation, state control of exchange governance does not make sense. Third, the SEC is capable of being flexible in its examination of SRO governance proposals. By setting baseline standards and allowing individual exchange variation, the SEC can ensure that regulation of governance is fair and appropriate for each institution.

The task force also recommends certain requirements for exchange corporate governance. The task force recommends that terms for Board of Director members last for two years and be staggered in terms of expiration. This will allow the more experienced members of the board to communicate to the newer members the history and rationale of various exchange rules and procedures. In this way, the public directors shall not have to rely exclusively upon the non-public directors for information; rather, they can gain information from both independent and non-independent sources. Second, the task force recommends mandated separation of the positions of CEO and chairman of the board; this will prevent the chief executive officer from exerting too much authority during board meetings. This prevents his or her perspective from automatically being the "accepted" one, and places him or her as an equal among the other board members. Third, the task force also recommends limited board size (a maximum of 13 voting members). Smaller boards prevent board members from not being fully engaged and relying on others to do the work in committee meetings. Fourth, an 8-consecutive-year term limit prevents individuals who have sat on the board for too long from becoming stale and failing to be as active. Fifth, required quarterly executive sessions without the presence of non-independent directors will allow these independent directors time to think critically about the suggestions of the board members that may have conflicts of interest.

Currently the SEC's proposed governance rule requires structural separation of the regulatory and business functions of the exchange. Complete independence of the regulatory function is necessary to prevent the business-side board members from influencing the decisions of the regulatory oversight committee. This would guard the SRO function from conflicts of interest and guarantee objective regulatory oversight. Complete independence could be codified either as a fully separate board of regulators or a standing committee on regulatory oversight that does not report to any non-independent directors – essentially it could only report to the executive sessions of the boards of directors. The task force also recommends mandated inclusion of the public, members, and listed companies in the nomination process as a way to safeguard that various constituencies are represented on the board of directors. While independent directors can represent the public in their nomination of directors, it is vital that members and listed companies be guaranteed a procedure by which they can nominate members to represent their interests as well.

The Integration of International Securities Markets

This task force recommends that the SEC permit foreign companies listing on US exchanges to organize their financial statements in accordance with either International

Accounting Standards (IAS) or US Generally Accepted Accounting Principles (US GAAP) – that is, foreign firms would no longer be required to reconcile IAS with US GAAP. This would significantly reduce the costs of cross-listing, allowing more companies to afford to cross-list and thus facilitating more globally integrated, liquid and efficient equity markets. Several in depth studies over the past decade have indicated that the differences between IAS and US GAAP are minor in impact and that the information they provide are valued almost identically by investors when all other factors are held constant. Permitting foreign companies to comply with IAS would contribute to an improved marketplace at no expense to investor protection. In addition, the International Accounting Standards Board (IASB) and FASB are already working to eliminate some of the key remaining differences between IAS and US GAAP. Mutual recognition of IAS and US GAAP is preferential to immediate, complete harmonization because allowing the two standards to compete should lead to a more efficient and informative uniform standard. Accounting standards sometimes reflect nuances in different countries' regulatory frameworks, and a harmonized standard may be less compatible with certain countries than existing standards, particularly if a new standard is formed to resemble US GAAP more closely than IAS.

The task force also recommends that the SEC permit qualified institutional buyers (QIB or professional investors) to access foreign screens within the US. Professional investors already trade on foreign markets, and have sufficient expertise to accurately assess the risks of trading on foreign exchanges with different disclosure requirements. For this reason, solicitation of institutional investors in unregistered stocks located on foreign screens should be allowed. Permitting foreign screens in the US would give investment companies the ability to solicit foreign stocks that are *already* being traded by these institutional investors, and thus inform their clients of a wider variety of investment options and opportunities without risk to investor protection. The task force does not recommend that retail investors be solicited with respect to trading in unregistered foreign stock, regardless of the existence of foreign screens in the United States. Retail investors in general do not have the sufficient expertise, capacity and depth of experience to accurately assess the risks of trading in unregistered foreign stock.

While permitting compliance with IAS in lieu of US GAAP will allow more access to foreign stocks through cross-listing on US exchanges, permitting foreign screens will provide another avenue for US investors to trade foreign stocks. Having both options will allow foreign companies to decide whether listing on US exchanges or simply having their stock traded by institutional investors via foreign screens within the US is most efficient.

Further, as noted in the introduction, we believe the EU approach to market structure is a preferable model for the United States and the SEC to look to as it reforms the US domestic market.

A Presidential Commission to Examine Trading Rules

In the current system, the SEC plays the dominant regulatory role, with no clear supervision from the Congress or other branches of the government. The dominance of one federal agency creates efficiency, since it consolidates in one institution expertise and experience. However the trade-off is the entrenchment of SEC philosophy into market regulation, through price-fixing and standard-setting, to serve as the "official market referee."[22]

Many existing regulations that may or may not be appropriate for current market conditions are still in place (what is sometimes referred to as "institutional memory-loss"), and this plethora of regulations hampers the functioning of a more efficient marketplace. We propose that a Presidential Commission be formed to review the various market regulations that currently exist. The Presidential Commission will consist of four members: one chosen representative each from the U.S. Treasury, the Federal Reserve, the Commodities Futures Trading Commission (CFTC), and from the SEC. This Commission would be an outgrowth of a pre-existing organization known as the President's Working Group on Financial Markets (formed in the wake of the 1998 Long-term Capital Management debacle)[23] which meets regularly to discuss issues relevant to all financial services regulators and consists of the Treasury Secretary, the Chairman of the SEC, and members from the CFTC and Board of Governors of the Federal Reserve system.

This Commission will have a lifetime of two years, and the members will present their analysis to the president at the end of that time. During its tenure, the Commission will review all the regulations that affect the operation of domestic securities markets and it will recommend to the president which regulations may be outdated and therefore unnecessary or in need of reform.

[22] Speech by SEC Commissioner Paul Atkins: Remarks before the Open Meeting to Consider the Reproposal of Regulation NMS December 15, 2004.
[23] President's Keynote Address http://www.ici.org/issues/dir/01_mfimc_fink_spch.html

At the discretion of the Commission, input may be brought from relevant constituencies. This Commission is the most efficient way of reviewing the current regulatory system as a whole, and the most effective way of involving the executive branch of the government in the review of market regulation without disrupting an existing system that relies primarily on the input of the SEC and the Congress.

Regulation of Short Sales

This task force believes that short selling is a necessary and beneficial aspect of an efficient market. Short sellers stabilize prices by providing liquidity and creating demand-by covering their shorts-in a falling market. The practice of margin trades and shorts are simply the inverse of one another: the margin trader borrows cash to buy stock; the short seller borrows stock to raise cash. The margin trader closes his position by repaying the cash loan through the sale of the stock; the short seller closes his position by purchasing the stock and returning it to the lender. In the opinion of this report, it is no less legitimate to borrow a stock in anticipation of a decline, than to borrow money and purchase in anticipation of a rise. Furthermore, the price that can be diminished by short selling is an inflated value, and the accurate pricing of securities is the aim of an efficient market.

The SEC made adjustments to short sale governance through Regulation SHO. The new regulations are a progressive measure. In Regulation SHO, the SEC has shown a willingness to consider the benefits of deregulation by constructing a pilot program to examine the behavior of stocks without a price test. After the pilot provides sufficient data to the SEC, this report urges a decision that moves toward a greater deregulation of short selling through removal of price tests altogether. Since the pilot has yet to be implemented and its results await a more distant time frame (nor has the SEC constructed a pilot program to determine how a uniform bid test might be preferable to current rules), this task force recommends the need for more research although the removal of price tests appears preferable to the current tick test.

Market Access Fees and Data Distribution

The task force recommends a market-based approach to the charging of fees for data and the means by which data is distributed. The SEC should eliminate its reporting and consolidation requirements and allow private entities to process, consolidate, and distribute data according to investor demand. Market centers should be allowed to sell their own data and investors should be allowed to buy the data that they desire. Market forces will determine the price of securities data and the revenues of market centers. If a market center attempts to keep its data private or charge too much for it, then investors will move their trading volume to market centers that sell their data at affordable prices and the withholding market center will lose market share. In the new system, the SEC must only ensure the integrity of market data in order to protect investors. In addition under this reformed structure, ECNs (like exchanges) would be able to sell their own data and this would eliminate payments necessary for print flow.

The current system of fee disclosure in price quotations requires market centers to include few of the fees that investors incur for trading. In particular, under current SEC regulations quotations do not have to include access fees, which are charged by market centers to fund liquidity rebates and business costs. The rise of ECNs, which often rely on access fees as an integral part of their business model, creates a situation in which an ECN quote and a market maker quote posted at the same price are not equivalent. Brokers trying to find the best price for their customers often cannot execute against best overall price, including access fees. Access fees also create incentives for market participants to lock and cross the markets in order to reap liquidity rebates without incurring access fee charges.

The task force further recommends a disclosure-based approach to trading fees. All market centers, including ECNs, exchanges, and Nasdaq should be able to charge any access, transaction, or communications fee they deem necessary, but must display all fees paid by all traders in the posted prices. Prices should continue to omit trader-specific fees such as brokerage commissions. The disclosure of all universal fees will most likely result in sub-penny pricing. In order to prevent the front-running associated with sub-penny quotes, market maker quotes should be subject to a minimum tick size.   The SEC should reduce its control over the data distribution system and allow market forces to efficiently price the data of each market center according to investor demand. By allowing ECNs to participate in this market-based approach, this would eliminate the need for payment-for-print flow. At the same time the SEC should increase its disclosure regulation of trading fees in order to ensure the accuracy of market information. The technological ability of modern markets to provide market data according to investor demand and the rise of ECN access fees requires an adjustment in SEC policy.

III. CONCLUSION

In conclusion, the task force recommendations are to eliminate the trade-through rule, establish a Presidential Commission to review all trading rules and regulations, allow brokers to credit their client's accounts with the NBBO, allow compliance with IAS standards for foreign companies that cross-list on US exchanges, permit institutional buyers to access foreign screens, approve Nasdaq's application to be an exchange, adopt a two-tiered system of exchange regulation, provide for exchange corporate governance rules of one-year term limits for Board of Directors, mandated separation of the positions of CEO and Chairman and limited board size, mandated inclusion of the public in the nomination process for directors, the removal of price tests altogether for short sales trading, and a market-based approach to data distribution and access fees.

APPENDIX:

INDIVIDUAL
TASK FORCE
REPORT
ON
SELF-REGULATION

Registration and Regulation of the exchanges, Nasdaq and ECNs

Rose Xu

Table of Contents

I. EXECUTIVE SUMMARY

There is blurry distinction between an exchange and a broker-dealer, and between an exchange and a national securities association. These minor distinctions lead to different regulatory processes, which may be impractical. Currently, ECNs choose their registration status based on incentives regarding finance and regulatory strictness. A registration system that categorizes trading venues by operational differences and obligations should be taken into account. Regulatory standards should be based on these differences. Nasdaq's application to be an exchange has been in deliberation by the SEC since 2000 and the SEC has granted itself an indefinite period to act on the application. The major stumbling block on the issue is a legal barrier regarding the central limit order book (CLOB). Until now, the SEC has required that every exchange possess a CLOB, which Nasdaq does not have.

Because an inherent conflict of interest lies in Nasdaq's affiliation with NASD, a move must be made to make Nasdaq independent. The SEC should approve Nasdaq's application to be an exchange without the CLOB to minimize conflicts of interest, and as not to foster anti-competitiveness. Consequently, other exchanges may consider getting rid of their CLOB, although the prospect of such is unlikely. The second recommendation is to amend the 1934 Act to remove the option to register as a National Securities Association. This change is only applicable to Nasdaq, which is trying to obtain exchange status. Once obtained, this category will not be necessary. A national securities association is treated and regulated essentially as an exchange. The only significant difference is formal acknowledgement from the SEC. The final component of these recommendations involves adopting a two-tier exchange system. This two-tier exchange system requires redefining an exchange to be, "a venue that provides a facility through which, or sets material conditions under which, participants entering such orders may agree to terms of a trade" (modified from SEC Concept Release). "Facility" in this instance does not have to be a physical place. This new definition of an exchange will include traditional exchanges and ECNs. Tier one 1 is any exchange (used with the new definition) without members. Tier 2 is any exchange (used with the new definition) with members. Under this system, Tier 1 exchanges are regulated by NASD and Tier 2 exchanges are regulated by SROs.

The main differentiation between the trading venues is the presence or absence of members. Members entail significantly more regulatory and enforcement responsibilities. Therefore exchanges with members should be recognized as functionally different from venues without members. With reference to the paper on "Market Access Fees and Data Distribution," data fees no longer are determinant of exchanges. Similarly, listing fees should not be used to differentiate the tier levels because it adds minimum regulatory responsibility. Under this system, ECN's are formally acknowledged as exchanges as well. ECNs should not have the option of registering as broker-dealers since ECNs should be held to a higher degree of responsibility for enforcing anti-fraud practices and anti-manipulation practices. Likewise, ECNs should be responsible for efficient operating systems, such as adequate software. These recommendations serve to re-categorize trading venues and their respective regulatory procedures.

II. INTRODUCTION

Following the crash of 1929, Congress noted the imperative need for market regulation and adopted the Securities Exchange Act of 1934, which bestowed powers on the Securities and Exchange Commission (SEC) to oversee the securities industry. The objective of the SEC is to "protect investors and maintain the integrity of the securities markets." The Act of 1934 gave the Commission the authority to register and regulate the various bodies involved in securities trading and also the self-regulatory organizations (SRO). The issues of registration and regulation are closely linked. Different registration statuses under the SEC entitle trading venues to different regulatory standards and financial remuneration.

With regards to changing technology, the effectiveness of this current market regulatory structure has become heavily questioned. Advancing technology has increased interaction and interdependence between markets.[24] A consequence of this phenomenon is increased difficulty in differentiating types of trading venues and determining the appropriate level of regulation.

This paper will assess the current mechanisms of SEC registration and regulation. In particular, it will examine the New York Stock Exchange (NYSE), the National Association of Securities Dealers Automated Quotation System (Nasdaq), and electronic communication networks (ECNs) in their registration with the SEC as securities exchanges, national securities association, or broker-dealers, and it will look at the differential regulatory processes that follow. The paper will discuss some of the issues with the current system. Finally, the paper will provide recommendations to approve Nasdaq's application to become an exchange and to adopt a two-tier exchange system.

The issues raised in this paper are important. As demonstrated by the stock crash of 1929 and the dot com bubble burst of 2000, activity in the securities industry has tremendous impact on the welfare of the general economy. Effective regulation is even more important now as more people are invested in public companies. When the SEC was first created in 1934, roughly 10% of the American population held investments in stocks.[25] This percentage was more than 52 in 1998[26]. The population of Americans with a stake in the securities industry is growing rapidly as

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[24] Aggarwal, R. "Integrating Emerging Market Countries into the Global Financial System." January 11, 2001. Retrieved on December 12, 2004 from http://www.msb.edu/faculty/aggarwal/brookings-wharton2000.pdf
[25] Stockholders. Retrieved December 15, 2004 from http://www.pbs.org/fmc/book/14business6.htm
[26] Ibid.

companies now use 401K plans for employee's pensions[27]. Appropriate regulation can ensure fair market function and minimize the negative impacts of the securities market.

III. BACKGROUND

a. Securities Exchange Act of 1934

The Act of 1934 requires that all trading venues register with the SEC as a national securities exchange, a national securities association, or a broker-dealer. The SEC notes that registration is necessary to achieve fair disclosure of relevant financial information, and to make sure that this information is of quality and accuracy. The SEC subscribes to the reasoning that registration is means of regulation.

The 1934 Act provides the following distinctions for trading venues:

(1) *The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.*[28]
(2) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others.[29]
(3) The term "dealer" means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.[30]
(4) *An association of brokers and dealers may be registered as a national securities association.*[31]

The definition for each status is vague. Furthermore, these definitions are uninformative of the features that differentiate one type of trading venue from another.

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[27] Ibid
[28] Securities and Exchange Commission. *Securities Exchange Act of 1934*. Retrieved on October 15, 2004 at http://www.law.uc.edu/CCL/34Act/sec3.html, Section 3.
[29] Ibid.
[30] Ibid.
[31] Securities and Exchange Commission. *Securities Exchange Act of 1934*. Retrieved on October 15, 2004 at http://www.law.uc.edu/CCL/34Act/sec15A.html, Section 15A.

Prior to the adoption of Regulation Alternative Trading Systems (Regulation ATS) in 1998, trading venues could only register as a securities exchange, a national securities association, or apply for no action from the SEC. The "No Action" application exempted ECNs, also known as alternative trading systems, from obtaining the exchange status. This was granted towards Instinet in the late 80's and early 90's with a few minor conditions[32]. The SEC pointed out that Instinet (and other ECNs) differed from traditional exchanges because it was for-profit, without members and it did not operate on the same scheme that traditional exchanges did[33]. At the time, ECNs did not threaten to consume a large volume in securities trading, and did not warrant the same attention from the SEC with regards to registration and regulatory as traditional exchanges did. However in recent years, ECNs have had a growing role in markets.

b. Regulation ATS

Regulation ATS allows alternative trading systems to register as either broker dealers or exchanges. (Similarly, it allows traditional exchanges to register as broker-dealer if the exchange conceded its listing fees and self-regulatory rights.) By 1998, alternative trading systems traded more than 20% of Nasdaq listed stocks, and around 4% of exchange listed stocks[34]. ECN market impact was considerable enough to deserve attention from the SEC with regards to registration and regulatory oversight. With Regulation ATS, ECNs are no longer exempt from registering as they are brought under the SEC's regulatory umbrella.

IV. REGISTRATION STATUS AND REGULATION

[32]Lee, Ruben. *What is an Exchange?* New York: Oxford University Press. 2001.
[33] Ibid.
[34] Quitter, J. (1999). "An SEC Rule Change Created a New Niche for Virtual Markets." *Business Week*. Retrieved on October 15 from http://www.businessweek.com/smallbiz/news/coladvice/reallife/rl990226.htm

a. Securities Exchange

Regulation ATS did not dramatically change the specific requirements and obligations of an exchange from past rules. By allowing for-profit exchanges, it permits ECNs to register as an exchange without restructuring their business operations. Traditionally, NYSE and other exchanges have been not-for-profit. On the same notion, Regulation ATS gives latitude for traditional exchanges to convert to for-profit exchanges with approval from the SEC.

The operational and regulatory demands are most stringent for exchanges. In summary, exchanges must have self-regulatory responsibilities over its members and listed companies. Exchanges must set listing and maintenance standards for their listed companies. They are responsible for enforcing general anti-manipulation and anti-fraud rules, as well as rules regarding conflicts of interest. An exchange must also have a central limit order book, which aggregates multiples buyers and sellers and facilitates the interaction of these orders. They also have record keeping requirements. This latter task is easier for ECNs because they have automated records. Finally, exchanges also must comply with uniform trading standards.

A major regulatory burden for exchanges is the surveillance of its members. These members must be registered as broker-dealers with the SEC. Exchanges enforce compliance of members with federal rules and the exchange's rules. Often times, more than one exchange may share common members. Under such circumstances, the SEC assigns a designated examining authority (DEA) with oversight of a broker-dealer.[35] In the past, the SEC has commonly named NASD or the NYSE as this authority[36]. This act removes the regulatory responsibilities from the other SROs that the broker dealer is a member of, as to avoid repeated regulation.

[35] Securities and Exchange Commission, Rule Release No. 34-40760; File No. S7-12-98. Retrieved on December 20 from http://www.sec.gov/rules/final/34-40760.txt
[36] Ibid.

The SEC requires exchanges to comply with uniform trading standards including trading halts and circuit breakers, which are used to minimize the effects of extraordinary market activity. While the SEC stipulates that these trade suspensions are necessary, it leaves it to the exchanges to setup framework and standards for these suspensions, unless the SEC imposes trading halts.[37] The NYSE has procedures for implementing trading halts while news announcements are pending regarding a particular security[38]. The NYSE then determines when it is suitable to recommence trading. For the NYSE, specialists also play a role in alleviating the effects of major price fluctuations for a particular security. Furthermore, exchanges also cooperate with imposing circuit breakers in times of unusual market activity. The NYSE has three levels of these circuit breakers (which the NYSE refers to as halts).[39] These levels are computed to incorporate the average closing value from the Dow Jones Industrial Average of the month before the pertaining quarter.[40]

The NYSE has structured a regulatory body independent of its business component. The NYSE regulation consists of three divisions: Member Firm Regulation, Market Surveillance and Enforcement. These three divisions report to Richard Ketchum, the Chief Regulatory Officer, who then answers to a sector of the independent Board of Directors. Compensation of the regulatory divisions is also determined independently. The aim of this structure is to avoid conflicts of interest between the business and the regulatory responsibilities.[41]

Despite having some autonomy, the self-regulatory process possesses several downsides. Self-regulation is costly. While the exact breakdown of regulatory spending by the NYSE has

[37] Ibid.
[38] New York Stock Exchange. 202.07 Trading Halt Procedures. Retrieved on November 2, 2004 from http://www.nyse.com/Frameset.html?displayPage=/lcm/1078416930749.html?archive=no
[39] New York Stock Exchange. *Constitution and Rules*. 2003.
[40] Ibid.
[41] Interview with Richard Ketchum, October 27, 2004.

not yet been disclosed, it spends approximately more than $150 annually on regulation[42]. And while exchanges should enjoy more freedom because they are self-regulatory, the SEC is heavily involved in this process.

. In writing, self-regulation is a valuable opportunity for ethical self-reflection; in reality, the NYSE's regulatory process is dominated by the SEC's presence.[43] Within the dialog between the SEC and the NYSE, the SEC may issue strong regulatory recommendations to the NYSE. If the NYSE is uncooperative, the SEC may apply great pressure to the NYSE. Furthermore, each rule and action is subject to the approval of the SEC in an administrative process that takes 45 days. The regulatory burden and great SEC involvement discourage many ECNs from registering as exchanges when presented the choice.

On the flip side, there is substantial financial remuneration for registering as a securities exchange. These financial benefits are attractive to achieving business objectives (especially for profit oriented ECNs). An exchange can "impose a reasonable schedule or fix reasonable rates of commissions, allowances, discounts, or other fees to be charged by its members..." which includes listing, data, and tape fees.[44] Listing fees comprise a significant portion of total exchange revenue. In 2003, 27% of the NYSE's $1 billon revenue came from listing fees (3)[45]. The financial advantage of registering as an exchange is one of the principal reasons that trading venues, such as ArcaEx (an ECN), do so.

b. National Securities Association

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[42] "SEC Plans to Expand Review of Governance at NYSE. 2003. Retrieved on December 17 from http://www.theage.com.au/articles/2003/10/23/1066631565101.html?oneclick=true
[43] Interview with Richard Ketchum, October 27, 2004.
[44] Securities and Exchange Commission. *Securities Exchange Act of 1934*. Retrieved on October 15, 2004 at http://www.law.uc.edu/CCL/34Act/, Section 6.
[45] Royle, Bill. 2004. "Google to Debut on NASDAQ, not NYSE." TechFocus. Retrieved on October 22 from http://www.techfocus.org/comments.php?shownews=4491&catid=27

Nasdaq is currently the only registered national securities association. There is negligible difference between a securities exchange and a national securities association. Nasdaq is able to register as such because it is owned by National Association of Securities Dealers (NASD). Nasdaq is entitled to listing, data, and tape fees just as an exchange is. In fact, 28% of the Nasdaq's $590 million revenue was collected from listing fees (3)[46]. Likewise, Nasdaq faces the similar regulatory obligations as exchanges do. The SEC noted, "...national securities associations are subject to requirements virtually identical to those applicable to national securities association."[47]

Regulation is outsourced to NASD-R, which operates separately from the business portion of Nasdaq.[48] Nasdaq's regulatory process also has a large SEC presence. For example, on its own accord, Nasdaq did not have a circuit breaker. Following strong SEC recommendation, Nasdaq is working to establish standards for a circuit breaker[49]. However, unlike Ketchum's sentiment of the SEC's excessive involvement, Douglas Shulman, President of Markets, Services and Information at NASD, remarks that there is very productive discourse between the SEC and the NASD. He addresses that the regulatory relationship is mutual between the two entities.

c. Broker-Dealer

ECNs are allowed to register as broker-dealers if they comply with Regulation ATS in addition to the requirements of a traditional broker-dealer. A venue with less than 5% of the trading volume in the securities it trades may register as a broker dealer.[50] A system with more

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[46] Ibid.
[47] Securities and Exchange Commission, Rule Release No. 34-40760;
[48] Interview with Douglas Shulman, October 20, 2004.
[49] National Association of Securities Dealers. NASD Manual. Retrieved on October 22 from http://cchwallstreet.com/nasd/nasdviewer.asp?SelectedNode=1&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml#chp_1_1
[50] Securities and Exchange Commission, Rule Release No. 34-40760

than 5% trading volume that chooses to register as a broker-dealer must be integrated into the national market system by linking with an exchange or Nasdaq to disseminate their orders.[51] This system must also comply with the execution rules and obligations of that particular market it is linked to.

In an effort to encourage development of new markets, the SEC has minimized the regulatory burden on ECNs registered as broker dealers. Such venues are only required to:[52]

> *(1) File with the Commission a notice of operation and quarterly reports;*
> *(2) maintain records, including an audit trail of transactions; and*
> (3) refrain from using the words "exchange," "stock market," or similar terms in its name.

The other obligations of the broker-dealers are limited to employee supervision, financial reporting, customer confirmation, and loose anti-fraud, anti manipulation rules. Unlike exchanges, broker dealers do not have members or listed companies to enforce. Broker-dealers must also register with NASD. The SEC is only indirectly involved in the regulatory process through NASD.

Broker-dealers do not have trading halt rules. Furthermore, it is found in a study authorized by the SEC that ECNs after-hours trading decrease the need for trading halts on other exchanges, by the “orderly public dissemination of corporate news” and giving investors an opportunity to gradually act in information in the hours after the major markets close.[53]

With authority granted by the SEC, NASD has oversight and enforcement responsibilities of ECNs registered as broker dealers. NASD charges its members a fee. The impetus in NASD’s case is that it can fine its members and deny membership as an ultimatum for compliance.[54]

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[51] Ibid.
[52] Ibid.
[53] Securities Exchange Commission. *Special Study: Electronic Communication Networks and After-Hours Trading.* June 2000. Retrieved on December 15, 2004 from http://www.sec.gov/news/studies/ecnafter.htm
[54] Lee, R.

Since the SEC requires all broker-dealers to be registered with NASD, ECNs are pressured to comply with NASD. In addition, the SEC's authority gives NASD immunity from lawsuits.[55] NASD's relationship with the SEC is dissimilar to the NYSE's relationship with the SEC, because NASD serves as an independent body that receives authority from the SEC, whereas the NYSE's regulatory body is still affiliated with the exchange's business.

One major complaint towards the NASD is the conflict of interests. Since NASD has a vested business interest in the Nasdaq, which is a competitor of the ECNs, there is debate in NASD's fairness and effectiveness in regulating. Douglas Shulman, President of Market Information at NASD, explains that regulatory firewalls are in place to prevent abuse of information in situations of conflicting interests.[56] Shulman notes that information about each market participant is confidential, and that Nasdaq and Instinet would not find their data divulged to the competitor. Despite these reassurances, many don't subscribe to the idea that NASD is the most effective regulatory of ECNs registered as broker-dealers while it has a financial stake in Nasdaq.

Still, the regulatory burdens placed on broker-dealers are so minor that most ECNs opt to register as broker dealers, despite the fact that broker-dealers are not entitled to financial remuneration. Broker-dealers are spared the hefty costs of self-regulation and the obligations of an exchange. Finally, they are spared the intrusion of the SEC.

V. WHAT ARE THE PROBLEMS?

There are numerous flaws with the current system of registration and regulation. These issues include Nasdaq's pending application to become an exchange, the blurry distinction

[55] Ibid.
[56] Interview with Douglas Shulman, October 20, 2004.

between registered broker-dealers and exchanges, and authority in imposing trading halts. These issues are addressed in the following section.

a. Nasdaq's application to register as a securities exchange

Nasdaq is applying for the exchange status. In 2000, the NASD board voted to sell Nasdaq in order to "reorganize" and "recapitalize" Nasdaq, and to eliminate NASD's conflicting interest as a regulatory organization.[57] Since, NASD's ownership has decreased to 55%.[58] Nasdaq needs to register as an exchange in order to retain its current rights to data and listing fees.

Nasdaq submitted an application to obtain securities exchange status with the SEC on November 9, 2000. The review process is typically 45-days. The SEC has not yet approved Nasdaq's application. The SEC now has an indefinite time period to deliberate the registration status of Nasdaq.[59] Until approval comes from the SEC, NASD cannot relinquish its remaining ownership.

ECNs registered as broker-dealers are eager to see Nasdaq's application approved because it will remove the regulatory conflict of interests. Approval allows NASD and Nasdaq to separate. There is debate over whether or not NASD can fairly oversee the activities of ECNs while still owning Nasdaq. The SEC attempted to quiet debate by assuring that SEC oversight of NASD's regulation will curtail the possibility of NASD acting unjustly towards their registered broker-dealers.[60] However, ECNs and some observers remain skeptical that such designation of

[57] Nasdaq. Nasdaq Press Release: Nasdaq Completes Private Offering and Expands Board. 2001. Retrieved on October 24, 2004 from http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_025.html
[58] Interview with Douglas Shulman, October 20, 2004.
[59] Bresiger, G. "Nasdaq Cries Foul Over Exchange Petition." Traders Magazine. 2003. Retrieved on October 24, 2004 from http://www.keepmedia.com/pubs/TradersMagazine/2003/07/01/545424?from=search
[60] Securities and Exchange Commission, Rule Release No. 34-40760

regulatory authority is in the best interest of fairness, and would like to see Nasdaq's application approved.

Nasdaq's lengthy application to be an exchange is met with legal obstacle. According to Richard Ketchum, then president of Nasdaq, "This is an application to be recognized formally for what we essentially already are... It is a change in our legal status, as opposed to the way Nasdaq operates."[61] But the SEC's hesitation to grant Nasdaq the official exchange status is precisely a legal barrier. Until now, the SEC has required all exchanges to have a central limit order book (CLOB). Annette Nazareth, president of the SEC's Division of Market Regulation noted that this provision is "inconsistent with the Nasdaq model in which each dealer can interact exclusively with its own order flow, while ignoring the limit order book."[62] Nasdaq has not proposed to incorporate a CLOB in their application. Thus the SEC has reached a roadblock on the matter; lest it amend its rules or find some clever way around this clause, it cannot grant Nasdaq the exchange status.

The SEC has required exchanges to operate a CLOB honoring time/price priority. Rule 3b-16 of the Regulation ATS act release specifies that a CLOB brings together orders of multiple buyers and sellers and displays this information on screens.[63] Furthermore, a CLOB allows the orders to interact in the system before execution.

Nasdaq's Supermontage, implemented in 1997, has features pursuant to a CLOB, but the SEC is concerned with Nasdaq's internalized trades.[64] Supermontage collects quotes posted by market makers and ECNs. It displays bid and ask prices five levels deep on the Level II screens

[61] Bresiger.
[62] Nazareth, Annette. Speech by SEC staff. 2003. Retrieved on October 24, 2004 from http://www.sec.gov/news/speech/spch061303aln.htm
[63] Securities and Exchange Commission, Rule Release No. 34-40760
[64] Interview with Stephanie Dumont, December 13, 2004.

(which are viewed by institutional investors).[65] However, financial intermediaries off the primary market execute Nasdaq's internalized trades when Nasdaq dealers route orders.[66] Nasdaq's system allows orders to be executed without interaction with out other Nasdaq market makers on the condition that trades are reported within 90 seconds.[67] Furthermore, orders do not necessarily follow the time/price priority by allowing preferenced customers while neglecting price displays on Supermontage. The SEC is concerned about these internalized trades which do not go through Supermontage.

The records of internalized executions are sent to an exchange, which monitors these trades for best execution and anti-manipulation, and receives tape fees from ECNs. Originally, the majority of these trades were sent to Nasdaq. However, in recent years, the National Stock Exchange (formerly the Cincinnati Stock Exchange), has been collecting these trades because of their lower fees.[68]

The SEC is convinced that internalization is negative. In keeping with Adam Smith's *Wealth of Nations*, internalization undermines competition by curtailing full information dissemination to the market.[69] A competitive market requires that investors post their quotes in a system that is available to all. However internalization undercuts this step and therefore arguably limits transparency, liquidity and competition in the market. Theoretically the implications of internalization are larger spreads and less depth.[70] For these reasons, the SEC looks unfavorably upon it and is reluctant to validate it by approving Nasdaq's application without a CLOB.

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[65] Biais, B., Davydoff, D. "Internalization, Investor Protection and Market Quality." 2002. Retrieved on December 14, 2004 from http://www.oee.fr/pdf/oeefree_pdf/361_10.pdf
[66] Ibid.
[67] Brown, J. Cincinnati Stock Exchange's Comments to SEC on Nasdaq's application to be an exchange. 2001. Retrieved on December 14, 2004 from http://www.sec.gov/rules/other/10-131/brown1.htm
[68] Biais.
[69] Ibid.
[70] Ibid.

Nasdaq's central limit order book issue is controversial, with opposition on both sides of the matter. Several ECNs that trade Nasdaq listed stocks support approval of Nasdaq's exchange application without a CLOB. Island argues that despite the SEC's requirement of a CLOB in exchanges, Nasdaq has always operated as "decentralized competing market maker system," and therefore executions can take place without going to other market participants.[71]

> *"Nasdaq members that internalize customer order flow by either trading as principal (e.g. market makers) or by matching orders (e.g. ECNs) can operate with a degree of autonomy not possible in traditional exchange markets. The primary value of the Nasdaq market is that it allows multiple market participants to trade the same security without being forced, by rule, to interact with orders held by competing market participants within Nasdaq."*[72]

Island notes that this aspect allows ECNs to compete with Nasdaq. A CLOB would force ECNs to send all their quotes to Nasdaq, investors would execute orders on Nasdaq, and Nasdaq would have a virtue monopoly as a market center.[73] With this gravitation towards Nasdaq, the credibility of the orders quoted on the ECNs would become questioned and investor confidence in ECNs would suffer remarkably. The ECNs would not be able to compete with Nasdaq. ECNs argue that such action would be extremely anti-competitive.

Other exchanges are against approval of Nasdaq's application without a CLOB. Other exchanges argue that Nasdaq operates without the same obligations as traditional exchanges. Cincinnati Stock Exchange has stated that if the SEC approves Nasdaq's application without a CLOB, it will get rid of its own CLOB to remain competitive with Nasdaq. Other exchanges may follow.

The SEC is in a difficult position to comment on Nasdaq's CLOB because of the issues raised by the ECNs and by the Cincinnati Stock Exchange (CSE). The CSE tried to obtain

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[71] Smith, C. Island's Comments to the SEC regarding Nasdaq's application. 2001. Retrieved on October 15, 2004 from http://www.sec.gov/rules/other/10-131/smith1.htm
[72] Ibid.
[73] Ibid.

approval for its preferencing program. The SEC granted internalization of same-priced orders, but maintained that priority must be given to customers on its CLOB. The CSE noted that CSE's preferencing program (competitive dealer system) resembled an over-the-counter market.

> *"The NSTS system provides a central location for CSE dealers to interact in a manner similar to a traditional exchange trading floor. Preferencing, however, suspends time priority between professional trading interest so that the multiple CSE dealers can execute their own customer orders without interruption by other dealers and is more akin to trading in the over-the-counter markets."*[74]

On one hand, the SEC has obligations to consider anti-competitive policies. Forcing Nasdaq to adopt a CLOB would be anti-competitive for the ECNs. However, ruling that a CLOB is not required of Nasdaq would be reversing its position with CSE.

b. Blurry Distinction between Broker-Dealer and Exchange

The truth is that while alternative-trading systems may appear to operate like broker-dealers, they have market functions similar to traditional exchanges.[75] The current option to register as a broker-dealer does not capture the significance of an ECN's potential market impact. Simply because they do not have the exact features as traditional exchanges, does not mean that they warrant a less a conspicuous role before the SEC. ECNs can move the market. As markets become more entangled and its boundaries less clearly defined, it is more important than ever to accurately recognize the role of ECNs in the securities industry.

The SEC itself has used trading volume as an indicator of whether a venue should register as a broker-dealer or exchange. The SEC has set a threshold for ECNs to 5% of the trading volume in a listed security that it trades. If such, the SEC recommends integration in the

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[74] Brown.
[75] Securities and Exchange Commission. *Concept Release: Regulation of Exchanges*. Release No. 34-38672, 1997. Retrieved on November 10, 2004 from http://www.sec.gov/rules/concept/3438672.txt

national market system. Thus, the SEC is aware of the growing size of particular ECNs and it also sees fit that volume justifies recognition as an exchange. But it falls short of extending this understanding to the whole category of ECNs.

The status of broker-dealer is misleading. It gives a misconception that these are private entities that affect the market on a very limited scheme. This status validates not holding ECNs to a higher degree of market responsibility. It is important to give credit to the full extent of ECNs' operations and then to incorporate that fact into creating a system that sufficiently includes and monitors ECNs.

This current system also leads to a discrepancy of regulation between venues. It allows for like venues to be regulated differently. For example, one ECN that chooses to register as an exchange is subject to regulatory burdens much greater than a similarly operating exchange that chooses to register as a broker-dealer. Meanwhile, the two venues have comparable operations. However, hypothetical venue A prefers listing fees and registers as an exchange while hypothetical venue B prefers loose regulations and registers as a broker-dealer. Neither of these venues have members. Under the current system, ECNs registered as broker-dealers are subject to very little surveillance, supervision, and regulatory responsibility while it is the opposite for those registered as exchanges. The current system allows great inconsistencies in regulation that are not consistent with demands based on operational differences. In trying to achieve the goals of regulation, it would seem most effective that like venues are subject to like standards of regulation.

c. Authority in Imposing Trading Halts

A general stipulation of an exchange is to comply with uniform trading rules including the imposition of trading halts in times of extraordinary market activity. However, registered broker-dealers do not have trading halt obligations. A recent incident with the Corinthian Colleges stock (Tic Symbol: COCO) revealed a few complications surrounding implementation of trading halts when multiple markets are involved. The incident raises issues that question Nasdaq's authority and ECNs' compliance with trading halts.

Nasdaq has a MarketWatch Department which surveillances the trades in real time for unusual activity.[76] In suspect market activity, MarketWatch contacts the issuers and the market makers to determine the source of such activity. In most cases, market volatility is due to imperfect information dissemination. Upon evaluation of involving unusual market activity, MarketWatch may advise a trading halt to the issuer, which typically lasts for one-half hour. According to NASD's Conduct Rules, "the reopening may not occur until the Association has determined that trading in underlying stocks whose weighted value represents more than 50% of the index is occurring."[77] Nasdaq may halt trading based on two categorical reasons: the impact of information on the market, and electronic/system malfunction.

A recent incident with the Corinthian Colleges stock raised debate about the legitimacy of Nasdaq's trading halts. In December 2003, the COCO stock plunged from $57.45 to $38.97 in 12 minutes, dropping 32%.[78] Nasdaq MarketWatch caught the unusual activity and decided to halt trade. It was later determined that price plummet was a result of a single customer sending multiple orders to multiple market centers and ECNs.[79] In addition to halting trade, Nasdaq decided to cancel trades that occurred before the halt.

A number of controversies surround this incident. While Nasdaq announced to halt trade, trade continued to other exchanges. The issue is under review before the SEC. Nasdaq claimed that ArcaEx "didn't honor" its trading

[76] NASD Manual.
[77] Ibid.
[78] "SEC Eyes Corinthian Trade Amid Broad Market Review" 2003. Forbes.com. Retrieved on October 20, 2004 from http://www.forbes.com/newswire/2003/12/10/rtr1176015.html
[79] Yahoo Business Announcement. 2003. Retrieved on October 20, 2004 from http://biz.yahoo.com/rf/031205/services_corinthian_announcement

halt decision because ArcaEx recommenced trading 30 minutes prior to the other exchanges.[80] Since COCO is a Nasdaq listed stock, Nasdaq assumes authority over these decisions. However, in a complaint to the SEC, the Pacific Stock Exchange charged that Nasdaq had no authority to install the trading halt as the issue was systematic and not regulatory.[81] ArcaEx's spokesperson, Dale Carlson, also told Traders Magazine that, "The cancellation was unjustified, inappropriate and badly communicated." [82] The SEC is deliberating the matter to determine whether or not Nasdaq's actions were appropriate on the matter, and furthermore, if Nasdaq should have the authority over such actions.

There is no clear policy towards trading halts and other suspensions. For the most part, the SEC allows each venue to determine the appropriate standards and processes for halts. There is disconnect and inconsistency between markets in the imposition of trading halt rules. In light of increasing market interdependence, this current system of trading halts may create disorder. As demonstrated by the COCO incident, the lack of a universal policy on the appropriate conditions and who has authority of a trading halt leads to confusion between market players, and create more stress on the market.

VI. POLICY RECOMMENDATIONS

In order to make most effective of registration and regulation, some modifications should be made to the current system. The following section expresses the recommendations and the reasoning behind them.

a. Approve Nasdaq's application to be an exchange

Nasdaq's application to be an exchange has been a divisive issue. In summary, the SEC puts great emphasis on the CLOB and its time/price order priority. It looks unfavorably upon

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[80] Bresiger, G. "Nasdaq and ArcaEx Fight Over Halt." 2004. Retrieved on October 20, 2004 from http://www.highbeam.com/library/doc0.asp?docid=1G1:112801925&refid=ink_puballmags&skeyword=&teaser=
[81] "SEC Eyes Corinthian Trade Amid Broad Market Review" 2003.
[82] Bresiger, G. "Nasdaq and ArcaEx Fight Over Halt."

Nasdaq’s lack of a CLOB and its internalized trades. However, forcing Nasdaq to create a CLOB would virtually diminish the viability of ECNs. Forcing Nasdaq to set up a CLOB would be extremely anti-competitive. The SEC has self-adopted rules that require it to consider the anti-competitiveness nature of all its actions. On the other hand, the SEC’s previous action on CSE’s preferencing program makes it difficult to approve Nasdaq’s application without being self-contradictory.

Nasdaq’s difficulty in obtaining exchange status is noteworthy. Nasdaq already enjoys essentially the same financial benefits of an exchange and is subject to comparable regulations. The SEC’s inability to come up with appropriate action on this matter is unfavorable in a practical sense. First, Nasdaq is unable to proceed with its plans to be independent of NASD, which includes adopting its own governance board and regulatory system, etc. Second, NASD’s potential conflict of interests a self-regulatory body persists. This is an important concern. It is in the interest of regulatory fairness to disassociate Nasdaq from NASD. The rate at which the SEC is attending to the issue is inadvisable; the market is fast-paced and inaction may have unfavorable effects.

This paper recommends the approval of Nasdaq’s application to be a securities exchange without a CLOB. Furthermore, this paper recommends the revision of Regulation ATS to remove the requirement of an exchange to have a CLOB. Nasdaq must become independent of NASD as soon as feasible, as to remove conflicting interest. As long as NASD has a vested business interest in Nasdaq, it cannot qualify as a fair and effective regulatory of ECNs.

In order to approve Nasdaq’s application, the SEC will first have to remove an exchange’s prerequisite of a CLOB (as is presently specified in Regulation ATS releases). As aforementioned, the SEC cannot require Nasdaq to adopt a CLOB because the move would be anti-competitive. Section 23 of the Exchange Act "requires the Commission to consider the anti-competitive effects of any rules it adopts, and to balance these effects against the benefits that further the purposes of the Exchange Act."[83] In this particular situation, Nasdaq's having a CLOB could have detrimental effects. All order flow would be required to sent to Nasdaq and ECNs would not be able to compete with Nasdaq's CLOB. Since Nasdaq thrives on a decentralized market, this action would be counter-productive.

The SEC will need to extend the same non-CLOB policy towards all exchanges. This will have implications for other exchanges. To remain competitive with Nasdaq, other exchanges may remove their CLOB to capture the same order flow that Nasdaq is currently capturing. Cincinnati may choose to resubmit their preferencing program, which the SEC will now have to accept.[84] Other exchanges may go ahead and create similar competing dealer markets. Approval of Nasdaq's application will mean that the SEC must approve internalization as valid activity of exchanges.

The internalization of order flow may be a positive step towards more competition. Other exchanges may also adopt competing dealer markets. "There will be competition between markets to attract the key revenue generators within Nasdaq: ECNs and market makers."[85] The monopoly of other exchanges may be lessened as markets become more decentralized. The ECNs' electronic limit order books are competitive with Nasdaq's Super Montage. They have been successful for a reason. They offer attractive price discovery and supply liquidity to the market.[86] In another scenario, other markets do not abandon their CLOB and continue to operate as they are. Such a scenario should not be worrisome for the SEC.

[83] Securities and Exchange Commission, Rule Release No. 34-40760
[84] Brown, J.
[85] Smith, C.
[86] Biais.

When Nasdaq obtains approval for their exchange status, it will have to be regulated through an SRO. It has two options for regulation. In one option, it can set up a self-regulatory division, similar to what the NYSE has done. In a second option, Nasdaq can outsource the regulatory responsibility similar to how the American Stock Exchange's (AMEX) contracts NASD to regulate. Nasdaq has expressed interest in the first option.[87]

b. Eliminate Option to Register as National Securities Association

This paper recommends eliminating the option for a trading venue to register as a national securities association. The differences between a national securities association and an exchange are negligible. A national securities association receives the same privileges of listing fees, data fees, and tape fees. Despite not being self-regulatory, it is subject to the same regulatory standards. After Nasdaq's application to be an exchange is approved, there will be no need for this status. Eliminating this status will be a move to consolidate the registration system.

c. Adopt a Two-Tier Exchange System

This paper recommends a two-tier exchange system that revises the definition of an "exchange" to include alternative trading venues currently registered as broker-dealers. This system puts trading venues into two categories: with members and without members. Regulation of these trading venues will be determined by their inclusion or exclusion of members. This two-tier exchange system registers trading venues according to their functional differences and responsibilities and also gives sufficient consideration for the market role of alternative trading venues. This tiered exchange system is modification of an SEC Concept Release from 1997.[88]

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[87] Nasdaq. Nasdaq Press Release: Nasdaq Completes Private Offering and Expands Board. 2001.
[88] Securities and Exchange Commission. Concept Release: Regulation of Exchanges.

Instead of the current different definition specified in the 1934 Act, an exchange shall be defined as: "An organization that brings together multiple buyers and sellers and provides a facility through which, or sets material conditions under which, participants entering such orders may agree to the terms of a trade." "Facility" in this context does not have to be a physical location, and can include an electronic network, etc.

This definition acknowledges that ECNs operate like markets and have immediate market impact. Regulation ATS does not effectively recognize the differences between a traditional broker-dealer and an ECN registered as a broker-dealer. This proposed definition provides distinction between traditional broker-dealers and ECNs that currently register as broker-dealers.

The SEC should take a tiered approach to registration of trading venues. Instead of having the options of exchange, broker-dealer, and national securities association, there will only be two tiers of registered exchanges. The first tier will consist of trading venues without members. This first tier will mostly include all ECNs that currently register as broker dealers. The second tier will consist of trading venues with members. This second tier will mostly include traditional exchanges and ECNs that have members.

As SEC rules currently stand, there are essentially two characteristics that separate an exchange from a broker dealer: listing fees and members. This paper recommends differentiating the two tiers by their membership, reason being that members present significant regulatory responsibility. Listing fees are not used to different tiers because they add limited regulatory burden.[89] The regulation of listed companies is limited to setting financial standards for companies and compliance with SEC rules on dissemination of quality information. Therefore, the existence of listed companies should not to determine whether a trading venue ought register as a tier one or two exchange.

[89] Burden determined after analysis of regulatory obligations and discussion of listing standards in class.

This policy towards listing fees presents a favorable business opportunity for some venues. Listing fees bring substantial revenue to exchanges. The two-tier system does not exclude any venue from obtaining listing fees, regardless of whether it registers as tier one or two. This two-tier exchange registration system would allow alternative trading system to list companies and collect listing fees without the regulatory obligations of a traditional exchange, should this alternative trading system choose to register as a tier-one exchange. This clause disassociates listed companies with regulatory obligations. Therefore, tier-one exchanges would include current ECNs that register as broker-dealers. Vice versa, tier-two exchanges could operate without listed companies. However, because of the listing fee revenue and regulation costs, it is unlikely that an exchange would opt to have members without listed companies.

Under this two-tier exchange system, the SEC reserves the authority to compel a trading venue to register as a tier-two exchange if a trading venue has greater than 5% of the market volume. If the trading venue has enough market impact to warrant increased regulation, the SEC can recommend for such a venue to register as a tier-two exchange.

Regulation of trading venues will be determined by whether they are tier-one or tier-two exchanges. NASD will regulate tier-one exchanges. The regulatory burden for tier-one exchanges will be similar to that of currently registered broker-dealers. These venues will submit quarterly reports and audit trails of all trades to NASD and also the SEC upon request. Tier-two exchanges are self-regulatory. Tier two exchanges must demonstrate the capacity for self-regulating and regulating their members. Tier two-exchanges will face a regulatory similar to traditional exchanges. They must enforce member compliance with federal rules and exchange rules.

The members of tier-two exchanges must continue to register as broker-dealers with the SEC and also NASD. For instances of common membership in more than one SRO, the SEC will continue to adhere to past action. The SEC will appoint either the NASD or the NYSE as the designated examining authority over the broker-dealer. With this appointment, other SROs are no longer responsible for the regulation of that particular broker-dealer.

The SEC should recommend a ballpark figure for listing and maintenance standards. In addition, the SEC must approve all standards. This is especially relevant since more venues can list companies under this proposed system. The requirement of SEC approval will function as a filter, to make sure that there is not too much discrepancy of listing standards between exchanges. However, this recommended figure will only be a recommendation made known to the public, but not strictly enforced. Investors can then use their own judgment.

As more venues are permitted to list companies, there may be a range of listing standards, some more lenient than others. There may be concern that some ECNs may issue low listing and maintenance standards to attract more companies and to collect more revenue. However, the level of listing standards is closely linked to company perception and investor confidence.[90] For some companies that choose to list on venues with low listing standards, investors can act with more discretion. Furthermore, many companies currently choose to list on the NYSE rather than Nasdaq because the NYSE has stricter listing standards than Nasdaq, and companies want this better image.

Trading halts must be made more consistent in securities that are traded on multiple venues. With growing technology, there is increasing market interdependence. The enforcement of trading halts across different markets has become more difficult. As exemplified by COCO

[90] Bainbridge, S. "A Critique of NYSE's Director Independence of Listing Standards." 2002. Retrieved on December 12, 2004 from http://www.fed-soc.org/pdf/NYSEStandards.pdf

security incident, there is a need for firm specification of authority in the issuance of trading halts. The SEC must give the exchange which lists the stock the unequivocal authority in imposing trading halts and in making decisions surrounding the trading halt. The venue imposing the trading halt is the one with the capacity to measure the volatility or activity of the trades and is in the best position to judge the circumstances. In the COCO incident, the other ECNs ought to have complied with Nasdaq's edict to halt and to cancel the trades prior to the halt. If the SEC does not enforce this authority, then other markets also trading the relevant securities may find it acceptable to not comply with its issuance. This would defeat the purpose of imposing a trading halt in the first place.

VII. CONCLUSION

Technological advances in the last decade have changed the dynamics of various players in the securities industry. These developments have extended the boundaries of exchanges, consequently making our current system of registration and regulation inadequate. While Regulation ATS attempted to improve the registration system, it did not satisfactorily anticipate and address the rapid growth of ECNs. The issues of registration and regulation are complex and sensitive, which is why it has been difficult for changes to take place. However, adopting the appropriate registration system, which accurately categorizes trading venues by their operations, responsibilities, and market impact, is extremely important for the healthy function of the securities industry. The right classification of trading venues can determine the appropriate set of responsibilities and regulations for venues.

In the interest of regulatory fairness, Nasdaq's application to become an exchange should be approved as soon as feasible. Approval of Nasdaq's application will give the green light for the business makeover that Nasdaq has been awaiting. Removing the CLOB requirement of an exchange also gives other exchanges an opportunity to introduce competing dealer markets, which would promote competition. Following Nasdaq's application approval, there will no longer be a need for the option of a trading venue to register as a national securities association. Eliminating this status will work to consolidate the registration system.

A two-tier exchange system accurately addresses the increasing role of ECNs in securities trading, and their market impact. The two-tier exchange system is differentiated by the regulatory burdens and obligations of a venue. It also makes regulatory standards more consistent, by setting same standards for like venues.

The problems of the current market registration and regulation system will only be amplified with advancing technology and increased interaction between markets. While it is difficult to make registration and regulation completely without objection, the SEC can aim to improve the current system by making the system more adaptable to changing market dynamics in the securities industry.

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