"NO CRYING IN BASEBALL"—AND NO MORE CRYING ON THE STOCK MARKETS: AN ALTERNATE-HYBRID APPROACH TO SELF-REGULATION

Jarad D. Hunter[*]

I. INTRODUCING THE SELF-REGULATORY MODEL

If baseball is America's national pastime, stock trading is a close second. Al Spalding, a pitcher for the Chicago White Stockings in 1876, said, "To secure the presence of intelligent, honest, unprejudiced, quick witted, courageous umpires . . . has been one of the most vexatious problems confronting those in control of our national sport."[1] Likewise, for more than two hundred years investors have sought "intelligent, honest, *unprejudiced*, quick witted, courageous umpires" to referee the securities markets.

For the most part, stock-industry participants call their own balls and strikes. Hence, the national stock exchanges[2] and registered securities associations[3] are deemed self-regulatory organizations (SROs). Despite quite a few breakdowns in history, Congress consistently favored self-regulation for several reasons.[4] Most salient, taxpayers should not exclusively support stock-market regulation.[5] In other words, considerable funding would be essential for the federal government to intervene as *sole* market regulator. And to place this burden on the average, non-trading taxpayer is unfair.

Of course, the 1929 crash exposed the need for federal market oversight. States lacked the jurisdiction, resources, and expertise to

* Associate Member, 2004–2005 *University of Cincinnati Law Review*.

1. Baseball Almanac, *at* http://baseball-almanac.com/umpiresmenu.shtml. Spalding compiled an incredible forty-seven wins in 1876, pitching 528 innings. *Id*.

2. National stock exchanges register under section 6 of the Securities Exchange Act of 1934 (Exchange Act). 15 U.S.C. § 78f (2000).

3. Registered securities associations register under section 15A of the Exchange Act. 15 U.S.C. § 78o-3 (2000).

4. *See* Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,256 (Dec. 8, 2004), *available at* http://www.sec.gov/rules/concept/34-50700.pdf [hereinafter Self-Regulation Concept Release] (discussing several reasons why Congress prefers self-regulation, including cost effectiveness, industry expertise, and the SROs' ability to set higher standards than Congress and the SEC).

5. *Id*.

effectively police the fraud and manipulation inside the industry.[6] And the markets' effects on the national economy were too great to leave the markets unchecked.[7] Thus, Congress crafted federal securities laws[8] and created the Securities and Exchange Commission (SEC or Commission)[9] to administer these laws.

But Congress never intended for federal regulation to displace the SROs' function. Rather, the SEC's role was limited (akin to a baseball commissioner). SROs remained primary regulators in the industry (the umpires).[10] This fundamental structure withstood multiple reassessments[11] and remains in place today.

Recently, the Commission embarked on another re-evaluation of the SRO model, publishing a self-regulation concept release[12] and proposing SRO governance rules.[13] Notably, three factors have altered the securities landscape over the past thirty years: (1) the growing presence of institutional investors, (2) advances in technology, and (3) an increasing number of markets (and resulting boost in competition for order flow).[14] Moreover, in the past decade, scandals like the National Association of Securities Dealers' (NASD) failure to regulate members

6. For a look at the origin of state securities laws, see Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991).

7. In 1929, the U.S. Gross Domestic Product (GDP) was $103.6 billion. Current-Dollar and "Real" Gross Domestic Product, *at* http://www.bea.gov/bea/dn/gdplev.xls. The GDP dropped in the years following the 1929 crash, bottoming out at $56.4 billion in 1933. *Id.* The GDP did not surpass the 1929 figure until 1941. *Id*.

8. *See, e.g.*, 15 U.S.C. § 77a (2000) (Securities Act of 1933); *id*. § 78a (Securities Exchange Act of 1934).

9. *Id*. § 78d(a) (2000).

10. As former SEC Chairman William Douglas said, "Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 185 (3d ed. 2003).

11. *See, e.g.*, Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o) (authorizing the SEC to register national securities associations); 1961–1963 Special Study of Securities Markets, H.R. DOC. NO. 88-95 (1963); Securities Exchange Act Amendments of 1975, Pub. L. No. 29, 89 Stat. 97 (1975).

12. *See* Self-Regulation Concept Release, *supra* note 4.

13. Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, Exchange Act Release No. 34,50699, 69 Fed. Reg. 71,126 (Dec. 8, 2004), *available at* http://www.sec.gov/rules/proposed/34-50699.pdf [hereinafter Proposed Governance Rules].

14. *See generally* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 729–39 (5th ed. 2004).

conspiring to fix brokerage commission rates,[15] the collapse of several listed issuers for accounting fraud,[16] and former New York Stock Exchange (NYSE) Chairman Richard Grasso's resignation after release of his lavish compensation package[17] have sparked the debate as to who should regulate the markets in the modern era.

This Comment proposes a fresh model (alternate-hybrid model) that maintains the traditional benefits of self-regulation, while addressing many concerns in the present structure. Leading this proposal is the creation of a system where the NYSE and NASD would be dually responsible for regulating all SRO members. Individual SROs would retain responsibility for regulating activity on their own markets. Additionally, this Comment suggests creating an oversight committee composed of representatives from the NYSE, NASD, individual SROs, SRO members, listed issuers, and general investors. The oversight committee would draft uniform member rules (for the NYSE and NASD to enforce), draft uniform market rules (for the individual SROs to enforce), resolve funding dilemmas, and hear selective appeals from enforcement actions.

Part II details the U.S. stock markets' chaotic history, from the NYSE's inception in 1792 to the present. Part III depicts the major players in the industry and their contemporary roles. Part IV describes weaknesses in the current model, including inherent concerns and flaws exaggerated by recent market changes. Part V summarizes alternative models suggested in the SEC's concept release, including the proposed governance rules, and also describes the alternate-hybrid model proposed herein. Finally, Part VI concludes that the alternate-hybrid model strikes the appropriate balance between a system devoid of federal regulation and a completely centralized regime.

II. THE SRO HALL OF FAME: BEGINNINGS AND BLEMISHES

The legendary, but mistaken,[18] beginning for U.S. stock markets dates

15. *See* Nat'l Ass'n of Sec. Dealers, Inc., 62 SEC Docket 1346, Exchange Act Release No. 34-37538, 1996 WL 447193 (Aug. 8, 1996).

16. Enron Corporation is the easy target when referring to the accounting frauds from 2001–2002. Interestingly, Enron's stock steadily dropped from $84 per share in January 2001 to $0.40 per share on December 2, 2001 (when Enron filed for Chapter 11 bankruptcy); but the NYSE did not move to delist Enron until January 15, 2002. *Wall Street Dumps Enron*, CNN, Jan. 15, 2002, *available at* http://cnnstudentnews.cnn.com/2002/fyi/news/01/15/enron/index.html.

17. *See* Thor Valdmanis, *NYSE faces Thursday without Richard Grasso*, USA TODAY, Sept. 17, 2003, *available at* http://www.usatoday.com/money/markets/us/2003-09-17-grasso-meet_x.htm. Grasso's compensation package was reportedly worth at least $140 million. *Id*.

18. Often, people are surprised to learn that the Philadelphia Stock Exchange was organized in

back to 1792, when twenty-four New York brokers gathered on Wall Street to sign the Buttonwood Agreement.[19] The agreement initially required the parties to prefer each other when buying and selling securities.[20] As the exchange grew, trading customs were ratified into exchange rules.[21] In 1817, the NYSE adopted a constitution with rules for the conduct of business.[22] Other exchanges followed in the NYSE's footsteps.[23]

Over time, the NYSE imposed stricter listing requirements. By 1853, issuers had to provide statements disclosing capital resources and outstanding shares.[24] Sixteen years later, the NYSE adopted measures to prevent companies from issuing secret stock (watered stock), requiring all shares traded on the exchange first be registered with a bank or agency.[25] And before the twentieth century, the NYSE forced issuers to submit periodic financial statements.[26]

Until 1911, securities regulation was at the exchanges' sole discretion. But that changed when Kansas adopted the first "blue-sky" laws,[27] imposing registration and financial requirements on broker-dealers.[28] Shortly thereafter, several states enacted securities laws later upheld by the Supreme Court in the 1917 *Blue Sky Cases*.[29] All seemed

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1790, two years before the NYSE. *See* A Blueprint for America's Free Markets: The History of the Philadelphia Stock Exchange, http://www.phlx.com/exchange/history.html.

19. *See* About the NYSE, History, Timeline, http://www.nyse.com/about/history/timeline_chronology_index.html.

20. Self-Regulation Concept Release, *supra* note 4, at 71,257.

21. *See* About the NYSE, *supra* note 19.

22. *Id*.

23. The American Stock Exchange (AMEX) traces back to the so-called Curb Market in the early 1800s, when brokers literally traded on the Broad Street curb outside the NYSE. *See generally* ROBERT SOBEL, THE CURBSTONE BROKERS: THE ORIGINS OF THE AMERICAN STOCK EXCHANGE 13–14 (1970). The Chicago Stock Exchange (CHX) formed in 1882. About CHX, http://www.chx.com/about/index_about.htm. The Pacific Exchange (PCX) also relates back to 1882 when its predecessor, the San Francisco Stock and Bond Exchange, formed. *See* History of the Pacific Stock Exchange, http://www.pacificex.com/aboutus/aboutus_history.html.

24. About the NYSE, *supra* note 19.

25. *Id*. at http://www.nyse.com/about/history/timeline_1860_1899_index.html.

26. *Id*.

27. The origin of "blue-sky law" is uncertain. Macey & Miller, *supra* note 6, at 359 n.59. The reference obviously connotes negatively on broker-dealer practices at the time—broker-dealers who "would sell building lots in the blue sky in fee simple." *See* Thomas Mulvey, *Blue Sky Law*, 36 CAN. L. TIMES 37, 37 (1916).

28. The Kansas laws generally required investment companies or firms selling securities to obtain a license from the state's banking commissioner. Macey & Miller, *supra* note 6, at 361. Firms filed a business plan, report of financial condition, and copies of securities they proposed to sell in-state. *Id*. The commissioner could conduct examinations and exclude firms that failed state requirements. *Id*.

29. *See* Hall v. Geiger-Jones, 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917).

well, as prices soared during the mid-twenties "bull market." Unfortunately, the combined regulatory efforts of exchanges and states failed to prevent the market's collapse in 1929.

After the Great Crash, Congress deemed federal intervention necessary to restore investor confidence in the markets.[30] Of particular concern was the exchanges' inability to identify and prevent price manipulations.[31] Thus, Congress created the SEC to oversee implementation and enforcement of the new federal securities laws.[32]

But Congress never envisioned the Commission as *sole* regulator of the securities industry.[33] Rather, Congress favored dual-regulation from the SEC and SROs for several reasons. The markets are highly complex and SROs are more adept to detect and respond to violations because of their familiarity with operational nuances.[34] Also, SROs can set higher standards that focus on fair trade and business practices.[35] And industry participants prefer the less bureaucratic SRO regulation.[36] Most important, the government simply does not have the resources to assume full responsibility for regulating the markets.[37]

Thus, at Congress's behest, and under the direction of initial SEC Chairman Joseph Kennedy, the Commission endorsed "cooperative regulation."[38] But over the years, the SEC was forced to reexamine self-regulation after breakdowns occurred at several prominent SROs.

The first breakdown occurred in the late 1950s at the American Stock Exchange (AMEX). From 1941–1955, SEC enforcement relaxed; the staff dwindled from 1,678 to 667 employees.[39] Specialists took advantage of the lax oversight in a string of market manipulations, finally prompting the SEC to investigate the porous regulation at

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30. *See* 15 U.S.C. § 78b (2000) ("Necessity for regulation").

31. *Id*. § 78b(3) ("Frequently the prices of securities on . . . exchanges and markets are susceptible to manipulation and control . . . ."). *See* Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1349–50 (2004). One type of price manipulation brought to the Senate Banking Committee's attention in 1932 was the pool operation. *Id*. at 1349. In a pool operation, stock traders conspire to purchase large percentages in the same stock, driving the demand (and consequently the market price) for the stock up. *See id*. at 1349–50. Once the price has topped out, the conspirators sell all their shares at a large profit. *See id*. As a result, the stock's demand (and price) nosedives, to the detriment of the unbeknownst buyer. *See id*.

32. 15 U.S.C. § 78d.

33. *See generally* S. REP. NO. 73-1455 (1934); H.R. DOC. NO. 73-1383 (1934).

34. *See* Self-Regulation Concept Release, *supra* note 4, at 71,256.

35. *Id.*

36. *Id*.

37. *Id*.

38. *See* SELIGMAN, *supra* note 10, at 111–12.

39. Seligman, *supra* note 31, at 1362.

AMEX.[40] SEC Chairman William Cary eventually used this platform to initiate the 1961–1963 Special Study of Securities Markets (Special Study).[41]

The Special Study's depiction of the growing presence of institutional investors,[42] advances in communication,[43] and the anticompetitive nature of fixed-commission rates,[44] foreshadowed the need for SRO reform.[45] Most significant, the Special Study found that exchanges tend to protect members' interests.[46] Without diligent SEC oversight, SROs lack incentive to fulfill their regulatory duties.[47]

In 1994, Professors William Christie and Paul Schultz uncovered collusion and a breakdown in regulation by the NASD.[48] Shocked by the absence of odd-eighth quotes on NASDAQ, the professors hypothesized that market makers were implicitly agreeing not to use odd-eighth quotes to keep wider spreads.[49] A subsequent SEC investigation confirmed this suspicion; market makers were secretly agreeing to keep wide spreads.[50] Market makers who attempted to quote odd-eighths were ridiculed.[51]

The SEC brought administrative proceedings against the NASD for

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40. *See id*.

41. 1961–1963 Special Study of Securities Markets, *supra* note 11; *see* Seligman, *supra* note 31, at 1362–64.

42. Institutional investors held 61.3% of outstanding equity securities by 2001. LOSS & SELIGMAN, *supra* note 14, at 729. The shift from general to institutional investor is significant. Institutional investors generally rely on the portfolio theory when trading securities. *Id*. at 730. Thus, rather than attempting to select the best stocks, institutional investors generally diversify their holdings to eliminate firm-specific risk. *Id*.

43. While the Special Study recognized the value in technology, the computer movement was actually jumpstarted by the "back-office crisis" in the late 1960s. *See* Seligman, *supra* note 31, at 1366–69. From 1964 to 1968, the NYSE average daily reported volume escalated from 4.89 million/day to 12.97 million/day. *Id*. at 1366. Firms simply did not have the resources to clear and settle all orders. *See id*. at 1366–67. As a result, the industry turned to the computer as an alternative to the manual transaction system. *See id*. at 1367–69.

44. Before 1975, the NYSE fixed (by agreement) commission rates members could charge. LOSS & SELIGMAN, *supra* note 14, at 797. In the 1975 Amendments, Congress promulgated section 6(e), eliminating this practice. 15 U.S.C. § 78f(e)(1) (2000) ("[N]o national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members . . . .").

45. Seligman, *supra* note 31, at 1362–64.

46. *See id*.

47. *See id*.

48. William G. Christie & Paul H. Schultz, *Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, 49 J. FIN. 1813, 1813 (1994).

49. *See id*. at 1813–14; *see also infra* note 75 and accompanying text (defining "spread").

50. *See* NASD § 19(h)(1) Order, *supra* note 15, at 1. The SEC found that NASDAQ market makers "coordinated price quotations, transactions and transaction reports in order to protect or advance their proprietary interests, to the detriment of investors and other market participants." *Id*.

51. *Id*. at 2.

failing to detect and take appropriate actions with respect to the dealers' collusion.[52] In the settlement agreement, the SEC found that the NASD did not use its surveillance and enforcement capacities to determine whether the dealers were violating NASD rules or federal securities laws.[53] And in a subsequent section 21(a) report, the Commission expressed great concern for the inherent conflicts and lack of independence between the NASD's regulatory and market operations divisions.[54]

Most recently, excessive compensation and neglectful enforcement gave the SEC another opportunity to revisit the SRO model. In 2003, former NYSE Chairman Richard Grasso was forced to resign after the revelation of his secret compensation package, which included retirement benefits of more than $140 million.[55]

NYSE merged with Archipelago Holdings, Inc. on March 7, 2006, to form the new publicly-traded NYSE Group, Inc.[56] In response, in part, to the public reaction regarding Grasso, NYSE Group, Inc. now requires that all directors except the CEO satisfy certain independence requirements.[57] The Board is required, at least once a year, to make independence determinations with respect to each director.[58]

III. TEE-BALL: STOCK MARKETS FOR BEGINNERS

Before venturing into concerns with the current model, a brief look at the industry's major players and their functions is helpful. Specifically, the following actors are described below: (1) Congress and the SEC, (2) SROs, (3) listed issuers, (4) broker-dealer members (including alternative trading systems), and (5) institutional investors.

52. *See id*.

53. *See id*.

54. *See In re* Nat'l Ass'n of Sec. Dealers, Inc., Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, Exchange Act Release No. 34-37542, at 3 (Aug. 8, 1996) [hereinafter NASD § 21(a) Report].

55. *See* Valdmanis, *supra* note 17.

56. NYSE Group News Releases, http://www.nyse.com/Frameset.html?displayPage=/press/PressReleases.html (last visited Mar. 28, 2006).

57. For a complete list of the new NYSE corporate governance guidelines, see NYSE Group, Inc. Corporate Governance Guidelines, http://www.nyse.com/pdfs/nyse_corporate_governance_guidelines.pdf (last visited Mar. 28, 2006). *See also* Independence Policy of the NYSE Group Board of Directors, http://www.nyse.com/pdfs/DirectorIndependencePolicy_01_05_2006.pdf (last visited Mar. 28, 2006). The corporate governance changes were initiated by Interim NYSE Chairman Josh Reed in 2003, after an SEC staff report criticized the NYSE for lack of investigation and discipline of specialists. *See* Deborah Solomon & Suzanne Craig, *Market Discipline: SEC Blasts Big Board Oversight of 'Specialist' Trading Firms*, WALL ST. J., Nov. 3, 2003, at A1.

58. *See* Independence Policy of the NYSE Group Board of Directors, *supra* note 57.

Congress deemed federal regulation of the markets necessary in order "to protect interstate commerce, the national credit, the Federal taxing power, . . . the national banking system . . . , and to insure the maintenance of fair and honest markets . . . ."[59] In the Exchange Act, Congress made the SEC primarily responsible for oversight and enforcement of federal securities laws.[60] Notably, federal securities laws are *disclosure oriented*; their primary goal is to protect investors from manipulation and fraud.[61]

SROs must also ensure compliance with federal laws on their individual markets.[62] Additionally, SROs draft rules that go beyond the disclosure-related federal laws and require "just and equitable principles of trade and detailed business conduct standards."[63] In general, SRO rules police three distinct classes: (1) issuers, (2) market participants, and (3) members.

Issuers seeking to list securities on an SRO must comply with listing standards, which have two components: financial and corporate governance requirements. The financial requirements ensure that an issuer is financially stable and meets minimum distribution and size benchmarks.[64] The corporate governance standards are a relatively new offspring of the Sarbanes-Oxley Act and require issuers to satisfy audit committee and director independence requirements.[65]

SROs regulate market participants through rules directed at insider trading, market manipulation, breach of fiduciary duties, and investor protection.[66] Issuers, members, and investors are all market participants who can be disciplined for violating trading rules. One advantage to self-regulation most often cited is the SROs' intimate knowledge and ability to oversee market activities.[67]

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59. 15 U.S.C. § 78b (2000).

60. *See id.* § 78d (creating the SEC).

61. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose, common to [the federal securities laws], was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.").

62. § 78f(b) ("An exchange shall not be registered as a national securities exchange unless the Commission determines that—(1) Such exchange is so organized and has the capacity . . . to enforce compliance by its members [and associates] . . . with [federal securities laws] . . . .").

63. Self-Regulation Concept Release, *supra* note 4, at 71,257.

64. *See, e.g.*, N.Y. Stock Exch. Listed Co. Manual, § 102.01, *at* http://www.nyse.com/lcm (giving minimum standards for domestic companies with equity listings).

65. *See, e.g.*, *id.* § 303A, *available at* http://www.nyse.com/pdfs/section303A_final_rules.pdf (listing NYSE corporate governance rules).

66. *See, e.g.*, NYSE Market Surveillance, http://www.nyse.com/regulation/howregworks/1022221394213.html.

67. Self-Regulation Concept Release, *supra* note 4, at 71,256.

The SRO, itself, is composed of members, who are traditionally brokers, dealers, or both. A broker is "any person engaged in the business of effecting transactions in securities for the account of others."[68] A dealer is "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise" in the "part of a regular business."[69] The SRO must ensure members comply with federal laws and SRO rules.[70]

Two types of dealers are worth distinguishing: "specialists" and "market makers." A specialist is a member of an exchange who matches buy and sell orders for a particular security at the specialist's post on the exchange.[71] If activity is not sufficient to match orders, the specialist must act as a "dealer," purchasing and selling enough stock to maintain a liquid market.[72]

Conversely, a market maker is generally a dealer in over-the-counter (OTC) securities.[73] Traditionally, after receiving a customer's order, a broker would route the order to the market maker with the best quote listed on NASDAQ.[74] The difference in the price the broker pays the market maker and the price the customer pays the broker is the "spread."[75]

Advances in technology assisted many market makers and others in forming alternative trading systems (ATSs).[76] For example, a broker, rather than using NASDAQ to find the best available price, may prefer to match the order internally by computer. In this sense, the broker is acting as both a market maker and an exchange. This is the same function of the electronics communications networks (ECNs). The obvious benefit to the investor is that ATSs can afford to charge a lower spread, since the transaction is handled internally.[77] But ATSs blur the

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68. 15 U.S.C. § 78c(a)(4)(A) (2000).

69. *Id*. § 78c(a)(5)(A)–(B).

70. *Id*. § 78f(b)(1).

71. *See* LOSS & SELIGMAN, *supra* note 14, at 742–43. Specialists actually serve three roles: dealer, broker, and auctioneer. *Id*. at 742. Specialists act as "brokers"—executing buy and sell orders (usually limit or stop orders). *Id*. And as auctioneers, specialists establish the prices at which the stock will be bought and sold. *Id*.

72. *See id*.

73. *See* Market Maker, http://www.sec.gov/answers/mktmaker.htm.

74. *See* Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753, 758–59 (1999).

75. Investopedia, http://www.investopedia.com/terms/m/marketmakerspread.asp.

76. *See generally* Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 1998 WL 849548 (Dec. 8, 1998) [hereinafter Regulation ATS].

77. *See id*. at 2 ("Market participants have incorporated technology into their businesses to provide investors with an increasing array of services, and to furnish these services more efficiently, and often at lower prices.").

line between broker-dealer and exchange; both are subject to different rules under the Exchange Act.[78]

In 1998, the SEC adopted Regulation ATS expanding the duties of market makers functioning as ATSs.[79] Rule 3b-16 broadly reinterpreted the definition of "exchange" in section 3(a)(1) of the Exchange Act.[80] Now, only two requirements need be satisfied for an entity to be deemed an exchange: the entity "(1) brings together the orders of multiple buyers and sellers; and (2) 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 the trade."[81]

Rule 3a1-1, however, excuses most ATSs from registering as an exchange, so long as they comply with Regulation ATS and do not engage in certain self-regulatory activities.[82] Naturally, ATSs can still register as an exchange (since they fit within the definition of "exchange").[83] But for those who choose to comply with Regulation ATS, the requirements will vary depending on the percentage of trading the ATS handles in any national market system (NMS) security.[84]

Finally, note that many investors in today's industry are not the same investors whom drafters of the Exchange Act sought to protect. The presence of institutional investors grew immensely after the advent of the portfolio theory.[85] And many of these institutional investors are the same member broker-dealers subject to SRO rules. Not surprisingly, the interests of institutional investors do not always conform to the interests of general investors.[86]

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78. *See id*. Exchanges must register and comply with section 6 of the Exchange Act. 15 U.S.C § 78f (2000). Broker-dealers, on the other hand, are subject to different requirements under section 15. *Id*. § 78o.

79. *See generally* Regulation ATS, *supra* note 76, at 2.

80. *See id*. at 4–5.

81. *Id*. at 5.

82. *Id*.

83. *See id*.

84. *See id*. at 5–7. An ATS with less than five percent trading volume in all NMS securities it trades must (1) file a notice of operation and quarterly reports with the SEC, and (2) maintain records and an audit trail. *Id*. at 5. If an ATS has greater than five percent trading volume in any NMS security, then, in addition to the previous requirements, the ATS must link with a registered market, so that its best priced orders will be publicly available. *Id*. at 6. Finally, if an ATS carries more than twenty percent trading volume in any NMS security, the ATS must comply with all previous requirements, provide non-discriminatory access to its markets, and take measures to ensure adequate systems capacity. *Id*.

85. *See* LOSS & SELIGMAN, *supra* note 14, at 730. Institutional investors attempt to eliminate company-specific risk through diversification and manage market-specific risk through insurance and index arbitrage. *See id*.

86. *See, e.g.*, Regulation NMS, Exchange Act Release No. 34-50870, 69 Fed. Reg. 77,424,

IV. WHY THE CURRENT MODEL STRIKES OUT

The current model has several defects, including: conflicts between regulatory duties and market operations, members, issuers, and (if applicable) shareholders; inefficiencies in duplicative SRO regulations; and difficulties in regulating cross-market trading.[87]

A. Conflicts of Interest

The central flaw in the present model is that market operations, members, issuers, and shareholders influence SRO regulation.[88] SROs must oversee their markets to protect investors.[89] Yet, like all going concerns, SROs have to attract order flow to stay in business. Shareholders in demutualized SROs, *operating for profit*, further strain regulatory duties.[90] Essentially, SROs are less inclined to vigorously enforce rules against financially supportive members, issuers, and shareholders.

Internally, regulatory goals often conflict with the SRO's market objectives.[91] The SRO's regulatory staff must adopt trading rules and establish a system for identifying violations.[92] When a violation is discovered, the staff must bring a disciplinary action, or (when appropriate) refer the matter to the SEC.[93]

At the same time, the SRO's market division needs to attract and

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77,425 (Dec. 27, 2004), *available at* http://www.sec.gov/rules/proposed/34-50870fr.pdf (noting that while the markets' decimalization clearly benefited retail investors by reducing small-order spreads, the effects are less obvious for institutional investors who rely on price impact to compute trading costs).

87. Self-Regulation Concept Release, *supra* note 4, at 71,259–75. The concept release also discussed regulatory funding issues. The Exchange Act requires "the rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers . . . ." 15 U.S.C. § 78f(b)(4) (2000). The funding concerns are intriguing but beyond the scope of this Comment.

88. *See* Self-Regulation Concept Release, *supra* note 4, at 71,259–64.

89. *See* § 78f(b)(5) ("An exchange shall not be registered as a national securities exchange unless the Commission determines that—(5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest . . . .").

90. *See* Arthur Levitt, Dynamic Markets, Timeless Principles, Address at Columbia Law School 6–7 (Sept. 23, 1999), *available at* http://www.sec.gov/news/speech/speecharchive/1999/spch295.htm (noting that conflicts will have to be resolved "if the SRO is enmeshed within a for-profit corporation").

91. Self-Regulation Concept Release, *supra* note 4, at 71,261–63.

92. *See* § 78f(b) (requirements for registration as a national securities exchange); *id*. § 78o-3(b) (requirements for registration as a registered securities association).

93. *See id*. § 78f(b)(6) ("[M]embers shall be appropriately disciplined for violation of . . . [the Exchange Act], the rules or regulations thereunder, or the rules of the exchange . . . ."); *see also id*. § 78o-3(b)(7) (same for registered securities associations).

maintain order flow to keep the SRO competitive.[94] Conflicts arise between the regulatory and market staffs when regulating dilutes order flow.

Take, for example, conflicts with respect to members. The order flow a member brings to the SRO can affect how the SRO disciplines that member. Hence, the more business a member creates, the greater the incentive for the SRO to be lenient in regulating that member.[95] Consequently, a sort of "race to the bottom"[96] for SROs is created. Members are motivated to seek out exchanges with soft regulations. And SROs are induced to apply less regulation to attract more order flow.

Aside from market operations, members influence SRO regulation in other ways.[97] For instance, member fees are an indispensable source of SRO funding.[98] And members often sit on SRO governing boards, which oversee regulatory and enforcement staffs.[99] Remarkably, after recent consolidation in the brokerage industry, a smaller group of members have a greater influence over SRO regulatory duties.[100]

In fact, member dominance on SRO boards is perhaps the most visible component in previous SRO breakdowns.[101] Recall, the SEC highlighted this concern in the § 21(a) Report following the NASD's settlement for market maker collusion: several market makers profiting from the odd-eighth quote conspiracy sat on the NASD's Board.[102]

Another discord for SROs is with issuers.[103] SROs create listing standards that set minimum financial, reporting, and corporate governance requirements.[104] Simultaneously, SROs must compete to

94. Self-Regulation Concept Release, *supra* note 4, at 71,261 (noting that the growing competition among markets enhances the pressure to capture order flow).

95. *Id*. at 71,261–62.

96. Of course, this axiom was popularized in the late 1990s when referring to the corporate production shift from global giants like the United States to countries with weaker labor and environmental laws. *See generally* ALAN TONELSON, THE RACE TO THE BOTTOM (2000).

97. Self-Regulation Concept Release, *supra* note 4, at 71,259–61.

98. *See id*. at 71,259.

99. *See id*.

100. *Id*. at 71,259 (noting that the number of specialist firms on the NYSE fell from twenty-seven to seven from 1999–2002).

101. *See* Seligman, *supra* note 31, at 1362 (describing the trading scandals at AMEX that resulted from specialists' domination).

102. See NASD § 21(a) Report, *supra* note 54, at 2. The § 21(a) Report discussed the NASD's "regulatory deficiencies" and the undue influence many market makers had over the NASD "with respect to rulemaking, the disciplinary process, and the admission of new members." *Id*.

103. Self-Regulation Concept Release, *supra* note 4, at 71,263.

104. *See supra* notes 64–65 and accompanying text.

draw and maintain issuers.[105] The increasing market fragmentation (i.e., ATSs and ECNs) strengthens the competition for issuers.[106] Accordingly, the same "race to the bottom" rationale would seem to apply to issuers.

On the other hand, issuers are motivated to list on an exchange with a strong regulatory reputation, because investors will be more confident in the issuer's business. Thus, issuers are not as motivated as members to seek SROs with lax rules.

Finally, SRO demutualization hoists concerns previously lacking from the current model: the conflict between a shareholder's profit motive and the SRO's regulatory obligations.[107] The SRO can be forced to choose between funding regulatory programs and satisfying hungry shareholders. Obviously, the shareholder desires a return on investment, usually via dividend. But concerns arise when dividends are issued at the expense of regulatory obligations.[108]

B. Multiple SRO Inefficiencies

Members often complain about the waste created in complying with multiple SRO rules.[109] SRO rules and interpretations can overlap. Even worse, these rules may contradict each other, causing confusion as to the proper industry standard.[110]

The Commission previously addressed these concerns. If a member belongs to multiple SROs, Rule 17d-1 requires the SEC to select a single SRO to ensure the member's financial responsibility.[111] Also, Rule 17d-2 allows SROs to enter joint agreements to divide regulatory obligations with respect to common members.[112] Under both rules, nondesignated SROs do not have to ensure compliance with regulations assigned to

105. *See* Self-Regulation Concept Release, *supra* note 4, at 71,263 (noting that the recent competition for the Google IPO).

106. *See id*.

107. *See id.* at 71,263–64; *see also* Regulation ATS, *supra* note 76, at 5.

108. *See* Self-Regulation Concept Release, *supra* note 4, at 71,263 (hypothesizing that SROs might "commit insufficient funds to regulatory operations or use their disciplinary function as a revenue generator with respect to member firms that operate competing trading systems or whose trading activity is otherwise perceived as undesirable").

109. *See* Charles Schwab Comment Letter 3, *available at* http://www.sec.gov/rules/concept/s74004/jtbrown030905.pdf (arguing that "the greatest single flaw in the current [SRO] structure is that it produces both duplication and divergence").

110. *See id*.

111. 17 C.F.R. § 240.17d-1 (2004).

112. *Id*. § 240.17d-2. A 17d-2 Plan has been implemented in the options market to reduce superfluous regulation. *See* Self-Regulation Concept Release, *supra* note 4, at 71,264.

another SRO.[113]

But the potential for redundant regulation is intensified by the increased disparity in order flow among SROs. And, as mentioned before, this market fragmentation raises the potential for regulatory arbitrage (i.e., the "race to the bottom" for securities exchanges).

C. Cross-Market Trading

Market fragmentation also makes intermarket trading challenging to supervise.[114] Violations, easily detectible if made on a single exchange, can be difficult to identify where spread across multiple SROs.[115] Moreover, SROs might deny responsibility for violations that occur as a result of transactions stretched over several SROs.

To assist in market surveillance, most SROs implement audit trail systems. For example, NASDAQ's Order Audit Trail System (OATS) provides sequential orders (with price and trading information) to facilitate NASDAQ surveillance.[116] But the audit trail systems do not supply adequate information for cross-market oversight.[117] Even the NASD admitted the deficiencies in OATS, which does not capture trades that occur on other markets.[118]

The original solution to cross-market surveillance—the Intermarket Surveillance Group (ISG)—is now obsolete. Created in 1983 to synchronize intermarket surveillance, the ISG facilitates *voluntary* sharing of regulatory information among participating SROs.[119] But the ISG data is clearing level, not executing level, prompting the NASD to question the data's value in cross-market supervision.[120] Also, ISG time fields are not uniformly synchronized.[121] And ISG data are not relayed

113. *Supra* notes 111–12.

114. *See* Self-Regulation Concept Release, *supra* note 4, at 71,265–67.

115. *See id*.

116. For the NASD rules relating to OATS, see NASD Manual, ¶¶ 3110, 6951–6957, *available at* http://www.nasd.com/web/groups/reg_systems/documents/regulatory_systems/nasdw_010183.pdf. Generally, the NASD requires members to record certain information upon receipt, transmission, and modification, cancellation, or execution of an order. *See id*. ¶ 6954. Members must transmit this information in electronic form to OATS. *Id*. ¶ 6955. Violation of these requirements is considered "conduct that is inconsistent with high standards of commercial honor and just and equitable principles of trade . . . ." *Id*. ¶ 6956.

117. *See* Self-Regulation Concept Release, *supra* note 4, at 71,265.

118. *See id*.

119. *Id*. While participation in the ISG is "voluntary," this designation is misleading as the SEC requires new markets to join the ISG before registering as an SRO. *See id*.

120. *Id*. at 71,266 n.161.

121. *Id*.

until two days after the actual trade.[122]

A uniform audit trail system will be necessary to effectively oversee cross-market trading.

V. SWINGING FOR THE FENCES (POTENTIAL SOLUTIONS)

The SEC's concept release explored seven models that could improve the current system.[123] Apparently, the Commission spent the majority of its time developing the most conservative approach: the proposed governance rules.[124] But of the models presented, the pure-hybrid and industry regulator models best satisfy industry concerns. And the alternate-hybrid model—proposed in this paper—is even more enticing because it addresses weaknesses in the pure-hybrid and industry regulator.

A. Proposed Governance Rules

The governance rules would preserve the current self-regulatory model, while enhancing governing independence and disclosures. There are five proposed sections to the rules: (1) Rules 6a-5 and 15a-3 (fair administration and governance of SROs), (2) Regulation AL (regulation of affiliated securities), (3) revised Form 1 and new Form 2 (revisions for SRO registration), (4) Rule 17a-26 (periodic reports on SRO regulation), and (5) Rule 17a-27 (notification requirements for broker-dealer members who acquire greater than a five percent interest in the SRO).[125]

Proposed Rules 6a-5 and 15a-3 set minimum administration and governance requirements for SROs similar to those now required for listed issuers. First, the rules require a majority of the SRO's board of directors to be independent.[126] Also, certain "standing committees" must be entirely independent.[127] SROs are required to separate

122. *Id*.

123. *See* Self-Regulation Concept Release, *supra* note 4, at 71,275–82. The seven models are (1) proposed governance rules, (2) independent subsidiary, (3) pure hybrid, (4) competing hybrid, (5) industry regulator, (6) non-industry regulator, and (7) direct SEC regulation. *Id*.

124. *See* Proposed Governance Rules, *supra* note 13.

125. *See generally id*. at 71,126 (summary of the proposed governance rules).

126. *Id*. at 71,134–38. "Independent" is defined as having no "material relationship" with the SRO or an affiliate. *Id*. at 71,135. The board would be required to determine the independence of a director upon his appointment or nomination and reaffirm such independence at least annually. *Id*. The SRO would also have to establish policies and procedures for directors to inform the SRO of relationships or interests that may reasonably bear on the director's independence. *Id*.

127. *Id*. at 71,138–40. The five proposed standing committees are: (1) nominating, (2)

regulatory and market operations, either structurally or functionally.[128] And the SROs must adopt rules prohibiting member broker-dealers from owning and voting any interest in the SRO that exceeds twenty percent.[129] Finally, to ensure fair representation as required by the Exchange Act,[130] SROs must enable members to select twenty percent of the board, and issuers and investors shall each have one representative on the board.[131]

To combat conflicts created by SRO demutualization, the SEC also proposed new Regulation AL. The rules demand that the SRO's regulatory oversight committee approve any listing of an "affiliated security."[132] To maintain listing, the SRO must file a quarterly report summarizing affiliated-security monitoring and an annual report prepared by a third party examining the affiliated security's compliance with the SRO's listing rules.[133] The SEC emphasizes that the listing rules shall not apply to affiliated securities in a manner that is "materially different" from nonaffiliated securities (although the SRO may apply stricter standards for affiliated securities).[134] Rule 800(f) provides an exception to Regulation AL where "necessary or appropriate in the public interest," as determined by the Commission.[135]

To increase transparency with the SEC and investors, the proposed rules demand more disclosures by the SROs. The rules harmonize disclosures required for registration as a national securities exchange and registered securities association, revising Form 1 (exchanges) and replacing Forms X-15AA-1 and X-15AJ-1 & 2 with new Form 2 (associations).[136] More disclosures on governance, regulatory functions, and ownership are required in registration.[137] Moreover, Rule 17a-26

governance, (3) compensation, (4) audit, and (5) regulatory oversight. *Id*. at 71,138.

128. *Id*. at 71,141–43.

129. *Id*. at 71,143–46.

130. Section 6(b)(3) of the Exchange Act requires "[t]he rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer. 15 U.S.C. § 78f(b)(3) (2000). *See also id*. § 78o-3(b)(4) (same for registered securities associations).

131. Proposed Governance Rules, *supra* note 13, at 71,138.

132. *Id*. at 71,152. "Affiliated security" generally refers to a security issued by the SRO or an affiliate, or a trading facility of the SRO or affiliate. *See id*. at 71,151–52.

133. *Id*. at 71,152–53. The SRO would also be responsible for timely filing non-compliance and response reports with the SEC whenever an affiliated security was not in compliance with a listing rule. *Id*.

134. *Id*. at 71,153.

135. *Id*.

136. *See id*. at 71,155–67.

137. *See* Proposed Governance Rules, *supra* note 13, at 71,155–67.

would require SROs to provide periodic reports, updating certain aspects of their regulatory programs.[138]

Finally, proposed Rule 17a-27 requires broker-dealer members to notify the SEC and SRO within ten days of acquiring an interest greater than five percent in the SRO or a facility.[139] The Commission can grant a public-interest exemption to this requirement.[140]

The governance rules retain the current regime's stability and address many concerns. The rules ease conflicts between the SROs' business and regulatory obligations, requiring independence in a majority of the board of directors and separation of market and regulatory functions. Moreover, the rules address new conflicts that arise when SROs demutualize. And increased transparency gives investors access to more accurate information.

But the rules do not adequately address the one flaw in the current model consistently vital in SRO breakdowns: SROs regulating their own members.[141] Even an *independent* board of directors must, nevertheless, balance regulatory duties with economics. Nor will structural separation or increased reporting cure this classic tension. So long as members financially support the SROs' existence, SROs will remain reluctant to enforce regulatory obligations with the enthusiasm that the Exchange Act requires.

The proposed rules also fail to address multiple SRO rules and cross-market surveillance. Under the rules, members remain subject to several SRO rules and interpretations. As indicated before, these rules can contradict each other, leaving members uncertain as to the proper industry standard. And the proposed rules do not facilitate a comprehensive audit trail system or better cross-market surveillance.

Although the proposed governance rules may be a positive step, other alternatives better address the current model's weaknesses.

B. Other Alternatives

In addition to proposing the governance rules, the Commission described several alternative models for self-regulation.[142] For example, Congress or the SEC could require the SROs to form an independent

138. *Id*. at 71,171.

139. *Id*. at 71,180.

140. *Id*. at 71,182.

141. Recall, the 1961–1963 Special Study stated the basic problem with the SRO model is the tendency of each SRO to protect its members. *See* 1961–1963 Special Study of Securities Markets, *supra* note 11; Seligman, *supra* note 31, at 1362–64.

142. *See* Self-Regulation Concept Release, *supra* note 4, at 71,277–82.

subsidiary for regulatory operations, akin to the now-defunct NASD Regulation, Inc.[143] Structural separation would provide even more independence between market and regulatory operations than that required under the proposed governance rules.[144]

Yet, subsidiaries are not entirely removed from pressures directed at their parents. Both entities are part of one comprehensive scheme. Hence, a regulatory-subsidiary would not be entirely removed from the financial interests of its market-parent. Consequently, the fundamental (and fatal) flaw with the current model—SROs regulating their own members—is still alive here. If members can lure a market-parent into the financial trap, the regulatory-subsidiary will surely follow (albeit at a distance).

Moreover, structural separation does not address conflicting SRO rules and cross-market surveillance.

One of the more creative models is the creation of a universal "private" non-industry regulator, akin to the Public Company Accounting Oversight Board (PCAOB) to promulgate rules, oversee, and enforce securities laws.[145] Undeniably, the non-industry regulator would be free from the financial pressures that members exert on SROs.

The non-industry regulator also cures inefficiencies that result from multiple SRO regulations. Industry standards would be well defined, by the non-industry regulator's rules and interpretations.

Moreover, the non-industry regulator provides an avenue for improving cross-market surveillance. The regulator could update the ISG or create a new comprehensive audit trail system to compile information for adequate detection of cross-market violations.

Alas, constitutional issues make the (alleged "private") non-industry regulator less attractive. Professor Donna Nagy questions whether this model, as implemented to regulate the accounting profession, is truly private.[146] She argues that, despite Congress's delegation of the PCAOB as a private entity, the PCAOB is a public entity under Supreme

143. After the SEC enforcement action against the NASD for failing to detect violations against market makers conspiring to fix odd-eighth quotes, the NASD structurally split its regulatory obligations into a subsidiary. Seligman, *supra* note 31, at 1372. In 2002, the NASD reassumed regulatory duties. *Id*. at 1373.

144. *See* Proposed Governance Rules, *supra* note 13, at 71,141–43 (proposed governance rules require either structural or functional separation of market and regulatory operations).

145. *See* Self-Regulation Concept Release, *supra* note 4, at 71,280–81. The PCAOB was created in the Sarbanes-Oxley Act to oversee the accounting industry following the scandals after Enron's collapse in 2001. For an in-depth look at the PCAOB, see Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1006–22 (2005).

146. *See* Nagy, *supra* note 145, at 1029–44.

Court precedent.[147] And with that public status, the PCAOB is subject to additional restraints.[148] As indicated earlier, an often cited advantage to the current model is the ability of SROs to draft rules that go beyond those promulgated by Congress and the SEC.[149]

Probably the least likely alternative is the proposed SEC direct regulation. While this model resolves member-SRO conflicts and multiple SRO inefficiencies, financially this option makes little sense. Again, self-regulation (on some level) is necessary to prevent the average taxpayer from supporting the relatively few individuals who invest in the markets.[150] To be sure, the previous SEC experiment with direct regulation, SECO, was a disaster.[151]

The most promising models suggested in the concept release are the

147. *See id*. The leading case is *Lebron v. National Railroad Passenger Corp.*, where the Supreme Court held that Amtrak was a public entity under the Constitution, despite Congress's labeling the entity a private corporation. 513 U.S. 374, 391 (1995).

After *Lebron*, the lower courts developed two tests for determining whether an entity is a "public entity." The strict test applies three prongs under *Lebron* analysis; all must be satisfied for the entity to be public: (1) the entity was created by the government, (2) to further government objectives, and (3) the government has permanent authority to appoint a majority of the entity's board of directors. *See* Hack v. President & Fellows of Yale Coll., 237 F.3d 81, 84 (2d Cir. 2000); Horvath v. Westport Library Ass'n, 362 F.3d 147, 153 (2d Cir. 2004). The flexible test requires the same first two prongs, but looks at several factors after that, including the government's (1) appointment authority, (2) funding, (3) approval of rules and policies, and (4) supervision. *See* Nagy, *supra* note 145, at 1043 nn.390–93 (citing cases). *See also* Sotack v. Pa. Prop. & Cas. Ins. Guar. Ass'n, 104 F. Supp. 2d 471, 479 (E.D. Pa. 2000). Professor Nagy contends that both of these tests are easily satisfied when applied to the PCAOB. Nagy, *supra* note 145, at 1040–44. Congress crafted the PCAOB in Title I of the Sarbanes-Oxley Act, responding to the 2001–2002 accounting scandals. Members are appointed by the SEC. 15 U.S.C.A. § 7211(e)(4)(A)–(B) (West Supp. 2004). The SEC also approves the PCAOB's rules and budget and reviews disciplinary actions. *Id*. § 7217 (Commission oversight of the board); *id*. § 1719 (funding). Board members can be disciplined or removed by the Commission if cause is shown. *Id*. § 7211(e)(6).

148. Nagy, *supra* note 145, at 1044–48 (describing constitutional restraints on the PCAOB, including: (1) enhanced employee rights, (2) limitations on how inspections and investigations are conducted, and (3) due process requirements in disciplinary proceedings and rulemaking).

Some courts—looking at the "intimate involvement" between the SEC and SROs—have held SRO action constituted state action under traditional state action analysis. *See, e.g.*, Intercontinental Indus., Inc. v. Am. Stock Exch., 452 F.2d 935, 941 (5th Cir. 1971); Villiani v. N.Y. Stock Exch., Inc., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y 1972), *aff'd sub nom.* Sloan v. N.Y. Stock Exch., Inc., 489 F.2d 1 (2d Cir. 1973). But the modern (and proper) trend rejects this analysis. *See, e.g.*, Jones v. SEC, 115 F.3d 1173 (4th Cir. 1997) (holding that prior NASD enforcement action did not implicate res judicata or double jeopardy in SEC enforcement proceeding despite SEC review over the NASD). *See also* Nagy, *supra* note 145, at 1035 n.345.

149. *See* Self-Regulation Concept Release, *supra* note 4, at 71,256.

150. *See id*.

151. Congress employed SECO in 1964, requiring broker-dealers not registered with an SRO to register with the SEC. Self-Regulation Concept Release, *supra* note 4, at 71,267 n.181. For consistency, the SEC's regulations under SECO generally paralleled the NASD's. *Id*. But SECO proved unworkable, as the SEC tried to promulgate and enforce "just and equitable principles of trade." *Id*. In 1983, Congress abandoned SECO making SRO membership mandatory. *Id*. at 71,267.

pure-hybrid and industry regulator.[152] Under the pure-hybrid, the SEC would designate a single SRO to promulgate a uniform set of membership rules and to enforce these rules.[153] Individual SROs would remain responsible for regulating activity on their own markets.[154]

Thus, the pure-hybrid model smothers member-SRO conflicts. The single SRO would retain sole responsibility for regulating members. While conflicts remain between individual SROs and their issuers and shareholders, traditionally these conflicts have not been key factors in SRO breakdowns.

The pure-hybrid also improves on inefficiencies in multiple SRO rules and interpretations. Industry standards on member regulation would be defined by the single SRO. But individual SROs would still be responsible for enacting and regulating their own market rules; thus, all inefficiencies would not cease.

Also, the single SRO could take responsibility for developing a more comprehensive audit trail system to advance cross-market surveillance.

A universal industry regulator would be very similar to the non-industry regulator; only, rather than create a "private" board, a single SRO would take responsibility for overseeing member *and market* rules and regulation.[155] At first blush, this model is appealing: the industry regulator extinguishes SRO conflicts and multiple SRO inefficiencies, while providing a stable entity for audit trail development. Moreover, constitutional issues in the non-industry regulator analysis are not as likely to stir trouble because the regulating SRO is probably a *private* entity (unlike the PCAOB).[156]

The troubling aspect in the industry regulator model is that a single SRO could never oversee the markets with the attention and detail given by the individual SROs. In fact, with the industry regulator, non-industry regulator, and direct SEC regulation, the individual SROs become nothing more than a place for investors to gather and barter. Given the markets' complexity and the individual SROs' familiarity with operations, it seems quite radical to take away the individual SROs'

152. *See id*. at 71,277–80.

153. *Id*. at 71,277. The concept release also discussed a competing-hybrid model. *See id*. at 71,278–80. Instead of selecting a single SRO to regulate members, several SROs would be able to register with the SEC and offer regulatory services for members. *Id*. at 71,278. This model, however, does not ease the conflict between regulator and member. The competing SROs still have an incentive to enact soft rules in order to attract members. Nor does this model address multiple SRO inefficiencies or cross-market surveillance.

154. *Id*. at 71,278.

155. *Id*. at 71,280.

156. *See* Jones v. SEC, 115 F.3d 1173 (4th Cir. 1997); *supra* note 148.

authority to regulate their own markets.[157]

Both the pure-hybrid and industry regulator models have promising characteristics. The following proposed alternate-hybrid model builds on those positives.

C. The "Alternate-Hybrid" Model

The alternate-hybrid model combines concepts discussed in the pure-hybrid and industry regulator models. I recommend creating an industry-oversight committee, composed of directors from the NASD, NYSE, and individual SROs. SRO members would also be entitled to select twenty percent of the committee.[158] And listed issuers and investors would each have at least one representative on the committee.[159]

This committee serves several functions. To eliminate inefficiencies in duplicative SRO rules, the committee would draft uniform member and market rules. The committee, however, would not draft listing standards, which are to be left to the individual SROs. Also, the committee would hear selective appeals from the NYSE and NASD (on member enforcement actions), and the individual SROs (on market and listing enforcement actions). Appellate review ensures that rule interpretations are applied consistently by the SROs.

The NASD and NYSE would be dually responsible for member surveillance and enforcement. All SRO members would have to register with either the NYSE or NASD. Consequently, members would have to pay the NYSE or NASD for their regulatory services.[160] But this fee could be offset, in part, by a reduction in the individual SROs' fees, because the individual SROs will no longer discipline members. Nevertheless, total member fees would likely increase. While this increase may appear unfair, members would save in operational expenses from uniformity in SRO rules and interpretations.[161] As mentioned before, the industry-oversight committee, twenty percent member-selected, would establish uniform member and market rules.

Individual SROs remain responsible for market surveillance and

157. *See* Self-Regulation Concept Release, *supra* note 4, at 71,256.

158. Enabling members to select twenty percent of the committee is consistent with section 6(b)(3) of the Exchange Act, which generally ensures that members have a voice in SRO regulation. *See supra* note 130.

159. This requirement is also consistent with section 6(b)(3). *See id*.

160. Alternatively, members could continue to pay the individual SROs for all services. In this scenario, the individual SROs would then subsidize the NYSE and NASD for the member services they provide.

161. *See* Charles Schwab Comment Letter, *supra* note 109.

enforcement. Moreover, individual SROs still enact, oversee, and enforce their own listing standards. Thus, individual SROs can still compete for issuers through listing standards.[162]

The Commission expressed concern over distinguishing "member" and "market" rules.[163] For example, under the alternate-hybrid model, someone would have to distinguish member rules (regulated by the NYSE and NASD) from market rules (regulated by the individual SROs). While this may be a difficult task, the industry-oversight committee would be capable of making this determination. But, to avoid inherent conflicts, the NYSE or NASD would be ultimately responsible for enforcing any violation by a member. Thus, where a member potentially violates a market rule, the individual SRO would refer the matter to the NASD or NYSE, whomever the member is registered with.

The alternate-hybrid model addresses the conflicts that arise when SROs regulate their own members.[164] The committee would draft uniform member rules. Thus, financial interests will not affect rule creation. Nor will fiscal attraction disturb enforcement, which will be handled by the NYSE and NASD. Both of these SROs are leaders in their respective markets: NYSE (exchanges) and NASD (OTC). Moreover, these organizations have a history of successfully working together.[165]

In the pure-hybrid model, the SEC suggested designating a single SRO for member regulation.[166] But splitting member regulation between the NYSE and NASD is better. If a single SRO is responsible for member regulation, conflicts still exist between that SRO and its *own members*. To avoid this conflict, under the alternate-hybrid model, the NYSE would regulate NASD members, and vice versa.[167]

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162. Enabling individual SROs to lower listing standards in order to attract issuers does run the risk of regulatory arbitrage (the race to the bottom for SROs). *See supra* note 96 and accompanying text. But, historically, SRO conflicts with members—*not issuers*—cause the most trouble. *See supra* Part II (discussing breakdown at AMEX, NASD odd-eighth quote scandal, and SEC criticism of NYSE's discipline of specialists). And SRO listing standards would still be subject to SEC approval. 15 U.S.C. § 78s(b)(1) (2000) ("Each [SRO] shall file with the Commission, in accordance with [Rule 19b-4], copies of any proposed rule or any proposed change. . . . No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with . . . this subsection."). *See* 17 C.F.R. § 240.19b-4 (2004).

163. *See* Self-Regulation Concept Release, *supra* note 4, at 71,278 (describing the pure-hybrid's "boundary issue" between member and market rules).

164. *See* Part IV.A.

165. For example, the SEC worked together with the NYSE and NASD to adopt a uniform definition of "branch office." *See* Self-Regulation Concept Release, *supra* note 4, at 71,264.

166. *Id*. at 71,278.

167. Conflicts would still exist where members belong to both the NYSE and NASD. In this

More practically, giving member regulation to a sole-regulator requires that SRO's staff to drastically grow.[168] Dividing the responsibilities in half will reduce the expansion a single SRO would have to undertake.

The alternate-hybrid model also provides Congress and the SEC with a direct liaison to the industry.[169] The committee could serve as a link between the Commission and individual SROs.

With respect to cross-market surveillance, the industry-oversight committee would be the ideal entity to fashion a more comprehensive audit trail system. As indicated before, current systems like NASDAQ's OATS and the ISG do not provide necessary or timely information to effectively oversee cross-market trading.[170] Thus, the committee could be proactive in the development of a new system that would enable the individual SROs to better detect cross-market violations.

The alternate-hybrid approach does not raise the same constitutional concerns inherent in the non-industry regulator.[171] Recall, the PCAOB is arguably a public entity (subject to additional constitutional restraints): (1) the PCAOB was created by Congress, (2) to further governmental objectives, and (3) the commissioners are appointed by the SEC.[172] Conversely, under the alternate-hybrid model, the industry-oversight committee could originate under a Rule 17d-2 joint-regulatory agreement among SROs.[173] Lack of governmental establishment alone is sufficient to remove the committee from public-entity designation.[174] And, to be sure, the committee's board would be elected by industry

scenario, the NYSE and NASD would have to regulate their own members. But, these enforcement actions would be under the close scrutiny of the industry-oversight committee, who carries appellate review power. Thus, the likelihood for regulatory arbitrage is minimal.

168. *See* Self-Regulation Concept Release, *supra* note 4, at 71,278 (asking how the single SRO would be funded under the pure-hybrid model).

169. *See id*. (noting that the single SRO could "serve as a more effective liaison with the SEC, Congress, and international entities on behalf of the industry").

170. *See id.*, *supra* note 4, at 71,265.

171. *See* Nagy, *supra* note 145, at 1029–48; *supra* notes 146–48 and accompanying text.

172. *See* Nagy, *supra* note 145, at 1040–44; *supra* note 147.

173. *See* 17 C.F.R. § 240.17d-2 (2004); *supra* notes 112–13. Participation in the plan could be made a condition of registration as an exchange or association, similar to current conditions mandating registration with ISG. *See* Self-Regulation Concept Release, *supra* note 4, at 71,265.

174. Recall, both the strict and flexible tests under *Lebron* require the government to be the creator for the entity to be deemed a "public entity." *See supra* note 147.

A court could still apply traditional state action analysis and find that—due to the government's "sufficiently close nexus," Am. Mfrs. Mut. Ins. Co. v. Sullivan, 526 U.S. 40, 52 (1999), or "entwinement," Brentwood Acad. v. Tenn. Secondary Sch. Athletic Ass'n, 531 U.S. 288, 291 (2001), with the industry-oversight committee—the committee's actions constitute "state action." *See* Nagy, *supra* note 145, at 1033–34. But, as indicated before, modern courts are rejecting this analysis. *See* Jones v. SEC, 115 F.3d 1173 (4th Cir. 1997); *supra* note 148.

participants (SROs, members, issuers, and investors), not the federal government.

Finally, unlike direct SEC regulation, the alternate-hybrid model leaves the financial burden on those who participate in the industry and not the nonparticipating taxpayer. As previously noted, the SEC previously tackled the securities industry directly, and the experiment failed miserably.[175] Economic support should rest in those most likely to benefit from the system.

VI. THE ALTERNATE-HYBRID MODEL = HOME RUN

Tom Hanks was right: "There's no crying in baseball."[176] Now, the time has come to ease investors' whimpers.

The alternate-hybrid model achieves this result. Member-SRO conflicts are eliminated, because the NASD and NYSE would control member regulation. Multiple SRO inefficiencies are removed; the committee would set universal member and market rules. Superior cross-market surveillance is foreseeable—the committee could facilitate development of a comprehensive audit trail system. And the system retains the primary advantage of self-regulation: the industry's financial support.

175. Self-Regulation Concept Release, *supra* note 4, at 71,267 n.181; *supra* note 151.

176. A LEAGUE OF THEIR OWN (Columbia Pictures 1992). Even Red Sox fans no longer can whine after 2004's championship. O.K., the Cubs have not won the World Series since 1908. Baseball Almanac, http://baseball-almanac.com/ws/wsmenu.shtml. Poor Steve Bartman. *See id*., http://www.baseball-almanac.com/articles/Marvin-Terry-2003c.shtml.