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Best Execution: The National Market System's Missing Ingredient

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In 1975 Congress enacted legislation designed to foster the establishment of a national system for the trading of securities. Many of the goals of a national market cannot be achieved if brokers are not compelled to seek the best price when executing transactions in multiply traded securities. To date, the Securities and Exchange Commission has failed to adopt a rule either requiring or encouraging a best execution practice.

*This article examines the importance of a best execution rule to investors, to the national market system and to the economy. It explores the changes that have evolved in the securities industry in the wake of the national market system legislation. Finally, the article examines how these changes provide a strengthened argument for the implementation of a best execution rule.***

I. Best Execution: A Central Element of the National Market System

A. *Best Execution and The National Market System Legislation*

Virtually from its inception the concept of the national market system[1] included the imposition of a "best execution" obligation

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** This article addresses developments occuring prior to February 1982.

1 The "national market system" envisions a central market for securities of national importance created by linking existing market centers through communication and data processing facilities. The purpose of this linkage is to insure that all buying and selling interest in the subject securities can participate and be represented in a competitive market system. The phrase is also used to designate the rules governing the relationships among market participants. *See* 1 SECURITIES AND EXCHANGE COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92d Cong., 1st Sess. Pt. 1, at XXIV (Letter of Transmittal) (1971) [hereinafter cited as INSTITUTIONAL INVESTOR STUDY]; SECURITIES AND EXCHANGE COMMISSION (SEC), FUTURE STRUCTURE OF THE SECURITIES MARKETS, 37 Fed. Reg. 5286, 5287 (1972) [hereinafter cited as 1972 FUTURE STRUCTURE STATEMENT]. *See* notes 164 - 237 and accompanying test *infra* for a description of several national market system enhancements. The national market system received an explicit statutory mandate in 1975. *See* notes 12 & 13 *infra*.

Throughout the initial studies proposing the national market system, the word "national" was used interchangeably for "central" without necessarily intending any distinction.

upon market participants.[2] Such an obligation would encourage or perhaps require brokers to effect transactions in the market where execution could be made at the best available price.

The first congressional document that focused on the specific characteristics of the national market system suggested that "[m]embers of the [national market] system would have a fiduciary duty to seek 'best execution' of trades wherever within the system such trades may be effected."[3] When the Securities and Exchange Commission (SEC or Commission) first addressed the national market system, it likewise endorsed a best execution rule. In February, 1972, the Commission released a policy statement regarding the development of the national market system.[4] That statement indicated that in establishing goals for the future structure of the securities

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Ultimately, the phrase "national market system" gained currency and it is the phrase that will be used in the article.

2 The term "best execution" refers to a broker's fiduciary duty to seek the most favorable terms when executing his client's order. In determining which execution is most favorable to his client, a broker may consider many factors. Price is the primary factor, however, and it is the one that is generally intended when the phrase "best execution" is employed. Non-price factors which might prove significant when executing an order include (1) the speed and certainty of execution and (2) transaction and clearing costs. Non-price factors will be considered with the proposed best execution rule *infra*.

This article focuses on seeking the best price. The duty to seek the best price will refer to the highest price when selling and the lowest price when buying. PLI, THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 319-20 (R. Mundheim & A. Fleischer eds. 1972).

This article will examine the possibility of requiring best execution only for certain transaction orders. There are 21 different transaction orders defined in the New York Stock Exchange Constitution and Rules, Rule 13, 6 New York Stock Exchange Guide (CCH) ¶ 2013. It is instructive to distinguish between two basic categories of orders: (1) market orders (orders to execute at the most advantageous price available in the market, which includes all orders seeking broker discretion as to price and timing); and (2) limit orders (orders to execute at a specified price). This article does not attempt to analyze the possible effects of a best execution requirement on limit orders entered by a broker on a specialist's book. Such orders do not require broker discretion in price determination (though discretion is involved in determining in which specialist's book to leave the order). By contrast, best execution of market orders deals directly with the exercise of discretion by a broker operating within a multiple market system. The question of brokers' discretion as to the market on which to place a limit order is a discrete matter to be dealt with in general discussions of limit order systems. The Commission has proposed a limit order rule, but no public action has been taken on this proposal. Securities Exchange Act Rel. No. 15770, 44 Fed. Reg. 26,692 (1979).

3 SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. REP. NO. 1519, 92d Cong. 2d Sess. (1972). The study was actually comprised of two reports, prepared separately by each house of Congress over a period of about a year and a half. *See* SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. DOC. NO. 13, 93d Cong., 1st Sess. (1973) [hereinafter cited as SECURITIES INDUSTRY STUDY].

4 1972 FUTURE STRUCTURE STATEMENT, *supra* note 1. In 1971, the Commission had articulated some of the major goals of the national market system, but had not yet developed

markets, attention should be focused upon "where and how to get the best price for a buyer or seller of securities."[5] The Commission found that making available information on prices, volume and quotes would be an "essential step" toward the formation of the national market system. Investors should "not pay more than the lowest price at which someone is willing to sell nor sell for less than the highest price a buyer is prepared to offer."[6] In 1973, after receiving reports from three advisory committees,[7] the Commission issued another policy statement on the structure of the national market system.[8] The statement reiterated that a broker's primary duty to his customer would be "to use reasonable diligence to obtain best execution of each order entrusted to him."[9] Although the 1973 Policy Statement did not recommend a strict best execution rule, the statement clearly established best execution as a goal.

The Commission's next advisory committee on the national market system[10] articulated this best execution goal even more definitively. The committee concluded that a "broker-dealer acting as agent has an affirmative obligation to execute orders at their best possible price for its customer; a broker-dealer who does not execute a customer's order at the best possible price must be able to show reasonable justification."[11]

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a comprehensive plan for the system. INSTITUTIONAL INVESTOR STUDY, *supra* note 1, at XXII-XXV (Letter of Transmittal).

5 1972 FUTURE STRUCTURE STATEMENT, *supra* note 1, Statement of William J. Casey, SEC chairman, at 1 (Commissioner Casey's statement is not reprinted in the Federal Register).

6 *Id.* at 5287.

7 In the 1972 Future Structure Statement, the Commission announced that it would designate three working committees to evaluate the policies outlined in the Statement. The three committees were the Advisory Committee on a Central Market System, the Advisory Committee on Market Disclosure and the Advisory Committee on Block Transactions. The Central Market System Committee filed an interim report on October 11, 1972, and a second report on March 6, 1973. The Disclosure Committee reported on July 17 and November 21, 1972. The Block Transactions Committee reported on August 7, 1972.

8 SEC, STRUCTURE OF A CENTRAL MARKET SYSTEM, *reprinted in* 3 *Hearings on H.R. 5050 & 340 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign Commerce*, H.R. REP. NO. 52, 93d Cong., 1st Sess. 912 (1974) [hereinafter cited as 1973 Policy Statement].

9 *Id.* at 8.

10 In 1974 the Commission announced its plans to establish a Central Market System Advisory Committee to "provide the Commission with the views of knowledgeable people on ways of implementing its proposals for a central market system . . . ." Securities Exchange Act Rel. No. 10688 (Mar. 18, 1974), 3 SEC DOCKET 722 (Apr. 2, 1974). The proposals to be implemented were those incorporated in the 1973 Policy Statement, *supra* note 8.

11 SEC, REPORTS OF THE ADVISORY COMM. ON THE IMPLEMENTATION OF A CENTRAL

In 1975, as a result of the national market system studies,[12] Congress enacted legislation to promote the national market system (the 1975 Amendments). This legislation—specifically section 11A of the Securities Exchange Act[13]—directed the Commission to facilitate the establishment of a national market system consistent with the objec-

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MARKET SYSTEM (1975). The Committee transmitted its full and final report to the Commission on September 12, 1975.

12 While the Commission was in the process of formulating its national market system policies, Congress initiated its own studies on the matter. Extensive hearings by subcommittees in both Houses of Congress were conducted in 1971 and 1972. These hearings produced the Securities Industry Study in 1972. *See* SECURITIES INDUSTRY STUDY, *supra* note 3. The Securities Industry Study became the basis for various legislative proposals which were ultimately enacted as the 1975 Amendments. *See* note 13 *infra*. For a history of the hearings and the resulting legislative proposals, see HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT TO ACCOMPANY H.R. 4111, H.R. REP. NO. 125, 94th Cong., 1st Sess. 45 (1975) [hereinafter cited as 1975 HOUSE REPORT]; SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, REPORT TO ACCOMPANY S. 249, S. REP. NO. 75, 94th Cong., 1st Sess. 1-3 (1975) [hereinafter cited as 1975 SENATE REPORT].

13 Securities Exchange Act of 1934, § 11A(a)(1), 15 U.S.C. § 78k-1(a)(1) (1976) (added by Securities Act Amendments of 1975, Pub. L. No. 94-29, § 7, 89 Stat. 111) [hereinafter cited as 1975 Securities Amendments or 1975 Amendments]. Section 11A(a) reads:

> (1) The Congress finds that—
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> (A) The securities markets are an important national asset which must be preserved and strengthened.
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> (B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.
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> (C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—
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> (i) economically efficient execution of securities transactions;
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> (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and other exchange markets;
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> (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
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> (iv) the practicability of brokers executing investors' orders in the best market; and
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> (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.
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> (D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders and contribute to best execution of such orders.
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> (2) 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 (which may include sub-systems for particular types of securities with unique trading characteristics) in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission, by rule, shall designate the securities or classes of securities qualified for trading in the national market system from among securities other than exempted

tive of assuring "the practicability of brokers executing investors' orders in the best market."[14] Although the 1975 Amendments did not mandate a best execution rule, the legislative history left little doubt that a central goal of the national market system legislation was to insure that "investors will be able to obtain the most favorable price for securities."[15]

B. *Best Execution and Market Functions*

Assuring "the practicability of brokers executing investor's orders in the best market"[16] is not mere window dressing. The concept of best execution is central to goals of the national market system.

Allocational efficiency is a primary economic function performed by the securities markets.[17] The SEC's 1973 Policy State-

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securities (securities or classes of securities so designated hereinafter in this section referred to as "qualified securities").

(3) The Commission is authorized in furtherance of the directive in paragraph (2) of this subsection—

(A) to create one or more advisory committees pursuant to the Federal Advisory Committee Act (which shall be in addition to the National Market Advisory Board established pursuant to subsection (d) of this section) and to employ one or more outside experts;

(B) by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system (or a subsystem thereof) or one or more facilities thereof; and

(C) to conduct studies and make recommendations to the Congress from time to time as to the possible need for modifications of the scheme of self-regulation provided for in this title so as to adapt it to a national market system.

14 *Id.* § 11A(a)(1)(C)(iv) & (a)(2), 15 U.S.C. § 78k-1(a)(1)(C)(iv) & (a)(2) (1976).

15 1975 HOUSE REPORT, *supra* note 12, at 93. *See* 1975 SENATE REPORT, *supra* note 12, at 7. The Senate Report stated that a "paramount" objective of a national market system was "the centralization of all buying and selling interest so that each investor will have the opportunity for the best possible execution of his order, regardless of where in the system it originates." *Id.*

16 Securities Exchange Act of 1934, § 11A(a)(1)(C)(iv), *supra* note 13, 15 U.S.C. § 78k-1(a)(1)(C)(iv) (1976).

17 I. FRIEND, THE SEC AND THE ECONOMIC PERFORMANCE OF SECURITIES MARKETS, ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 190 (H.G. Manne ed. 1969) [hereinafter cited as THE ECONOMIC PERFORMANCE OF SECURITIES MARKETS]. Allocational efficiency is a function of secondary as well as new issue markets. Professor Friend indicates that although allocational efficiency is a particularly important function of the primary distribution markets, it also is significant for secondary trading markets because "[p]rices and the flow of capital in the new issues markets are, of course, closely (but not completely) tied to prices and activity in the market for outstanding issues." *Id.* at 190 n.5. The other generally recognized primary function of a securities market is raising capital. *See generally* W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY (1965); S. ROBBINS, THE SECURITIES MARKETS: OPERATIONS AND ISSUES (1966); R. WEST & S. TINIC, THE ECONOMICS OF THE STOCK MARKET (1971).

ment affirmed this truism, stating that a vital function of the securities markets is the allocation of investment capital.[18] The Policy Statement noted that for allocation to be effective, "the markets [must] value each security in a manner which reflects an accurate appraisal of overall supply and demand."[19] Accurate appraisal of securities, and hence allocational efficiency,[20] can only be achieved if market participants seek the best price for their executions. If all brokers seek best execution, a transaction price reflective of the total supply and demand in the market will result.[21]

In addition to improving allocational efficiency, a best execution policy advances the capital formation function of markets by promoting investor confidence. A best execution policy enhances investors' perception of the market's fairness. In one of its initial statements concerning the development of the national market system, the SEC contended that investor confidence would be strengthened by a best execution policy.[22] Such strengthened investor

18 1973 Policy Statement, *supra* note 8, at 6.

19 Assuring "efficient and effective allocation of investment capital" within the trading market was also a primary motivation behind the drafting of the 1975 Securities Amendments. 1975 HOUSE REPORT, *supra* note 12, at 44. Arguably, a best execution policy would also aid the capital formation function of securities markets. If investors are assured that they will receive best execution, they will be more willing to enter the securities markets. The increased willingness of investors to enter the markets should lower the costs of raising capital.

20 "Allocational efficiency" has been defined by Professor Friend as the "relationship between the security price and the subsequent actual return on the underlying economic asset." THE ECOMONIC PERFORMANCE OF SECURITIES MARKETS, *supra* note 17, at 190 n.6.

21 In the national market system, the same security is often traded in more than one market center. A best execution requirement would probably not achieve allocational efficiency if the various market centers were not linked to one another through a system providing both communication and execution facilities. Essential to effecting best execution, this linkage is a critical element of the national market system. 1975 Securities Amendments, § 11A(a)(1)(D), *supra* note 13, 15 U.S.C. § 78k-1(a)(1)(D)(1976). The Commission, in commenting on the interrelationship between the various elements of the national market system, stated:

> [A]n essential step toward the formation of a central market system is to make information on prices, volume and quotes for all securities in all markets available to all investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell nor sell for less than the highest price a buyer is prepared to offer. Such a communication system would thus serve to link the now scattered markets for listed securities.

1972 FUTURE STRUCTURE STATEMENT, *supra* note 1, at 5287. Although it is difficult to examine best execution without discussing market linkages (and vice versa), to avoid circularity this article will first analyze best execution requirements and then examine market linkage systems.

22 In 1972, the Commission opined that "investor confidence will be strengthened as professional attention is reconcentrated on finding the best market. . . ." 1972 FUTURE STRUCTURE STATEMENT, *supra* note 1, Statement of William J. Casey, SEC Chairman, at 1-2.

confidence should attract more investors and capital into the securities market[23] and thus lower the costs of raising capital.

C. *Best Execution and Competition*

The national market system is based on a framework of competing market centers. The very existence of these multiple market centers creates the potential for different execution prices in multiply traded securities.[24] This potential makes it particularly important to require best execution in order to insure efficient market operations. Moreover, the existence of multiple market centers also allows for intermarket competition in pricing.

Historically, the Commission and Congress have encouraged competition among market centers. In the 1963 Special Study of Securities Markets, the Commission strongly supported the maintenance and fostering of competitive regional markets.[25] A high percentage of the trading conducted on regional exchanges involves securities listed on the New York Stock Exchange.[26] The Special

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Strengthening investor confidence also was important to Congress. In 1975, the rapid attainment of a national market system was recognized as an important means of "bolster[ing] sagging investor confidence." 1975 SENATE REPORT, *supra* note 12, at 3.

23 The new chairman of the SEC, John S.R. Shad, has stated that attracting capital into American business is his top priority concern. The Washington Post, July 26, 1981, § F (Business & Finance), at 1, col. 5.

24 Of the approximately 2200 securities traded on the New York Stock Exchange, in any given month between 1100 and 1300 of them are traded on at least one other exchange. *See* note 244 *infra*.

25 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 2, at 946-61 (1963) [hereinafter cited as SPECIAL STUDY]. The "regional exchanges" are generally defined as all stock exchanges other than the New York Stock Exchange and the American Stock Exchange, which are referred to as the "primary exchanges."

The major regional exchanges today include the Boston, the Cincinnati, the Midwest, the Philadelphia and the Pacific Stock Exchanges. For an account of the development of regional exchanges, see Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233 (1975); 2 SPECIAL STUDY, *supra* at 922-36. For a discussion of securities traded on the primary and regional exchanges, see note 26 *infra*.

26 A security may be traded on an exchange either in a listed or unlisted trading capacity. For a security to be traded in a listed capacity, the issuer must apply for and be granted registration by an exchange pursuant to § 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(b) (1976). The most prestigious exchange on which to list and the one on which an issuer will receive the greatest exposure if it can meet the listing standards is the New York Stock Exchange. 2 SPECIAL STUDY, *supra* note 25, at 811. An issuer may infrequently be listed on more than one exchange.

A security already listed on one exchange may be traded on another exchange if that exchange applies to the Commission pursuant to § 12(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*(f) (1976), for unlisted trading privileges and if such privileges are granted. Typically, such privileges are sought for securities which are heavily traded on the primary exchange. 2 SPECIAL STUDY, *supra* note 25, at 951. Privileges can also be sought for

Study considered competition a desirable means of encouraging technological developments,[27] for providing incentives toward better executions,[28] for reducing the need for government regulation[29] and, possibly, for increasing total market depth.[30] The Commission concluded that the benefits of intermarket competition outweighed any possible negative effect on the depth of existing markets.[31]

The theme of competing market centers was echoed in later Commission and congressional reports.[32] The reports proposed that, rather than being separate, these markets should be linked by a communications system.[33] The linkage of these competing markets was

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unlisted trading in non-exchange traded securities pursuant to § 12(f). In recent years, however, no such application has been approved. Except for an initial period, immediately after the enactment of § 12(f), the Commission routinely granted unlisted trading privileges in exchange-traded securities. Then in 1977, in response to the Midwest Stock Exchange's application for unlisted trading privileges in 910 securities listed on the New York Stock Exchange, the Commission instituted an unofficial moratorium on the extension of unlisted trading privileges. The moratorium was lifted in 1979, and the Commission returned to its liberal policy. Securities Exchange Act Rel. No. 16422 (Dec. 12, 1979), 18 SEC DOCKET 1323 (Dec. 26, 1979). *See* 2 SPECIAL STUDY, *supra* note 25, at 919-23. Securities with a primary listing on the New York Stock Exchange that are traded on a regional exchange are called "dually" or "multiply" traded securities.

By 1963, 93% of the dollar volume of trading on major regional exchanges was in multiply-listed securities. 2 SPECIAL STUDY, *supra* note 25, at 930. Today, trading on regional exchanges continues to be dominated by multipy-traded securities. The total trading volume on the five major regional exchanges, however, constitutes only 10.3% of the total volume of trading in New York Stock Exchange-listed stocks. SEC, 39 STATISTICAL BULL. no.4, at 15 (May 1980) (the percentage represents trading volume in Dec. 1979). Although 10% of the New York Stock Exchange trading volume can have a significant effect on a security's trading price, the effect would be even greater if the regionals had greater trading volume. Enforcement of a best execution rule and implementation of adequate order execution equipment would arguably increase the trading volume conducted on the regionals in multiply-traded securities. *See* text accompany notes 32-34 *infra*.

27 2 SPECIAL STUDY, *supra* note 25, at 946-47.

28 *Id.* at 956.

29 *Id.* at 957.

30 *Id.*

31 *Id.* at 951.

32 "[T]he encouragement of multiple, competitive markets appears to be the most direct and efficient way of achieving a truly national [market] system." SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, 92d Cong., 2d Sess. 45 (Comm. Print 1972) (interim report covering the period up to Feb. 4, 1972). *See* INSTITUTIONAL INVESTOR STUDY, *supra* note 1, at XXII-XXV; 1972 FUTURE STUCTURE STATEMENT, *supra* note 1, at 5286; 1973 Policy Statement, *supra* note 8, at 6-16.

33 The 1972 Future Structure Statement noted that the Commission's position on the national market system in the Institutional Investor Study represented a shift in philosophy. 1972 FUTURE STRUCTURE STATEMENT, *supra* note 1, at 5286. Until that time, the Commission had favored competing, but separate, markets. Starting with the Institutional Investor Study, the Commission began to favor competing markets linked by communication systems to form a central market system.

intended to increase efficiency and liquidity. The various pronouncements regarding competition were ultimately embodied in the 1975 Amendments, which included a congressional finding of a need to insure "fair competition . . . among exchange markets . . . ."[34]

The goal of competitive market centers was to be achieved in part through the elimination of certain anti-competitive barriers such as fixed commission rates and restrictions on offboard trading.[35] It was also understood, however, that competition among markets could not be fully achieved without a best execution requirement. Like many of the objectives of the national market system, competitive markets and best execution are closely interrelated. One objective cannot be successfully achieved without the other. In addition, both objectives are closely tied to the distribution of order flow to market centers. To earn a profit, market makers must be exposed to order flow.[36] Order flow will only develop if market makers are competitive and if brokers are required to seek the best market for their executions. Market makers will only be competitive if it is technically feasible for them to be exposed to order flow[37] and if they know that in making good markets they will attract brokers seeking the best available price.[38]

34 1975 Securities Amendments, § 11A(a)(1)(C)(ii), *supra* note 13, 15 U.S.C. § 78k-1(a)(1)(C)(ii) (1976). The 1975 House Report adopted by reference the competitive goals advocated in the Institutional Investor Study, the 1972 Future Structure Statement, the 1975 Policy Statement and the Securities Industry Study. 1975 HOUSE REPORT, *supra* note 12, at 51 nn. 6 & 9.

Section 11A(a)(1)(C)(ii) also speaks of a need for competition "between exchange markets and markets other than exchange markets . . . ." 15 U.S.C. § 78k-1(a)(1)(C)(ii) (1976).

35 *See, e.g.*, 1975 HOUSE REPORT, *supra* note 12, at 49-50.

36 1973 Policy Statement, *supra* note 8, at 9.

37 It is argued that order flow is necessary for market makers to make competitive markets. In the analogous context of options trading, the Commission has stated "[w]ithout exposure to customer orders, it may be unlikely that an exchange will be able to improve the quality of its market and thereby attract more orders in the future. Such improvements may be unlikely because market makers on the secondary exchange will not be able to assess accurately the supply and demand for, or to adjust their position easily with respect to, multiply-traded [securities] if they do not have an opportunity to be exposed to, and trade with, customer orders." SEC, REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS 854 (Comm. Print 1979) (House Comm. on Interstate and Foreign Commerce). In enacting the 1975 Securities Amendments, Congress found that exposure of market makers' quotations to the entire market system should "encourage dealers to risk their capital in the market." 1975 HOUSE REPORT, *supra* note 12, at 91. To be an effective competitor, a market maker must have sufficient capital to enable him to take risks. Such capital comes from profits which arise only with order flow.

38 The 1973 Policy Statement explained that "[t]he desire to attract business provides incentive to a market maker to bid higher or offer lower than his competitors, narrowing the spread between available bids and offers and enabling investors to buy for less and sell for

The relationship between best execution, competitive markets and order flow was recently described by the SEC in the context of a discussion of order-routing facilities:[39]

> If market makers in a particular market center have reasonable expectations that they will receive a greater amount of order flow if they make markets which are consistently better in terms of price, depth, or ease of execution, the Commission believes they will be more likely to compete aggressively—thereby providing a better and more efficient market.[40]

The market makers' expectation of order flow can only develop if brokers are under a best execution obligation and if facilities exist to allow such obligations to be satisfied. The relationships are interwoven. If the best execution requirement is removed from the equation, competitive markets will not be achieved and the national market system will not develop much beyond the theoretical stage.

D. *Best Execution and National Market System Facilities*

A best execution rule is necessary to insure the effective operation of the communication and order-routing facilities designed to integrate competing market centers. A symbiotic relationship exists between a best execution rule and these systems. Brokers must employ these systems to fulfill their best execution obligations and the functioning of the systems depends upon brokers seeking best execution. Later in this article the ability of these communications and execution systems to assist brokers in achieving best execution will be fully analyzed.[41] At present, these systems will be briefly discussed, in order to describe the impact of the lack of a best execution rule upon them.

The composite quotation system (CQS)[42] is one of the communications systems designed to integrate the competitive market centers of the national market system. The "quote rule," rule 11Acl-1,[43] gov-

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more." 1973 Policy Statement, *supra* note 8, at 9. This model will only work as described if brokers always seek the best price.

39 Order-routing facilities permit brokers to route orders for securities from the broker's office to market trading centers.

40 Securities Exchange Act Rel. No. 15671, 44 Fed. Reg. 20,360, 20,366 (1979) [hereinafter cited as Progress Assessment Release]. This release assessed the development of the national market system.

41 *See* text accompanying notes 161-245 *infra*.

42 For a full discussion of the operation of CQS, see text accompanying notes 161-90 *infra*.

43 Adopted by the Commission pursuant to § 11A(a)(1)(C) of the 1934 Act. Securities Exchange Act Rel. No. 14415, 43 Fed. Reg. 4342 (1978) [hereinafter cited as Quote Release].

erns CQS. The quote rule requires each exchange and association to collect quotation information generated on its floor, including quotation size, for those securities for which last sale information is reported pursuant to rule 11Aa3-1.[44] The exchange or association must make the quotation information available to securities information vendors for dissemination to members of the securities industry and the public. In most instances, the rule also requires that the broker or dealer generating the quotes execute any order at the price quoted and up to the quoted size.

The Commission has described CQS as being "[a]t the heart of the central market system."[45] Despite the considerable costs involved in collecting and disseminating "firm" quotation information on a continuous basis, the Commission determined that these costs must be borne in order to advance the purposes of the Exchange Act.[46]

CQS was intended to enable brokers to make informed order routing decisions and to increase order flow to markets providing better quotations. This price-responsive order flow should foster increased competition among markets.[47] Many large retail brokerage houses, however, rely heavily on routing systems that send orders to a single designated exchange to which they belong or to which they have access.[48] This routing is performed without regard to displayed

44 Rule 11Aa3-1 was promulgated in Securities Exchange Act Rel. No. 15250, 43 Fed. Reg. 50,606 (1978), as an amended version of former rule 17a-15. It establishes procedures governing the collection, processing and dissemination of last sale reports. 17 C.F.R. § 240.11Aa3-1(1981). Pursuant to this rule the major exchanges and the securities association established a Consolidated Tape Association to administer a plan providing a single data stream of last sale reports. These reports, appearing on the "Consolidated Tape," comprise a critical element in unifying the trading centers of the national market system.

45 1973 Policy Statement, *supra* note 8, at 64. The 1975 Securities Amendments, in noting the potential impact of communication systems such as CQS, pronounced that "[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations." Securities Exchange Act of 1934, § 11A(a)(1)(B), *supra* note 13, 15 U.S.C. § 78k-1(a)(1)(B) (1976). *See* note 161 *infra*.

46 Quote Release, *supra* note 43, at 4347.

47 *Id.* at 4346.

48 The 1975 Senate Report stated that "[l]arge brokerage firms rely heavily on high speed systems for the direction of orders to a designated facility for execution. The [Senate] Committee has been informed that many of these systems are currently geared to route orders for any particular security to only one market center, e.g., the NYSE [New York Stock Exchange]. The functioning of such systems in this manner is inconsistent with the development and operation of a national market system. It may also be inconsistent with a broker's obligation to obtain 'best execution' for his customer." 1975 Senate Report, *supra* note 12, at 104-05. Because these routing systems are not neutral in nature, they do not route orders to the market with the best quotation, and consequently order flow will not necessarily develop at the market with the best quotations. The Commission recently confirmed that many retail firms also ignore the over-the-counter markets in their routing decision. In describing the

quotations. In the absence of an enforced best execution rule, brokers will not necessarily examine the prices quoted on CQS before routing their orders. This makes it less likely that order flow will develop to the market center with the best price. Consequently, there is less incentive for exchange members to provide, and for exchanges to collect and forward to vendors, reliable quotation information.[49] The lack of a best execution rule has compelled exchanges to implement surveillance systems and to employ monitoring personnel to insure member compliance with the quote rule.[50] This has made it even more expensive for exchanges to insure the efficient operation of CQS. Moreover, the lack of a best execution rule prevents CQS from operating as effectively as possible.[51]

Another technological improvement upon which the national

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routing of 19c-3 securities, see text accompanying notes 238-40 *infra*, the Commission noted that retail firms "route their retail orders in [19c-3] securities to the primary markets." SEC, A MONITORING REPORT ON THE OPERATION AND EFFECTS OF RULE 19C-3 UNDER THE SECURITIES EXCHANGE ACT OF 1934, 17 (1981), Securities Exchange Rel. No. 18062 (Aug. 25, 1981), [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,024 [hereinafter cited as RULE 19C-3 MONITORING REP.].

49 The Commission has frequently noted that compliance with the quote rule is often not at a satisfactory level. In November, 1979, in response to inquiries made by Congress, the Commission cited the following compliance problems: "failure of brokers and dealers (1) to provide quotations, (2) to honor their quotations, (3) to provide quotations which reflect the actual prices at which they are willing to trade and (4) to update their quotation on a timely basis." *Joint Hearings on Progress Toward the Development of a National Market System Before the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 96th Cong., 1st Sess. 514 [hereinafter cited as *1979 Oversight Hearings*] (letter from Harold M. Williams, SEC Chairman, to the Honorable Bob Eckhardt, Chairman, Subcomm. on Oversight and Investigations, and the Honorable James Scheuer, Chairman, Subcomm. on Consumer Finance and Protection, Nov. 9, 1979) [hereinafter cited as *1979 Oversight Hearings Response Letter*].

More recently, the Philadelphia Stock Exchange was censured for violating the quote rule by failing to "establish and maintain adequate procedures and mechanisms necessary to collect, process, and make reliable quotations from its members." Securities Exchange Act Rel. No. 16648 (Mar. 13, 1980), 19 SEC DOCKET 876 (Mar. 25, 1980). Shortly thereafter, Dean Witter Reynolds, Inc., a large retail brokerage house, was found to have violated the quote rule for failing to report quotations in certain securities in which it operated as a specialist on the Philadelphia Stock Exchange. Securities Exchange Act Rel. No. 16808 (May 15, 1980), 20 SEC DOCKET 14 (May 27, 1980). In each of the above instances, the Commission stressed that compliance with the quote rule is the "touchstone" of the national market system. A stringent best execution rule would not entirely eliminate these compliance problems. There would be more incentive, however, to comply with the quote rule if market participants knew that compliance with the quote rule might bring increased order flow.

50 To insure compliance with the quote rule, one exchange has stationed full time employees on the exchange floor to monitor compliance. Another exchange has established a quotation audit trail to insure that quotes remain firm. *1979 Joint Hearings Response Letter*, *supra* note 49, at 513-14.

51 For a full discussion of the operational problems of CQS, see notes 180-90 and accompanying text *infra*.

market system relies for bringing together all buying and selling interests is the Intermarket Trading System (ITS).[52] ITS is an execution system[53] that links together the two primary exchanges and five regional exchanges.[54] By mid-1982, the over-the-counter markets are to be linked to ITS.[55]

ITS is central to the national market because it enables a broker who is physically present on the floor of one market to electronically route an order to another market for execution. The broker is no longer restricted to executing orders in the market center in which he is present nor is he required to go through timely external communication facilities to execute an order on another market. In conjunction with the quotations available from the CQS, a broker can determine which market is quoting the best price for a particular transaction and then execute the order on that market through ITS. Together, CQS and ITS should permit trading volume to flow to the markets with the best prices. This should encourage competitive markets while affording customers best execution.

In its first general pronouncement on the national market system made after the 1975 Amendments, the Commission stated that the development of intermarket execution systems was necessary to "increase the opportunities for brokers to secure best execution of their customers' orders, to ensure effective competition among qualified markets and to achieve the purposes of a national market system established by the Congress in Section 11A(a) of the Act."[56]

ITS, however, cannot be effective without a strong best execution rule. The failure of brokers to seek the best price for their customers' orders leads to the execution of transactions on one exchange at prices inferior to those quoted on another exchange. These executions at inferior prices, or "trade-throughs,"[57] serve to convince bro-

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52 The SEC originally authorized the planning, development and operation of ITS through the joint action of various exchanges in Securities Exchange Act Rel. No. 14661, 43 Fed. Reg. 17,419 (1978).

53 For a discussion of other intermarket execution systems, see text accompanying notes 207-41 *infra*.

54 By February, 1981, all the major national securities exchanges were participants in ITS. *See* note 192 and accompanying text *infra*.

55 *See* note 142 *infra*.

56 Securities Exchange Act Rel. No. 14416, 43 Fed. Reg. 4354, 4358 (1978) [hereinafter cited as National Market System Development Release].

57 In a recent order extending the life of the ITS to January 31, 1983, the Commission indicated that its monitoring of ITS confirmed that trade-throughs occasionally occur. Securities Exchange Act Rel. No. 16214, 44 Fed. Reg. 56,069, 56,070 (1979) [hereinafter cited as *ITS Extension Order*].

kers that ITS is not an effective tool for promoting best execution.[58] This in turn discourages use of ITS and impedes the regional markets from developing effective competition.

E. *Lack of a Best Execution Rule*

SEC and congressional studies of the national market system have stressed the importance of developing means to insure that buyers and sellers obtain the best price for their transactions. The 1975 Securities Amendments directed the SEC to insure the practicability of executing transactions in the best market. Despite this background, the Commission has refrained from adopting a best execution rule.

In fairness, the Commission's refusals to adopt a best execution rule are nearly always accompanied by caveats which either explain: (1) that although no best execution rule will be adopted, a specific technological development will improve the opportunity for best execution; or (2) that, even in the absence of an SEC rule, brokers are already under a fiduciary obligation to secure best execution. For example, when the Commission adopted the quote rule it argued that it did not believe it "appropriate . . . to promulgate a 'best execution' rule" given the structure of the securities market at that time.[59] The Commission did believe, however, that the quote rule "should spur brokers to make greater efforts to achieve best execution of their customers' orders."[60] Similarly, in 1979, the Commission deferred consideration of the merits of requiring individual routing of customers' orders to the best market (as opposed to automatic routing to the primary market). In the same release, the Commission reminded the brokerage community of its duty to make at least periodic assessments of the quality of competing markets in order to assure that it was taking all "reasonable steps under the circumstances" to seek best execution of customer orders.[61]

The SEC has on occasion flirted with the idea of adopting a best execution rule. On the same day that the Commission determined

58 In testimony of the Pacific Stock Exchange, trade-throughs were described as a "major problem" of ITS, the "widespread occurrence" of which discourages "all participants in ITS exchanges from taking ITS seriously." *1979 Oversight Hearings*, *supra* note 49, at 244-45.

59 Quote Release, *supra* note 43, at 4347.

60 *Id.* at 4346-47.

61 Progress Assessment Release, *supra* note 40, at 20,366. The Commission argued that this obligation arose from decisions dealing with the broker's duty to seek best execution. Some of these decisions were listed by the Commission. For the Commission's list of decisions dealing with existing broker duties to seek best execution, see *id.* at 20,366 n.30.

not to adopt a best execution rule in its Quote Release, it warned in its National Market System Development Release that "[s]hould development of a comprehensive [national] order routing system . . . not be undertaken voluntarily by the self-regulatory organization, the Commission is prepared to initiate rulemaking to consider appropriate means of ensuring" the development of such a system.[62] The Commission explained that one of the "actions available" to it was the adoption of a rule which would "require brokers to demonstrate that they have given appropriate consideration to execution opportunities in all qualified markets on directing their customers' orders to any particular market."[63]

The Commission's message remains, however, that it will not, at present, promulgate a best execution rule. The Commission typically cites the "current trading environment" as the basis for its refusal. The Commission has stated that it is not reasonable to "require brokers under all circumstances to route their customers' orders to the market displaying the best quotation."[64] No public examination has been made, however, of the reasonableness of requiring brokers under *some* circumstances to route *some* of their customers' orders to the best markets. As of the writing of this article, more than six years after the passage of the 1975 Amendments, participants within the national market system are not bound by a specific SEC best execution rule.

II. Present Best Execution Law

A broker's duty to obtain the best price when executing his customers' orders can arise from federal judicial and administrative law, exchange regulations or common law.[65] The principles governing these bodies of law, however, were developed before the national market system legislation and the technological restructuring of the securities market. An examination of these bodies of law and the advancements achieved under the national market system must be

62 National Market System Development Release, *supra* note 56, at 4359.

63 *Id.*

64 Quote Release, *supra* note 43, at 4347.

65 As the Commission has observed in a number of releases, existing standards for broker execution of customer's orders require a broker to seek best execution for his customer. "[T]he Commission believes that a broker's existing fiduciary duty to his customers requires that he take cognizance of quotation information available through a composite quotation system in seeking best execution of his customer's orders." Quote Release, *supra* note 43, at 4347. *See* Progress Assessment Release, *supra* note 40: "[T]he [development of a limit order protection system] would in no way limit a broker's *existing* duty to seek to obtain best execution of his customer's orders." *Id.* at 20,366 n.30 (emphasis added).

conducted before a realistic national market system best execution policy can be proposed.

A. *Federal Common Law*

Federal law, both case law and administrative law, governing the broker's best execution duty is based upon either the "shingle theory" or the "fiduciary theory." Under the shingle theory,[66] when a broker-dealer hangs out his shingle to do business, he impliedly represents to the public that he will deal fairly and act in accordance with the standards and practices of the profession.[67] If the broker's conduct fails to meet the standards of his profession, he has misrepresented his behavior to his customer, thereby violating the antifraud provisions of the federal securities acts.[68]

Closely aligned to the shingle theory is the fiduciary theory of broker responsibility. This theory is applied primarily in situations where a broker-dealer has established a relationship of trust and confidence with his customer.[69] The duties of the broker-dealer under the fiduciary theory arise from common law principles governing the duties of an agent to his principal. These principles require an agent to disclose any conflicting interest which would dissuade the agent from acting in the principal's best interest. A breach of this duty constitutes, as with the shingle theory, a violation of the antifraud provisions of the securities laws.

In order to analyze the effect of the shingle theory and the fiduciary theory upon a broker's best execution duty, it is necessary to briefly explore the development of these theories.

1. Origin and Nature of the Shingle Theory

The Commission first enunciated the shingle theory in *In re Duker & Duker*.[70] In this case a partner in a brokerage firm sold se-

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66 So christened by Professor Louis Loss. *See* Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948) [hereinafter cited as *Broker-Dealer*].

67 *In re* Duker & Duker, 6 S.E.C. 386, 388-89 (1939).

68 *See generally* 5A A. JACOBS, THE IMPACT OF RULE 10b-5 ¶ 211 (Securities Law Series, rev. ed. 1980) [hereinafter cited as JACOBS]; S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS ¶ 7.09 (1977) [hereinafter cited as JAFFE]; 3 L. LOSS, SECURITIES REGULATION 1482 (1961) [hereinafter cited as 3 L. LOSS]; N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.03 (1977) [hereinafter cited as WOLFSON, PHILLIPS & RUSSO]; *Broker-Dealer*, *supra* note 66, at 518.

69 *See generally* 3 L. LOSS, *supra* note 68, at 1500-08, Cohen & Rabin, *Broker-Dealer Seller Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 703 [hereinafter cited as *Cohen & Rabin*].

70 6 S.E.C. 386 (1939).

curities to customers at prices substantially above the market price and purchased securities from other customers at prices substantially below the market price. The Commission, in a proceeding for the revocation of the broker's registration, found that the broker's behavior violated section 15(c)(1) of the 1934 Act—the antifraud provision specifically applicable to brokers.[71]

The Commission explained that an obligation to deal fairly with the customer is "inherent in the relationship between a dealer and his customer."[72] Thus, the broker-dealer, by virtue of his relationship with the customer, impliedly represented that he would deal fairly and act in conformance with the standards of the profession. In this instance, the broker knew the implied representation to be false. The Commission found that the broker, by charging excessive markups and mark downs, had defrauded customers who relied on the broker's implied representation.

The Second Circuit, in *Charles Hughes & Co. v. SEC*,[73] was the first court to adopt the Commission's shingle theory. The court affirmed an order revoking a broker-dealer's registration for willful violation of the antifraud provisions of section 17(a) of the 1933 Act,[74]

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71 Section 15(c)(1) of the Securities Exchange Act of 1934 reads as follows:

> No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, and no muncipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

15 U.S.C. § 78*o*(c)(1) (1976).

72 6 S.E.C. at 388.

73 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

74 Section 17(a) of the 1933 Act reads as follows:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976).

and section 15(c)(1) of the 1934 Act. The Commission found that the broker-dealer failed to reveal true market prices to its customers and that it charged prices ranging from 16.1 percent to 40.9 percent over market value. In affirming the Commission's order, the court held that the broker's markup policy operated "as a fraud and deceit upon the purchasers, as well as constituting an omission to state a material fact."[75] Judge Clark found the broker-dealer to be "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions."[76] This duty requires the broker who has actively solicited customers and who holds himself out as competent to advise customers to "disclose the market price [of securities to be sold] if sales are to be made at substantially above that level."[77] In light of this duty, the *Hughes* court found that the failure to disclose the excessive markup was "both an omission to state a material fact and a fraudulent device."[78]

2. Origin and Nature of the Fiduciary Theory

The fiduciary theory is traditionally applied in those instances in which the broker has placed himself in a unique position of trust and confidence vis-a-vis his customer. *In re Arlene W. Hughes*[79] is the watershed Commission decision which enuciated the fiduciary theory of broker responsibility. In that case, the Commission determined that a fiduciary relationship existed between the broker and her clients based on: (1) the clients' adherence to their broker's advice "in almost every instance;" and (2) the relationship created by the broker in acting as her clients' investment advisor.[80] The Commission concluded that Arlene Hughes had violated her fiduciary duty by failing to adequately disclose:[81] (1) that she was selling her own securities; (2) the markup she was charging her clients; and (3) the market price of the securities.[82]

The Commission suggested that a fiduciary relationship would

75 139 F.2d at 436.

76 *Id.* at 437.

77 *Id.*

78 *Id.*

79 27 S.E.C. 629 (1934).

80 *Id.* at 634-35.

81 There was an agreement with clients, disclosing the broker's customary execution practices, but the agreement was not understood by the broker's customers. *Id.* at 632-34, 640-41.

82 In part, Hughes' price was above market because it included an investment advisory charge. *Id.* at 633-34.

be found in almost any situtation in which a broker provides investment counsel for a fee. "[L]earning the personal and intimate details of the financial affairs of clients and making recommendations as to the purchases and sales of securities . . . cultivates a confidential and intimate relationship and imposes a duty upon the [broker-advisor] to act in the best interests of her clients . . . . [The broker-advisor] has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interest of her clients."[83]

3. Current Application of the Shingle and Fiduciary Theories

Today, courts employ the shingle theory in their holdings more frequently than the fiduciary theory. Opinions often focus on the obligations brokers owe to all customers as opposed to the existence of a special relationship between the broker and his customer.[84] As a practical matter, however, the shingle theory and the fiduciary theory overlap and merge into one another.[85] In essence, the elements giving rise to liability under the fiduciary theory are not readily distinguishable from the elements that create liability under the shingle theory. Both theories involve the broker: (1) obtaining the client's trust (whether actively or passively); (2) acting against the client's interest; and (3) failing to declare his self-interest. For all practical purposes, one can speak collectively about the duties imposed by these two theories.

Regardless of which theory is applied, both administrative law and case law have found broker-dealers to have certain basic responsibilities to their customers. Both the shingle theory and the fiduciary theory have been expanded to cover a broad range of broker misdeeds.[86] Antifraud violations have been found under these theories for: (1) effecting unauthorized transactions;[87] (2) failing to fill customers' orders promptly;[88] (3) pledging a customer's securities without approval;[89] (4) soliciting orders while lacking the facilities to

83 *Id.* at 635.

84 *Cohen & Rabin*, *supra* note 69, at 704.

85 JACOBS, *supra* note 68, at 704; 3 L. LOSS, *supra* note 68, at 1508; WOLFSON, PHILLIPS & RUSSO, *supra* note 68, at ¶ 2.15; *Cohen & Rabin*, *supra* note 69, at 703.

86 *See generally* JACOBS, *supra* note 68, ¶ 210.03, at 9-10 to 9-62; 3 L. LOSS, *supra* note 68, at 1488-89; 6 L. LOSS at 3683-86; WOLFSON, PHILLIPS & RUSSO, *supra* note 68, at ¶¶ 2.07, 2.09, 2.10 & 2.11.

87 *In re* First Anchorage Corp., 34 S.E.C. 299 (1952).

88 *In re* Carl J. Bliedung, 38 S.E.C. 518 (1958).

89 *In re* Richard A. Sebastian, 38 S.E.C. 865 (1959).

consummate prompt delivery;[90] (5) transacting business while in violation of the net capital requirements of the New York Stock Exchange;[91] (6) making recommendations to investors without a reasonable basis and without sufficient investigation;[92] (7) recommending securities which are not suitable for the financial needs of the customer;[93] and (8) trading excessively in a customer's account in light of the customer's needs and objectives.[94] Most significantly for purposes of this article, the shingle and fiduciary theories have been extended to situations in which brokers have failed to obtain best execution for their customers' orders. Under the shingle and fiduciary theories, the duty of an agent to seek the best possible terms for his principal is incorporated into the broker-customer relationship.

The best execution duty has been enunciated in a variety of contexts. In a landmark administrative proceeding, the Commission found an unregistered broker had committed antifraud violations when he failed "to get the best possible prices for [his] customer."[95] The broker sold stock to his customers and failed to disclose that he owned the stock and that he was taking personal profits beyond the commission charged. Without specifically labeling the violation a breach of the shingle theory or the fiduciary theory, the Commission found that the broker "violated the basic obligations owed by an agent to his principal."[96] In an analogous situation, the Commission determined that an investment advisor owed a fiduciary duty to his client to obtain the best available price[97] when executing transactions on a principal or riskless principal[98] basis.

Another situation in which a best execution duty has been found arises when a broker interposes an unnecessary second broker to execute his customers' orders. The initial broker channels the transaction through the second broker for reasons other than the best

90 *In re* Ned J. Bowman Co., 39 S.E.C. 879 (1960).

91 *In re* Joseph V. Shields, Jr., [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,643 (SEC 1969).

92 *In re* Alexander Reid & Co., 40 S.E.C. 986 (1962).

93 *In re* Shearson, Hammil & Co., 42 S.E.C. 811 (1965).

94 Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, 494 F.2d 168 (10th Cir. 1974).

95 *In re* Harry Marks, 25 S.E.C. 208, 215 (1947). The violations were found under § 17(a) of the Securities Act, 15 U.S.C. § 77q(a)(1976), and §§ 10(b) & 15(c)(1) of the Securities Exchange Act, 15 U.S.C. §§ 78j(b) & 78*o*(c)(1) (1976).

96 25 S.E.C. at 220.

97 *In re* Kidder, Peabody & Co., 43 S.E.C. 911, 915 (1968). *See* Newman v. Smith, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,078 (S.D.N.Y. 1975).

98 In a "riskless principal" transaction, a dealer acquires a security solely to execute a transaction, thus avoiding any risk of not selling the security.

interests of his customer. In *In re Delaware Management Co.*,[99] investment advisors for two investment companies directed portfolio transactions through a superfluous second brokerage firm. The second brokerage firm was one of the primary dealers in shares of the two investment companies. By placing portfolio orders with these dealers, the investment advisors sought to increase their underwriting concessions and advisory fees. In addition, the investment advisors selected brokers on the basis of the broker's willingness to provide research and statistical services. Brokers willing to provide these services were retained even when the executions they obtained were inferior to other transaction prices available to the investment companies. In regard to both practices, the Commission found the advisor's behavior incompatible with its duty "to obtain the best prices" for its clients. The Commission held that this breach of duty constituted a fraud on the investment company and its shareholders.[100]

Finally, the failure of investment advisors to recapture brokerage commissions for their clients has been held to be a violation of the advisor's best execution duty.[101] Typically, the brokerage "give-up," instead of being recaptured for the client, is directed to brokers who sell shares of the investment company. The increased sales benefit the advisor, who is compensated in proportion to the size of the investment company. Directing the give-up to the investment company's benefit instead of elsewhere would lower the net execution costs to the customer.

A best execution duty has been enforced by courts and by the Commission. It is apparent from the above discussion, however, that the duty has been enforced almost exclusively in situations involving

99 43 S.E.C. 392 (1967). This administrative proceeding deals with the duty to obtain best execution when a second broker is being interposed in the transaction. In *Delaware*, the interposed broker was found to have violated the antifraud provisions of the Securities Act and of the Securities Exchange Act. *See also* Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971)(originating broker found to have violated the antifraud provisions by interposing superfluous broker to gain reciprocal brokerage commissions); *In re* Hoit, Rose & Co., Securities Exchange Act Rel. No. 8563 (SEC 1969)(arising out of the same facts as *Sinclair*; interposed broker found to have violated § 17(a) of the Securities Act and §§ 10(b) & 15(c)(1) of the Securities Exchange Act., 15 U.S.C. §§ 77q(a), 78j(b) & 78*o*(c)(1) (1976); interposed broker induced originating broker to employ him as a superfluous broker in exchange for cash payments and business referrals to originating broker's employees); *In re* Thomson & McKinnon, 43 S.E.C. 785 (1968) (initiating broker found to have violated antifraud provisions of the 1934 Act by interposing a superfluous broker to reciprocate for business favors).

100 43 S.E.C. at 397.

101 Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976); Moses v. Burgin, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627 (S.D.N.Y. 1976).

broker conflicts of interest. To date, neither the courts nor the Commission have held a broker liable for breach of his best execution duty for mere failure to seek the best market for a client's orders.[102]

The holdings in best execution cases are generally not limited to conflict of interest situations.[103] In practice, however, best execution has not been employed in situations involving a mere lack of diligence. This does not appear to have resulted from a judicial unwillingness to apply the standard in these situations. Rather, it appears that until recently,[104] the question of a mere lack of diligence in pursuing best execution did not arise in litigation.

One possible explanation why a best execution standard has not been applied in non-conflict of interest situations is the past structure and technical capability of the securities markets. A number of the

102 A number of commentators have noted this limited application of the best execution duty. "[N]either the Commission nor the courts have attempted to attack directly the broker's business judgment or exercise of due diligence in best execution cases." WOLFSON, PHILLIPS & RUSSO, *supra* note 68, ¶ 2.09, at 2-42. *See* Phillips, *Best Execution and Negotiated Rates*, in PLI, THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 319, 322 (R. Mundheim & A. Fleischer eds. 1972) ("The problem of best execution is really a question of conflicts of interest and nothing more . . . . No one is interested in second guessing the business compliance and judgment of an executing broker.") Mattlin, *The Quest For a Definition of "Best Execution,"* 9 INSTITUTIONAL INVESTOR 60, 70 (Apr. 1975) [hereinafter cited as *The Quest For Best Execution*] ("A fiduciary is seldom sued on the grounds of some second guessing that he might have saved a quarter of a point by shopping the block around.") (quoting Abraham Pomerantz, attorney).

In a recently settled controversy, however, the plaintiff did seek to hold defendant brokers liable under rule 10b-5 for failure to use adequate care in selecting the best price at which to execute transactions. Lesko v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. C-78-1740 (N.D. Ohio, complaint filed Dec. 22, 1978; dismissed per settlement, Jan. 14, 1980) [hereinafter cited as Lesko v. Merrill Lynch]. Both plaintiff and defendant acknowledged that an antifraud action based upon the failure to exercise due care to obtain best execution is "by no means a traditional 'garden variety' securities fraud suit between a customer and broker." Reply to Motion to Strike Plaintiffs' Motion for Partial Summary Judgment, p. 1. *See* Reply Memorandum to Plaintiffs' Brief in Opposition to Motion to Compel Arbitration, p.2.

103 *See, e.g.*, Sinclair v. SEC, 444 F.2d 399, 400 (2d Cir. 1971) ("Sinclair [a trading clerk in a brokerage house] was obligated as a matter of fiduciary duty to use due diligence to obtain the best available price for [his] customers upon execution of orders placed by them for purchase or sale of securities on the over-the-counter (OTC) market . . . ."); Newman v. Smith, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,078, at 97,783 (1975) ("A stockbroker who purchases stock for an investor is under an implied contract to buy the stock at the market price or the best price obtainable."); *In re* Kidder Peabody & Co., 43 S.E.C. 911, 915 (1968) ("One of the basic duties of a fiduciary is the duty to execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances . . . ."); *In re* Delaware Management, 43 S.E.C. 392, 397 (1967) ("Such conduct [executing through a broker at an inferior price in order to obtain research services] was incompatible with the duty of the [investment company's] manager to obtain the best prices for [the investment company] and constituted a fraud upon that [investment company] and its shareholders.").

104 *See* Lesko v. Merrill Lynch, *supra* note 102.

industry communication and execution devices, such as CQS, ITS and the Consolidated Tape, are very recent innovations.[105] Without devices such as these, it would have been difficult for a broker to attempt a best price execution. In addition, it would be difficult, if not impossible, for a broker or customer to determine whether best execution had been obtained.

Technological innovations[106] have essentially changed the trading environment in which the historical case law on best execution developed. It now is technologically feasible for a broker to rapidly seek out the best price for a customer's order on CQS and, if it is an ITS security, to effect that order without leaving his trading post. The Composite Tape[107] then allows the participants to verify whether the transaction was executed at the best price. With these developments, it should be easier to demonstrate a breach of the best execution duty. Indeed, when the SEC planned the national market system, it indicated that the implementation of CQS would serve "in most cases to require that a broker execute an order wherever the best price is obtainable."[108]

At common law, agents are required to exercise "reasonable care, skill and diligence."[109] This common law duty would appear to compel a broker to make use of easily accessible communication and order routing devices which help to achieve best execution.

Another potential reason for the absence of case law applying a best execution rule to situations involving a lack of diligence is the relative costs involved in bringing the suit. Failure to obtain the best price in the instance of a purchase might mean that a broker has paid as little as a fraction of a point more a share or as much as several points more a share. In the instance of a sale, failure to obtain best execution might mean receiving a fraction of a point less, or as much as several points less, a share. Even when a customer is effecting a transaction involving several thousand shares, the amount of damage caused by the broker's failure to obtain best execution would rarely provide a plaintiff with more than a marginal recovery

105 For a discussion of recently developed communication and execution technology in the securities markets, see text accompanying notes 41-58 *supra*. For a discussion of how these developments facilitate a broker's best execution duties, see text accompanying notes 161-244 *infra*.

106 *See* text accompanying notes 207-45 *infra*.

107 For a discussion of the Composite Tape, see notes 242-45 and accompanying text *infra*.

108 1973 Policy Statement, *supra* note 8, at 48.

109 F. MECHEM, OUTLINE OF THE LAW OF AGENCY ¶ 524 (4th ed. 1952).

above his legal fees.[110] The prospect of limited recovery may have discouraged individual suits for failure to obtain best execution.[111]

In addition, in at least one instance in which a plaintiff established the prerequisites for a cause of action based upon his broker's failure to obtain best execution, the parties settled the case prior to judgment.[112] Why the parties chose to settle is not revealed in the record. Recognizing the effect a decision for the plaintiff might have on future best execution cases, it is possible that brokerage houses wish to avoid establishing legal precedent holding brokers to a best execution duty in a business judgment context.

Finally, an investor harmed by his broker's failure to achieve best execution in a non-conflict of interest situation might be reluctant to bring suit due to his inability to demonstrate the requisite elements of fraud under the antifraud provision of the Securities Exchange Act. *Ernst & Ernst v. Hochfelder*[113] held that damages under rule 10b-5 cannot be predicated upon mere negligence. *Aaron v. SEC*[114] extended this scienter requirement to injunctive actions by the Commission.

Even prior to *Hochfelder*, several authorities had held that scienter was required to establish a rule 10b-5 violation.[115] The scienter requirement may have discouraged suits against brokers for failure to achieve best execution. A broker's failure to obtain best execution resulting solely from a lack of care might not have been considered sufficient to establish scienter. This viewpoint, upon further exploration, appears to be in error.

Historically, neither the federal courts nor the Commission have demonstrated any reluctance in finding rule 10b-5 violations based upon a broker's breach of his implied representation (under the shingle theory or the fiduciary theory) to deal fairly with the public and

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110 Mattlin concurs, stating that "unless the trade were exceptionally large, the case wouldn't be substantial enough to make a lawsuit worthwhile." *The Quest for Best Execution*, *supra* note 102, at 72.

111 Although the recovery per investor might be marginal, in the aggregate, brokers' failures to obtain best execution have a significant effect on the market.

112 *See* Lesko v. Merrill Lynch, *supra* note 102. The defendant broker settled with plaintiff, Stipulation of Dismissal (Jan. 14, 1980), only after the federal court for the Northern District of Ohio denied defendant's motion to compel arbitration. The court, in evaluating the motion, applied the standards applicable to a motion to dismiss. Memorandum and Order (filed June 22, 1979). The dismissal motion was based on the argument that plaintiff's allegations were inadequate to demonstrate the requisite scienter for a manipulative or deceptive practice.

113 425 U.S. 185 (1975).

114 444 U.S. 914 (1980).

115 *See* 6 L. LOSS, *supra* note 68, at 3883-88.

to observe the standards of the profession. For example, an insolvent broker who continued to deal with customers was found liable under the shingle theory for misrepresentation of an implied statement that he was indeed solvent.[116] A broker's failure to execute properly a customer's order was held to constitute a false and misleading statement of the broker's implied representation to execute transactions promptly.[117] A broker who recommended securities without proper investigation was held to have violated an "implied warranty" that the broker had an adequate basis for the opinion rendered.[118] Executing transactions in violation of an exchange's net capital rule (or the Commission's bookkeeping rules) has also been held to violate a broker's duty of care, thus constituting an antifraud violation.[119]

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116 SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 978-79 (S.D.N.Y. 1973). *See* Brennan v. Midwestern Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (failure to disclose broker's insolvency held to be a violation, under rule 10b-5, of broker's implied representation to deal fairly with the public). *But cf.* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) (broker assured its customer that it would promptly execute a sale and failed to do so; broker sold plaintiff's securities without providing the plaintiff an opportunity to post additional margin; broker's actions held to be a "garden-variety" suit for breach of contract in the absence of an allegation of facts amounting to scienter).

117 *In re* D. Earle Hensley Co., 40 S.E.C. 849, 853 (1961); *In re* Carl J. Bliedung, 38 S.E.C. 518, 521-22 (1958). The Commission has advised that:

> Trade Custom requires a dealer to consummate transactions with customers promptly, and in every transaction, an implied representation to this effect is made, unless there is a clear understanding to the contrary. If a dealer intends not to consummate a transaction promptly, and fails to disclose this intention to his customer, he omits to state to that customer a material fact necessary to make the above representation not misleading, in violation of the antifraud provisions of the Securities Act and the Exchange Act.

Securities Exchange Act Rel. No. 6778, 27 Fed. Reg. 3991, 3991 (1962) (quoting *In re* Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949)).

The elements of the fraud appear to be: (1) a known trade custom; (2) an intention not to comply with the custom; and (3) non-disclosure of this intention to the customer. Arguably, these elements exist whenever a broker executes an order without seeking the best market if he fails to disclose this to the customer. If "custom" includes the dictates of case law, there is clearly a custom requiring brokers to seek best execution.

118 Hanley v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969). In this injunctive proceeding to bar the defendants from association with a broker or dealer, the opinion is sufficiently broad to support an antifraud violation based either upon a misstatement in making the implied warranty (covered by clause 2 of rule 10b-5) or upon failure to comply with the implied warranty (covered by clause 1 or 3 rule 10b-5). *See* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969).

119 SEC v. Charles Plohn & Co., 433 F.2d 376 (2d Cir. 1970) (denying stay of lower court order appointing a receiver for a broker/dealer's assets and restraining the broker from further antifraud violations, including failure to disclose non-compliance with the New York Stock Exchange's net capital rule); *In re* Joseph V. Shields, [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,643 (SEC 1969) (section 10b action against broker-dealer employees for accepting customers' orders when firm's books and records not current and firm not in compliance with exchange-imposed financial requirements). The language in these cases is

Hochfelder and *Aaron* have significantly limited a court's willingness to base antifraud violations upon a broker's failure to exercise due care.[120] Requiring scienter in antifraud actions, however, should have a quite limited effect on best execution suits. Failure to obtain the best price typically occurs because brokers automically route orders to a primary market instead of availing themselves of the facilities of the national market system.[121] The newly developed brokerage and communication technology should make it possible to demonstrate scienter in many best execution suits. Brokers are on actual or constructive notice of the technological advancements which enhance their ability to secure the best price for their customers' orders. In promulgating the quote rule, the Commission asserted that a "broker's existing fiduciary duty to his customer requires that he take cognizance of quotation information available through a composite quotation system in seeking best execution of his cus-

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sufficiently broad to interpret the antifraud violation as arising under any one of the three clauses of rule 10b-5.

120 Shortly after *Hochfelder*, the Supreme Court granted certiorari in a rule 10b-5 action brought against an underwriter for failure to adequately investigate securities—specifically, commercial paper—which he recommended and sold, John Nuveen & Co. v. Sanders, 425 U.S. 929 (1976). The Court vacated the Seventh Circuit's ruling for the plaintiffs, 524 F.2d 1064 (7th Cir. 1975), and remanded the case for reconsideration in light of *Hochfelder*. On remand, the Seventh Circuit found the record "barren of any showing of actual intent to deceive, manipulate or defraud" and consequently reversed the lower court's judgment. Sanders v. John Nuveen & Co., 554 F.2d 790, 792 (7th Cir. 1977). The court of appeals not only reversed the case but remanded it to the district court to determine whether a cause of action existed against the broker for his misstatements under § 12(2), 15 U.S.C. § 78*l*(2) (1976). When the § 12(2) argument was developed and the case returned to the court of appeals (for the fourth time), the court found that the underwriters sold the commercial paper by means of false and misleading prospectuses and that their investigation was not sufficient to establish a "reasonable care" defense under § 12(2). Sanders v. John Nuveen & Co., 619 F.2d 1222, 1227 (7th Cir. 1980). This same investigation was sufficient to prevent plaintiffs from demonstrating defendant's scienter in the rule 10b-5 claim.

Ultimately, the Supreme Court refused to grant certiorari, despite a vigorous dissent by Justices Powell and Rehnquist. John Nuveen & Co. v. Sanders, 101 S. Ct. 1719 (1981).

Although *Sanders* dealt with an underwritier's duty to investigate under rule 10b-5 and not a broker's duty, the court of appeals found that a greater quantity of information is "reasonably ascertainable" by an underwriter than a broker and thus more than mere published data must be analyzed by an underwriter to fulfill his duty. Sanders v. John Nuveen & Co., 619 F.2d 1222, 1227 (7th Cir. 1980). Thus, if anything, an underwriter's duty is more comprehensive than a broker's. If scienter is required to establish a cause of action against an underwriter, the same requirement should apply, *a fortiori*, against a broker.

See also Shemtob v. Shearson, Hamill & Co., 448 F.2d 442 (1971) (pre-*Hochfelder* case held that scienter is required to find a broker liable for a 10b-5 violation for failing to promptly sell out a customer's position).

121 *See* text accompanying notes 48-49 *supra*. *See also* Lesko v. Merrill Lynch, *supra* note 102.

tomer's order."[122]

Intentionally bypassing the facilities of the national market system in executing a customer's order may constitute a misstatement of the broker's implied representation to exercise due care. This misstatement would be actionable under rule 10b-5(2).[123] The public dissemination of information concerning the availability of national market system facilities may create expectations on the part of the investing public. Failure to use the national market system facilities, and, consequently, failure to seek the best price, may constitute a knowing misstatement of an implied representation.[124]

Failure to obtain the best price is likely to reflect a broker's total lack of effort.[125] The scienter requirement of rule 10b-5 should be satisfied if a broker: (1) has notice of the new technological facilities available to aid best execution (as all brokers do);[126] and (2) fails to use the means available to seek out the best market. When the above facts exist, the broker's violation under the shingle theory for failure to achieve best execution arises not from a lack of due care but from misstating an implied representation to seek out the best market.[127]

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122 Quote Release, *supra* note 43, at 4347.

123 Rule 10b-5(2) makes it unlawful, in connection with the purchae or sale of any security, "to make any untrue statment of a material fact . . . ." 17 C.F.R. § 240.10b-5(b)(1981).

124 Arguably, establishing scienter based upon a misrepresentation of fact under the shingle theory and rule 10b-5(2) does not present the same obstacle as it does in a case argued under 10b-5(1) or (3). Although *Hochfelder* held that scienter is required in all 10b-5 actions, 425 U.S. at 212-14, at least one commentator argues that *Hochfelder* has not altered the shingle theory because fraud was already an element of the cause of action. JACOBS, *supra* note 68, at 9-18. Professor Jacobs cites to *Charles Hughes*, which held that "[t]he law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other." Charles Hughes & Co. v. SEC, 139 F.2d 434, 436-37 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). Essentially, the Jacobs argument asserts that scienter is built into 10b-5(2) cases based upon misstatements. *But cf.* 6 L. LOSS, *supra* note 68, at 3884-85 (1969). ("[O]ne might have expected the courts . . . to avoid an *ultra vires* question with respect to Clause (2) of Rule 10b-5 by reading some watered-down scienter element into that clause, at least in private actions . . . . But one gags at sketchy §10(b)'s 'maniplative or deceptive device or contrivance' to cover any material misstatement or omission on a strict liability basis—the more so since, except for the issuer's liability under §11 of the 1933 Act none of the express civil liability provisions with respect to misstatements or omissions in either act goes that far . . . .").

125 This total failure of care is readily distinguishable from the exercise of some care in *Sanders*. Exercise of some care was found sufficient to show a lack of intent to defraud.

126 *See* text accompanying note 117 *supra*.

127 This implied representation is discussed in the text accompanying notes 95-104 *supra*. The cause of action described in the text would arise under 10b-5(2) only if the broker fails *to attempt* to secure the best price. An unsuccessful good faith effort to secure the best price would not be actionable. Best execution cases, however, typically involve a failure to attempt rather than an unsuccessful good faith effort. In an interpositioning case, the Commission held that a trader's failure to use the facilities of a large "wire" house for which he worked

Scienter can also be found in the knowing deception of a customer. When a broker allows a customer to rely upon his implied representation to seek the best market and then fails to make any effort to comply with this representation the scienter requirement is arguably satisfied.[128]

Even after *Hochfelder*, it is not always necessary to prove scienter to establish a rule 10b-5 violaton. The *Hochfelder* decisions specifically left open the question of whether reckless behavior would constitute scienter for purposes of rule 10b-5.[129] In jurisdictions which consider reckless behavior sufficient, non-use of market facilities which assist brokers in achieving best execution should be deemed a sufficiently reckless breach of the duty of care to constitute fraud.

A number of courts have held reckless behavior sufficient to establish scienter in actions against brokers. In *Rolf v. Blyth, Eastman Dillon Co.*,[130] a broker repeatedly assured his customer of the competence of an investment advisor. The lower court found that the advisor was engaged in fraudulent stock manipulations which reduced the value of the customer's portfolio by two-thirds. The broker was ignorant of the advisor's fraud. Nonetheless, the Second Circuit found the broker aided the investment advisor's fraud by "assurances of confidence" in the advisor and by "reckless disregard of whether those assurances were true or false."[131] The broker's behavior was not knowing, but it was reckless. The court concluded that where the broker owed a duty to the defrauded customer, "recklessness satisfied the scienter requirement."[132]

Similarly, the Sixth Circuit has indicated that recklessness might be sufficient to establish scienter when a broker fails to execute promptly his customer's order or when a broker makes a false repre-

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corroborated the finding that his fraudulent scheme was willful. *In re* W. K. Archer & Co., 11 S.E.C. 635, 642 (1942), *aff'd*, 133 F.2d 795 (8th Cir. 1943).

128 In a comparable situation, an accounting firm alllowed an unsupervised employee to draft a misleading opinion letter. Investors who relied upon the letter initiated an action against the firm. Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 50 U.S.L.W. 3659 (U.S. Feb. 23, 1982).

Although the firm did not have actual knowledge of the misstatements, it was aware of its "stringent duty to supervise its employees." In disregarding this duty, it was found to have demonstrated sufficient scienter to be held liable for a 10b-5 violation under the doctrine of *respondeat superior* (the court did not specify under which clause of rule 10b-5 liability was established). Similarly, the scienter requirement should be satisfied if a broker knowingly disregards not a duty to supervise, but, rather, a duty to seek best execution.

129 425 U.S. at 194 n.12.

130 570 F.2d 38 (2d Cir. 1978).

131 *Id.* at 44.

132 *Id.*

sentation that a purchase has been made.[133]

Finally, at least one federal district court has acknowledged that reckless behavior might be a sufficient basis for scienter when a broker fails to seek best execution. The district court, in denying a motion for dismissal, noted that the customer might be able to prove that the broker's behavior was sufficiently "reckless or fraudulent" to constitute a 10b-5 violation.[134] Plaintiff's complaint alleged that the defendant, Merrill Lynch, Pierce, Fenner & Smith, failed to obtain the best price "by virtue of a deliberate and intentional policy of sending all orders in [the securities in question] to the [American Stock Exchange] rather than seeking the best price in the available markets."[135] The court intimated that the intentional use of a routing procedure which does not seek the best market price may constitute fraudulent behavior by a broker.

Despite *Hochfelder* and *Aaron*, it appears that customers may bring suits against brokers for failure to seek best execution based upon either intentional or reckless disregard of brokers' implied duty to seek the best market price. In light of the newly developed national market system communication and execution facilities, better performance should be expected of a broker exercising due diligence to obtain the best market price. A broker's failure to seek the best market price through these facilities should constitute fraud.[136]

B. *Exchange Rules*

The rules of the national securities exchanges and the National Association of Securities Dealers are also potential avenues for enforcing a broker's best execution duty. In order to be registered with the Securities and Exchange Commission, both national securities exchanges and national securities associations must establish rules which 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 public interests."[137]

The exchange rules dealing with best execution are generally

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133 Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979).

134 Lesko v. Merrill Lynch, *supra* note 102, Memorandum and Order at 7 (filed June 22, 1979).

135 Lesko v. Merrill Lynch, *supra* note 102, Plaintiffs Complaint at 5.

136 The Commission, in corroborating its argument that the trader's failure to achieve best execution was part of a fraudulent scheme, pointed out that certain communication facilities available to the trader had gone unused. *See In re* Archer & Co., 11 S.E.C. 635 (1942), *aff'd*, 133 F.2d 795 (8th Cir. 1943).

137 Securities Exchange Act of 1934, §§ 6(b)(5) & 15A(b)(6), 15 U.S.C. §§ 78f(b)(5) & 78*o*-3(b)(6) (1976).

qualified by a due diligence requirement. Thus, the New York Stock Exchange (NYSE) requires that a "broker handling a market order is to use due diligence to execute the order at the best price or prices available to him under the published market procedures of the exchange."[138] The American Stock Exchange's (ASE) best execution rule is identical to that of the NYSE.[139] These rules do not specifically require brokers to look to outside markets when seeking the best price in multiply traded securities. These rules, however, were established at a time when it was difficult to locate the best market or to execute in any market other than the one in which the broker was presently trading.

The National Association of Securities Dealers' (NASD) interpretation of its Rules of Fair Practice more explicitly outlines the behavior expected of brokers in seeking best execution.[140] The broker is held to a standard of "reasonable diligence." The interpretation of this standard lists a number of factors that affect the reasonableness of a broker's actions, including the demand on communication facilities and the accessibility of primary markets and quotation sources.[141] Thus, under the NASD rule, what constitutes "reasonable diligence" in seeking the best market price will vary with the availability of communication and execution facilities. The reasonable diligence standard applied by the NASD Business Conduct Committee should be affected by improved communication facilities such as CQS and the Composite Tape. Similarly, when ITS is linked

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138 New York Stock Exchange Rule 123.41, 2 NYSE GUIDE (CCH) ¶ 2123A.41, at 2737-3 (1975).

139 American Stock Exchange Rule 156(a), AMEX GUIDE (CCH) ¶ 9296, at 2469.

140 NASD MANUAL (CCH) ¶ 2151.03A (1978) Rules of Fair Practice, art. III, § 1, Interpretation reads as follows:

> In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Failure to exercise such diligence shall constitute conduct inconsistent with just and equitable principles of trade in violation of Article III, Section 1 of the Rules of Fair Practice.
> *Comment*: Among the factors which will be considered by the Business Conduct Committees in applying the standard of 'reasonable diligence' in this area are:
>
> (1) The character of the market for the security—e.g., price, volatility, relative liquidity, and pressure on available communications;
>
> (2) the size and type of transaction;
>
> (3) the number of primary markets checked;
>
> (4) location and accessibility to the customer's broker-dealer of primary markets and quotations sources.

141 NASD Manual (CCH) ¶ 2151.03A (1978).

to the over-the-counter markets,[142] reasonable diligence should result in an even higher level of performance since a broker's ability to reach the best market will be enhanced.

A correlation between the availability of facilities and the brokers' standard of care is not explicitly stated in the NYSE and ASE rules. As improvements make it simpler for brokers to achieve best execution, however, the "due diligence" obligation of brokers should compel them to use the available facilities to secure the best price when executing customers' orders.[143]

Even if the exchanges stringently enforced their best execution rules, it would remain unclear whether private investors could bring suit for damages caused by a violation of these rules. Judicial attitudes toward implied rights of actions for violation of exchange rules have been inconsistent. In 1966, when courts were taking an expansionary attitude toward implied rights of action, the Second Circuit, in *Colonial Realty Corp. v. Bache & Co.*,[144] ruled that investors may bring actions based upon an exchange rule only if the rule was intended to serve as a substitute for Commission regulations (the substitution test). The plaintiff in *Colonial* alleged that his broker violated NYSE and NASD rules promulgated to promote "just and equitable principles of trade." Judge Friendly held that Congress did not intend such rules to impose upon exchange members legal obligations not recognized at common law.[145] The court concluded that no private right of action existed. It should be noted that the NYSE and NASD best execution rules were are also promulgated to promote "just and equitable principles of trade."

Three years after *Colonial*, the Seventh Circuit in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith*[146] held that the NYSE "know your customer" rule did give rise to an implied private right of action since it

142 In April, 1981, the SEC issued an order requiring the exchanges participating in ITS and the NASD to establish, by March 1, 1982, a link between ITS and NASD's order routing and execution system—NASDAQ. Securities Exchange Act Rel. No. 17744 (Apr. 21, 1981), [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,866 [hereinafter cited as NASDAQ-ITS Linkage Release]. As this article was going to press, the SEC temporarily postponed the scheduled date of the linkage. SEC. WEEK, Mar. 1, 1982, at 1.

143 An agent's duty is defined in part by the circumstances surrounding his agency. F. TIFFANY, HANDBOOK OF THE LAW OF PRINCIPAL AND AGENT § 145, at 377-86 (2d ed. 1924). As circumstances make best execution simpler, a higher level of performance will result from the same effort.

144 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). Judge Friendly added that "the case for implication would be strongest when the rule imposes an explicit duty unknown at common law." *Id.*

145 *Id.*

146 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

was designed "for the direct protection of investors"[147] (the public benefit test). The best execution rule, like the "know your customer" rule, provides for direct protection of investors. A court influenced by *Buttrey* would probably hold that an exchange's best execution rule gives rise to an implied remedy.

In 1975, the Supreme Court, in *Cort v. Ash*,[148] established a four part test for determining whether a federal statute creates an implied right of action. To imply a private right of action, the *Cort* test requires a finding that: (1) the plaintiff is a member of the class for whose especial benefit the statute was enacted; (2) the legislature, either explicitly or implicitly, intended to create a private remedy; (3) a private right of action would be consistent with the underlying statutory scheme; and (4) the cause of action is not one traditionally relegated to state law.

After 1975, the federal courts began applying the *Cort* test to suits brought pursuant to exchange rules. Federal judges have incorporated into the *Cort* test elements of both the substitution test and the public benefit test. The results have been varied. In *Sachs v. Reynolds Securities, Inc.*,[149] a customer sought compensation from his broker for delaying transfer of the customer's account to another securities broker. The D.C. Circuit applied the *Cort* test. The court held that NYSE rule 412, which required members to expedite transfers of securities, was not intended to create a private right of action. The court found that the rule was promulgated as a "housekeeping" measure to protect brokers. Providing a private right of action was held to be inconsistent with the scheme of the Exchange Act. Moreover, investors were found to be sufficiently protected by common law remedies. The court indicated, however, that a private right of action might be implied under an exchange rule designed to protect investors in substitution for a Commission regulation.[150]

In contrast, the Ninth Circuit, in *Jablon v. Dean Witter & Co.*,[151] offered no encouragement to implied actions under exchange rules. The court found that Congress did not intend to provide a private right of action under section 6(b) of the Securities Exchange Act of

147 *Id.* at 142 (quoting Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 29 (1966)). A later case noted that rule 405 was not intended for the protection of brokers. The *Buttrey* test itself, however, was cited favorably in the same case, Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164, 167-68 (10th Cir. 1977).

148 422 U.S. 66 (1975).

149 593 F.2d 1234 (D.C. Cir. 1978).

150 *Id.* at 1244-45.

151 614 F.2d 677 (9th Cir. 1980).

1934. Consequently, plaintiff investors were held to have no implied rights of action under either the NYSE "know your customer" rule or the NASD "suitability" rule. *Jablon* held that under the recent restrictive holdings of the Supreme Court[152] a specific congressional intent to allow a private action must be demonstrated. The court could not find a specific congressional intent in section 6(b) to authorize private actions for violations of stock exchange rules.

The Second Circuit, in *Leist v. Simplot*,[153] specifically rejected *Jablon*'s complete denial of implied rights of action under exchange rules. The court did agree, however, that private remedies should not be implied under the "know your customer" rule.[154]

As the above cases demonstrate, although there is a growing judicial reluctance to find implied private rights of action under exchange rules, the circuits are in conflict concerning the availability of this remedy.[155]

C. *Agency Principles at Common Law*

Common law agency principles[156] are another potential means for enforcing a broker's best execution duty. The broker is an agent.

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152 Touche Ross & Co. v. Reddington, 422 U.S. 560 (1979); Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). Both *Touche Ross* and *Transamerica* require a showing of affirmative congressional intent before a private right of action will be allowed. The *Cort* test is a means of determining that intent.

153 638 F.2d 283 (2d Cir. 1980). The comments on *Jablon* made in *Leist* were dicta. *Leist* has been appealed and certiorari was granted by the Supreme Court of the United States. New York Mercantile Exch. v. Leist, 101 S. Ct. 1346 (1981). Oral arguments were heard November 2, 1981. 627 SEC. REG. & L. REP. (BNA) E.1 (Nov. 4, 1981). A decision may be reached in this case near the time this article is published. The controversy in *Leist* arose under the Commodities Exchange Act. Although *Leist* did not involve an exchange rule, the case has clear implications for implied remedies arising under exchange regulations. *Leist* has been cited in the Second Circuit, however, as a basis for holding against the finding of an implied private right of action under § 6 of the Securities Exchange Act of 1934. Picard v. Wall St. Discount Corp., [1981 Current Binder] FED. SEC. L. REP. (CCH) ¶ 98,364 (S.D.N.Y. Nov. 4, 1981).

154 638 F.2d at 296 n.11.

155 Since *Touche Ross* and *Transamerica*, several other circuits have dealt with the issue of implied private rights of action either under exchange rules or under the securities acts. The holdings, however, are at times limited to the specific provisions in question. *See* Gutter v. Merrill Lynch, Pierce, Fenner & Smith, 644 F.2d 1194 (6th Cir. 1981) (*Cort v. Ash* test applied to § 7(c) of the 1934 Act and Regulation T promulgated thereunder; holding not applied to the question of implied rights under the Securities Acts or the Exchange Rules). At other times, courts have refrained from ruling on the implied remedy issue, while debate still rages. Miley v. Oppenhiemer & Co., 637 F.2d 318 (5th Cir. 1981) (court avoided taking position regarding the existence of private rights of action under NYSE Rule 405 and NASD Suitablity Rule).

156 RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

He is empowered to act as a fiduciary for his customer in the purchase and sale of securities. A broker's agency duties are described at common law in very broad principles. The application of these common law principles to the specific issue of a broker's duty to secure the best price for multiply-traded securities is uncertain.

The Restatement (Second) of Agency requires an agent responsible for purchases or sales to use "reasonable care to obtain the terms which best satisfy the manifested purposes of the principal."[157] This prescription is refined in the comments, which indicate that an agent must "obtain the terms most advantageous to the principal."[158] The general common law duties of an agent are applicable to brokers. Thus a broker "is bound to obtain for [his principal] the most advantageous bargain possible under the particular circumstances."[159] In fulfilling his duty, the broker, as a fiduciary, is held to a "high degree of skill and integrity, ordinary care and judgment being insufficient."[160]

The common law gives even less guidance for determining a broker's best execution duty than that provided by federal law and exchange rules. Again, the availability of the technological improvements of the national market system should raise the level of due diligence a broker must exercise in seeking the "terms most advantageous" to his customer. The requirement that an agent obtain the most advantageous bargain possible suggests that a broker may breach his common law duty if he does not employ the readily accessible information and execution systems when executing his customers' orders.

III. National Market System Developments

Since 1975, market trading facilities have been developed which provide brokers with the means to achieve best execution effectively. These facilities are designed to integrate the competitive market cen-

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157 *Id.* § 424.

158 *Id.*, Comment b.

159 12 AM. JUR. 2D *Brokers* § 96 (1964). *See* Norton, *A Simple Purchase and Sale Through a Stockbroker*, 8 HARV. L. REV. 435, 445 n.2 (1895). *See also* Hall v. Paine, 224 Mass. 62, 73, 112 N.E. 153, 158 (1916) ("broker's obligation to his principal requires him to secure the highest price obtainable").

160 C. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES 265 (1931). *See* 1 W. BLACK, STOCK EXCHANGES, STOCKBROKERS & CUSTOMERS 449 (1940) (characterizing broker's duty as that of a fiduciary). *See also* Warwick v. Addicks, 157 A. 205, 205-06 (Del. Super. Ct. 1931) ("broker with the power to buy and sell securities for another is an agent for such person and in general his duty toward his client . . . is to exert himself with reasonable diligence in his behalf").

ters of the national market system. This section will examine both the structure and operation of these newly developed facilities and the effect these innovations will have on a best execution rule.

A. *The Composite Quotation System*

Among the recent technological enhancements in the securities industry, the Composite Quotation System (CQS) is the most vital to the national market system. CQS is also the most forceful reason for modifying present best execution policy. CQS provides brokers a simple means for determining the best available price for a multiply-traded security. The Commission continues to endorse its earlier statements regarding the importance of CQS both to the national market system and to the goal of insuring best execution.[161]

CQS assists brokers in determining the best market for effecting executions of multiply-traded securities. CQS provides brokers with the currently reported bids, offers and quotation sizes communicated by all brokers and dealers in listed securities both on exchanges and over the counter.[162] Rule 11Ac1-1,[163] the quote rule, governs CQS. The rule[164] requires all exchanges and associations to establish procedures for collecting quotations from their respective member brokers and third market-market makers.[165] The broker or third market-market maker must communicate his bid or offer and quotation size to his exchange or association pursuant to established procedures. The exchange or association must then process the quotations and make them available to quotation vendors.[166] The broker is obligated to execute any order in an amount up to his published quotation and at a price as favorable as that quotation.[167]

161 In 1979, Chairman Williams repeated the Commission's belief that CQS is a "fundamental building block of the national market system," and that "quotation information from all markets was prerequisite to providing investors with the ability to assure that their orders received the best possible execution." *1979 Oversight Hearings*, *supra* note 49, at 450 (opening statement of Chairman Harold M. Williams, Sept. 25, 1979).

162 CQS reports those listed securities which are also reported on the Composite Tape. *See* notes 242-45 and accompanying text *infra*. Although not every listed security is carried on the Composite Tape, the most frequently traded securities are reported. Virtually all multiply-traded securities are reported on the Composite Tape.

163 17 C.F.R. § 240.11Ac1-1 (1981), promulgated January 25, 1978. Quote Release, *supra* note 43.

164 17 C.F.R § 240.11Ac1-1(a)(3) & (b)(1) (1981). The rule requires collection of quotations being communicated to other members and (in the instance of third market makers) those quotations being communicated to other brokers, dealers or customers.

165 The "third market" refers to over-the-counter trading in listed securities.

166 17 C.F.R § 240.11Ac1-1(b)(1)(i) & (ii) (1981).

167 17 C.F.R. § 240.11Ac1-1(c)(1) & (2) (1981).

The quote rule requires the exchanges to collect bids and offers from all members, not just specialists. Thus, CQS includes the best price offered in the crowd surrounding the specialist's post where brokers interrogate one another regarding proposed transactions.[168] CQS can thereby inform brokers in one exchange of all buying and selling interests on other exchange floors (not merely the quotations of the specialist). The Commission chose to require brokers to provide and exchanges to collect and process the quotations. In so doing, the Commission sought to insure that all market information would be included in the quotation system and thus "spur brokers to make greater efforts to achieve best execution of their customer's orders."[169]

Finally, rule 11Ac1-1(c)(1) requires brokers to communicate not merely their bids and offers but the size at which they are willing to effect their transactions. The broker is then obligated, with certain exceptions,[170] to execute orders at prices at least as favorable as his published quotation and in an amount up to his published quotation size.[171] This size and firmness requirement affords market partici-

168 When the quote rule was first proposed, quotations were to be collected only from specialists or market makers. Securities Exchange Act Rel. No. 12670, 41 Fed. Reg. 32,856 (1976). Commentators felt that such a system would not adequately reflect all buying and selling interest. Consequently, the rule was revised to include quotations from all brokers communicating quotations to other members. Quote Release, *supra* note 43, at 4343.

169 Quote Release, *supra* note 43, at 4346-47. A number of commentators opposed a mandatory rule. They believed the rule would be "anti-competitive," imposing a greater cost burden on smaller market centers which could not easily pass on the costs of providing quotations due to a lack of significant order flow. *Id.* at 4346. Recently, the Commission began to rethink its policy requiring all brokers and market makers in reported securities to provide quotations to the exchange or association. In February, 1981, the SEC proposed that mandatory dissemination of quotations be limited to: (1) primary market centers; (2) brokers or dealers trading in 19c-3 securities (securities not covered by off-board trading restrictions in market centers with 1% or more of the trading volume); or (3) securities traded exclusively over-the-counter in market centers with 1% or more of the trading volume. Securities Exchange Act Rel. No. 17583, 46 Fed. Reg. 15,713 (1981) [hereinafter cited as 1981 Quote Rule Modification Release]. This proposal has met significant opposition. *See* letter from James E. Buck, NYSE Secretary, to George A. Fitzsimmons, SEC Secretary (June 24, 1981) (SEC File No. S7-648); letter from Robert J. Birnbaum, ASE President, to George A. Fitzsimmons, SEC Secretary (June 24, 1981) (SEC File No. S7-648); letter from Nicholas A. Girodano, PHLX President, to George A. Fitzsimmons, SEC Secretary (May 14, 1981) (SEC File No. S7-648); letter from Professor David A. Lipton to George A. Fitzsimmons, SEC Secretary (Apr. 30, 1981) (SEC File No. S7-648).

170 Reporting brokers are not obligated to execute orders at the reported quotation if: (1) before the order is presented the broker has changed his price or size; or (2) at the time the order is presented the broker is already in the process of effecting a transaction in the reported security and immediately afterwards he communicates a revised quotation. 17 C.F.R. § 240.11Ac1-1(c)(3) (1981).

171 17 C.F.R. § 240.11Ac1-1(c)(2) (1981).

pants some assurance that their orders will be executed at the size and price specified.[172] The quote rule thus enables market participants to find the best available market and to determine whether their entire order can be executed in that market.

Since the adoption of the quote rule, CQS has been fine-tuned. The quote rule is primarily directed at exchanges and brokers. Originally, the rule did not require quotation vendors,[173] who communicate quotation information to market participants, to display all the information the exchanges made available to them. Although many vendors developed cathode ray tube montage displays of quotations from multiple exchanges, not all market centers were included on the displays nor was the best price always readily apparent.[174] In 1980, to improve the effectiveness of the quote rule, the Commission adopted rule 11Ac1-2 (vendor display rule).[175] This rule requires information vendors: (1) to provide a consolidated best bid and offer display; (2) to provide the same caliber of quotation information for all market centers; and (3) to make certain that the retrieval of quotation information from all market centers is equally simple. In essence, the vendor display rule simplifies the process of determining the best market. It is expected that this simplification will help route orders to the market with the best price instead of the market with the greatest volume. The Commission views the purpose of the vendor display rule as a means to enhance investor awareness of competing market centers and to avoid the "pervasive preference for primary market information."[176]

In commenting upon the rule, two vendors suggested that the adoption of a best execution rule[177] would be the most effective

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172 Quote Release, *supra* note 43, at 4346.

173 "Vendors" are defined by the Commission as "any securities information processor engaged in the business of disseminating transaction reports, last sale data or quotation information with respect to subject securities to brokers, dealers or investors on a real-time or other current and continuing basis whether through an electronic communications network, moving ticker or interrogation device." 17 C.F.R. § 240.11Ac1-2(a)(2) (1981).

174 *See* SEC Proposed Rule 11Ac1-2, 43 Fed. Reg. 50,615, 50,620 (1978). This proposed rule dealt with regulating the dissemination of last sale and quotation information.

175 17 C.F.R. § 240.11Ac1-2 (1981) (*adopted in* Securities Exchange Act Rel. No. 16590, 45 Fed. Reg. 12,391, 12,398 (1980)) [hereinafter cited as Vendor Display Rule Release].

176 Vendor Display Rule Release, *supra* note 175, at 12,398.

177 Implementation of the best bid and offer display provision of the Vendor Display Rule was deferred until September 1, 1981. Securities Exchange Act Rel. No. 17368, 45 Fed. Reg. 83,477 (1980). The date of implementation was later pushed back to October 2, 1981. Securities Exchange Act Rel. No. 18066 (Aug. 26, 1981), [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,022. Shortly after implementation, a securities industry commercial news service described reaction to the vendor display rule as "mixed." While a regional exchange specialist thought the rule was bringing business to his exchange, a specialist on the NYSE felt that

means of insuring broker usage of consolidated best bid and quote display.[178] These comments emphasize the symbiotic relationship between the technical improvements of the national market system and a best execution rule. Best execution is made feasible through these improvements.[179] At the same time, the improvements will only be used if brokers are motivated to seek best execution.

CQS has not been entirely free of problems. In large measure, however, the difficulties encountered by CQS can be attributed to the absence of a best execution rule. The primary problems associated with the system include: (1) regional exchanges' use of machine-generated quotes to comply with the quote rule; and (2) a lack of consistent compliance with the quote rule by market participants, particulary with the rule's firmness requirement.

Regional exchange specialists make markets in a greater number of securities than specialists on the primary exchanges.[180] In addition, the order flow to regional specialists is frequently too limited to warrant competitive market making. As a result, regional specialists often use computers to generate quotations in the securities in which they trade.[181] At times, these "autoquote" quotations are programmed to be a fraction of a point "away from" (worse than) the primary market.[182] Although such use of autoquote quotations technically complies with the quote rule,[183] it does not encourage meaningful competition in multiply-traded securities.

The failure of some regional specialists to honor consistently

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the rule had had no effect on his business. Staff at the SEC were reported to believe that regional and NYSE specialists were competing to get on the screen. SEC. WEEK, Nov. 2, 1981, at 5-6.

The potential effect of the vendor display rule might only be felt after a best execution rule is adopted by the SEC.

178 Vendor Display Rule Release, *supra* note 175, at 12,399 (referring to letter from GTE Information Servs. to the SEC (Dec. 22, 1978) (SEC File No. S7-759) and letter from Bunker Ramo Corp. to the SEC (Dec. 15, 1978) (SEC File No. S7-759)).

179 The Commission suggested in its 1973 Policy Statement on the structure of a central market system that "composite last sale reporting and quotation systems should serve not only to facilitate but in most cases to require that a broker execute an order wherever the best price is obtainable." 1973 Policy Statement, *supra* note 8, at 48.

180 *See ITS Extension Order*, *supra* note 57, at 56,070.

181 *See* 1981 Quote Rule Modification Release, *supra* note 169, at 15,715 n.17.

182 *Id.* at 15,716 n.24.

183 According to rule 11Acl-1(a)(3), if you communicate quotations on the floor of an exchange you are a "responsible broker or dealer." Responsible broker/dealers must transmit their quotations to the exchange. 17 C.F.R. § 240.11Acl-1(c)(1) (1981). Therefore, brokers must comply with the quote rule if they wish to continue to communicate quotations while trading on the floor of their exchange. The autoquote quotations provide brokers with a means for technical compliance with the quote rule.

their quotations as required by the quote rule has heightened the perceived unreliability of autoquote quotations.[184] This non-competitive participation in the composite quotation system undermines both the effectiveness of CQS[185] and the competition in multiply-traded securities that is basic to the national market system.[186] Without significant order flow, regional specialists lack the requisite economic incentive to disseminate competitive quotations and to stand firm behind those quotations.[187] In the present trading environment, many large retail brokerage houses, unrestricted by a firm best execution rule, automatically route their small and medium-size orders to the primary exchanges.[188] Thus, even if regional specialists disseminated competitive quotations, order flow would not follow.[189] A best execution rule would provide order flow to the specialist disseminating the best quotes. This in turn would encourage market centers to disseminate competitive quotes and rectify the CQS problems resulting from non-competing market makers.[190]

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184 1981 Quote Rule Modification Release, *supra* note 169, at 15,716 n.22. *See ITS Extension Order*, *supra* note 57, at 56,070. Some brokers have failed to comply with the portions of the quote rule requiring the reporting of quotations communicated on the floor of the exchange. *See* Securities Exchange Act Rel. No. 16808 (May 15, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,600 (SEC settlement with Dean Witter Reynolds, Inc. in conjunction with quote rule violations).

185 The Commission has proposed that only certain market makers (those with a sizeable market share or those trading in 19c-3 securities) continue to be compelled to furnish quotations to CQS. Those market makers who lack the economic incentive to participate in CQS would be relieved of the obligation to provide CQS with quotations. *See* 1981 Quote Rule Modification Release, *supra* note 169. If the Commission, however, promulgates and enforces a best execution rule, regional market makers would have an economic incentive to participate in CQS.

186 *See* text accompanying notes 35-38 *supra*.

187 1981 Quote Rule Modification Release, *supra* note 169, at 15,714 & nn. 10 & 11. Prior to the quote rule, regional specialists offered quotations primarily in response to customer inquiry. *Id.*

188 *Id.*

189 Similarly, prior to the new vendor display rules, regional specialists were reluctant to disseminate competitive quotes because the format for displaying quotations often excluded regional specialists. In adopting the vendor display rule, the Commission suggested that improved dissemination of regional quotations "may increase [regional specialists'] willingness to compete for order flow." Vendor Display Rule Release, *supra* note 175, at 12,398.

190 The Boston Stock Exchange (BSE) urged the Commission to adopt a best execution rule along with the quote rule in order to insure the establishment of a meaningful quotation system. Letter from James E. Dowd, BSE President, to George A. Fitzsimmons, SEC Secretary (Oct. 22, 1976) at 2 (SEC File No. S7-648) [hereinafter cited as BSE Best Execution Letter]. The Pacific Stock Exchange (PSE) also stated that a best execution rule would "insure" that CQS "would result in real competition between market centers." Letter from G. Robert Ackerman, PSE President, to George A. Fitzsimmons, SEC Secretary (Aug. 10, 1977) at 3 (SEC File No. S7-648) [hereinafter cited as PSE Best Execution Letter].

B. *Intermarket Trading System*

CQS informs brokers of the location of the best market. The Intermarket Trading System (ITS) allows a broker to execute an order in the best market quickly without leaving the trading post where he is located. Along with CQS, ITS provides the basis for competition among exchange markets and assures the practicality of best execution.

In the spring of 1978, the Commission issued a temporary order authorizing[191] five stock exchanges[192] to act jointly in developing, operating and regulating ITS. ITS electronically links participating market centers. It allows brokers and specialists in one market to communicate with participants in other market centers in order to buy and sell securities.[193] Each exchange has a terminal device linking it to a centralized computer. A broker with an order to execute in a specific security examines the quotation display screen at the trading post where the security is handled. If the quotation on another exchange is superior to the bid or offer presently available on his exchange (either from the specialist or "in the crowd") the originating broker can enter a "commitment to trade" into the ITS computer terminal. A commitment to trade specifies: (1) the number of shares to which the broker is committed; (2) the price at which the transaction is to be executed; (3) whether it is an order to buy or sell; and (4) either a one- or two-minute time period during which the commitment is to remain firm and after which the commitment is to be cancelled.[194] The commitment is transmitted to the destination market by the central computer. If the commitment is accepted at the destination market, the system immediately reports back to the originating broker. If the commitment is "away from" the destination market quotation by the time it arrives (because the

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191 Securities Exchange Act Rel. No. 14661, 43 Fed. Reg. 17,419 (1978). Section 11A(a)(3)(B) of the 1934 Act empowers the SEC to authorize exchanges to act jointly in developing and operating the facilities of the national market system, 15 U.S.C. § 78k-1(a)(3)(B) (1976).

192 The five original exchanges were the American, Boston, New York, Pacific and Philadelphia Stock Exchanges. The Midwest Stock Exchange joined soon thereafter and in February, 1981, the Cincinnati Stock Exchange was linked by a manual interface. SEC, A MONITORING REPORT ON THE OPERATION OF THE INTERMARKET TRADING SYSTEM 4 (Feb. 1981) (a 45 page offset reproduced report with appendices publicly available from the Commission's Directorate of Economic and Policy Analysis) [hereinafter cited as ITS MONITORING REP.].

193 For operating details of ITS, *see generally* ITS MONITORING REP., *supra* note 192; *ITS Extension Order*, *supra* note 57.

194 The NYSE permits its brokers only a one minute operation period during which a commitment is to remain firm. ITS MONITORING REP., *supra* note 192, at 7 n.9.

destination market quotation has changed since the originating broker made the commitment), it may be rejected by the receiving broker or specialist. If nothing is done, the commitment expires after the firm commitment period. If a receiving broker refuses a commitment to trade which meets his quotation price, he violates the "firmness" requirement of the quote rule (unless an exception is found).[195] To complete a transaction using ITS requires an average of forty-one seconds.[196] In the absence of ITS, intermarket transactions could only be accomplished through a slower and more cumbersome process relying on the telephone and manual broker executions.

At times, ITS encourages executions at prices which are better than the existing quote in CQS. This occurs when the originating broker sends a firm commitment at a price better than the existing quote. Of course the receiving broker can cancel the commitment since he is not obligated to execute at a better price than his quotation. Receiving brokers, however, accept approximately one-third of the better-than-the-quote commitments which are sent.[197] The commitment essentially becomes an inquiry by the originating broker asking: "Can't you do better?" The acceptance is the receiving broker's affirmative response. Thus, ITS also simulates the bargaining process and allows brokers, in limited instances, to better the prices displayed on CQS.

ITS also expands the depth and liquidity of participating markets. The exposure a broker's bid or offer receives in any market center is augmented by the exposure it receives on other exchanges through ITS. When ITS became operational in 1978, there were eleven securities traded in its system. By the fall of 1980, there were 871 securities traded in ITS.[198] Trading frequency expanded to 68,000 trades per month, representing a total volume of 38.4 million shares.[199] This constituted 6.6% of all trading in these securities.[200] Although ITS volume is a relatively small portion of the overall trading done in ITS securities, it should be noted that ITS is employed only when a broker in one market is trying to better his execution price in another market. ITS is not used when the price offered in a

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195 *See* notes 170-71 and accompanying text *supra*.

196 ITS MONITORING REP., *supra* note 192, at 18. A transaction begins with the transmission of the originating broker's commitment and ends with his receipt of the accepting response.

197 *Id.* at 33.

198 *Id.* at 44.

199 *Id.* at 10.

200 *Id.* at 11.

participant's own market is equal to (or better than) the prices offered in other markets.

Since ITS is used only when a better execution is available on another market, the 38.4 million shares traded each month through ITS are executed at a price at least 1/8 of a point[201] better than they would have been in the absence of ITS. Thus, ITS results in a minimum monthly savings of $4.8 million for initiating market participants. This figure does not take into account the savings which result when specialists on one exchange better their own quotations in order to discourage brokers from using ITS to execute orders on another exchange.

In 1982, ITS is scheduled to be linked to the over-the-counter markets.[202] This will further expand the opportunities for brokers to secure best execution. What previously constituted due diligence for a broker in securing the best price must assume a new meaning in light of the advantages of ITS. For ITS-traded securities, brokers now have an efficient and expedient means both to determine the best market and to effect execution in that market.

ITS is not without problems. These problems, however, are partially attributable to the lack of a strict best execution requirement. On occasion, an execution takes place on the floor of one exchange while, at the same time, another ITS linked exchange is offering a better price. These "trade-throughs"[203] occur with more frequency during particularly heavy trading periods. One explanation the Commission has offered for trade-throughs is market participants' reluctance to interrupt their trading activities to use the ITS terminal.[204] This reluctance might reflect brokers' concern with delays and inconvenience. Since the transaction time has been lowered to forty-one seconds, however, the inconvenience of using ITS has been minimized.

A second explanation for trade-throughs is that quotations gen-

201 The minimum price differential in securities exchange trading.

202 *See* note 142 and accompanying text *supra*.

203 For a discussion of trade-throughs, see *ITS Extension Order*, *supra* note 57, at 56,070; ITS MONITORING REP., *supra* note 192, at 35. The Monitoring Report estimates the number of trade-throughs at less than 1% of the total number of ITS trades. *Id.* The regional exchanges, however, view trade-throughs as a real problem which prevent participants from taking ITS "seriously." *1979 Oversight Hearings*, *supra* note 49, at 245 (testimony of Charles Rickershauser, Pacific Stock Exchange President). Rickershauser blamed the existence of trade-throughs on primary market specialists, whom he viewed as having no commitment to ITS. Rickershauser warned that "[e]very time a trade-through occurs it represents a failure for ITS and a failure for the national market system that ITS is intended to create." *Id.*

204 *ITS Extension Order*, *supra* note 57, at 56,070.

erated by some markets are perceived as unreliable.[205] Brokers who perceive a better quote as unreliable will not attempt to "reach" that quote through ITS. Instead, the broker will execute a transaction on his own exchange, perhaps creating a "trade-through." The Commission has expressed concern that the problem of unreliability may be exacerbated when ITS is linked to the over-the-counter market. This problem will be exacerbated by the failure of some third market makers to update their quotations in a timely fashion.[206] In the absence of a best execution rule, good quotes will not necessarily bring order flow. Consequently, quotation disseminators may believe that dissemination of reliable quotations is simply not worth the effort.

C. *National Securities Trading System*

Another intermarket trading system that has been developed in the wake of the national market system legislation is the Cincinnati Stock Exchange's National Securities Trading System (CSE's NSTS).[207] Whereas ITS links the various exchanges, NSTS electronically creates its own "exchange." CSE brokers need not be present on any exchange in order to effect executions on NSTS. As a practical matter, however, NSTS is directly linked to a number of exchanges from which brokers can transmit orders.

In CSE's trading system, orders can be placed directly from a broker's office into a central computer where all orders are automatically matched. ITS is used only when a broker is seeking to better the quotation available on his own exchange. In contrast, CSE's NSTS is designed to expedite all trading for retail brokers seeking automatic execution of both market and limit orders directly from their office ("upstairs firms"). Orders entered into NSTS are stored and queued. Executions occur according to specified priorities based upon price and time of entry.[208] Stored firm bids and offers are displayed on cathode ray tube terminals. Brokers may place orders exe-

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205 *Id.* This problem also impairs the operation of CQS.

206 *Id.* at 56,070 n.14.

207 On April 18, 1978, the SEC authorized CSE to establish the NSTS as a 9-month experiment. Securities Exchange Act Rel. No. 14674, 43 Fed. Reg. 17,894 (1978). The experiment was extended twice thereafter, for a 1-year period, Securities Exchange Act Rel. No. 15413, 44 Fed. Reg. 129 (1978), and ultimately for a 3-year period, Securities Exchange Act Rel. No. 16216, 44 Fed. Reg. 56,081 (1979) [hereinafter cited as CSE Extension Order].

208 For a discussion of CSE's NSTS, see CSE Extension Order, *supra* note 207; SEC, A MONITORING REPORT ON THE OPERATION OF THE CINCINNATI STOCK EXCHANGE NATIONAL SECURITIES TRADING SYSTEM (May 1981) (38 page offset reproduced report with appendices made publicly available by the Commission's Directorate of Economic and Policy Analysis) [hereinafter cited as CSE MONITORING REP.].

cuting against these stored orders. If the displayed prices are not acceptable, a broker may enter a limit order for his customer which is then stored and queued along with the earlier orders. NSTS thus provides price protection for limit orders left in its system.[209] Customer orders are given priority over dealer orders at the same price.

There are close to fifty securities traded in the NSTS.[210] Trading volume for the system has reached four million shares a month,[211] accounting for two percent of the total trading done in NSTS securities.[212] Only a few retail firms, however, have joined NSTS. In addition, very limited use is made of the system by specialists on exchanges.[213] In fact, the Commission recently reported that ninety percent of all NSTS volume is attributable to only two participating dealers.[214] A possible explanation for the low level of popularity enjoyed by NSTS is the traditional bias of the brokerage industry against a system that could eliminate the need for an exchange floor.[215]

Since NSTS has been unable to attract a large customer order flow, the two major dealers often deal directly with their customers on a principal basis or they cross two of their own customers' orders (an "agency-cross") in NSTS.[216] Although the absence of interaction with orders from other market centers (internalization) could result in inferior prices on NSTS, this has not proven to be the case. A Commission study reveals that NSTS executions for agency orders equalled or bettered the current NYSE price ninety-nine percent of

209 This price protection is only in terms of other orders exposed in the NSTS system.

210 CSE MONITORING REP., *supra* note 208, at 11.

211 *Id.*

212 *Id.* at 13.

213 Progress Assessment Release, *supra* note 40, at 20,364.

214 CSE MONITORING REP., *supra* note 208, at 16. The Commission remains perplexed over the limited use made of NSTS. In May 1981, Commissioner Stephen J. Friedman stated that "the failure of other broker/dealers to use [NSTS] is an anomaly which can't be explained over a period of time." SEC. WEEK, May 11, 1981, at 3.

The identity of the two primary NSTS dealers has recently changed. In November, 1981, one of the two major brokerage houses participating in NSTS left. SEC. WEEK, Nov. 23, 1981, at 1-2. In December, another major brokerage house began trading a portion of its executions through NSTS. SEC. WEEK, Dec. 14, 1981, at 1-2.

215 *See 1979 Oversight Hearings*, *supra* note 49, at 251 (testimony of Charles E. Rickershauser, Pacific Stock Exchange President)(referring to CSE's NSTS as "a detour on the road to a national market system").

216 For the first week in December 1980, 58% of total share volume involving transactions for customers on NSTS consisted of trades between dealers and their customers, while an additional 30% of NSTS agency share volume was made up by agency crosses. CSE MONITORING REP., *supra* note 208, at 20.

the time.[217] CSE's NSTS is bettering the NYSE price, however, in only three out of every ten executions.[218] In 1981, the Cincinnati Stock Exchange began participating in ITS.[219] It is now possible to use ITS in conjunction with NSTS for a limited number of securities by means of a manual interface. The markets made for those securities may improve due to the opportunity for routing to other ITS markets.

At present, NSTS is not as effective a means as ITS for finding the best market. Increased dealer participation and linkage with ITS, however, could make NSTS a practical tool for brokers seeking best execution.

D. *Small Order Routing Devices*

ITS and NSTS are intended to augment competition among exchanges and among dealers by linking them together. By contrast, a number of exchanges, a securities association, and one major retail firm have developed order routing systems to assist brokers in the routing and execution of orders.[220] Using these systems, the upstairs broker need not manually telephone his floor broker to effect execution. Confirmation of executions are also transmitted on these systems back to the originating broker. In some instances these routing systems provide best market protection by routing orders to the market quoting the best price. When designed with a market-protection element, the order routing devices resemble the universal neutral order message switch called for by the Commission in its National Market System Development Release.[221] There are several routing devices that provide some market protection. These order routing devices help brokers achieve best execution for limited size orders.

217 *Id.* at 37.

218 *Id.* Statistics indicating the frequency with which NSTS would better a composite market price are not available.

219 Securities Exchange Act Rel. No. 17532 (Feb. 10, 1981).

220 For a general description of the various order routing systems, see Securities Ind. Automation Corp., Profile of Securities Industry Automation Systems (1978) (a 46 page offset reproduced booklet). For brief discussions of the various systems, see Progress Assessment Release, *supra* note 40, at 20,365 n.42; Securities Exchange Act Rel. No. 16888, 45 Fed. Reg. 41,125, 41,126 nn.19 & 41,129 n.45 (1980) (promulgating rule 19c-3); *1979 Oversight Hearings*, *supra* note 49, at 68 (testimony of William A. Schreyer, President, Merrill Lynch, Pierce, Fenner & Smith, Inc.) (discussing the Best Price Selector System); Securities Exchange Act Rel. No. 17516, 46 Fed. Reg. 12,379, 12,380 (1981) (initial ITS-NASD linkage release discussing the NASD routing system).

221 National Market System Development Release, *supra* note 56, at 4358.

1. Scorex

In 1969 the Pacific Stock Exchange (PSE) instituted a routing system called Scorex.[222] Scorex accepts market and limit orders from PSE members of up to 599 shares for securities[223] which are multiply-traded on the PSE and either the New York Stock Exchange or the American Stock Exchange. The PSE member keys an order into a terminal in his office. Market orders are priced by computer for execution by the PSE specialist. The orders are priced to meet the best bid or offer of any ITS market center trading the same security (composite market price). The PSE specialist then has thirty seconds in which to improve upon the composite market price or allow the transaction to be executed automatically for him at that price.

Thus, Scorex assures PSE members that orders for PSE-ITS traded[224] securities of less than 600 shares can be executed at either the best displayed price or at a better price. Although Scorex does not increase order flow to those markets offering prices superior to PSE (because the trade will always be executed on PSE at the superior price) it does make it easy for brokerage firms to fulfill their best execution duty by sending their small orders to PSE.[225]

2. Pace

The Philadelphia Stock Exchange (PHLX) has a facility for order routing and execution comparable to Scorex called Pace. Pace became operational in 1977 and today provides automatic execution and pricing for PHLX members' orders of up to 399 shares for securities multiply traded on PHLX and NYSE. Unlike Scorex, Pace's automatic pricing for market orders is based only upon the better of the NYSE and PHLX price. There is no thirty-second delay for specialist price improvement. The order is automatically executed on the floor of the PHLX and confirmation reports go both to the specialist

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222 The Scorex system was originally called Comex. For a general description of Scorex, see PSE pamphlets *Scorex* and *10 Reasons Why Scorex Should be Executing Your Market Orders* [hereinafter cited as Scorex Description Materials].

223 It was reported in late August, 1981, that the Scorex's capacity had been increased to 599 shares. SEC. WEEK, Aug. 31, 1981, at 12. By contract, brokerage firms can arrange with PSE specialists to use Scorex for larger than normal share orders. Telephone conversation between Professor David A. Lipton and Mr. Larry McNamara, PSE Marketing Manager (July 24, 1981).

224 The PSE states that approximately 750 securities are eligible for execution on Scorex. Scorex Description Materials, *supra* note 222.

225 A number of major firms, including Kidder Peabody and Paine Webber, regularly send a portion of their small orders to PSE for execution in the Scorex system. *See* SEC. WEEK, Apr. 28, 1980, at 3; SEC. WEEK, June 16, 1980, at 3.

and the originating brokerage firm. Thus, Pace does not have the potential to improve upon existing market prices in a given execution. Pace is a tool to help PHLX members achieve best execution as between PHLX and NYSE for limited size orders. Pace, however, does not provide the universal market protection of Scorex.[226]

3. Best Price Selector

Implemented in 1979 by Merrill Lynch, Pierce, Fenner and Smith, the Best Price Selector System (BPS) automatically routes small orders of a limited number of securities[227] to the market displaying the best quotation at the time the order was made. BPS gives Merrill Lynch the capability to break away from the industry practice of automatically routing small orders to the primary market.[228] When an order is entered, BPS scans CQS for the market displaying the best bid or offer and individually routes orders up to 500 shares to that market.

When two markets display the same best price, BPS directs the order flow to markets according to a priority ranking. Historically, order flow priorities generally favored the primary markets. In BPS, however, non-primary markets are favored. This reversal of priorities has resulted in significant order flow to non-primary markets in BPS designated securities.[229] Thus, BPS not only increases the prospect for best execution but also enhances intermarket competition through an order flow system that encourages all markets to disseminate good prices. The routing priority allows non-primary markets to compete more effectively. This increased competition should narrow market maker spreads, thus improving the transaction prices received by customers.

BPS does not provide automatic execution. Therefore, it is pos-

226 Like Scorex, Pace does not provide PHLX specialists with an incentive to better NYSE prices. Regardless of the PHLX price, the PHLX specialist will receive the Pace order flow. Both Scorex and Pace are really quotation matching devices and not quotation improvement devices.

227 As of November, 1981, eleven securities were being traded in BPS. Telephone conversations with Peter G. Metzger, Assistant Vice President, Order Processing Systems, Merrill Lynch, Pierce, Fenner and Smith (Oct. 14, 1981 & Nov. 5, 1981) [hereinafter cited as MLPFS Conversations]. The number of securities covered by the system is expected to expand. *1979 Oversight Hearings*, *supra* note 49, at 90-91.

228 *See* text accompanying note 48 *supra*.

229 In March, 1980, Merrill Lynch revealed that 43% of its order flow in Delta Airlines and Kennecott (the two securities then handled by BPS) was being diverted to the third market. 12% was being sent to PSE and MSE. While the NYSE, which prior to BPS got virtually 100% of Merrill Lynch's order flow in these two securities, was now getting only 32%. SEC. WEEK, Mar. 31, 1980, at 1.

sible that by the time an order is executed the designated market might no longer be quoting the best price.[230] In addition, because BPS is limited by order size and the number of eligible securities, it is presently of limited value in assisting customers in obtaining best execution. It provides, however, a model of the kind of routing system brokerage firms can develop relatively inexpensively.[231] The competitive advantage a firm could achieve with a fully developed automatic neutral routing and execution system might be sufficient to compel other brokerage firms to follow suit.[232]

4. Computer Assisted Execution System

In late 1980, the National Association of Securities Dealers implemented an automatic order routing and execution system. This system facilitates trading in a limited number of over-the-counter securities. In its first phase, NASD's Computer Assisted Execution System (CAES) provides seven NYSE member firms a routing device for sending their orders to fifteen different third market makers who are making markets in approximately forty-eight different securities.[233] The system allows orders to be routed either to a particular market maker or to a computer which automatically selects the best available market maker. The originating broker can be either an exchange member or one of the market makers. Execution is automatic or manual depending upon the size of the order.[234] If the order does not exceed the size or price of the receiving market maker's quotation, it is automatically executed. Otherwise, the market maker has the option of not executing the order.[235] If he chooses to execute the order, he may manually seek out other market makers to assist in the execution.

For participating exchange members, CAES eliminates the slower and more cumbersome procedure of telephoning orders to ef-

230 An official at Merrill Lynch stated that it is "very infrequent" that a market is missed because of manual execution problems. MLPFS Conversations, *supra* note 227.

231 BPS was developed for an initial cost of $70,000. MLPFS Conversations, *supra* note 227.

232 *See* text accompanying notes 267-75 *infra*.

233 Telephone conversation between Professor David A. Lipton and Ms. Patricia Vizenhaus, Administrative Assistant at NASDAQ (NASD's communication and execution facilities subsidiary) in charge of CAES (July 27, 1981) [hereinafter cited as NASDAQ Conversation]. Ms. Vizenhaus estimated the weekly volume in July, 1981, at 30,000 to 40,000 shares. *See* 10 page reproduced letter prepared by NASD Market Services, Inc. describing CAES (May 6, 1981).

234 SEC. WEEK, June 23, 1980, at 4.

235 NASDAQ Conversation, *supra* note 233.

fect over-the-counter transactions. The practical impact is that a wider selection of markets is expediently available when seeking best execution. CAES, particularly when linked by ITS to all the exchanges,[236] will potentially develop significant trading volume.[237]

With the promulgation of rule 19c-3, exchange members can now act as dealers and brokers in designated "19c-3 securities" on both exchange and over-the-counter markets.[238] CAES already provides routing and execution facilities for twenty 19c-3 securities.[239] Through CAES, upstairs offices of member firms can conduct both their principal and agency trades. This should allow competition to develop between exchanges and over-the-counter markets in 19c-3 securities. This competition should encourage the dissemination of larger quotations, adding to the depth and liquidity of 19c-3 securities' markets. This, in turn, will improve the execution price available to customers.[240]

As with the Best Price Selection system, CAES is presently too limited to have a major effect on the ability of most brokers to fulfill their best execution obligations. CAES routes orders only to third market makers. If the entering broker has not examined CQS, and if an exchange is offering a better price than the best third market maker, best execution will not be achieved. The system, however,

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236 *See* note 142 and accompanying text *supra*.

237 *See* RULE 19C-3 MONITORING REP., *supra* note 48. The Report explained that without an ITS-CAES link, specialists found it very difficult to execute against superior quotations on the OTC market. Without the link, the specialists first had to call their office and instruct an employee to call the OTC market maker. The specialist's office then had to contact the specialist again to confirm the execution.

238 In June, 1980, the SEC promulgated rule 19c-3, 17 C.F.R. § 240.19c-3(1981). Rule 19c-3 amended the rules of the national securities exchanges which limited the ability of exchange members to effect transactions off the exchange in exchange-traded securities. The exchange rules were changed to prohibit their application to any securities not exchange-traded by April 16, 1979. As a practical matter, this means that exchange members can now effect principal transactions, other than on exchanges, in over 180 securities that have gained exchange listing since April, 1979. Securities Exchange Act Rel. No. 16888, 45 Fed. Reg. 41,125 (1980) [hereinafter cited as Rule 19c-3 Promulgation Release]. A monitoring report on the operation and effects of rule 19c-3 was released by the Commission in August, 1981. RULE 19C-3 MONITORING REP., *supra* note 48. The report indicated that trading in 19c-3 stocks had been limited. The report's statistics, however, were based on trading prior to the commencement of the CAES operations. The report speculated that 19c-3 trading would expand when CAES and ITS are linked together.

Prior to rule 19c-3, exchange rules had already been amended to allow members to effect over-the-counter transactions in agency trades. Rule 19c-1, 17 C.F.R § 240.19c-1 (1981), promulgated pursuant to § 19(c) of the Securities Exchange Act of 1934. 15 U.S.C. § 78s(c)(1976).

239 SEC. WEEK, Oct. 13, 1980, at 5-6.

240 Rule 19c-3 Promulgation Release, *supra* note 238, at 41,126.

has promise. With an increase in the number of participants, an expansion of the list of available securities and the linkage with ITS, CAES should allow brokers to achieve best execution in the over-the-counter markets as well as the exchange markets.[241]

5. Composite Tape

The capstone to CQS and the automatic routing and execution devices is the national market system enhancement which preceded all others—the Composite Tape.[242] Partially operational in October, 1974 (eight months prior to the passage of the national market system legislation), and fully implemented in April, 1976,[243] the Composite Tape allows market participants to evaluate their success in achieving best price. The Composite Tape provides current last sale data from all market centers trading in securities which meet the reporting requirements of the Composite Tape.[244] This includes virtually all multiply-traded securities.[245] For these securities, brokers

241 Linking CAES to ITS may allow large retail firms to execute customer orders over the counter, through the linked system, without exposing the orders to the order flow of the exchange floors. If a large retail firm "hits" its own bid or offer in the linked system, it can effect an agency cross or a principal-agency trade without ever bringing the bid to the exchange floor. This could result in the customer not receiving best execution. The Commission believes these risks are outweighed by the potential benefits of increased competition. *See* NASDAQ-ITS Linkage Release, *supra* note 142, at 84,276 & nn.51 & 52.

242 In November, 1972, the Commission adopted rule 17a-15. This rule requires every exchange and association member who effected transactions in listed securities to file a plan with the Commission providing for the collection, processing and dissemination of last sale reports in these securities. A joint industry plan was filed in March, 1973 and declared effective in May, 1974. Securities Exchange Act Rel. No. 10787 (May 10, 1974). To administer the plan, a Consolidated Tape Association was established. The Securities Information Automation Corp. was employed to serve as a consolidated reporting system. The result of this plan is the Composite Tape. The enabling rule was amended in 1978 and renumbered rule 11Aa3-1, 17 C.F.R. § 240.11Aa3-1 (1981), under § 11A of the 1934 Act. Securities Exchange Act Rel. No. 15250, 43 Fed. Reg. 50,606, 50,606-07 (1978) (release proposing the modification of last sale reporting rule) [hereinafter cited as Last Sale Reporting Modification Proposal Release].

243 Last Sale Reporting Modification Proposal Release, *supra* note 242, at 50,606.

244 The reporting system actually consists of two discrete data streams—network A and network B. Network A carries last sale information for NYSE-listed securities and network B carries comparable information for ASE-traded securities (including listed and unlisted securities). Exchanges can also provide last sale information for securities traded on a listed or unlisted basis on exchanges other than the NYSE or ASE provided the security meets the listing requirements of those two exchanges. Essentially all multiply-traded securities are reported on the Composite Tape. *See* Last Sale Reporting Modification Proposal Release, *supra* note 242, at 50,611 n.63.

245 Of the over 2200 securities reported on network A, somewhere between 1100 and 1300 are traded on more than one exchange in any given month. Telephone conversation between Professor David A. Lipton and Ms. Patricia Hussey, Senior Consultant, Consol. Transaction Ass'n (July 12, 1981).

and customers are able to determine whether an execution was effected at the best price by requesting, through interrogation devices, a consolidated display of current sales in the particular security from all markets. The system also gives an indication (though obviously not as reliable as CQS) as to which market would provide the best price for an upcoming execution.

6. National Market System Enhancement Devices Generally

A number of routing and execution devices, such as BPS and CAES, are not sufficiently developed to significantly improve brokers' ability to achieve best execution. Others such as ITS, Scorex and Pace are fully operational and presently enhance brokers' ability to reach the best market. The availability of these national market system advancements in conjunction with CQS and the Composite Tape makes it more feasible for brokers to meet their fiduciary duties to obtain best execution. This, in turn, should heighten the level of diligence brokers are required to exercise in order to satisfy their duties to their customers.

IV. Recommendations

A best execution requirement is essential to the development of the national market system. Nonetheless, the present law enforcing a best execution practice is, at best, uncertain. In light of the national market system's technological advancements, recommendations to compel brokers to seek best execution should be proposed.

A. *Commission Best Execution Rule*

The Commission has traditionally been reluctant to impose a best execution rule. As noted above, however, the lack of a best execution rule has impaired the functioning of many national market system enhancements. Moreover, a best execution practice would make markets more efficient in their capital formation and resource allocation functions. In addition, a best execution rule is necessary to encourage effective intermarket competition. Finally, the national market enhancements have made it easier for brokers to achieve best execution. In light of these factors, the SEC should promulgate a rule making it unlawful for brokers to fail to seek best execution. The rule could be promulgated under section 10(b) of the 1934 Act. A broker's intentional or reckless breach of his implied representation to seek best execution may constitute a "manipulative or deceptive device or contrivance."

Alternatively, the Commission might promulgate the rule under section 11A(a)(1) and (2) of the 1934 Act. Under this section the rule would be promulgated in order "to facilitate the establishment of the national market system . . ." in accordance with the objective of assuring "the practicability of brokers executing investors' orders in the best market."[246] A rule promulgated under section 11A would avoid the question of satisfying the scienter requirement of section 10(b), but might not create a private right of action for investors.

A more flexible approach would be for the Commission to issue an interpretative release announcing its position on best execution. The release would explain that the broker's best execution duty has been heightened by the technological enhancements of the national market system. Therefore, a broker's failure to seek best execution would be viewed by the Commission as a violation of rule 10b-5.[247] The scienter element would be established by demonstrating that the broker failed to use national market system enhancements while implicitly representing to the public that he was seeking best execution. The Commission would also have a panoply of administrative sanctions available to impose against offending brokers under section 15(b) of the 1934 Act. The advantage of this approach is its flexibility. The Commission would not lock itself into a hard and fast rule which might be necessary to amend as the practical problems of requiring best execution are discovered.

As a final alternative, the Commission, pursuant to section

246 The Commission's authority under § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (1976), was previously exercised when it adopted other national market system initiatives such as the partial removal of offboard trading restrictions. Securities Exchange Act Rel. No. 11942, 41 Fed. Reg. 4507 (1976).

247 This proposal for an interpretative release is similar to the suggestion made in 1978 by the NASD in response to the Commission's request for views on a best execution rule. The NASD stated that it believed:

> [A] consolidated quotations system with firm quotes and size and a neutral order routing system [which the NASD defined in terms comparable to ITS] with access to all market centers will enable brokers to obtain the best price for customers and . . . *since existing legal requirements and fiduciary responsibilities mandate best execution* the broker will, if put to the test by the Commission or a self regulatory organization, have to justify his conclusions.

Letter from Gordon S. Macklin, NASD President, to Harold M. Williams, SEC Chairman (Aug. 1, 1978) at 3 (SEC File No. S7-735a) (emphasis added) [hereinafter cited as NASD Best Execution Letter]. After the SEC's adoption of the quote rule, the PSE also argued that the SEC's adoption of a best execution rule would "simply be underlining and giving greater specificity, to what is already the broker's fiduciary duty." PSE Best Execution Letter, *supra* note 190, at 3.

19(c),[248] could add a best execution rule to the rules governing the exchanges. The rule would compel exchanges to impose a best execution duty upon brokers. When brokers breach this duty, however, it is doubtful that the rule would afford investors a private right of action.[249]

Regardless of the approach taken by the Commission, a best execution rule should not, at present, apply to transactions in all securities or by all brokers. The national market system enhancements which most significantly aid brokers in achieving best execution—CQS and ITS—do not facilitate execution in all securities. Moreover, ITS is not available to all brokers. A best execution rule should apply only to market order executions in ITS-traded securities and to brokers who are exchange members (or NASD members once ITS is linked with CAES).[250]

Brokers cannot achieve best execution each time it is sought. Therefore, a degree of flexibility should be built into the rule. After a broker places his order in ITS, a number of situations could develop which would prevent the broker from achieving best execution. For example, best execution would not be achieved if after transmission, but prior to acceptance of the order, the quotations being disseminated on a market other than the receiving market are upgraded. Similarly, best execution will not be achieved if the receiving broker's limited size quotation is satisfied prior to receipt of the originating broker's order.

To accomodate the problems a broker using reasonable diligence might experience, the rule should require brokers to "seek" best execution, not necessarily to "achieve" it. One approach would be to require brokers to examine all market prices before routing market orders. The existence of an ITS trade-through on a particular execution would presumptively establish a broker's violation of

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248 Section 19(c) of the 1934 Act allows the Commission to "abrogate, add to, and delete from . . . the rules of a self regulatory organization. . . ." 15 U.S.C. § 78s(c) (1976).

249 *See* text accompanying notes 151-55 *supra*.

250 It is possible that a best execution rule could eventually be extended to non-listed, OTC securities. By February, 1982, roughly 50 over-the-counter securities, which have been identified for trading as national market system securities (qualified securities), will be subject to real time reporting for last sale information and to the quotation rule, Securities Exchange Act Rel. No. 17549, 46 Fed. Reg. 13,992 (1981). In addition, on August 1, 1982, a far greater number of over-the-counter securities, which meet specified size and financial requirements, will be eligible for designation as material market system securities upon application by the issuer. If the ITS-CAES link-up provides execution accessibility for these national market system securities, there will be no reason to exclude them from a best execution rule. The Commission, in Release No. 17549, proposed to examine whether qualified OTC securities should be traded in CAES.

the rule. The presumption could be rebutted if a broker demonstrated that: (1) ITS was properly used and that the trade-through was caused by an intervening price change; or (2) ITS was properly used and the trade-through was caused by the failure of the receiving broker to comply with the firm quote rule; or (3) the trade-through occurred at a time when the receiving broker was relieved of his obligation under the firm quote rule by the exceptions in rule 11Ac1-1(c)(2);[251] or (4) the decision not to seek a better market through ITS was based on external cost factors (e.g. clearing costs, or the New York State transfer tax) which the broker can demonstrate would make the ultimate cost of execution greater than the cost of execution in the broker's own market;[252] or (5) the broker had reason to believe (based on the demand for the particular security on his own exchange) that he could better the CQS quotation by personally bargaining with the crowd on his own floor.[253]

At first, the best execution rule need not apply to all securities. The Commission could promulgate a rule which would initially apply only to market order executions in a limited number of securities.

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251 *See* note 170 and accompanying test *supra*.

252 Allowing the use of external factors to rebut the presumption established by the rule should satisfy those critics who argue that factors other than the best price are of such significance as to make unattractive a best execution rule based upon best price. The NYSE has enumerated the factors which might override best price: (1) quotation reliability; (2) market volatility and the customer risk involved in trying for a particular quote; (3) the possiblity of bettering the best quote presently available; (4) cost factors; and (5) service factors. Letter from J.E. Buck, NYSE Secretary, to George A. Fitzsimmons, SEC Secretary (Aug. 4, 1978) (SEC File No. S7-735a) (responding to the Commission's questions concerning order by order routing) [hereinafter cited as NYSE Best Execution Letter]. Many of the NYSE factors are of considerably less significance since the full implementation of CQS and ITS. Although reliability of quotations remains a concern, it is a concern which should disappear with more rigorous enforcement of the quote rule by the SEC and with implementation of a best execution rule. Market volatility is of less importance with the improvements made in ITS, which now is providing execution in an average of 41 seconds. Thus it is less likely that a broker will miss a good market quote on another market. *See* text following note 204 *supra*.

The American Stock Exchange also opposed a best execution rule. ASE's opposition was based upon: (1) the impracticality of manual routing on an order by order basis; (2) the economic unacceptability of the system to brokers; and (3) an automatic routing system's lack of responsiveness to investors' needs. Letter from Robert J. Birnbaum, ASE President, to George A. Fitzsimmons, SEC Secretary (Aug. 22, 1978) (SEC File No. S7-735a) [hereinafter cited as ASE Best Execution Letter]. It is worth noting that the nation's largest brokerage house has successfully developed and implemented the kind of automatic routing system which the ASE argued would be economically unacceptable to brokers. *See* text accompanying notes 227-31 *supra*.

253 If a broker repeatedly "trades-through" on his own floor based upon a "belief" that he can better the best CQS quotation by bargaining with the crowd on his exchange, he ultimately should be found to have violated his obligations under the proposed best execution rule.

Trading in those securities should be monitored to avoid unexpected difficulties.[254]

The initial group of securities to which the rule is applied could be the 19c-3 securities. Trading in these securities is already being monitored by the Commission for increased competition and improved market quality.[255] Alternatively, the best execution policy could initially apply to executions of a specific size, such as all one hundred share market orders.[256] The additional effort involved in individually routing orders of a specified size would be less burdensome on the brokerage industry than would application of the rule to all round lot executions. Whatever limiting criteria are adopted, the rule should be gradually phased in and the results should be monitored.

Brokerage houses have argued that order by order routing would increase the costs of execution more than the savings that would be achieved by effecting best execution.[257] During the monitoring period, statistics should be gathered to evaluate the incremental cost of order by order routing and the customer savings resulting from best execution.

Exchanges, the NASD and several brokerage houses have asserted that order by order routing to the best market would be im-

254 In promulgating rule 19c-3, the Commission adopted a rule implementation approach similar to the one suggested in the text. Rule 19c-3 removed off-board trading restrictions for a limited number of listed securities. Rule 19c-3 Promulgation Release, *supra* note 238, at 41,133.

255 *See* note 238 *supra*.

256 Large market executions are already typically routed on an order by order basis.

257 In August, 1978, eight brokerage firms responded by letter to questions raised by the Commission about the feasibility of a best execution rule. In the letter the firms indicated that collectively they acted as agents for more than half of all executions for listed securities in the United States. At the time the letter was written CQS had just begun operation and ITS was still in the planning stages. These brokerage houses urged the Commission to let the securities industry, "through reliance on the discipline of competition and the exercise of professional judgment," develop its own means of achieving the goals of the national market system rather than having the Commission mandate a rule. Without knowing how CQS (and ultimately ITS) would work, the brokers felt they were unable to balance the costs against the benefits of an order by order routing system. The brokers suggested that if a reasonable period of time elapsed during which they had been unable to establish a procedure to assure execution in the best market, the Commission could consider dictating a policy. Letter from Bache Halsey Stuart Shields Inc., Blyth Eastman Dillon & Co., Dean Witter Reynolds Inc., E. F. Hutton & Co., Merrill Lynch & Co., Paine, Webber, Jackson & Curtis, Inc., Smith, Barney, Harris Upham & Co., & Thomson McKinnon Securities Inc. to George A. Fitzsimmons, SEC Secretary (Aug. 1, 1978) (SEC File No. S7-735a) [hereinafter cited as Brokers' Best Execution Letter]. More than 3 years have passed since this letter was written and no best execution procedures have been established that provide specific customer protection. See discussion of anti-trade-through rule, text accompanying notes 260-66 *infra*.

practical.[258] Despite this, the exchanges have recently adopted anti-trade-through and locked market[259] rules[260] which foreshadow the Commission rule proposed in this article. Under the exchange rules, if trade-throughs occur for orders originating off the floor (which include all customer orders), the originating member must satisfy whatever bid or offer was traded through or the transaction price must be corrected to a non-trade-through price.[261] Similarly, an exchange member who creates a locked market in bidding for an ITS security must promptly send a commitment to trade to such other market.[262]

The trade-through rule does not specify that brokers shall seek best executions on all ITS-listed securities. The rule, however, does require originating brokers to compensate trade-through brokers when the originating broker fails to seek best execution. Unfortunately, the trade-through rule has serious limitations which impair its effectiveness as a substitute for a Commission best execution rule. The trade-through rule only applies to orders in excess of one hundred shares.[263] It provides no best execution protection for the smallest round lot orders. Moreover, the remedial provisions of the rule do not apply if complaint of the trade-through is not received within five minutes of dissemination of the reported transaction.[264] Thus, only those trade-throughs which come to the immediate attention of the aggrieved quotation disseminator are punishable. This limitation demonstrates that the rule is designed to protect brokers who want to insure that attractive bids receive appropriate order flow. It

258 *See* NYSE Best Execution letter, *supra* note 252; ASE Best Execution Letter, *supra* note 252; Brokers' Best Execution Letter, *supra* note 257.

259 A "locked market" occurs whenever a bid or offer is disseminated for an ITS security which equals or betters a countervailing offer or bid for the same security which is already displayed by CQS. For example, if the specialist on the NYSE has disseminated a bid of 19 3/4 for XYZ security and the specialist on the PSE offers 19 1/2 for the same security the market is locked. The PSE specialist could obtain an immediate execution at a better price than what he is offering by effecting an ITS trade with the NYSE specialist.

260 *See* Securities Exchange Act Rel. No. 17703 (Apr. 9, 1981), 22 SEC DOCKET 707 (Apr. 21, 1981) (approving exchange rule changes).

261 *See* Proposed Rule Change of NYSE, SEC File No. SR-NYSE-81-8 (received Mar. 2, 1981) (rule 15A(b)(2)B) [hereinafter cited as NYSE Trade Through Rule Proposal]. The NYSE rule is virtually identical to the rules adopted on the other exchanges and will be cited as an example of how all the rules are phrased.

262 *Id.*, rule 15A(d).

263 The anti-trade-through rule was designed to exclude 100 share orders from its protection in order that brokers need not respond to autoquote quotations, which generally are of 100 share size. Rather than remedy the problem of unreliable autoquote quotations, the rule created a large hole in its protective umbrella.

264 NYSE Trade Through Rule Proposal, *supra* note 261, at rule 15A(b)(3)(G).

is not designed to protect customers who could only discover a trade-through some time after the five minute limitation. Additionally, since the trade-through rule is an exchange rule designed essentially to protect brokers, it most likely does not afford investors a private remedy.[265] The trade-through rule is an interesting means of encouraging best execution. In its present format, however, it fails to provide adequate customer protection. Even if the exchanges developed a more effective rule, it would not have the potency of an official SEC policy which the Commission is willing to stand behind and vigorously enforce.[266]

B. *An Execution Policy Disclosure Rule*

Those elements of the securities industry[267] which have been critical of a best execution rule, have judged it impractical because of: (1) the cost estimates for the development of the necessary routing and execution facilities;[268] (2) the operational cost of such facilities;[269] or (3) execution concerns other than best price which are arguably inconsistent with a best execution requirement.[270] The de-

265 *See* note 147 & text accompanying notes 151-55 *supra*.

266 Interestingly, in the rule 19c-3 monitoring report, the Commission noted that a number of firms believe that the trade-through rule, even in the format adopted by ITS, will serve to attract order flow to markets with superior quotations. RULE 19C-3 MONITORING REP., *supra* note 48, at 84,511.

267 Support or opposition to a best execution rule seems to correspond to one's economic interest in such a rule. The primary markets for multiply-traded securities (NYSE and ASE) seem to oppose a best execution rule. *See* NYSE Best Execution Letter, *supra* note 252; ASE Best Execution Letter, *supra* note 252. Some brokerage firms have also opposed a best execution rule. *See* Brokers' Best Execution Letter, *supra* note 257. The regional exchanges may benefit from increased order flow if a best execution rule is adopted. Not surprisingly, several regional exchanges appear to favor a best execution rule. *See* BSE Best Execution Letter *supra* note 190, at 2 ("[W]e strongly urge that the commission . . . adopt a Best Execution rule, or in the alternative, that it issue a clear statement of the agency responsibility of a broker with an order to execute his best professional judgment to direct such orders to the market offering the best price."); PSE Best Execution Letter, *supra* note 190, at 3 ("[W]e . . . see no justification for the commission to hesitate further in adopting a 'best execution rule'."); Philadelphia Stock Exchange, Report on the National Market System 20 (July 28, 1976) ("Once the Composite quotation system is operational, the Commission should immediately adopt a strong 'best execution' rule").

268 ASE Best Execution Letter, *supra* note 252, at 5 ("given *unlimited funds* and sufficient time, [a best execution automatic routing] facility is technologically possible") (emphasis added). It should be recalled that BPS was developed for approximately $70,000. *See* note 231 *supra*.

269 Brokers' Best Execution Letter, *supra* note 257, at 8 ("these additional costs [of effecting best execution] could readily exceed the benefits a customer might derive by occasionally obtaining a better price").

270 NYSE Best Execution Letter, *supra* note 252, at 4 (enumeration of five countervailing factors).

velopment of routing and execution facilities such as Scorex, Pace, BPS and CAES weaken the argument that a best execution rule would be impractical. If industry resistance to a best execution rule makes SEC adoption of such a rule politically infeasible, however, an alternative would be to promulgate a broker disclosure rule.

A disclosure rule would provide investors with the information necessary to determine a broker's execution policy for market orders. The proposed rule would be similar to rule 10b-10,[271] which requires brokers to disclose to their customers in what capacity a trade was effected. Rule 10b-10 disclosure alerts customers to possible conflicts of interest which might affect execution price. Under the proposed disclosure rule, brokers would be compelled to disclose their routing techniques for multiply-traded securities. Brokers must indicate whether their routing systems direct market orders to the best priced market or whether another routing policy is employed and how it works. Thus, the disclosure rule would also inform customers of matters which might affect execution price. Brokers should be required to disclose the practical difference between adopted and non-adopted routing procedures. Variables such as market prices, commission costs, speed of execution, and the reliability of different market quotations might also be explained to the customer.

Compliance with a disclosure rule should safeguard brokers who do not seek best execution from investor suits based on the shingle theory. If a broker automatically routed all orders in multiply-traded securities to a single market he would not be misleading his clients if he clearly disclosed this practice. His disclosure should overcome any implied representation arising from his shingle theory duty[272] thus avoiding implied misrepresentations.

The disclosure rule should be activated upon the opening of an account. A brokerage firm should advise a customer which factors, other than price (such as clearing costs or the reliability of market quotations), it takes into consideration in executing orders. The customer should be able to choose whether he wants a particular bro-

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271 17 C.F.R. § 240.10b-10 (1981).

272 *See* text accompanying notes 72 & 77 *supra* in which a failure to disclose a mark-up policy constituted fraudulent behavior. Also see *Arleen Hughes*, where an essential element of the broker's violation stemmed from her failure to disclose how she was executing her clients' orders. Text accompanying notes 79-83 *supra*. Some commentators have suggested that when a *conflict of interest* is involved notice should be "crystal clear" and even then it might not be sufficient. JACOBS, *supra* note 68, at 9-16. *See Cohen & Rabin*, *supra* note 69, at 703. *But see* WOLFSON, PHILLIPS & RUSSO, *supra* note 68, at 2-15. Since the disclosure proposed in the text does not involve a conflict of interest, courts should be willing to accept disclosure as a means of overcoming the implied representation of best execution.

kers's services to effect a transaction.[273] Brokerage firms might develop different prices for executions effected through best market routing as opposed to primary market routing. A similar price differentiation in brokerage service developed with the rise of discount brokerage houses[274] after fixed commissions were eliminated in 1975.[275] In addition, the disclosure rule might encourage competition among brokers to develop better routing execution systems, such as Merrill Lynch's Best Price Selector.

The disclosure rule would allow customers to determine how much they are willing to pay for the incremental benefits of best execution. In like manner, the rule may force brokers to determine whether it can be economically rewarding to provide order by order routing for small and medium-size orders.

C. *Judicially Imposed Best Execution Rule*

If the Commission fails to act, the courts may effectively impose a best execution rule. As stated earlier, there is precedent holding brokers to a duty of best execution.[276] This best execution requirement has been applied almost exclusively in situations involving broker conflicts of interest. Recent national market system developments make it relatively simple, however, for brokers to seek and to obtain best execution in multiply-traded securities. The failure of brokers to avail themselves of these facilities, in the absence of legitimate countervailing considerations, may constitute a knowing violation (or reckless disregard) of a brokers' implied representation to seek the best price for customer transactions. Although not all customers have a sufficient financial interest to bring suit against a broker for failure to seek the best market price, some investors have already been motivated to do so.[277] Elements of the securities industry have speculated that such suits will eventually win favor in the courts.[278]

National market system developments have heightened the level

273 Although some firms permit customers to select the market to which their orders will be routed, this information is not normally communicated to investors. SEC, REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS 832 (1979).

274 A discount broker provides securities execution services at reduced rates, without complementary benefits such as research and advice.

275 *See* rule 19b-3, 17 C.F.R. § 240.19b-3 (1981), effective May 1, 1975.

276 *See* note 103 & text accompanying notes 95-104 *supra*.

277 *See* Lesko v. Merrill Lynch, *supra* note 102.

278 The Pacific Stock Exchange has predicted that "[i]f the Commission does not adopt [a best execution] rule, we would expect it eventually to be enunciated by the courts." PSE Best Execution Letter, *supra* note 190, at 3. The NASD has similarly suggested that the Commis-

of performance required of brokers in executing customer orders. When the ramifications of this system become fully understood, the courts will begin to impose more stringent best execution requirements.

The progress of the national market system would be most effectively advanced if the Commission were to develop its own best execution policy. The Commission could then control the dimensions of the rule.[279] In the absence of Commission action, however, it is not unlikely that a best execution policy will be developed in the courts.

V. Conclusion

The national market system is an innovative effort to link our various securities markets in order to enhance competition, to foster efficient execution, to make available current quotation and sale information and to assure the practicability of best execution. An essential ingredient of the national market system—a broker's obligation to execute multiply-traded securities in the best market—is missing. This missing ingredient not only impairs customers' ability to obtain the best price, but it also impairs the operation of the basic market system components. For the national market system to function effectively, either the Commission or the courts must establish a best execution rule.

Addendum

As this article was going to press, the SEC amended the quote rule.[280] *The amendments are similar to those proposed by the Commission in February, 1981.*[281] *The amendments limit the mandatory quotation dissemination requirement to either the exchange or the OTC market maker that is the primary market center for the subject security. With respect to 19c-3 securities, the mandatory provisions apply only to quotations from market centers commanding one percent or more of the trading volume in the subject security. All other market centers may disseminate quotations on a voluntary basis. In terms of the concerns of this article and the ability of brokers to determine*

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sion, based on existing fiduciary law and national market system developments, could compel brokers to justify their routing decision. *See* NASD Best Execution Letter, *supra* note 247.

279 Aspects of the rule over which the Commission would want to maintain control include: (1) applicability of a best execution rule to other than ITS-traded securities; (2) the legitimacy of a broker's countervailing considerations in not seeking best execution; and (3) whether a best execution rule should be phased in rather than applied totally.

280 Securities Exchange Act Rel. No. 18482 (Feb. 11, 1982), 24 SEC DOCKET 876 (Feb. 23, 1982).

281 *See* note 169 *supra*.

the best price in multiply-traded securities, the impact of the amendment is insignificant. Under the ITS plan, all participating market centers must furnish current quotations for each ITS security traded in that center to the other ITS participants.[282] *Thus, regardless of the quote rule, secondary markets are compelled to continue the dissemination of quotations in all ITS-traded securities. (ITS-traded securities include nearly all of the active multiply-traded securities.) In addition, third market-market makers who have traditionally attracted meaningful trading volume have an economic incentive to disseminate quotations on a voluntary basis.*[283] *The only quotations which will probably no longer appear in CQS are those disseminated by: (1) regional specialists of relatively inactive non-ITS securities; and (2) third market-market makers of securities with limited trading volume.*

The Commission, in adopting the amendments, sought to remove the economic burden of mandatory quotation dissemination from the market makers who had not been receiving the offsetting benefits resulting from order flow.[284] *As the Commission explained, the retail brokerage firm practice of automatically routing orders to the primary market inhibited order flow from responding to competitive quotations.*[285] *Note that if the Commission had already adopted a best execution rule, order flow would have been responsive to competitive quotations. Market centers would then have had an incentive to disseminate competitive quotations and there would have been no need to amend the quote rule.*

282 24 SEC Docket at 881.

283 *Id.* at 882.

284 *Id.* at 881.

285 *Id.* at 887.