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New Rules and Regulations

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NEW RULES AND REGULATIONS

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CONSTANTINE N. KATSORIS:¹

No one likes to be regulated, but life is such that regulation is necessary, even in our everyday life. Regulation is absolutely necessary in the securities industry because the health of any market determines the integrity of that market. American markets are the most trusted in the world because of the transparency of companies and the belief of investors that they will be treated fairly when they invest.

As markets become more global in scope, the financial products traded become more complex and diverse, and technological inventions increase the execution speed of transactions. As a result, old rules and regulations must be adjusted to cope with emerging problems. However, the integrity of the markets must be upheld, otherwise the market will shrivel and fade away.

Today our panelists will present the new rules and regulations that are being implemented to deal with the changing nature of the securities industry. Each speaker will address what are these new regulations and whether these regulations are working?

¹ Wilkinson Professor of Law, Fordham University School of Law and has been a public member of the Securities Industry's Conference Association since its inception in 1977. Prof. Katsoris was a public member of the National Arbitration Committee of the NASD from 1975 to 1981. He has served as: a public arbitrator at the New York Stock Exchange since 1971; a public arbitrator at the National Association of Securities Dealers since 1968; an arbitrator for the First Judicial Department in New York since 1972; a private judge at Duke Law School's Private

Dr. Richard Lindsey will begin our discussion by presenting the Securities and Exchange Commission's ("SEC") view on these new regulations. Robert J. McSweeney and Eugene Lopez will present the perspective of the self-regulatory organizations, the New York Stock Exchange ("NYSE"), and National Association of Securities Dealers, Inc. ("NASD") on these new rules and regulations. Professor Yusif Simaan will discuss the view of academicians. Our discussion of new rules and regulations will conclude with Ed Fleischman who will provide the practitioner's perspective on new rules.

DR. RICHARD LINDSEY:²

To begin our discussion, I would like to highlight some of the events that occurred over the past year that impacted the regulation of the securities industry. This discussion will include a review of the Concept Releases and the Proposing Releases that were issued by the SEC over the past year.

First, the implementation of the order handling rules ("OHR") brought about dramatic changes in trading operations for the Nasdaq system, the over the counter ("OTC") market, and the exchange listed markets.³ The implementation of the OHR made people question whether the eighth was the proper trading increment. The industry has moved rapidly from eighths to

Education Center since 1989; an arbitrator at the American Arbitration Association since 1992; and a mediator at the National Association of Securities Dealers since 1997.

² Director, Division of Market Regulation, Securities and Exchange Commission. B.S. in chemical engineering, Illinois Institute of Technology; M.S. in chemical engineering and Ph.D. in finance, University of California at Berkeley; M.B.A., University of Dallas. Dr. Lindsey served as Chief Economist for the SEC; was a finance professor at Yale University School of Management; has been a visiting academic at the Nikko Research Institute in Tokyo; and served as a visiting economist at the NYSE.

³ Order Execution Obligations, 62 Fed. Reg. 40,732 (1997) (to be codified at 17 C.F.R. pt. 240) (proposed July 30, 1997). The new Order Execution Obligations adopted the Limit Order Display Rule and amendments to the Quote Rule. *Id.* The Limit Order Display Rule requires that customer limit orders with better prices be displayed. *Id.* The amendments to the Quote Rule require publication of trades in excess of one percent of the aggregate volume of a listed security. *Id.*

sixteenths.⁴ Furthermore, we are now well along the course of converting to decimals in our market.⁵

In addition to the implementation of the OHR, the SEC introduced Electronic Communication Networks ("ECN").⁶ An ECN is an electronic system that disseminates to third parties orders entered by exchange market makers or OTC market makers. Orders on an ECN may be executed in whole or in part. At the time we started the OHR there were probably only three ECNs. Today, there are at least seven ECNs in use with more on the way.⁷

About this time last year, the SEC issued a Concept Release on the regulation of exchanges addressing the rapid growth of electronic marketplaces.⁸ There were concerns that electronic marketplaces may be treated differently, and thereby receive less coverage. The end result may be that regulators have limited the ability to adequately control the electronic marketplaces.⁹

⁴ Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to Trading Differentials for Equity Securities, 62 Fed. Reg. 42,847, 42,848 (1997) (granting the NYSE permission to lower its minimum quote increments to one sixteenth); Self-Regulatory Organizations; American Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to Trading One Sixteenth of a Dollar, 62 Fed. Reg. 25,682 (1997) (granting the American Stock Exchange permission to trade stocks priced at or above \$0.25 in sixteenths); Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval to Proposed Rule Change to Decrease the Minimum Quotation Increment for Certain Securities Listed and Traded on the Nasdaq Stock Market to 1/16th of \$1.00, 62 Fed. Reg. 30,363 (1997) [hereinafter Minimum Quotation Increment for Securities Traded on the Nasdaq Stock Market] (granting Nasdaq permission to accept quotes in sixteenths provided the security is priced at or above \$10).

⁵ Minimum Quotation Increment for Securities Traded on the Nasdaq Stock Market, 62 Fed. Reg. 30,363, 30,364 (1997) (recommending the use of decimals as a means to add further transparency and liquidity to the market).

⁶ 17 C.F.R. § 240.11Ac1-1(e)(5)(i)(1996); see also *id.* § 240.11Ac1-1(a)(8).

⁷ See Om Malik, *The ECN Playing Field: Existing Players*, TRADERS MAG., June 1, 1998, available in 1998 WL 12693866 (describing some of the existing and upcoming ECNs; including Reuter's Instinet, Bloomberg's Tradebook, Datek Online Holding Corp's Island, Archipelago/Terra Nova, Spear, Leeds & Kellogg's Rating & Execution Dot Interface Book (RediBook), All-Tech's Attain; Automated Securities Clearance Corporation and Knight Securities' Brut and Bear Stearn's Strike).

⁸ Regulation of Exchanges, 62 Fed. Reg. 40,316 (1997) (to be codified at 17 C.F.R. pt. 240) (proposed July 28, 1997) (explaining that the SEC is reevaluating exchange regulation in light of technological advances).

⁹ *Id.* (explaining how Section 11A of the Exchange Act gives the SEC authority to address possible conflicts of law issues concerning the regulation of electronic activity between U.S. markets and foreign markets).

The Concept Release caused almost every market in this country to evaluate its present and future role. Furthermore, it caused the U.S. markets to adopt new technology that modifies marketplaces, systems, and business strategies. An example of this realization was the adoption of Optimark, by the Pacific Exchange, as one of its facilities.¹⁰ The SEC has approved the move and, later this year, Optimark will probably start trading as a new type of trading system for the Pacific Exchange.

Nasdaq also made a number of changes to its proposed system that the industry currently refers to as "the system formally known as NAqcess."¹¹ Nasdaq and Optimark announced their intention to incorporate Optimark into the Nasdaq system, with Nasdaq agreeing to make Optimark available to its broker-dealers.

The SEC issued another Concept Release addressing alternative methods of calculating capital requirements for broker-dealers.¹² Currently, many broker-dealers use "value at risk" for control of their business but we do not allow their use for capital.¹³ In addition, the SEC issued several proposals associated with making sure that systems are more than capable of handling their Year 2000 problems.¹⁴

¹⁰ Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Numbers 1, 2 and 3 to Proposed Rule Change Relating to the PCX Application of the OptiMark System, 62 Fed. Reg. 50,036 (1997) (explaining that OptiMark is a computer-based trading system that facilitates anonymous trading).

¹¹ Self-Regulatory Organizations; Notice of Filing of Amendment No. 2 to Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to NAqcess System and Accompanying Rules of Fair Practice, 61 Fed. Reg. 31,574 (1996) (referring to a new Nasdaq system that offers nationwide limit order protection and price improvement over the dealer quotation of small-sized customer orders).

¹² OTC Derivatives Dealers, Net Capital Rule, 63 Fed. Reg. 11,173, 11,176 (1998) (to be codified at 17 C.F.R. pts. 200, 240 and 249) (proposed Mar. 6, 1998) (stating that the SEC incorporated statistical models into the net capital rule in order to minimize capital changes).

¹³ *Id.* (stating that value at risk, which is used by several large broker-dealers, is "an estimate of the maximum potential loss expected over a fixed time period at a certain probability level").

¹⁴ Reports to Be Made by Certain Brokers and Dealers, 63 Fed. Reg. 59,208 (1998) (to be codified at 17 C.F.R. pt. 240)(proposed Nov. 3, 1998) (requiring certain broker dealers to file two reports regarding year 2000 compliance); Year 2000 Readiness Reports To Be Made by Transfer Agents, 63 Fed. Reg. 58,630 (1998) (to be codified at 17 C.F.R. pt. 240)(proposed Nov. 2, 1998) (explaining how the temporary rule requires all non-bank registered transfer agents to file a report regarding year 2000 readiness).

There were a number of other important rule filings, changes, and regulations. For example, order audit trail system (“OATS”) was developed by the NASD to improve its automated surveillance capabilities for the Nasdaq market.¹⁵ OATS is designed to compile trading and order information reported by NASD members.¹⁶ It provides time sequenced trading information, requiring members to electronically submit detailed information, including when the order was received; what part was executed; and whether there were any modifications to the order.¹⁷ Members will be required to keep their business clocks synchronized for a more accurate audit trail.¹⁸

The SEC issued several releases in attempts to establish a process whereby entities can become a nationally recognized statistical rating organization (“NRSRO”) to rate stocks and bonds.¹⁹ Traditionally, this had been a business line that few people had been able to get into because of the existence of a “Catch-22” situation.²⁰ If an entity was a nationally recognized statistical rating organization, it received the classification. If it was not nationally recognized, however, it did not get the classification.

The SEC also issued a Proposing Release, commonly referred to as “broker-dealer lite,”²¹ specifically tailored for OTC derivative activities.²² These entities would have a wide range of

¹⁵ Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to NASD’s Order Audit Trail System and Record Keeping Rules, 63 Fed. Reg. 42,088, 42,089 (1998). In settlement of the enforcement action, the NASD agreed to create an order audit trail sufficient for surveillance purposes. *Id.*

¹⁶ *Id.* at 42,089 (requiring orders to be captured from NASD member information).

¹⁷ *Id.* (requiring member firms to synchronize their business clocks and keep them synchronized).

¹⁸ *Id.*

¹⁹ Regulatory Flexibility Agenda Part LXIII, 63 Fed. Reg. 23,060 (1998) (to be codified at 17 C.F.R. Ch. II) (proposed Apr. 27, 1998) (proposing for the amendment of the net capital rule to provide a definition of NRSRO).

²⁰ Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, 62 Fed. Reg. 68,018, 68,019-20 (1997) (to be codified at 17 C.F.R. pt. 240) (proposed Dec. 30, 1997) (explaining that currently, only five NRSROs exist: Standard and Poor’s, Moody’s, Fitch IBCA, Duff & Phelps, and Bankwatch).

²¹ OTC Derivatives Dealers; Part II, 62 Fed. Reg. 67,940, 67,941 (1997) (to be codified at 17 C.F.R. pts. 200, 240, and 249) (proposed Dec. 30, 1997). This proposal was adopted as a final rule in 63 Fed. Reg. 59,362, 59,363-64 on Nov. 3, 1998.

business opportunities and the ability to actually conduct that business. Operating as an OTC derivative dealer as opposed to a fully registered broker-dealer would allow the derivative dealer the benefits of less regulation and smaller capital requirements. Prior to this, the derivative business was conducted offshore to avoid SEC capital requirements. Now, with broker-dealer lite, the SEC creates a voluntary vehicle with a rational approach to capital requirements.²³ This approach would be similar to the capital approach used by banks, the primary competitors of large broker-dealers.

The SEC issued a Proposing Release, which suggest that the exchanges themselves should be allowed to run pilot programs of new trading systems without going through the SEC's normal rule filing process.²⁴ In this instance, the exchanges would file a notification with the SEC that they were going to try a new type of trading process and give periodic updates to the SEC. Thus, the exchanges would avoid the long, involved procedure required when introducing a new system.²⁵

This proposal has fairly strict controls because a new system could not supplant an existing trading system.²⁶ It is really meant to create a testing ground for the exchanges and the NASD. This will enable them to experiment with innovative trading systems and avoid cumbersome regulation.

²² *Id.* (stating that proposed rules would tailor capital, margin and other broker-dealer requirements to a class of registered dealers, called OTC dealers).

²³ See Katherine M. Reynolds, *Regulation: Tastes Great, Less Filling? Players Quiet on SEC Broker-Dealer 'Light' Proposal*, BOND BUYER, Dec. 22, 1997, at 32 (explaining that OTC derivatives dealers would have the option of setting up a derivatives subsidiary with less regulation and would calculate their net capital using value-at-risk models).

²⁴ Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 23,504 (to be codified at C.F.R. pts. 201, 240, 242 and 249) (proposed Apr. 29, 1998) (stating that the proposed rule would more effectively integrate the growing number of alternative trading systems into the national market).

²⁵ *Id.* at 23,532-34 (listing the conditions for a simplified procedure for integrating new trading systems).

²⁶ *Id.* at 23,533 (noting the SRO's continuing obligation regarding pilot trading systems).

There is another Proposing Release that would reduce the SEC's review of certain types of new products.²⁷ This proposal applies to the New Derivative Security Products ("NDSP"),²⁸ which have listing standards for products that have already been filed and approved by the SEC. The NDSP applies to any type of option, warrant, hybrid securities product, or any other security whose value is based upon the performance of an underlying instrument. If the NDSP fits within the existing classification of listing standards and surveillance mechanisms, they should be able to start trading. The proposal does require, however, that a notification be filed with the SEC within five days of the commencement of the trading.²⁹ Under this particular proposal, the SEC estimates that roughly 90 percent of the product filings would no longer require review. Finally, I would like to conclude by discussing the recent Proposing Release on Alternative Trading Systems ("ASTs").³⁰ Two years ago, we had twenty-two to twenty-five ATSS. Today we have over fifty. As these systems reach a level of importance or predominance in the marketplace, it becomes important to have some basic safeguards to protect against gaps in system access, unfairness, and prevent transparency in the market. This Proposing Release attempts to address these issues.

²⁷ Proposed Amendment to Rule 19b-4, Under the Securities Exchange Act of 1934, That Would Deem the Listing and Trading of New Derivative Securities Products by Self-Regulatory Organizations To Not Be Proposed Rule Changes, 63 Fed. Reg. 23,584 (1998) (to be codified at 17 C.F.R. pts. 240 and 249) (proposed Apr. 29, 1998) (stating that under the proposed amendment to Rule 19b-4, as long as the new derivative securities products rules, procedures and listing standards are addressed under existing rules, there would be no need to submit a proposed rule change).

²⁸ *Id.* at 23,586-87.

²⁹ *Id.* at 23,590 (proposing from and time of notification for all new derivative securities products).

³⁰ Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 23,504 (1998) (detailing need for new regulatory framework for alternative trading systems); see Mark Hendrickson, *Generally NASD: SEC's Proposed ATS Regs "Step in Right Direction"*, SEC. INDUS. NEWS, Aug. 31, 1998, at 16 (explaining that the proposed regulatory system for the ATS's gives the ATS the choice to be regulated as either a broker-dealer or as a stock exchange/SRO depending on its business preference).

Essentially, the SEC would like to know that these systems exist. Rule 17a-23 provides regulators with a certain means of knowing which systems are currently out there.³¹ In this Proposing Release, however, the SEC suggested the elimination of Rule 17a-23 because it results in duplicative reporting requirements.³² The SEC would then require that entities or individuals report either as an exchange or a broker-dealer. Instead, for certain types of systems there should be some types of basic notification. When systems grow to a certain volume level, there should first be some responsibility to ensure system integrity. These safeguards should ensure that the system has a reasonable degree of protection, stability, and capacity.³³

The SEC suggested in this Proposing Release that those systems follow the automation review policy the SEC promulgated several years ago. This is the policy that all of the exchanges and many broker-dealer entities follow. The automation review policy partly incorporates a planning process for system capacity. It also employs protections aimed at assuring the security and stability of systems.

As systems become larger, users should have some degree of access to those systems.³⁴ Envision a system that has a reasonable percentage of the trading volume in any given security. There should be some fair access standards associated with that system. This is a little different than broker-dealer regulation. Broker-dealers can basically choose to service any customer they want and choose not to service any customers they do not want for any reason.

³¹ 17 C.F.R. § 240.17a-23 (explaining that Rule 17a-23 established the record keeping and reporting requirements for broker-dealer trading systems). A broker-dealer trading system is any system that provides for automated collection, dissemination or execution of orders. *Id.*

³² Regulation of Exchanges and Alternative Trading Systems, 63 Fed. Reg. 23,504, 23,531 (1998) (detailing the costs and benefits of eliminating Rule 17a-23).

³³ *Id.* at 23,520 (reviewing the SEC's concerns about protection, stability and capacity); see Sarah Stirland, *Gearing Up For Markets of the Future*, WALL ST. & TECH., Feb. 1, 1998 (explaining that the SEC laid out framework for regulating ATS's as tiered exchanges based on the volume of securities traded over the system).

³⁴ *Id.* at 23,519-20 (stating that the SEC agrees with commentators who recommend that subscribers should have fair access to systems that attain a significant portion of trading in a security).

The SEC has suggested that unfair discrimination should not be permitted.³⁵ Systems may set certain standards. For example, “I will not accept anybody without a certain amount of credit” or “I will not accept anybody that is not from a certain class of entity such as a broker-dealer or institution.” But once those fair standards are applied or set up, there should be a non-discriminatory application of those standards.

Additionally, a system’s firm-quotes should become incorporated into the public quote stream so they are accessible by the public.³⁶ The SEC has long tried to prevent a “two-tiered” market where two sets of quotes exist: one available to the public; and the other available to industry members.³⁷ This Proposing Release implies that the industry quotes should be incorporated in the public quote stream.³⁸ Thus, the SEC hopes to prevent any degradation of the market through the fragmentation of the trading process.³⁹ This is less important in the context of a very small system, but as volume increases it becomes more important.

As we have just seen, there has been a lot of change in the past year. The pace of change has actually just begun to increase and we will see even more change over the next two to three years. It will be interesting to see how our markets continue to change and evolve.

³⁵ *Id.* (proposing amendments to the SEC’s rules of practice to prohibit unfair discrimination by an alternative trading system).

³⁶ *Id.* at 23,515 (describing the SEC’s belief that Congress intended that the best trading opportunities should be available to the public).

³⁷ *Id.* at 23,514-16 (stating that for many years the SEC has been concerned about the development of so-called “hidden-markets”).

³⁸ Regulation of Exchanges and Alternative Trading Systems, 23,504, 23,516 (1998) (stating that the public display of quotes will prevent the development of a two-tiered market).

³⁹ *Id.* at 23,505 (describing the SEC’s motivation in its concept proposal).

ROBERT J. MCSWEENEY:⁴⁰

In order to give you a sense of how the regulatory process evolved, I will first describe regulation from the perspective of market surveillance. Secondly, I will discuss two rules that the NYSE has pending before the SEC.

The NYSE takes a broad approach to its regulatory responsibilities because it recognizes that investor confidence in the marketplace is crucial to its continued growth and success. Thus, the NYSE has established a Market Surveillance department that is responsible for monitoring abuses in insider trading, market manipulation, specialist responsibilities, order representation, and front-running.

The Market Surveillance department is comprised of 111 regulators. These include analysts, investigators, and attorneys, all of whom are supported by a staff of twenty-five technicians. The NYSE has made a multi-million dollar investment in regulatory technology, including customized software applications, and electronic data collection from member firms and public vendors.

Last year, extensive document analyses and interviews made by the Market Surveillance regulatory program resulted in over 500 formal investigation of which 141 summary fines were issued. These fines ranged from \$500 to \$5,000. Many of these investigations involved on the record testimony and inter-market cooperation.

The NYSE has jurisdiction only over its members, member organizations, and their employees. Therefore, when Market Surveillance detects possible violations of federal securities laws by parties outside of its jurisdiction, the NYSE refers the case to the SEC's enforcement

⁴⁰ Senior Vice President of Market Surveillance, New York Stock Exchange. He serves as the NYSE's representative to the Intermarket Surveillance Group comprised of regulatory officials from all U.S. exchanges and

division immediately. Last year, Market Surveillance made twenty-five referrals to its own enforcement division and sixty-four referrals to the SEC's enforcement division.

The market surveillance process requires a tremendous amount of regulatory cooperation and coordination. An example of this arises in the context of mergers and acquisitions.

The process would begin with the NYSE's Stock Watch System ("Stock-Watch System"), which detects unusual activity in stock prices and volumes. The Stock-Watch system comprised of a series of algorithms, continuously updates the historical profile of each of the securities traded on the NYSE. The Stock-Watch System measures price, volume, and volatility. Throughout the day, the Stock-Watch System flags aberrations and then ranks them based upon their degree of variance from the statistical norm. Market Surveillance would use this information to identify trading that is aberrational prior to a significant corporate development. The analysts would then refer to the audit trail database that provides a trade by trade reconstruction of the market. This database would enable the analysts to identify the member firms that were involved in representing orders that were cleared during the period prior to and after that corporate development was announced.

The analysts would also have access to additional information supplied by member firms. NYSE member firms are required to electronically submit to the NYSE detailed information regarding their represented accounts. This information includes the name of the account, Social Security number or tax identification number of the account, identification of the registered representative who handled the order, the opening branch office, when the account was opened, and whether or not the order was solicited. All of this information goes into the regulatory database.

the NASD. He is also a member of the Securities and Commodities Fraud Working Group, a nationwide

In addition, Market Surveillance would also collect information from the issuers involved in the transaction in question. To illustrate, in the mergers and acquisitions example, Market Surveillance would go to the General Counsel of each of the issuers and request a chronology of events leading up to that significant corporate announcement. Market Surveillance would receive information about the meetings that took place, individuals from those organizations and outside individuals who were privy to this information prior to the public announcement. Then Market Surveillance would go to the investment bankers for similar information. That process has been automated so that the information can be provided to the NYSE on diskette, and submitted to the NYSE's regulatory database.

Market Surveillance also notifies the other market centers, which trade the securities or the related derivatives, that the NYSE has commenced an investigation. Market Surveillance coordinates this investigation through the Inter-market Surveillance Group ("ISG").⁴¹ Currently, the ISG is investigating forty-four cases.

ISG is made up of regulators from the nine United States securities markets and fifteen affiliate members, of which twelve are foreign exchanges. This enables the NYSE to share information on trading that takes place in the derivative and the equity markets. It also enables the NYSE to obtain testimony from individuals that are not within the NYSE's jurisdiction, but are within the jurisdiction of another self-regulating organization ("SRO").

ISG can refer cases to the SEC's and NYSE's enforcement divisions simultaneously. Every time the NYSE commences an investigation in connection with insider trading or market manipulation, it alerts the SEC. Market Surveillance provides the SEC with the investigative

organization of federal and state securities law enforcement officials.

⁴¹ See James L. Cochrane et al., *The Structure and Regulation of the New York Stock Exchange*, 18 J. CORP. L. 57, 65-66 (describing the working relationship of ISG members).

findings at the conclusion of the investigation. This generally occurs within a three-month period from the commencement date of the investigation.

A variety of cases result from Market Surveillance investigations. For example, in 1996 Market Surveillance referred to the SEC's enforcement division a case that resulted in sanctions for the misappropriation of information by an insider.⁴² In addition, the NYSE commenced an action against a registered representative, of a NYSE member firm, for conduct that was deemed unjust and inequitable.⁴³ The individual did not trade on the inside information. The investigation concluded that the individual was reckless because he knew that the customer had inside information. The NYSE censured the individual by suspending his license for several months.⁴⁴

Market Surveillance also referred a case to the SEC's enforcement division that resulted in the commencement of a civil action against a geologist who traded based on insider information.⁴⁵ The SEC disgorged the ill-gotten profits made by the geologist and fined him over \$200,000.⁴⁶ This suit was possible because Market Surveillance questioned the issuers and investigated the trading information it received.

In 1997, Market Surveillance investigated a NYSE listed company that it suspected of price manipulation. Upon further investigation Market Surveillance determined that the sister of the chief executive officer of the suspected company owned the account. The SEC sanctioned

⁴² See Chris Welles, *Is Someone Sneaking a Peek at Business Week?*, BUS. WK., Feb. 5, 1996, at 48 (discussing an instance of suspected insider trading and the cooperation between the SEC and *Businessweek*).

⁴³ N.Y. Stock Exchange Hearing Panel Decision 93-176 (Dec. 6, 1993).

⁴⁴ See *id.*

⁴⁵ See S.E.C. v. David Pfister et al., Litigation Release No. 15,519, 65 S.E.C. Docket 1432 (Sept. 30, 1997).

⁴⁶ See *id.*

the chief executive officer by fining him \$50,000 and issuing a cease and desist order.⁴⁷ These cases exemplify the tremendous amount of researching, and investigation that Market Investigation is capable of conducting.

Currently, the NYSE is investigating, and issued summary suspensions for eight of its floor brokers.⁴⁸ Members of the NYSE's regulatory staff are assisting the U.S. Attorney's Office in this investigation. The staff has been working for several months with the U.S. Attorney on the investigation.

Market Surveillance also investigated Marisa Baridis, a former employee of Morgan Stanley. She was responsible for monitoring, for compliance purposes, the "Chinese Wall" separation of information within Morgan Stanley.⁴⁹ At the time of her arrest, Market Surveillance concluded that Marisa Baridis was the common link in the alleged Smith Barney insider trading cases.⁵⁰ The Manhattan District Attorney subpoenaed NYSE files and members from Market Surveillance provided expert testimony before a grand jury.⁵¹

Success of the NYSE's regulatory program depends on the supervisory component of its member firms. The NYSE expects that each of its member firms will implement supervisory procedures to detect violations of market manipulation and insider trading. While the NYSE does not expect its members to detect every violation, it does expect that they will have appropriate and reasonable procedures in place to detect business abuses.

⁴⁷ See Brett D. Fromson, *Bible Publisher's CEO Fined in Stock Case; Thomas Nelson Inc.'s Founder Settles SEC Fraud Allegations*, WASH. POST, Oct. 1, 1997, at D10 (alleging that CEO manipulated stock by buying shares through his sister's account thereby raising the price of the stock).

⁴⁸ See Greg Ip, *Big Board Posits Electronics for Floor-Broker Oversight*, WALL ST. J., Mar. 4, 1998, at C1 (discussing proposed changes, which would implement order receiving and recording systems to prevent abuses).

⁴⁹ See Dean Starkman, *Five Brokers Indicted for Insider Trades Linked to Ex-Morgan Stanley Officer*, WALL ST. J., Dec. 23, 1997, at B10; see also *New York State Drops Case Against Former Compliance Officer*, WALL ST. J., May 14, 1998, at B18 (indicating that Federal Prosecutors won jurisdiction over the case resulting in the Manhattan D.A.'s office dropping its charges. Baridis pled guilty in Federal court on December, 1997).

⁵⁰ Baridis had worked at Smith Barney prior to being employed at Morgan Stanley.

⁵¹ See Starkman, *supra* note 49.

Another important component to the NYSE's regulatory program is its rule development process. Before the NYSE files a proposed rule with the SEC, it seeks input from a variety of constituent committees at the NYSE. These committees represent institutional traders, pension managers, individual investors, corporate issuers, upstairs traders, and floor members. All of these different constituent groups are very interested in providing the NYSE with their view of proposed regulations. Thus, the Board is cognizant of the concerns of these diverse constituent groups before it evaluates the proposals presented. After Board approval, the NYSE then files the proposed rules with the SEC, submits the rules for public comment, and releases them for publication in the *Federal Register*.

The NYSE currently has two proposals pending with the SEC. The first proposal involves amending Rule 92.⁵² The Rule 92 proposal would prohibit any member firm or employee of a member firm from entering an order when they have knowledge of an executable agency order.⁵³

Not too long ago, the NYSE brought significant enforcement proceedings against two member firms for front-running institutional order flow. That resulted in six-figure fines against each of the broker-dealers involved. The NYSE did not bring the action under Rule 92 because that rule was enacted back in the 1930s and is crafted so as to apply only to individual members. Now, the NYSE aims to broaden Rule 92 to apply to the entire member organization and to govern the way firms do business with their customers.

⁵² Self-Regulatory Organizations; Notice of Filing of Amendment No. 4 to Proposed Rule Change by the New York Stock Exchange, Inc. Relating to Exchange Rule 92, "Limitations on Members' Trading Because of Customers' Orders", 63 Fed. Reg. 8244 (1998) [hereinafter *Limitations on Members' Trading*].

⁵³ *Limitations on Members' Trading*, 63 Fed. Reg. 8244 (1998).

The Rule 92 proposal was designed with a tremendous amount of constituent input. It has not, however, been completely accepted by all of the NYSE's members. The SEC has received comment letters that question whether some of its provisions should be changed.

The proposed rule has two exemptions. The first is very narrow and can be found in Rule 19(c)(3).⁵⁴ This rule excludes market making, regional specializing, bona fide and risk arbitrage and hedging of facilitation trade from complying with proposed Rule 92.⁵⁵ The second exemption is much broader and it applies to an individual investor with an order in excess of 10,000 shares.⁵⁶

I'll define a "facilitation position" as follows. Sometimes an institution will have a very large order, often as much as 200,000 shares. The institution's broker-dealer might initially sell 50,000 shares to the institution from the broker's own inventory but want to recoup these for itself while it executes the balance of the customer's 200,000 share order in the market. With the institutional customer's consent, the broker-dealer may buy 50,000 shares in the market before executing the remainder of the order.

The exemption is unavailable, however, in two situations. First, the broker-dealer covering its facilitation position may not continue to trade in a particular stock in the market before executing its customer's order.

If that happened, it would be as though the customer had provided material nonpublic information, because the broker's knowledge of the customer's large order would place the broker at a trading advantage over other market participants. Second, the broker dealer may not

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

close out a proprietary position where it knows a customer is putting a large sell order into the market.

The NYSE has a second proposal pending before the SEC. This proposal recommends that the NYSE amend the procedures it uses to deal with significant market imbalances that are associated with market-on-close ("MOC") orders.⁵⁷ These procedures are particularly important when dealing with MOC orders on expiration days, re-weighting indices, and stocks entering or existing indices.

The current procedures requires that MOC orders are entered by 3:40 p.m. on expiration days and by 3:50 p.m. on any other trading day.⁵⁸ Thereafter, member firms can enter MOC orders only to offset potential imbalances.⁵⁹ The exiting procedures require a publication of any imbalances that are 50,000 shares or more.

These are merely two examples how the NYSE would embark upon the rule making process to amend existing rules or procedures so as to provide a fair and efficient marketplace.

⁵⁷ Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto To Revise Exchange Policy for Entry of MOC/LOC Orders and Publications of Imbalances, 63 Fed. Reg. 33,975 (1998) [hereinafter MOC/LOC Orders and Publications of Imbalances]. This proposal was subsequently approved in June 1998. Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Revise Exchange Policy for Entry of MOC/LOC Orders and Publication of Imbalances, 63 Fed. Reg. 33,975 (1998) (proposed June 15, 1998).

⁵⁸ MOC/LOC Orders and Publications of Imbalances, 63 Fed. Reg. 33,975 (1998).

EUGENE LOPEZ:⁶⁰

With in the past two years, the NASD has separated its regulatory functions from its market functions. My presentation will focus on new market issues and existing rules because my work at the NASD is primarily concerned with market side transactions.

The implementation of the OHR has changed the trading landscape. This is most apparent in the Nasdaq where the OHR has reduced the average quoted spread on the first 500 stocks by more than 30 percent. While these rules have made the Nasdaq more attractive to companies, it has forced Nasdaq to make a number of changes in order to comply with the OHR requirements.

As a result of the OHR, Nasdaq established SelectNet to serve as a link to ECNs, which permits market makers to comply with the OHR's requirements.⁶¹ In addition, implementation of the OHR changed the spread rule,⁶² firm-quote compliance and best execution responsibilities.⁶³

In order to remain competitive, Nasdaq has undertaken a number of proposals.⁶⁴ The first proposal focused on developing a new trading system, which would help member firms comply

⁵⁹ *Id.* at 14,748.

⁶⁰ Vice President of Market Services, Nasdaq, Stock Market, Inc. At his current position, Mr. Lopez is responsible for ensuring that new products meet customers' needs while complying with the securities laws and rules. He is a previous Assistant General Counsel of the Nasdaq Stock Market System; Assistant Director at the Division of Market Regulation of the SEC; and has been an Adjunct Professor of Law at Georgetown, where he has taught on the global securities markets.

⁶¹ Self-Regulatory Organizations; Notice of Extension of the Comment Period for the Proposed Rule Change by the National Association of the Securities Dealers, Inc. Relating to an Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998) [hereinafter Integrated Order Delivery and Execution System] (explaining that the SelectNet link to ECNs disseminate quotes to the public).

⁶² Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving a Proposed Rule Change to Permanently Expand the NASD's Rule Permitting Market Makers to Display Their Actual Quotation Size, 63 Fed. Reg. 39,322 (1998).

⁶³ Order Execution Obligations, 62 Fed. Reg. 40,732 (1998).

⁶⁴ Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998).

with regulatory requirements.⁶⁵ Nasdaq currently employs two separate systems, Small Order Execution System (“SOES”) and SelectNet, that can not communicate with each other.⁶⁶

The new trading system should unify Nasdaq’s existing services by combining the functions of SOES and SelectNet into a single pipeline. Thus, the new trading system will eliminate the two separate trading systems that currently exist. However, it will maintain SOES’ automatic order execution system and SelectNet’s order delivery and negotiation system, while preserving the automated execution feature for small orders.⁶⁷ As a result, member firms will no longer need to worry about insignificant order flow orders. This will further enable them to interact with larger orders on a fairly rapid basis. It will provide member firms with a modicum of opportunity to react to those orders as opposed to having the orders automatically executed against them.

Nasdaq believes that the new system will help member firms with quote compliance because they no longer will need to worry about competing Nasdaq systems sending orders to a customer.⁶⁸ Nasdaq further believes that this will help small investors because they will be able to reach market maker quotes and ECN quotes on a rapid basis.⁶⁹ At the same time, the new system gives traders in the marketplace an electronic access tool that should serve their purposes well.

⁶⁵ Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Partial Approval and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to Proposed Rule Change Relating to Implementation of the Commission’s Order Handling Rules, 62 Fed. Reg. 2415 (1997).

⁶⁶ Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998).

⁶⁷ *Id.*

⁶⁸ *Id.* (indicating that the new system will provide market makers with a new tool enhancing efficiency and access to best prices in the market).

⁶⁹ *Id.*

Nasdaq has also included a limit order file feature in the new system.⁷⁰ This voluntary feature allows member firms to display either customer orders or their own proprietary interest in the Nasdaq market anonymously.

The last feature of this new trading system involves institutional access that would be sponsored by the member firms. The majority of institutional investors get deals done on private or separate systems such as SelectNet, which the institutional customer traditionally does not have access to. Trades made on these systems are executed at negotiated prices that are usually better than prices on the public Nasdaq system. The new feature will allow the firm to relate better to its customers. It will further enable member firms to service institutional customers more efficiently by providing member firms with better access to the Nasdaq Stock Market.

The second proposal involves the market makers ability to quote the size they intended to quote, as opposed to artificial quote sizes that are mandated by the Nasdaq. Under the current rules, market makers are required to quote a minimum of 1,000, 500 and 200 shares. With the introduction of the OHR by the SEC, Nasdaq believes that the rationale for the minimum size requirements, which was to ensure that an available market existed, has disappeared. Nasdaq would like to move away from the mandatory relationship between quote size and the SOES tier. Instead, under Nasdaq's proposal, market makers would be able to quote whatever size they wanted, from 100 shares on up, just like any other specialist in any other marketplace operating in the United States. Market makers would be held only to the number of shares funneled to them. Accordingly, trading firms and market making firms should be able to compete more efficiently with other entities operating in the marketplace.

⁷⁰ *Id.* at 15,471 (stating that the Limit Order File is a voluntary means for members to anonymously display customer limit orders); see Laura Santini, *What's Next?: SIA, Nasdaq to Discuss Alternatives to Next Alternatives to*

The third proposal involves primary market maker standards.⁷¹ When the OHR came into place last year, Nasdaq had to remove the existing primary market maker standards that determine whether or not a market maker is exempt from the Nasdaq short sale rule.⁷² Nasdaq removed those standards because they did not work in the new environment where customer orders are reflected in quotes.⁷³

For the last year, Nasdaq has been working with the market making community to determine how best to establish new standards.⁷⁴ Nasdaq issued proposals and is waiting for comments.⁷⁵ This comment period will expire very shortly. Nasdaq hopes the firms operating under this new rule will comment so it can benefit from everyone's expertise.

YUSIF SIMAAN:⁷⁶

Nasdaq has recently proposed the creation of an integrated system called Nasdaq Order Delivery and Execution System ("NODES").⁷⁷ This system would combine the two existing

Next Nasdaq Plan, WALL ST. LETTER, Jan. 19, 1998, at 1 (noting that Nasdaq's proposed control limit order book is one facet of next Nasdaq).

⁷¹ See Nat'l Ass'n of Sec. Dealers, Inc., NASD MANUAL (July 1996) at 5661 (setting out, in Rule 4612, the current standards for primary market makers) [hereinafter NASD Manual].

⁷² See Laura Santini, *Nasdaq to Raise Standards For Primary Market Makers*, WALL ST. LETTER, Jan. 26, 1998, at 1 (explaining that a firm designated as a primary market maker is exempt from Nasdaq's short sale rule prohibiting dealers from bidding down the price of a stock in which they also hold a short position).

⁷³ Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto Regarding Excused Market Maker Withdrawals and Reinstatements, 62 Fed. Reg. 66,160, 66,161 (1997) (stating that Rule 4612 were suspended because the criteria used to establish Primary Market Maker status was found to be significantly less relevant after implementation of the OHR).

⁷⁴ *Id.*; Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Partial Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. To Implement, on a Pilot Basis, New Primary Nasdaq Market Maker Standards for all Nasdaq National Market Securities and To Extend the Short Sale Rule Pilot, 63 Fed. Reg. 52,780 (1998).

⁷⁵ Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Partial Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. to Implement, on a Pilot Basis, New Primary Nasdaq Market Maker Standards for all Nasdaq National Market Securities and to Extend the Short Sale Rule Pilot, 63 Fed. Reg. 52,780 (1998).

⁷⁶ Professor of Finance, Fordham University Graduate School of Business Administration. He is a financial research consultant for the Electronic Traders Association where he has conducted studies on the quotation behavior of the Nasdaq markets, price and size quote behavior.

⁷⁷ Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998).

systems and would also contain a central facility to automatically display customer limit orders that arrive through Nasdaq dealers or through ECNs. NODES would provide immediate execution of non-directed orders; those not sent to a particular market makers or ECN, that match the price of orders in the central display. While the declared objective of this proposal is to increase competition, help the small investor, and bring more equity to the Nasdaq market, certain points in this proposal are in sharp contradiction with its declared objectives. Five principal problems exist.

I. ***NODES EXTENDS THE ACTUAL SIZE RULE ("ASR") TO ALL NASDAQ STOCKS***

The ASR allows market makers to quote in one normal unit of trading of 100 shares rather than the previously mandated minimum of 1,000 shares or the SOES-tier sizes of 500 or 200 shares. If the NASD market is perfectly competitive, the actual size rule is likely to result in a lower bid/ask spread, which is a good result because it enhances price competition.

In a recent study I co-authored with David Whitcomb we found that there are in effect two markets.⁷⁸ One market centers on the electronic system, in which best prices are set. The other market is the dealers market, which is a price follower.⁷⁹ The two markets are not perfectly linked. I was hoping that the new proposals would help link the two markets and increase price competition, but I have discovered otherwise.

Two studies were released recently by the NASD Economic Research: one in June, 1997, the other in March, 1998.⁸⁰ These demonstrated that bid/ask spreads are unaffected by the

⁷⁸ See Yusif Simaan and David K. Whitcomb, *The Quotation Behavior of ECNs and Nasdaq Market Makers*, Fordham University Working paper (1998).

⁷⁹ See *id.*

⁸⁰ See NASD Economic Research, *Effects of the Removal of Minimum Sizes for Proprietary Quotes in the Nasdaq Stock Market*, June 1997; see also NASD Economic Research, *The Effect of the Actual Size Rule on the Nasdaq*

existence of the ASR. Our study, however, shows that the ASR reduces market depth and liquidity particularly at times of market stress, such as the “market break” of October 27, 1997. Moreover, studies conducted by Dubinin and Whitcomb in 1997⁸¹ and the 1998 NASD Study determined that ASR diminishes access to SOES. As Dubinin and Whitcomb’s 1997 study shows, this in turn reduces market makers’ and SOES users’ need to “lay off” their positions using limit orders placed on ECNs.⁸² Given that limit orders tend to narrow the spread, they inhibit quote price competition by reducing access to SOES.

II. THE “PHONE AHEAD BUTTON” AND THE EFFECT ON THE MARKET MAKER

The proposed system would include a “phone ahead button” that a market maker could push if he receives a telephone order. Pushing the button would take the market maker’s quote out of the automated execution “rotation” for seventeen seconds without removing the quote from the NASDAQ quote montage. During this period, the market maker could revise his quote price; otherwise the quote would be “hittable” at the end of the seventeen seconds. During the time the “Phone Ahead Button” is engaged, the market maker quote looks accessible while it is not. This officially promotes false advertisement and creates discontinuity in the market. Quotes ought to be firm and available. One way to solve this problem is to make the market maker quote invisible as long as it is inaccessible.

Stock Market, Inc., Mar. 1998.

⁸¹ See Christie Barclay, Kandell Harris, and Schultz, *The Cost of Trading Nasdaq Issues: The Impact of Limit Orders and ECN Quotes*, Working Paper, Oct. 1997.

III. ***NODES WILL NOT PERMIT LIMIT ORDERS TO BE PLACED IN FINE PRICE INCREMENTS***

Currently, Nasdaq's SelectNet system permits limit orders to be priced in fine increments, as do all ECNs. It is not uncommon for SelectNet users to see orders placed in thirty-seconds and sixty-fourths although these quotes are rounded away from the inside before being posted as Nasdaq quotes. NODES, on the other hand, only allow its users to enter their orders if they are priced in increments of sixteenths. This is a step backward from increased price competition.

IV. ***MARKET MAKER QUOTES NOT TREATED LIKE LIMIT ORDERS***

Note 44 of the proposal to create NODES provides that, if NODES executes an order that partially exhausts a market maker's quoted size, the system will not deliver another order to the market for five seconds.⁸³ The proposal provides no rationale for this rule. The five seconds delay allows the market maker to consider the "signal" inherent in the small order and to move his quote away or "hold the market" under the protection of an invisible shield. Consider a case in which a market maker is alone on the inside with a 1,000-share offer. Ten 100-share buy orders will take 50 seconds to execute. Indeed, the five-second shield invites abuse by a market maker because it provides an incentive to delay price adjustments. No such protection is accorded to limit orders. Fundamentally, a market maker quote should be treated exactly like a limit order. When it is visible it should be accessible, in full or in part, as the counterpart orders are coming to the system.

⁸² See V. Dubinin and D.K. Whitcomb, *Daytraders and the Nasdaq Spread*, Automated Trading Desk, Inc., Working Paper, July 1997.

⁸³ Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998); see Thomas S. Mulligan, *For Nasdaq, Stakes Are High as It Plans on Further*, L.A. TIMES, Apr. 28, 1998, at D4.

V. ***THE NODES SYSTEM DOES NOT ALLOW LIMIT ORDERS TO BE CANCELLED FOR 10 SECONDS***

During the first ten seconds after a limit order entry, NODES will not permit the order to be cancelled.⁸⁴ No such "hold" is put on market makers' quotes.⁸⁵ If this is implemented two things will happen. Fewer limit orders will be placed on NODES⁸⁶ and the NODES spreads will be wider.⁸⁷ The NODES limit order facility will simply function as a place where market makers can dump unwanted retail customer limit orders and then mistreat them at will. They will be able to "hit" them when the market is moving against them, but ignore them otherwise.

I hope these five problems will be corrected in the near future. Thank you.

EDWARD FLEISCHMAN:⁸⁸

The Annual Seminar of the Compliance and Legal Division of the Securities Industry Association convened in Scottsdale, Arizona, over the last three days. The first part of the seminar involved 1,200 securities firm compliance officers in large and small groups, discussing current compliance problems in the financial service industry. The second part entailed general sessions addressed by senior staff personnel from the SEC, the NASD, and the NYSE.

⁸⁴ Integrated Order Delivery and Execution System, 63 Fed. Reg. 15,471, 15,472 (1998); see Mulligan, *supra* note 83.

⁸⁵ See Mulligan, *supra* note 83; see also John A. Byrne, *How the NASD's NODES Campaign Backfired Badly: What the World is Really Saying About the Trading System*, TRADERS MAG., June 1, 1998, at 1 (quoting a customers' broker as stating that with NODES, retail orders will be competing with brokers, market makers, and institutional traders as well as other public customers).

⁸⁶ See Byrne, *supra* note 85 (setting forth a variety of customer and broker concerns including not being able to cancel an order for ten seconds, the anonymity of the contra party, and the ability of market makers to avoid filling orders at will that might cause individuals to avoid trading on NODES).

⁸⁷ See *id.* (quoting a customer as saying that her broker told her NODES may impede rather than facilitate price determination).

⁸⁸ Senior Consultant, Linklaters & Paines. He has served as Commissioner of the SEC and as a past President of the American College of Investment Counsel. He also is currently a member of the American Law Institute and an Adjunct Professor in Securities Regulation at New York University School of Law. Mr. Fleischman also chairs the Business Law Section's Committee on Counsel Responsibility of the American Bar Association.

My presentation this morning carries the title “Through the Looking Glass,”⁸⁹ which describes what I construe to be regulators' unrealistic attitudes toward a variety of problems that this industry faces and is struggling to solve. My presentation will include the regulators' expressed views on insider trading, best execution and enforcement parameters.

A month and a half ago, at the Practicing Law Institute's “SEC Speaks” Conference, Chairman Levitt gave an impassioned “let's stamp out insider trading” speech.⁹⁰ His presentation was well received until he extended his thesis to encompass one of the most widely used methods for disseminating industry opinions on developing information to the marketplace.

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The classic pattern of dissemination is not, as Chairman Levitt seemed to assume, the announcement of a new product breakthrough, or a sizeable and unexpected earnings shortfall, or another event that would substantially move the market for a company's stock. Rather, the classic pattern is an explanation of developments, or the company's “spin” on them (if you like), where the developments themselves are not likely to be material but may border on material “inside” (in the sense of not previously communicated) information.

It was once standard practice for chief executive officers or chief financial officers of major companies to appear annually before the New York Society of Securities Analysts (“NYSSA”). The essence of the NYSSA speech would be captured in a press statement to be released when the speech began. Nevertheless if anything truly meaningful came out of the subsequent open question-and-answer session, it was heard by all the interested analysts, who act

⁸⁹ Lewis Carroll, *THROUGH THE LOOKING-GLASS: AND WHAT ALICE FOUND THERE* (1872).

⁹⁰ See Arthur Levitt, *A Question of Integrity: Promoting Investor Confidence by Fighting Insider Trading*, Remarks at the “SEC Speaks” Conference (Feb. 27, 1998) (transcript available at <<http://edgar.sec.gov/news/speeches/spch202.txt>>).

⁹¹ See *id.*

as proxies for the investing public as a whole. Today, however, analysts rarely take the time to go to lunch as a group. Nonetheless, if they did, their cell phones would allow virtually simultaneous transmittal of the resulting buy, sell or hold recommendations back to their respective research departments. Moreover, today's call-in phone numbers allow analysts who care, or about whom the issuer cares, to participate in that question-and-answer session from their own desks.

Chairman Levitt did not speak about the law on this issue. He said, as I remember, that legality was not the issue. He reasoned that the conveyance of information to analysts, and their actions based on that information are "ethically wrong" without general public dissemination.

The SEC staff needs no special incentive to pursue what the Chairman condemns in enforcement proceedings.⁹² Meanwhile, the SEC staff bobs, weaves and dodges and fails to give straight answers to honestly meant questions, such as: "What do we do about information that has not previously been disclosed when it blurts over the conference phone and we recognize its importance?"

The Supreme Court some eighteen years ago, held that the recognition of the materiality of information is the core of what analysts are supposed to do.⁹³ But the judges do not play a role in the regulatory examination and enforcement process. Practitioners do deserve some straight answers even if the answer is wrong.

Ask the SEC's General Counsel, as he was asked yesterday, whether the analyst can call the firm's clients or can send a revised analysis by e-mail. He will direct you to a series of facts, circumstances and cases where the analyst used the information for personal trades. Or he will

⁹² See *Compliance Clarified; Insider Trading*, COMPLIANCE REP., Apr. 27, 1998, at 10 (stating that regulators, following SEC Chairman Levitt's lead, are focusing on the role of securities analysts in insider trading based on non-public information).

direct you to a case where a trader ease-dropped on a phone call and walked out deliberately in order to beat the rest of his firm to the trading punch.

Ask the SEC's General Counsel, as he was asked yesterday, whether the firm's traders can go on making their market or performing their normal proprietary trading functions. He will answer with a series of warnings about fiduciary obligations and about the Commission's views on possession versus use of nonpublic information.

We deserve better than the "I won't say you can't, but you do so at your peril." "Gotcha" is not a game that contributes to transparency, efficiency or price discovery in the securities markets.

Best execution, to which Dr. Lindsey referred earlier, is a wonderfully elastic phrase with roots in agency law that antedate the SEC.⁹⁴ For decades, the regulators, and the self-regulators taking their cue, have pushed brokerage firms toward increasing efforts to achieve best execution for their customers.

Arguments over the effect of commissions per share and market impact on best-execution obligations took on fresh life with passage of the 1975 Securities Amendments Act.⁹⁵ Shortly after amending the Act the weekly news magazines carried stories of penny-per-share execution on the New York Stock Exchange and published studies of trade-by-trade market impact in the listed markets.

Regulatory and industry interest did not turn away from best execution after 1985, however, maturation and expansion of NASDAQ and the spread of order flow payment practices temporarily diverted industry and regulatory attention to subordinate issues. With the "Market

⁹³ See *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983).

2000” study,⁹⁶ and of course with the NASD investigation and the eventual Section 21(a) Report, best execution obligations are now in focus. The trend culminated in a multi-page disquisition bearing the title, “Best Execution Obligations” in the SEC’s Order Display Rules Adopting Release, released almost two years ago.⁹⁷

Having decided not to proceed with a safe harbor for market makers and listed market specialists, the SEC sought to draw some clear distinctions between execution price guarantees and execution price improvement opportunities. With respect to the latter, the latter the SEC focused on careful and periodic reevaluation of market execution quality differences, as well as the new limit order display rule’s impact on dealer and market maker obligations.

This makes it increasingly surprising to hear senior SEC staff members bob, weave and dodge any straight answers to honestly meant questions in this area. For instance, how do we handle matchable orders coming into the trading desk on both sides of the market between the prevailing best bid and offer? Ask the Division’s Deputy Director, as he was asked yesterday, whether the firm is required to cross those orders in-house. He will answer with a historical review culminating in a reference to the principles enunciated in the Limit Order Display Rule Adopting Release. Repeat the question, as it was repeated yesterday, explaining that the trading desk will not be satisfied with a reference to the principles enunciated in the Limit Order Display Rule Release.⁹⁸ The answer will be humorous, with explanation of the relevant dealer examination modules, but of no more useful guidance.

⁹⁴ See NASD Manual, *supra* note 71; see also *In the Matter of the Application of E.F. Hutton & Company Inc.*, 49 S.E.C. 829, 836-9 (1988) (Ruder Consenting)

⁹⁵ See generally Securities Amendments Act Pub.L. No. 94-29, 87 Stat. 97 (1975).

⁹⁶ See *Market 2000: An Examination of Current Equity Market Developments*, SEC Division of Market Regulation (Jan. 1994).

⁹⁷ See *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market Makers*, Exchange Act Release No. 34-37542, (Aug. 8, 1996).

⁹⁸ Order Execution Obligations, 62 Fed. Reg. 40,732 (1997).

Practitioners deserve some straight answers, even if the answers are frightening, counterproductive or wrong. We deserve better than the “apply the principles” response that regulators give the industry in matters that may have the most direct consequence to every customer in the marketplace.

Programmatic enforcement, by which I mean the implementation of the enforcement programs budgeted (if I may use that word) by the several financial regulators and self-regulators, is not something to be hidden by the regulators from the industry. The more members of the regulated community understand the grids of enforcement emphasis, exercise of prosecutorial discretion, and administration of sanctions, the more likely the accomplishment of the regulatory objectives presumably become.

It is even more surprising, therefore, when the heads of enforcement of the SEC, the NYSE, and the NASD deny the very existence of those grids. Ask those chiefs of enforcement, as they were asked yesterday, “What goals, what emphases, what minimums have been set by their respective crowned heads?” and the answer will be pleasant and demonstrative of outreach but of no value whatsoever. Furthermore, the answer will be coupled with an incredible denial that minimums for sanctions or withdrawals of staff discretion have been determined as regulatory institutional policy. Again, practitioners deserve some honest answers, however disheartening and counterproductive they may be.

I am reminded of “Through the Looking Glass” because no matter what policies are adopted to address emerging economic realities in this new internet dominated age, it is the interaction between the regulatory bodies and the financial services industry that spells success or failure. This is true whatever market regulation policies are adopted, and whatever rules and regulations are imposed to effectuate those policies.

The industry needs to be heard, guided and regulated. The regulators need to understand

that they are always playing catch-up with the markets and as a matter of fact, they are usually playing catch-up with the industry. If the regulators don't talk to us, don't treat us as intelligent market participants devoted to the same ultimate goals they espouse in terms of market transparency, efficiency, price discovery, then it truly will become a "looking-glass" world for all of us.