

MPRA

Munich Personal RePEc Archive

SuperMontage in the American Securities Markets Context

Myriam Senn

University of Pennsylvania

August 2002

Online at <http://mpa.ub.uni-muenchen.de/9818/>

MPRA Paper No. 9818, posted 5. August 2008 00:39 UTC

Article

SUPERMONTAGE IN THE AMERICAN SECURITIES MARKETS CONTEXT

Myriam Senn.

Copyright (c) 2002 Sweet and Maxwell Limited and Contributors

Subject: BANKING AND FINANCE

Keywords: NASDAQ; Securities markets; United States

Abstract: Scope of SuperMontage changes to NASDAQ including order collection, display of quotas and orders and execution services, electronic communication networks and issues raised including market structure, fragmentation and competition.

Abstract

The approval of NASDAQ's SuperMontage was described by the Chairman of the SEC Arthur Levitt in the following manner: "In my tenure, there has been no more time-consuming, controversial or divisive proposed rule-change than the SuperMontage". Due to its form and the functionalities it offers, SuperMontage raises issues in relation to market structure, fragmentation and competition. This article describes SuperMontage in the context of the U.S. securities markets and the potential of SuperMontage on those markets, in particular in the context of electronic communications networks.

***200** I. Introduction

The approval of NASDAQ's SuperMontage by the Securities and Exchange Commission (SEC) in January 2001 [FN1] was very controversial. The new system raises various issues, in particular in relation to the organisation of the securities markets. As SuperMontage has just become fully operational, [FN2] its practical consequences still are unknown.

This article provides a brief description of the Nasdaq system and of SuperMontage within the framework of the American securities markets. It deals only with aspects of the markets which are relevant to SuperMontage: the definition of an exchange, the auction and dealer markets, the over-the-counter market and Nasdaq. There is then a brief analysis and evaluation of the SuperMontage system and of its potential future effects on market structure and, in particular, an Electronic Communications Network (ECN). Finally, the article expresses the view that SuperMontage will have positive effects on the markets. As to the role of supervisory authorities, it stresses that they should not directly intervene in order to influence the structure of the market, when evaluating authorisation requests.

II. Description

1. Definition of Exchange

The Securities Exchange Act of 1934 (SEA) defines the term "exchange" in section 3(a)(1). [FN3] The definition has been modernised and adapted following the introduction of the rules for Alternative Trading Systems (ATS) in 1998. [FN4] In particular, it has been expanded in order to cover new requirements resulting from the electronisation of the securities markets.

The new Rule 3b-16(a) [FN5] interprets key language in the statutory definition of exchange. Two main features characterise an exchange, which as an organisation, association or group of persons:

- brings together the orders of multiple buyers and sellers,
- uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.

Rule 3b-16 has a dual function: it not only clarifies the applicability of the definition of "exchange" to ATS, but it also defines and gives the SEC general authority to exempt systems from being considered an exchange. [FN6]

These possible interpretations take market developments properly into account. In particular, due to the technological developments, it has become more and more difficult to seize and submit new systems to the supervisory regime applicable to exchanges or broker-dealers. With regard to ATS, which functionally can--depending on the system--be considered to be the equivalent of exchanges and which have the possibility of choosing between a body treated as exchanges or broker-dealers, a more flexible definition of "exchange" was necessary. [FN7]

***201** A system or entity which only executes some of the functions of an exchange will not be considered an exchange. For example, it can be a system that is limited to the routing of orders to a market, their execution, or it may offer the matching of orders. Furthermore, systems performing typical broker-dealer activities are explicitly excluded from the definition of exchange. [FN8]

As to the structure of the U.S. exchange market, [FN9] only a few exchanges have been authorised as National Securities Exchanges [FN10] until today. The authorised exchanges are all auction markets. [FN11] One very important stock exchange is the New York Stock Exchange (NYSE), which can be considered to be the main exchange. [FN12] The Amex exchange on the other hand represents the "minor league". [FN13] Seven other exchanges have been authorised. Five of them are known as the "regional exchanges". [FN14] When dealing with exchanges and markets participants, the SEC pursues the concept of the National Market System (NMS) [FN15] for securities. [FN16] Its efforts to facilitate the creation of this market system focus on the reporting systems and the organisation of the authorised exchanges, which are to be similar.

2. Auction/dealer markets

The market systems which can qualify as exchange markets are numerous. [FN17] However, the categories mainly follow two types of markets: the agency or auction and the dealer market.

An auction market is a market (such as the NYSE for example [FN18]) in which securities are bought and sold by competitive bidding through brokers. [FN19] An auction market has only one person for each stock, a specialist, [FN20] who in a centralised location or "floor" matches incoming orders to buy and sell each stock. These specialists are limited only to one firm's available capital. They offer no research or retail sales support. Furthermore, a fee is charged for bringing buyers and sellers together.

A dealer market is characterised by many dealers or market-makers [FN21] who use their own capital, research, retail or system resources to represent a stock. A market-maker is a firm or principal that maintains a firm bid and offer price in a given security by standing ready to buy or sell at publicly-quoted prices and who executes an order. [FN22] The market-makers are compensated by the profits on the trades made. However, because many market-makers can represent the same stock they can compete fiercely amongst each other to buy and sell that stock.

A dealer market is physically fragmented across the various competitive market-maker firms. [FN23] The dealers set the prices and thus provide for the necessary liquidity for the market. Due to the competition among the market-makers, the bid and ask spreads are tight, but the transactions costs may be higher. [FN24] Furthermore, it may be more difficult to find out which prices are offered by other competitors.

The economic theory attempts to assess how the type of market influences their performance. Different comparative analyses of the types of markets already exist. [FN25]

Contrary to other authorised exchanges in the United States, Nasdaq is a dealer market and not an auction market. Nasdaq is a decentralised network of competitive market-makers who process orders for their own customers and for other NASD brokers or dealers. [FN26]

*202 3. Over-the-counter market

Basically, the over-the-counter market (OTC) relates to all stocks not traded on a stock exchange. [FN27] The over-the-counter market can include different types of securities. [FN28] The main distinction between an OTC market and a stock exchange is that trading on the OTC market is not centralised and the dealers are normally market-makers in a specific security. [FN29]

An important feature of the OTC market is that it is a dealer market. Due to the structure of the market, it is not necessary to purchase a seat on an exchange. [FN30] Nowadays, the OTC market is an electronically linked market that comprises thousands of geographically dispersed competitive dealer and member firms linked together by telephones and computer screens. [FN31] Like the NYSE, the OTC market is more adequate to handle small orders than large ones. However, the negotiation of large block trades is possible on both markets. [FN32]

The OTC market, OTC market-makers and member securities firms are regulated by the NASD, [FN33] which also is responsible for NASDAQ. As a self-regulatory organisation, the NASD relies more on market and competitive forces than on regulation and the rules it applies are not complicated.

4. Nasdaq

The Nasdaq Stock Market Inc. (Nasdaq [FN34]) was first created 30 years ago for the purpose of collecting and displaying quotations posted by individual dealers in the over-the-counter market regulated by the NASD. [FN35]

Technically, Nasdaq was first thought to be an automated extension of the OTC market. Dealers could disseminate bid and offer quotes for securities, but they were free to execute the orders. All the transactions were agreed upon over the telephone. [FN36]

Basically, Nasdaq is a decentralised competing dealer market. The dealers or market-makers [FN37] use their own capital, research and retail system resources to represent a stock. The competitive situation is due to the fact that many market-makers can represent the same stock.

Since 1984, with the introduction of the Small Order Execution System (SOES), it is possible to execute small orders automatically against the quotation of a market-maker [FN38] at the best bid or offer. Thus, with SOES, the volume has increased as well as the efficiency in trading. In 1990, the SelectNet, an online screen negotiation and execution

service was launched. It enhances opportunities for finding and executing transactions at the best prices at greater volume than allowed by SOES. [FN39]

Ten years later, Nasdaq surpassed the New York Stock Exchange in annual share volume and, in 1999, became the largest stock market in the United States. Nasdaq also began to implement a global strategy and to restructure its organisation into a shareholder-owned, for-profit company. [FN40] The Nasdaq quotation management system now collects and displays quotations of registered market-makers and ECNs [FN41] that are members of the NASD. [FN42] They constitute its participants. [FN43] Nasdaq also collects and displays quotations in Nasdaq securities from Unlisted Trading Privileges (UTP) exchanges by agreement. [FN44] Nasdaq's market participants and UTP exchanges can enter quotations which are displayed on a quotation montage. This montage can be viewed and disseminated to other market participants. [FN45]

***203** Legally, Nasdaq is overseen by a registered securities association, the NASD, and is still not registered as an exchange. [FN46] Nasdaq was first a wholly-owned subsidiary of NASD, which acts as a self-regulatory organisation according to section 19(a)(1) of the Securities Exchange Act of 1934. However, the role of the NASD as owner of Nasdaq was not without its problems. On the one hand, it controlled Nasdaq, which in the course of time has become a dominant securities market. On the other hand, it acts as a regulatory authority with regard to the ECNs that as a matter of fact compete with Nasdaq itself. Thus, this market structure of Nasdaq presented a dilemma and conflict of interest were unavoidable for the NASD. [FN47]

5. SuperMontage

On January 10, 2001, the SEC approved the SuperMontage proposal, [FN48] which will radically modify the working of the Nasdaq. It has been operational since October 2002. [FN49]

In order to better understand what SuperMontage is, it is first worth to look at the meaning of the word and its composition, particularly the use of "montage". According to the Webster's International Dictionary, montage means:

-- "The act of photographic process of combining several distinct pictures so that they often blend with or into each other to produce a composite picture which may or may not appear to be made up of separate pictures.

-- An artistic composition made by combining heterogeneous elements." [FN50]

As a matter of fact and according to the definition of montage, the SuperMontage is composed of different elements, [FN51] each fulfilling other functions within the Nasdaq's system. The addition of the prefix "super" most probably indicates that the system will offer a new way of trading and will radically modify the existing system. [FN52]

The goal of SuperMontage is to modernise the existing trading configuration in order to improve the competitiveness of Nasdaq both nationally and internationally. The current trading platforms and quotation montage of Nasdaq will be completed by a new facility for collecting the quotes and orders, the Order Collecting Facility. Furthermore, the Nasdaq NMS, the primary Nasdaq trading platform, will be modified. Contrary to the existing Nasdaq systems, SuperMontage will offer the possibility of trading all Nasdaq securities on it. [FN53]

Basically, SuperMontage will alter the existing Nasdaq's system and its working functions in three principal areas: quote/order collection, quote/order display and execution services. [FN54]

a. Quote/Order Collection

The Order Collection Facility (OCF) will partially eliminate the distinction between quotes and orders. It will allow participants to enter either a single quotation or multiple quotes or orders at the same or at different price levels. In this case, the best priced

attributable quotes or orders on the bid and ask sides will be aggregated and a participant's displayed quote created. [FN55] The participants will also have the possibility of sending Nasdaq only their best quotes or "top of the book". Furthermore, anonymous (i.e., non-attributable) quotes or orders may also be entered into the system, but a two-sided attributable quote or order must be entered. [FN56] The elements of each quote (identity, price, time of entry) will be maintained. The orders may be directed or non-directed into the system to access quotes or orders through the Order Collection Facility. [FN57] A participant may also choose to maintain only his required quotation and not enter additional quotes or orders.

b. Display of Quotes/Orders

Basically, SuperMontage will give more information regarding the quotes and orders than the current quotation montage. The additional information will be displayed in two ways. [FN58] On the one hand, it will be possible to aggregate the best priced non-attributable orders or quotes from all participants and to display them in the quotation montage as one buy and one sell price together with the best-priced attributable orders or quotes of each Nasdaq Quoting Market Participant and UTP Exchange. On the other hand, the new system will aggregate all quotes or orders whether *204 they are attributable or not at each price level. Furthermore, the three best prices with associated aggregate size on each side of the market will be displayed through the Nasdaq Order Display Facility. The market data vendors will receive this information and will be able to provide an equivalent display service to their customers. [FN59]

Nasdaq will also give these vendors individual attributable quotes or orders displayed in the three best price levels in the Nasdaq Order Display Facility. [FN60] The result of the display improvements will be that the investors and other market participants will be able to see the aggregate of the interests at three price levels, which are easily provided and that the Nasdaq participants will be able voluntarily to enter their "near the market" quotes or orders. [FN61]

These changes will enhance the market transparency of trading interests, because more quotes and orders will be displayed than in other systems. [FN62] This will put the market participants in a far better position in order to decide which securities to buy or to sell. Thus, the already open market structure of Nasdaq will be largely reinforced through SuperMontage.

c. Execution Services

With SuperMontage the SOES and SelectNet services will disappear. The access will be replaced with two new processes: a directed order process and a non-directed order process. The participants are however also free to use other accessing methods like the telephone, direct connections to market-makers or even own execution services provided that they ensure an access. [FN63]

The directed order process will be functionally similar to the current SelectNet service. This means that the participants will have the possibility to direct an order to a determined Nasdaq Quoting Market Participant or UTP Exchange. The directed order may match a quote or order of the recipient or not. In order to avoid double liability, a Nasdaq Quoting Market Participant or UTP Exchange can elect to receive directed Liability Orders through the OCF. [FN64]

The non-directed order process will represent the default execution process for marketable orders. These orders will be matched with the highest ranked quotes or orders of Nasdaq Quoting Market Participants and UTP Exchanges and will be executed automatically or delivered to the matched Nasdaq Quoting Participants and UTP Exchanges, whereby the way these participants take part in the non-directed order process will be determining. [FN65]

In the non-directed order process, the ranking of Nasdaq Quoting Market participants and UTP Exchange quotes or orders is fixed by one of three order execution algorithms. A

non-directed order entered by a Nasdaq participant will be matched first against its own quote or order on the other side of the market, provided that its quote or order is at the best bid or offer. The orders may also be addressed to the "preference" of a determined Nasdaq Quoting Market Participant or UTP Exchange. [FN66] On the whole, the execution services will be more flexible and will offer more possibilities to the market participants.

6. ECNs [FN67]

Electronic Communications Networks (ECNs) belong to the category of Alternative Trading Systems. [FN68] There exist a variety of such systems and their markets normally are private. [FN69] ECNs may offer a whole range of services, which are typically based on technological developments. Depending on the system, they also can furnish services, which normally are or should be provided by registered exchanges. [FN70] In comparison to exchanges, the main advantage of ECNs is that the services they offer may be cheaper than the ones of an exchange and the execution can be more efficient. This may be due to their concentration on only specific functions of exchanges.

Through ECNs, investors can normally enter orders anonymously into the marketplace. ECNs also can provide facilities, which can be used by investors to trade directly with each other, and they can offer matching facilities too. Following the *205 introduction of a new Regulation for Alternative Trading Systems in 1998, [FN71] these systems now have to be recognised by the SEC and can choose to register either as broker-dealers or as exchanges. [FN72]

ECNs normally are linked to exchange systems. In particular, the Nasdaq network offers the possibility of connecting ECNs into its market. The participation or membership of ECNs to Nasdaq is governed by rule and private contract. [FN73]

Before the introduction of SuperMontage, ECNs have handled more than 20 per cent of the orders in securities listed on Nasdaq. [FN74] ECNs like Instinet [FN75] for example, can accept limit orders for Nasdaq issues and offer the possibility of making trades in Nasdaq. So public orders can compete with the dealer's bids and offers. [FN76]

ECNs that are NASD members will also be able to participate in SuperMontage. They will have full access to the system for order entry and delivery as well as other functions at their disposal. They will also have the possibility to participate in the functions of order delivery or automatic execution. [FN77]

III. Analysis

The authorisation of SuperMontage through the SEC was granted under section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4. [FN78] From a legal point of view, this authorisation was not problematic. The system belonged to a self-regulatory organisation (NASD) and was submitted to the SEC as a change of rules within the NASD. [FN79] Due to the complexity and role of Nasdaq within the U.S.-securities market and its competitive position with regard to other exchanges, the main question may be, rather, whether Nasdaq should be considered an exchange. An authorisation request for recognition as an exchange has been submitted in the meantime. [FN80]

Thus, the main issues raised by SuperMontage do not relate to the internal aspects of the system. They principally relate to the external consequences of the system on the market and are economic ones. In this context, three areas can be identified: market structure, market fragmentation and competition between Nasdaq and ECNs.

1. Market structure

With regard to market structure, [FN81] SuperMontage may first exercise an influence as to the role of *206 self-regulatory organisations, particularly the NASD. SuperMontage will directly compete with the ECNs. Some of the functions it will offer will be the same as the ones offered by ECNs. Thus, some market participants will prefer to be members of

SuperMontage only in order to make use of all the advantages of this new system. Most probably, some ECNs will become obsolete and disappear.

In this context, it has to be taken into account that the NASD not only owns and supervises Nasdaq--of which SuperMontage is a part--but it also supervises the ECNs, which are registered and regulated by it. With the introduction of Nasdaq's SuperMontage, the NASD will inevitably be confronted with a conflict of interest. It would then own and regulate SuperMontage whilst supervising the ECNs, which will compete amongst each other. [FN82] This situation presents the risk to NASD of losing its credibility and authority with regard to a lot of the institutes it supervises. [FN83]

A solution for the ECNs would be for themselves to register as national securities associations under section 15A of the Securities Exchange Act of 1934. This however necessitates a certain degree of organisation and creates new duties, so that not all ECNs would be willing and administratively able to choose this route.

The other way to solve this problem is that already chosen by the NASD, which is to spin-off Nasdaq [FN84] and have it organised as a profit-making corporation. [FN85] However, Nasdaq was exempted from the definition of "exchange" under Rule 3a1-1 because the NASD operated it. [FN86] So, before the NASD may relinquish control, Nasdaq will have to be registered as a national securities exchange, because no exemption will apply any more. Practically, this will be realised in the following manner: The NASD ownership is in the process of being changed. NASD now will divest itself of all its shares of Nasdaq, [FN87] which should become an independent, investor-owned stock market. Two private placement sales of shares and warrants [FN88] will shift the voting rights for NASD shares underlying warrants to the warrant holders once Nasdaq has been registered as an exchange. [FN89] In the meantime, a trustee will vote the NASD shares in Nasdaq at the direction of the NASD. [FN90]

Thus, the main benefits of the registration of Nasdaq as a national securities exchange will be that the structure of the market will be improved because Nasdaq will be an independent entity. It will be able to concentrate only on trading and will not have to rely on the NASD any more, which basically pursues different goals. Nasdaq will also avoid potential conflicts with ECNs resulting from the fact that they are supervised by the NASD. As a profit-maximising company, Nasdaq will be more adequately able to compete nationally and internationally with other exchanges and dispose of a modern structure. The NASD will then be able to concentrate only on the supervision of one category of entity, broker-dealers.

2. Market fragmentation

Another issue raised by SuperMontage is the possible effect of the system on market fragmentation. [FN91] The impact of the increasing number of *207 ECNs has mainly been that multiple market centres have been created. These centres can execute orders, but the risk exists that they reduce quote competition and liquidity and therefore prevent investors from receiving best execution. [FN92] The centres may be too isolated and the disclosure requirements may not be sufficient.

Basically, in the context of a national market system, the orders should interact with each other and the prices should be the result of fierce competition. In particular, the secondary markets should ensure that the investors get fair deals and the markets work efficiently. [FN93] In the case of multiple market centres, fragmentation may lead to price distortion and the inefficient execution of orders, in other words to an imperfect market. Furthermore, it will become more difficult for brokers to fulfill their duty of best execution. [FN94]

With view to this situation, the SEC now proposes to enhance market disclosure with regard to price transparency. It proposes to create a Consolidated Limit Order Book, which would establish price/time priority for all displayed orders in all markets. [FN95]

The introduction of SuperMontage will most probably represent a concentration of trading activities, because the system will offer some of the functions which were first offered by the ECNs. Some ECNs will probably disappear because SuperMontage will be

able to provide services more efficiently and they will also be cheaper. It is also expected that SuperMontage will offer a fairer market. It will provide for more liquidity and transparency and will enhance the ability to obtain the best execution. [FN96]

3. Competition: Nasdaq versus ECNs

As already stated, the introduction of SuperMontage means that a centralisation within the Nasdaq market will take place. As the market is expected to be more efficient and transparent, it should have a positive effect on the execution of orders and thus will improve the position of investors.

With regard to the competition among markets, there is however a risk that SuperMontage may have a negative impact. [FN97] An integration of the market will occur and SuperMontage will implement a rather monopolistic, centralised execution system. However, this should be considered within the historical context of the competitive situation existing between Nasdaq and the ECNs. For several years ECNs have continuously developed and thus attracted more and more Nasdaq orders. They offered technologically better solutions and could also provide for the matching of orders. [FN98] Thus, the introduction of SuperMontage is to be understood in the sense that Nasdaq now catches up with its own technological solutions. Order flow may even be forced into the SuperMontage. [FN99]

This new situation will increase competition among the market systems and force the ECNs to innovate and offer new services. However, it can also be considered to be anti-competitive, because SuperMontage will be able to cover all the functions of a securities market and will neutralise many if not all of the advantages of ECNs. [FN1] In a certain way, the system will be quasi self-sufficient and ECNs will lose market share. In order to survive, ECNs will have either to create products or build up own competitive markets.

When evaluating SuperMontage from a competition perspective, the SEC found that the system was consistent with the goal of enhancing competition and allowing economic forces to interact. According to the Commission, the system is reasonably designed to promote price discovery, best execution, liquidity and market innovation, while continuing to preserve competition among market centres. [FN2]

*208 IV. Evaluation

1. Market evolution

The introduction of SuperMontage will represent a basic change within the market structure. First, it will enhance the competitive position of the exchanges and reinforce their role within the market. As its introduction will probably threaten at least some of the existing ECNs, it will probably motivate these systems to offer services most certainly based on the development of new technological resources. Thus, a new competitive era is going to commence. On the whole, as to the national securities markets, the main question may be whether SuperMontage will contribute to the realisation of a National Market System or not.

With regard to international competition among securities markets, this development is very positive for the American markets. A lot of financial centres worldwide are still at least one step back. They are now discussing and evaluating proposals in order to regulate ATSSs, i.e. ECNs. [FN3] With the approval of the new rules regarding alternative systems in 1998 [FN4] and now of SuperMontage, the American securities markets have already reached a position where they can develop new and more efficient trading methods than the one offered by ATSSs.

2. Critique

The role of the supervisory authority was determining and central, because it was responsible for the approval of SuperMontage. In this case, the SEC did not simply

approve the system, but it first studied the whole market situation according to its duty to create and maintain a National Market System for Securities [FN5] and invited the market participants to take a position.

Although the SEC could not have refused the approval of SuperMontage based on legal grounds only, [FN6] it may have handled the case in a broad way with regard to a possible influence on the market structure. The role of the SEC regarding market structure [FN7] should be interpreted restrictively. As some fear, SuperMontage will almost certainly have important consequences, particularly for ECNs, and may even threaten their existence. However, this is not a strictly legal question, but the question of how far supervisory authorities should intervene in guiding or shaping the development of market structure. Supervisory authorities should not, as far as possible, intervene in order to shape the market and influence future developments through their authorisation practices. Market forces should operate without intervention from supervisory authorities.

V. Conclusion

The issues raised by SuperMontage tend to show that the securities markets work like a puzzle. The introduction of new systems like the SuperMontage may first put existing markets or their market structure out of balance.

The SEC was right to approve the SuperMontage proposal. The controversy created by SuperMontage relates to the external consequences of the system. The SEC did not have to interfere with regard to its economic consequences however.

With the introduction of SuperMontage, competition within the securities markets will be enhanced and market participants will decide which markets and in which form will survive, and which ones will disappear or have to develop and offer other, more sophisticated functions or services in order to continue. SuperMontage should be considered to represent an adaptation of the existing Nasdaq system to technological and electronic developments. It may also be considered a positive development for the future of exchange trading, as it introduces a new area.

FN I thank Professor William C. Tyson, Wharton School, University of Pennsylvania, for his useful comments.

FN1. SEC-Release No. 34-43863; File No. SR-NASD-99-53 (January 19, 2001) NASD Rulemaking: SuperMontage.

FN2. Nasdaq began the implementation of its next-generation trading system on July 29 with 32 test securities. See SuperMontage: The Next Generation in Nasdaq Trading, http://www.nasdaq.com/reference/sm_fact_sheet.pdf; SuperMontage, the Next Generation Market Platform from Nasdaq, <http://www.nasdaqnews.com/about/supermontage/SuperMontage.html>. It was set in operation on October 14, 2002. See "NASDAQ Marks Another Milestone As SuperMontage Trading Platform Goes Live Today", <http://www.nasdaqnews.com>.

FN3. An "exchange" means "... any organisation, 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".

FN4. See SEC-Release No. 34-40760; File No. S7-12-98 (December 8, 1998) Regulation of Exchanges and Alternative Trading Systems, 17 CFR Pts 202, 240, 242 and 249, Effective Date: April 21, 1999.

FN5. Rules and Regulations under the Securities Exchange Act of 1934, 17 CFR 240.

FN6. See Louis Loss and Joel Seligman, Fundamentals of Securities Regulation (4th ed.,

2001), pp. 719-720.

FN7. See SEC-Release No. 34-40760, *supra*, n. 4, at II. Executive Summary of Final Rules, A New Interpretation of "Exchange".

FN8. See Rule 3b-16(b) Rules and Regulations under the Securities Exchange Act of 1934, 17 CFR 240, which now expressly excludes systems performing the enumerated functionalities from the definition as "exchange".

FN9. To the over-the-counter market see point 3; to the ECNs see point 6 hereinafter. Other markets like the options markets or stock index futures markets, for example, are not discussed here, because they are not directly relevant to this topic.

FN10. According to Securities Exchange Act of 1934, s. 6. To the statute of Nasdaq see point 4.

FN11. However, Securities Exchange Act of 1934, s. 6 does not limit the authorisation as National Securities Exchanges to auction markets only. See point 2 hereinafter to the auction market.

FN12. See Loss and Seligman, *supra*, n. 6, p. 690.

FN13. Securities are first listed on the Amex and when the number of shareholders and shares as well as the size of the firm satisfies the NYSE's rules they will delist from Amex and list with the NYSE. See Loss and Seligman, p. 690.

FN14. Loss and Seligman, p. 690; however these authors count six exchanges as "regional exchanges". In the whole nine exchanges have been authorised. The Chicago Board Options Exchange (CBOE) is a national exchange; it describes itself as the second largest securities exchange in the United States and the world's largest options exchange. See <http://www.cboe.com/AboutCBOE/History.asp>. The International Securities Exchange is an entirely electronic options market, it has no trading floor. As an international exchange it is operating around the world. See <http://www.iseoptions.com/about/history.html>.

FN15. Securities Exchange Act of 1934, s. 11A.

FN16. See Ruben Lee, *What is an Exchange, The Automation, Management, and Regulation of Financial Markets* (1998), pp. 121-124; further, see point IV: Evaluation.

FN17. For an introduction see Robert A. Schwartz, *Reshaping The Equity Markets, A Guide For The 1990s* (1993); see also Lee, *supra*, n. 16, pp. 226-228.

FN18. See among others Mark Borrelli, *Market Making in the Electronic Age* Loy U. Chi. L.J., 822-824 (2001).

FN19. See Black's Law Dictionary (7th ed., 1999), p. 982.

FN20. See Richard W. Jennings et al., *Securities Regulation, Cases and Materials* (8th ed., 1998), pp. 661-664.

FN21. *ibid.*, p. 664.

FN22. *ibid.*, p. 664; see also <http://www.nasdaqnews.com/glossary/m.html>.

FN23. Schwartz, *supra*, n. 17, p. 48.

FN24. *ibid.*, p. 48.

FN25. See Lee, *supra*, n. 16, pp. 224-247. While proponents of the auction market model argue that it produces the best execution because orders interact with each other in a central location, proponents of the dealer system argue that dealers provide the much

needed liquidity for the market; see Borrelli, supra, n. 18, pp. 895-896.

FN26. See <http://www.nasdaqnews.com/glossary/d.html>.

FN27. Originally the term over-the-counter meant stocks which were bought and sold in banks and the physical certificates were passed "over-the-counter". According to Black's Law Dictionary, supra, n. 19, p. 1130 over-the-counter means not listed or traded on an organized securities exchange or traded between buyers and sellers who negotiate directly. See also Loss and Seligman, supra, n. 6, p. 700.

FN28. So for example corporate bonds and stocks, United States Treasury bonds and notes. See Loss and Seligman, *ibid.*, p. 700.

FN29. In the U.S., the OTC market normally is understood to include the Nasdaq, the Nasdaq National Market System (NMS) List and the Order Execution. See Loss and Seligman, supra, n. 6, pp. 701-709.

FN30. *ibid.* at p. 700; Schwartz, supra, n. 17, pp. 47-56.

FN31. Schwartz, supra, n. 17, pp. 47, 52-53.

FN32. *ibid.*, pp. 56, 98-105.

FN33. National Association of Securities Dealers. The creation of the NASD in 1939 was possible following the enactment of the Maloney Act Amendments to the 1934 Securities Exchange Act, which principal goal was the prevention of fraudulent practices in OTC trading. The NASD is a self-regulatory disciplinary authority. See Loss and Seligman, supra, n. 6, p. 700.

FN34. National Association of Securities Dealers Automated Quotation.

FN35. Loss and Seligman Fundamentals of Securities Regulation (2002 Supplement), p. 31.

FN36. Borrelli, supra, n. 18, p. 862.

FN37. See supra, point 2, see also <http://www.nasdaqnews.com/glossary/d.html>.

FN38. Nasdaq counts more than 500 market making firms or dealers; they distribute Nasdaq-listed securities, to which they commit their own capital. The market-makers constitute the core of Nasdaq. They add to the liquidity of the market by being willing to buy or sell stock based on their own funds and ensure that there are always buyers and sellers for Nasdaq-listed securities. See About Nasdaq, at http://www.Nasdaq.com/about/about_nasdaq.stm.

FN39. See The Evolution of Nasdaq, http://www.nasdaq.com/about/about_nasdaq_long.stm#evolution. However, a large majority of orders still are executed outside Nasdaq, through direct links among market-makers, ECNs, etc. See Loss and Seligman, supra, n. 35, p. 32.

FN40. See about Nasdaq, at http://www.nasdaq.com/about/about_nasdaq.stm and The Evolution of Nasdaq, at http://www.nasdaq.com/about/about_nasdaq_long.stm#evolution.

FN41. Electronic Communications Networks or Alternative Trading Systems; see point 6.

FN42. Loss and Seligman, supra, n. 35, p. 31.

FN43. *ibid.*, p. 31.

FN44. *ibid.*, p. 31.

FN45. *ibid.*, p. 31.

FN46. See Loss and Seligman, *supra*, n. 6, p. 718.

FN47. Nasdaq is now in the process of becoming an independent entity. See Loss and Seligman, *supra*, n. 35, p. 32; Borrelli, *supra*, n. 18, pp. 897-898; see also hereinafter III. Analysis, 1. Market structure.

FN48. Release No. 34-43863, *supra*, n. 1.

FN49. See *supra*, n. 2.

FN50. Webster's Third New International Dictionary (1993), p. 1465.

FN51. See a., b. and c. hereinafter.

FN52. See Borrelli, *supra*, n. 18, p. 869.

FN53. For example, SmallCap securities too will be traded on the new system. Thus, with SuperMontage the Small Order Execution System (SOES) will not be used anymore. See Borrelli, *supra*, n. 18, pp. 869-872.

FN54. Release No. 34-43863, *supra*, n. 1, at II. Executive Summary, B. Overview of the SuperMontage Proposal.

FN55. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 1. Quote/Order Collection.

FN56. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 1. Quote/Order Collection; see also Loss and Seligman, *supra*, n. 6, p. 33.

FN57. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 1. Quote/Order Collection.

FN58. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 2. Display of Quotes/Orders; see also Loss and Seligman, *supra*, n. 6, pp. 33- 34.

FN59. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 2. Display of Quotes/Orders; see also Loss and Seligman, *supra*, n. 6, pp. 33- 34.

FN60. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 2. Display of Quotes/Orders; see also Loss and Seligman, *supra*, n. 6, pp. 33- 34.

FN61. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 2. Display of Quotes/Orders; see also Loss and Seligman, *supra*, n. 6, p. 34.

FN62. See SuperMontage: The Next Generation in Nasdaq Trading, *supra*, n. 2.

FN63. See Release No. 34-43863, *supra*, n. 1, at II. Executive Summary, B. Overview of the SuperMontage Proposal, 3. Execution Services; see also Loss and Seligman, *supra*, n. 6, pp. 34-35.

FN64. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 3. Execution Services; see also Loss and Seligman, *supra*, n. 6, p. 34.

FN65. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 3. Execution Services; see also Loss and Seligman, *supra*, n. 6, p. 34.

FN66. *ibid.* at II. Executive Summary, B. Overview of the SuperMontage Proposal, 3. Execution Services; see also Loss and Seligman, *supra*, n. 6, p. 35.

FN67. The ECNs as Nasdaq's participants are mentioned separately here, because they play an important role with regard to the implementation of SuperMontage. Particularly, their future may depend on SuperMontage. *ibid.* at II. Executive Summary, C. Summary of Conclusions, 2. Inherent Conflicts of NASD Roles.

FN68. Release No. 34-40760, *supra*, n. 4. Rule 300(a), 17 CFR 242.300(a) defines the term Alternative Trading System.

FN69. See Jean-Baptiste Zufferey and Margaret Tschanz-Norton, *Regulation of Trading Systems on Financial Markets* (1997), pp. 225-237.

FN70. Release No. 34-40760, *supra*, n. 4, Introduction.

FN71. *ibid.* Before this new regulation was introduced, the SEC issued no-action letters for these systems. For an explanation of this practice see Lee, *supra*, n. 16, pp. 120-121. In the case of the Delta system, the no-action letter of the SEC was challenged, but the court affirmed the Commission order that the system was not an exchange. See *Board of Trade of City of Chicago v. SEC* 883 F.2d 525, 535 (7th Cir. 1989) and the remand 923 F.2d 1270 (7th Cir. 1991). To the question of regulation of Alternative Trading Systems see: Jonathan R. Macey and Maureen O'Hara, "Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective" (1999) 28 *J. Legal Stud.* 17.

FN72. Release No. 34-40760, *supra*, n. 4, II. Executive Summary of Final Rules, C. Regulation ATS and III. Rule 3b-16 under the Exchange Act.

In the case of a registration as broker-dealer, the ATS have to comply with additional requirements, whereby the kind of activity and trading volume are determining. The goal of the new Regulation ATS is to allow new markets to start without disproportionate administrative burdens in order to give them the possibility to survive during their introduction and also develop. See Loss and Seligman, *supra*, n. 6 at 719-720; Richard W. Jennings et al., *Securities Regulation, Cases and Materials*, 48 (Supplement 2001).

FN73. Release No. 34-43863, *supra*, n. 1, III. Description of the Proposal, H. ECN Participation.

FN74. In January 2000, for example, nine Alternative Trading Systems were collectively responsible for 26.2% of the total dollar volume of Nasdaq securities. See Gabriel Matus, "The Regulation of Alternative Trading Systems: Market Fragmentation and the New Market Structure" (2001) 44 *N.Y.L. Sch. L. Rev.* 600-601.

FN75. Instinet belongs to the Reuters Group PLC, which maintains an approximately 85% stake. It is an agency broker and therefore remains neutral, neither buying nor selling securities for its own account. Its core business is providing brokerage services for the benefit of its customers on the tenets of neutrality, anonymity, efficiency and transparency.

Instinet is able to reduce trading or transaction costs, and, in doing so, it potentially improves the investment performance.

Clients can enter orders on-screen and trade with fund managers, broker/dealers, market-makers, and exchange specialists around the world. Regardless of the size or location, each client has an equal opportunity to trade. See Lee, *supra*, n. 16, p. 121, regarding the former status of Instinet. Following the introduction of the new rules regarding ATS, Instinet has been authorised as a broker-dealer by the SEC.

FN76. See Schwartz, *supra*, n. 17, p. 48.

FN77. Release No. 34-43863, *supra*, n. 1, III. Description of the Proposal, H. ECN Participation.

FN78. Release No. 34-43863, *supra*, n. 1, I. Introduction.

FN79. It should be noted that the SEC could not decline an authorisation for competitive reasons or because a system represents a danger to other existing systems for example. When the legal requirements are fulfilled, the system has the right to be granted a license.

A self-regulatory organisation on the other hand could, in my opinion, decline the admission of new members for technical reasons for example like the impossibility to admit new members due to an over-capacity of its system. See in this context *Silver v. New York Stock Exchange* 83 S.Ct. 1246.

FN80. Nasdaq filed an application for registration with the Securities and Exchange Commission on November 9, 2000. See Loss and Seligman, *supra*, n. 35, p. 32.

FN81. s. 11A(a) of the Securities Exchange Act of 1934 sets forth findings and objectives that are to guide the SEC in its oversight of the national market system. In this context, the interests of the investors are determinant. See also Release No. 34-42450; File No. SR-NYSE-99-48--February 23, 2000, NYSE Rulemaking: Notice of Filing of Proposed Rule Change--To Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, IV. Commission's Request for Comment on Market Fragmentation, A. Overview of Current Market Structure.

The question of the market structure however is to be understood in a large sense. In the case of SuperMontage the consequences of changes within the market structure are indirect as far as the investors are concerned.

FN82. See Loss and Seligman, *supra*, n. 35, p. 32.

FN83. Furthermore, the disciplinary actions brought by the SEC particularly against the NASD and the NYSE clearly show the danger of this system. For more details, see Borrelli, *supra*, n. 18, pp. 878-883.

In this context, it should be noted, that the NASD is not only a regulatory authority for the ECNs, but also for all firms trading Nasdaq stock. These firms must be certified by the SEC and registered with Nasdaq and the NASD Regulation, which is a new self-regulatory arm of NASD to police themselves. See Jeffrey L. Harrison et al., *Regulation and Deregulation, Cases and Materials* (1997), pp. 351-352.

FN84. See Loss and Seligman, *supra*, n. 35, p. 32.

FN85. Once realised, this will also eliminate the tension existing within the NASD, which is a not for profit self-regulator on the one side and on the other side, as far as Nasdaq is concerned, tries to administer this entity so as to maximise its profit. See Loss and Seligman, *supra*, n. 35, p. 32.

FN86. Pursuant to Rule 3a1-1 of the Rules and Regulations under the Securities Exchange Act of 1934, an organisation, association, or group of persons shall be exempt from the definition of "exchange" if it is operated by a national securities association. Such organisation, association, or group of persons that meets the definition of an "exchange" must register as such, unless another exemption from the definition of "exchange" applies: 17 CFR 240.3a1-1; see also U.S. Securities and Exchange Commission, Commission Notice: Nasdaq Stock Market, Inc., Files Application for Registration as a National Securities Exchange, Release No. 34-44396; File No. 10-131; <http://www.sec.gov/rules/other/34-44396.htm>.

FN87. See Loss and Seligman, *supra*, n. 35, p. 32.

FN88. In June 2000, the NASD ownership of Nasdaq was reduced by 60% with the first private placement and by 40% with the second private placement later. See Loss and Seligman, *supra*, n. 35, p. 32; Borrelli, *supra*, n. 18, p. 899; Nasdaq Completes Common

Stock Repurchase from NASD at http://www.nasdaqnews.com/news/pr2002/ne_section02_063.html.

FN89. Nasdaq filed an application for registration as an exchange on November 9, 2000, but as some exhibits were incomplete, revised exhibits were submitted in March 2001. As a result, Nasdaq completed its application for registration as a national securities exchange under s. 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78(f)) on March 15, 2001. Within the registration of Nasdaq, SuperMontage will constitute a part of the Nasdaq system. See U.S. Securities and Exchange Commission, Commission Notice, *supra*, n. 86; see also Loss and Seligman, *supra*, n. 35, p. 32.

The Securities and Exchange Commission did not make any communication with regard to the approximate date of the granting of the authorisation to Nasdaq.

FN90. See U.S. Securities and Exchange Commission, Commission Notice, *supra*, n. 86; see also Loss and Seligman, *supra*, n. 35, p. 32 and Nasdaq Completes Common Stock Repurchase from NASD, *supra*, n. 88.

FN91. Other systems and regulatory proposals too raise issues in relation to market fragmentation. For example, within the NYSE Rulemaking, the proposed rule change regarding the Exchange Rule 390. See Release No. 34-42450, *supra*, n. 81. To the concept of fragmentation see Lee, *supra*, n. 16, pp. 53-55.

FN92. *ibid.* at IV. Commission's Request for Comment on Market Fragmentation, A. Overview of Current Market Structure, 3. Current Market Structure Components that Address Fragmentation, c. Broker's Duty of Best Execution.

FN93. *ibid.* at IV. Commission's Request for Comment on Market Fragmentation, A. Overview of Current Market Structure, 1. Investor Interests and Competition on Price. S. 11A(a)(1)(C)(ii) of the Securities Exchange Act 1934 provides that the national market system should assure "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets". Furthermore, one of the main objectives of the Securities Exchange Act of 1934, s. 11A(a)(1)(C)(i), is that a national market system should provide for the "economically efficient execution of securities transactions". In this context see also Harold S. Bloomenthal and Samuel Wolff, *Securities and Federal Corporate Law* (2nd ed., 1998), Part IX. Securities Markets and Broker-Dealer Regulation, Chap. 23. Securities Markets, Broker- Dealers, and Market-Makers, § 23:5. Fragmentation.

FN94. See Jennings et al., *supra*, n. 72, pp. 50-51.

FN95. *ibid.*, pp. 51-52; Release No. 34-42450 *supra*, n. 81, IV. Commission's Request for Comment on Market Fragmentation, C. Requests for Comment, 2. Possible Options for Addressing Fragmentation. The results of this consultation still are not published. See in this context Borrelli, *supra*, n. 18, pp. 894- 896.

For an economic view of the effects of market fragmentation see Lee, *supra*, n. 16, pp. 228-229; see also Schwartz, *supra* n. 17, pp. 174-180 and 186-187.

FN96. SuperMontage: The Next Generation in Nasdaq Trading, *supra*, n. 2.

FN97. Release No. 34-43863, *supra*, n. 1 at V. Discussion, I. Issues Relating to Competition, 1. Centralisation. As to the role of NASD, see above point 1. Market structure.

FN98. See Borrelli, *supra*, n. 18, pp. 897-899.

FN99. Release No. 34-43863, *supra*, n. 1 at V. Discussion, I. Issues Relating to Competition, 1. Centralization. As to the role of NASD, see above point 1. Market structure.

FN1. See Borrelli, *supra*, n. 18, pp. 897-899.

FN2. *Supra* n. 99 at V. Discussion, I. Issues Relating to Competition, 4. Commission's Conclusion on Competition Issues.

However, it should be noted that the Commission basically only has to apply the statute and should not intervene in order to shape the market in a way it would like. When approving a system or changes, the Commission basically only has to respect the goals set forth in the statute; particularly it has to ensure the protection of the investors and should be guided by the goal of creating a National Market System.

FN3. In the European Union for example the Committee of European Securities Regulators launched a final consultation on "Proposed Standards for Alternative Trading Systems" in January 2002. Final rules, "Standards for Alternative Trading Systems" were adopted on July 8, 2002. See Reference CESR/01-086b at <http://www.europefesco.org/v1/default.asp>.

FN4. See *supra*, n. 4.

FN5. s. 11A(a)(2) of the Securities Exchange Act of 1934 states that "The Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities ..."

FN6. The SEC cannot be compared to private or self-regulatory organisations like exchanges for example, which set up own, discretionary rules in order to admit members. See *supra*, n. 83.

FN7. s. 11A(a) of the Securities Exchange Act of 1934.
JIFM 2002, 4(6), 200-208

END OF DOCUMENT