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GOVERNANCE OF OUR SECURITIES MARKETS
AND THE FAILURE TO ALLOCATE
REGULATORY RESPONSIBILITY

David A. Lipton*

The market regulatory structure of the 1934 Securities Exchange Act¹ (1934 Act or Act) was conceived in response to the documented inability of the securities industry to maintain fair and honest trading markets.² The innovative oversight system created by the Act, as amended, is perceived as a model of authority sharing by government and industry in the regulation of a vital enterprise affected with the public interest.³


³ In 1934, the Act was described as “a tremendous experiment in governmental regulation of business.” Tracy & MacChesney, supra note 2, at 1037. Nearly 30 years later, the Securities and Exchange Commission in enumerating the virtues of the self-regulatory mechanism, which it had administered since 1934, found the self-regulatory scheme attractive because the expertness and immediacy of self-regulation often provide the most expedient and practical means for regulation. By making those regulated actual participants in the regulatory process they become more aware of the goals of regulation and their own stake in it. In some areas the self-regulatory bodies can promote adherence to ethical standards beyond those which could be established as a matter of law. SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 at 722 (1963) [hereinafter cited as SPECIAL STUDY].

That the exchanges were perceived as being affected with the public interest was evident in the 1934 report of the House Committee on Interstate and Foreign Commerce that noted that “[t]he great exchanges of this country upon which millions of dollars of securities are sold are
A curious feature of this cooperative regulatory system is that the authority of government and of industry to respond to specific market regulatory concerns frequently overlap. In many instances, both the Securities and Exchange Commission (SEC or Commission) and the self-regulatory organizations (SROs), that is, the major security exchanges and the National Association of Securities Dealers (the NASD), are statutorily authorized to initiate regulatory problem solving. Furthermore, in most instances of joint authority, the securities acts do not provide guidance as to which of the two parties should assume primary regulatory responsibility.

This dual authority system, while attractive as a demonstration of industry and government cooperation in a common regulatory endeavor, suffers from a number of existing and potential problems that result primarily from the lack of statutory guidance provided for allocating authority. Because of the dual nature of the regulatory system and its concomitant lack of explicit authority allocating principles, regulatory inaction is encouraged by the uncertainty that the system engenders as to whether government or industry ultimately will be allocated responsibility for specific problems. In other instances, responsibility is assumed by the regulatory body that is least likely to deal effectively with a specific regulatory concern. Finally, the system discourages industry diligence in the performance of its own self-regulatory obligations. This discouragement results from potential industry recognition that, without clearly assigned regulatory responsibilities, problems ignored by industry regulators will eventually have to be responded to by the Commission, which retains ultimate responsibility for market regulation.

I. ORIGINS OF OVERLAPPING AUTHORITY

As initially envisioned, the government was to assume primarily a standby role in the regulation of the securities markets. The government was

affected with a public interest in the same degree as any other great utility." H.R. REP. No. 1383, 73d Cong., 2d Sess. 15 (1934).

4. The major security exchanges include the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), the Midwest Stock Exchange (MSE), the Pacific Stock Exchange (PSE), the Philadelphia Stock Exchange (PHLYX), and the Cincinnati Stock Exchange (CSE).

5. The NASD was established primarily to govern trading in the over-the-counter (nonexchange) markets. Its authority arises under § 15A of the 1934 Act, supra note 1. In 1938, § 15A was added to the 1934 Act by the Maloney Over-the-Counter Market Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. §§ 78o, 78o-3, 78cc, 78ff, 78q (1982)) [hereinafter cited as the Maloney Act].

6. The House Committee on Interstate and Foreign Commerce, which was responsible for working on the bill that ultimately became the 1934 Act, stated:

[R]eserved control is in the Commission if the exchanges do not meet their responsibility. It is hoped that the effect of the bill will be to give to the well-managed
expected to oversee the activities of the self-regulators and to step in and regulate market trading only when the self-regulatory bodies proved incapable of regulating, or unwilling to regulate, themselves. During the House hearings on the bill that was to become the 1934 Act, Congressman Charles A. Wolverton explained the government's contribution to self-regulation under the proposed act as follows: "[T]he exchange should be permitted or required to regulate themselves; but there should be Federal authority holding the power . . . referred to as 'a big stick.'"\(^7\)

Yet, even pursuant to this somewhat limited role initially afforded the government, there were frequent instances in which the authority of the SEC and that of the exchanges overlapped. For example, the originally enacted section 6(b) of the 1934 Act required that before an exchange could be registered with the SEC, the exchange must have in place rules for disciplining members for conduct "inconsistent with just and equitable principles of trade."\(^8\) But this same misconduct that the exchanges were required to discipline could also trigger Commission injunctive action pursuant to the originally enacted section 21(e) that empowered the Commission to bring an action to enjoin any violation or potential violation of the 1934 Act.\(^9\)

Instances of overlapping authority between the SEC and the self-regulatory bodies have markedly increased in the past two decades as the Commission's market regulatory role has expanded as a result of Commission practice and congressional legislation. In the mid-1960's, the Commission,

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\(^7\) H.R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934).
\(^8\) Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 544 (1934) [hereinafter cited as 1934 House Hearings].
\(^9\) 1934 Act, supra note 1, § 6(b), at 886 (codified as amended at 15 U.S.C. § 78f (1982)). Today, a similar requirement for registration exists. Pursuant to the present § 6(b), exchanges may not be registered unless the rules of the exchange provide for appropriate discipline for violation of the rules of the exchange. The exchange rules in turn must be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5) (1982).

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exchanges that power necessary to enable them to effect themselves needed reforms and that the occasion for direct action by the Commission will not arise.

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1934 Act, supra note 1, § 21(e), at 900 (codified as amended at 15 U.S.C. § 78u(d) (1982)). The Commission's specific disciplinary authority over brokers was initially limited to a broad mandate to prescribe regulations to register brokers of over-the-counter securities. Id. § 15, at 895 (codified as amended at 15 U.S.C. § 78(o) (1982)). In 1936, this authority was refined to state clearly that the Commission could revoke the registration of brokers who willfully violated, among other statutes, the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77 (1982)), or the 1934 Act, supra note 1, or rules thereunder. Consequently, a broker who, for example, manipulated the market in violation of § 9(a)(2) of the 1934 Act could be disciplined by the Commission under §§ 21(e) or 15(b)(4)(d) of the 1934 Act or by the exchanges pursuant to their own rules.
motivated by the recommendations found in its seminal Report of the Special Study of the Securities Market, began more actively to assert its existing authority to correct trading abuses in the securities markets. As an example, in 1964 the Commission adopted rule 11a-1 restricting the activity of floor traders. Floor traders are brokers who trade for themselves while on the floor of an exchange thus experiencing certain competitive advantages over public investors resulting from being in the right place at the right time. Although the Commission had studied floor trading on several occasions since its inception and had concluded that it should be curtailed, the Commission had, by and large, left the resolution of how to deal with floor trading primarily to exchange rulemaking. It was not until nearly thirty years after completing its first study on floor trading that the Commission was sufficiently self-confident to assume responsibility for this activity by promulgating rule 11a-1. The restrictions adopted by the SEC were later incorporated into amendments made to the Securities Exchange Act.

10. Professor Richard W. Jennings describes this more aggressive use by the Commission of its then existing authority in Jennings, Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission, 29 LAW & CONTEMP. PROBS. 663, 665-67 (1964). This more assertive Commission behavior, particularly in the area of discipline, was championed by the then Chairman of the Commission, Professor William L. Cary, who stated:

In sum, I do not agree that the Commission should have to resign itself to a vestigial role in dealing with an exchange and its members. I feel we [the Commission] must become directly involved, as we have in major disciplinary proceedings involving exchange members, where important questions of principle are at stake.


12. As an example of how the Commission had failed to act on its own judgment regarding floor trading, the SPECIAL STUDY reported that: "In 1945 the Commission proposed the abolition of floor trading, but withheld action in light of repeated assurances that the exchanges would develop effective self-regulation of this activity." Id. pt. 2, at 241. Implicit in this account of the Commission's nonregulation of floor trading is the recognition that both the Commission and the exchanges had the authority to regulate floor trading.

Charts and tables from some of these Commission studies are reproduced in the SPECIAL STUDY. See SPECIAL STUDY, supra note 3, pt. 2, app. H, at 497-524.

13. Rule 11a-1 prohibits exchange members, while on the floor of such exchange, from initiating "directly or indirectly, any transaction in any security admitted to trading on such exchange, for any account in which such member has an interest, or for any such account with respect to which such member has [certain specified] discretion." 17 C.F.R. § 240.11a-1(a) (1984).

14. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 6(2), 89 Stat. 97, 110 (codified as amended at 15 U.S.C. § 78k(a)(1) (1982)) [hereinafter cited as the Securities Amendments Act]. Section 6(2) of the Securities Amendments Act amends § 11 of the 1934 Act by adding subsection (a)(1). This provision makes it unlawful for any member of a national securities exchange to "effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion." Eight exceptions to the general proscription are pro-
Of greater impact on the growth of the Commission's power (than the aggressive use of its existing authority) is the expansion of the Commission's market regulatory role mandated by Congress through amendments to the Securities Exchange Act. The most significant of these amendments is the Securities Reform Act of 1975 (Reform Act). The Reform Act provides the Commission with authority to add to and otherwise change the rules of the SROs, to enforce these rules, to discipline SROs and their officers, and to foster market structure developments.

As a result of this expansion of power, the Commission now has the authority to amend exchange and NASD rules in any respect and regarding any subject matter, provided the change is consistent with the purposes of the Act. The pre-1975 Act required the Commission to first request an


20. See Securities Amendments Act, supra note 14, § 16, at 150 (codified as amended at 15 U.S.C. § 78s(c) (1982)). This section amends § 19(c) of the 1934 Act by authorizing the Commission to

abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of [the Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this [Act] . . .
exchange to make a specified alteration itself before the Commission could adopt the amendment. Additionally, the Commission’s amendments were limited to certain subject matters.\textsuperscript{21} Furthermore, since 1975, the SEC has had the authority actually to enforce the SROs’ own rules by investigating violations of these rules and by bringing actions to enjoin such violations.\textsuperscript{22}

The Reform Act also grants the Commission, for the first time, a variety of disciplinary powers over the self-regulatory organizations.\textsuperscript{23} In addition,
the Commission is granted authority to suspend or expel from exchange membership any NASD members in instances where a member has been directly disciplined by the Commission or has committed securities acts violations.\footnote{24}

Finally, the Commission is given a broad mandate to alter the very structure of the trading markets. The Reform Act directs the Commission to facilitate the establishment of a national market system and to use its authority to carry out the objectives of this new system.\footnote{25} The objectives include the development of certain physical components for the system such as an intermarket communication and execution system.\footnote{26} In addition, the objectives also relate to the achievement of certain advancements in regulatory procedures that, among other matters, would increase the likelihood of customers' orders being executed at the best possible price\footnote{27} and encourage

discipline securities association officers. See Maloney Act, supra note 5, § 1, at 1075 (codified as amended at 15 U.S.C. § 78o-3 (1982)).

\footnote{24.}{Securities Amendments Act, supra note 14, § 16, at 153 (codified as amended at 15 U.S.C. § 78s(h)(2) (1982)), amends § 19 of the 1934 Act by adding subsection (h)(2). Section 19(h)(2) empowers the Commission to directly discipline by suspension or expulsion from an SRO any SRO member (i) disciplined by the Commission under § 15(b)(4) for securities law or other statutory violations impacting upon the member's integrity, or (ii) found, by the Commission, to have violated the Securities Act after notice and opportunity for a hearing.}

Prior to 1975, the bases for suspension or expulsion of an exchange member from an exchange by the Commission were limited to violations of the 1934 Act or the rules and regulations promulgated thereunder. See 1934 Act, supra note 1, § 19(a)(3), at 898 (codified as amended at 15 U.S.C. § 78s(a)(3) (1982)). However, under § 15A(l)(2), securities association members could be suspended or expelled from their association for both 1934 Act violations and violations of the Securities Act of 1933. See Maloney Act, supra note 5, § 1, at 1075 (codified as amended at 15 U.S.C. § 78o-3 (1982)).

\footnote{25.}{Securities Amendments Act, supra note 14, § 7, at 112 (codified as amended at 15 U.S.C. § 78k-1(a)(2) (1982)). This section amends the 1934 Act by adding § 11A(a)(2), which directs the Commission with "due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under [the Act] to facilitate the establishment of a national market system for securities." The Commission can facilitate the establishment of this market system by making such rules and regulations as are necessary to implement the provisions of the 1934 Act. See Securities Amendments Act, supra note 14, § 18, at 155 (codified as amended at 15 U.S.C. § 78w(a)(1) (1982)) (amending § 23 of the 1934 Act by adding subsection (a)(1)). The national market system was intended to allow all trading interests to interact through various communication and execution facilities in order that each investor would have the opportunity to receive the best execution for his transaction. Senate Comm. on Banking, Housing, and Urban Affairs, Report to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 7 (1975) [hereinafter cited as 1975 Senate Report].}


competition among various trading markets.28

These statutory additions to the Commission's authority were not accompanied by any corresponding withdrawal of authority from the SROs. The self-regulatory bodies retained the authority with which they were originally endowed in the 1934 Act in areas of discipline, rulemaking, and market operations. Thus, the authority of the Commission and the self-regulators became, in many respects, coextensive.29

II. THE DUAL REGULATORY SYSTEM

The result of this accretion to Commission power is that today the Commission is no longer merely a reactive body providing government oversight of exchange and NASD self-regulation. Rather, the regulatory system provides for government initiated direct regulation in conjunction with industry initiated self-regulation (albeit with government oversight). It is really a dual regulatory system with two potential initiators30 of rulemaking and en-


An instance in which the SROs initiated market structure policy was the adoption by the exchanges of the antitrade-through rules in 1981. See Notice and Order Approving Proposed Amendment to the Intermarket Trading System Plan, SEA Release No. 17,703 (Apr. 9, 1981), 22 SEC DOCKET (CCH) 707 (Apr. 21, 1981) (approving the rule changes). These antitrade-through rules made brokers who execute transactions in securities traded on the intermarket trading system or ITS (an execution device that allows brokers on one exchange to effect executions on another exchange) liable for failure to execute their transaction at the best possible price. These antitrade-through rules foster the objectives of the national market system, which seeks to assure the practicability of brokers achieving best execution for their trades. See Securities Amendments Act, supra note 14, § 7, at 112 (codified as amended at 15 U.S.C. § 78k-1(a)(1)(C)(iv) (1982)) (amending the 1934 Act by adding § 11A(a)(1)(C)(iv)).


30. As a practical matter, when this article describes the Commission as an "initiator" of regulatory policy or an "overseer" of such policy, cognizance is made of the fact that indeed it is typically the staff of the Commission that is initiating particular policy or overseeing policy
forcement of regulations. The Senate Report accompanying the bill that was to become the Securities Reform Act of 1975 described this regulatory system as one of "mutual regulatory responsibility." 31

Admittedly, the government still functions in part in a pure oversight or reactive capacity. The SEC has responsibility for reviewing most rule changes proposed for adoption by the SROs. 32 It can review disciplinary action taken by the exchanges and the NASD. 33 The Commission can also guarantee that the SROs are effectively enforcing their own rules through its authority to discipline these bodies. 34 Finally, the SEC can oversee struc-

31. 1975 SENATE REPORT, supra note 25, at 23. Instances of overlapping authority of the SROs and the Commission are not limited to matters solely concerning market regulation. Both the Commission and the SROs have the authority and exercise the authority to require issuers that are listed on the exchanges and that are reported in the NASD's transaction disclosure system (NASDAQ) to disclose information about themselves. The SROs' authority to require disclosure arises from §§ 6(b)(5) and 15(A)(b)(6), which are general antimanipulative provisions intended to "protect investors and the public interest." Securities Amendments Act, supra note 14, § 4, at 105 (codified at 15 U.S.C. § 78f(b)(5) (1982)); Securities Amendments Act, supra note 14, § 12, at 127-28 (codified as amended at 15 U.S.C. § 78o-3(b)(6) (1982)). The Commission's authority to compel disclosure by these issuers arises from the 1934 Act regulation and reporting provisions. 1934 Act, supra note 1, §§ 12(a), (b), (g), 13(a), at 892, 894 (codified as amended at 15 U.S.C. §§ 78(a), (b), (g), 78m(a) (1982)).

32. After notice and opportunity for written comments, the Commission must either approve proposed rules filed by the SROs or institute proceedings to determine whether the proposed rules should be disapproved. Securities Amendments Act, supra note 14, § 16, at 147-48 (codified as amended at 15 U.S.C. § 78s(b)(1) (1982)) (amending § 19 of the 1934 Act by adding new subsections (b)(1), (b)(2)). The Commission may also summarily approve proposed rules if such action is necessary for the protection of investors, the maintenance of fair and orderly markets, or the safeguarding of securities or funds. Securities Amendments Act, supra note 14, § 16, at 148 (codified as amended at 15 U.S.C. §§ 78s(b)(3)(B) (1982)) (amending § 19 of the 1934 Act by adding new subsection (b)(3)(B)).

33. An SRO must file notice with the Commission of any final disciplinary sanction it imposes upon any of its members. Securities Amendments Act, supra note 14, § 16, at 150 (codified as amended at 15 U.S.C. § 78s(d)(1) (1982)) (amending the 1934 Act by adding § 19(d)(1)). The Commission can review such disciplinary sanction either on its own motion or upon motion of any party aggrieved by such disciplinary sanction. Securities Amendments Act, supra note 14, § 16, at 150-51 (codified as amended at 15 U.S.C. § 78s(d)(2)(1982)) (amending the 1934 Act by adding § 19(d)(2)). After notice and opportunity for hearing, if the Commission finds that an actionable violation has occurred, it may affirm the sanction imposed, modify it, or remand the matter to the SRO for further proceedings. If the Commission does not find an actionable violation, it may set aside the sanction and, if appropriate, remand the matter to the SRO for further proceedings. Securities Amendments Act, supra note 14, § 16, at 151 (codified at 15 U.S.C. §§ 78s(e)(1)(A), (B) (1982)) (amending the 1934 Act by adding §§ 19(d)(1)(A), (B)).

34. See supra notes 23-24.
teral market changes made by the securities industry through the Commission's authority to oversee the rulemaking efforts of the self-regulators and its authority to register the SROs. In each of these areas of oversight regulation, however, the Commission now also possesses the authority to initiate regulatory activity. The Commission can directly alter the rules of the self-regulators. It can discipline exchange and NASD members for violations of both Commission rules as well as the rules of the members' own organizations. It can also order changes in the physical components of trading markets and the operations of these markets.

This authority of the Commission to initiate direct regulatory activity is generally not restricted to instances in which self-regulatory bodies have already expressed an unwillingness or an inability to regulate. Congress has demonstrated an ability to so restrict the Commission when such limitations were deemed desirable. The original section 19(b) of the Securities Exchange Act, which gave the Commission authority to directly amend some categories of exchange rules, indeed did limit the Commission's ability to amend these rules. Under the original section 19(b), before amending an

35. See supra note 20. Also, the Commission, after notice and an opportunity for written comments, must either grant applications for registration by SROs or institute proceedings to determine whether registration should be denied. Securities Amendments Act, supra note 14, § 16, at 146-47 (codified as amended at 15 U.S.C. § 78s(a)(1) (1982)) (amending § 19 of the 1934 Act by adding new § 19(a)(1)). The Commission must grant registration if it finds that the requirements of the 1934 Act and its rules with respect to the applicant are satisfied. See Securities Amendments Act, supra note 14, § 16, at 146 (codified as amended at 15 U.S.C. § 78s(a)(1)(B) (1982)) (amending § 19 of the 1934 Act by adding § 19(a)(1)(B)).

36. See supra note 20.

37. See supra note 22 for the Commission's authority to discipline SRO members for violations of SRO rules. The Commission also has the authority to discipline SRO members for violations of the Commission's rules. See supra note 24. In addition, the Commission has authority to discipline brokers for (i) willfully supplying the Commission with misinformation with regard to broker registrations; (ii) being convicted of certain specified crimes reflecting upon a broker's integrity; (iii) being judicially enjoined from acting in a specified capacity in various financial industries; (iv) willfully violating the securities laws; (v) willfully aiding and abetting any person in securities law violations, or (vi) being subject to a Commission order barring such broker from associating with another broker. See Securities Amendments Act, supra note 14, § 11(2), at 122-23 (codified as amended at 15 U.S.C. § 78o(b)(4) (1982)).

38. See supra note 25.

39. In one instance, the Commission's authority has been restricted so that it may only be utilized in a reserve fashion. Even when so limited, however, there is a broad exception that allows the Commission to act in other than a reserve manner. Thus, the Commission's authority to bring an action enjoining persons from violating the rules of a self-regulatory organization (as opposed to the Commission's own rules) is limited to instances in which "it appears to the Commission" that (i) the SRO is unable or unwilling to take appropriate action against the violator, or (ii) the Commission's action is "otherwise necessary or appropriate in the public interest or for the protection of investors." Securities Amendments Act, supra note 14, § 21(3), at 155 (codified as amended at 15 U.S.C. § 78u(f) (1982)) (amending the 1934 Act by adding § 21(f)) (emphasis added).
exchange rule, the Commission had first to make an "appropriate request in writing" to an exchange for that body to effect, on its own behalf, the desired change in its rules or practices.⁴⁰ Such qualifying restrictions are absent from the present section 19(c) of the Act (which empowers the Commission to alter the rules of the self-regulatory bodies). Similarly, the other grants to the Commission of direct authority discussed above are largely unfettered by requirements that the Commission make any attempt to seek action by the self-regulatory bodies before acting on its own.

III. THE ABSENCE OF GUIDELINES FOR ALLOCATING REGULATORY RESPONSIBILITY

The difficulties engendered by this dual regulatory system arise from Congress' failure to formulate clear guidelines as to which entity should be responsible for initiating regulation in a given instance. Arguably, the presumption that underlies the Securities Exchange Act, that day-to-day administration of the trading markets is the responsibility of the self-regulatory bodies,⁴¹ is actually a principle for allocating regulatory responsibility. Indeed, under the scheme of the Act, SROs are responsible for all perfunctory market regulatory activities, such as admitting members to the organizations,⁴² assuring them fair representation in selecting directors,⁴³ allocating dues equitably,⁴⁴ implementing fair trading,⁴⁵ and enforcing the organization's rules.⁴⁶ This presumption regarding day-to-day regulatory concerns,

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⁴⁰ See supra note 21.

⁴¹ An essential philosophy underlying the 1934 Act was that the exchanges would be responsible for the administration of their respective market centers. John Dickinson, then Assistant Secretary of Commerce and Chairman of the Interdepartmental Committee on Stock Exchange Regulation that laid the foundation of the 1934 Act, opined that it would be "sheer ineffectiveness" to have the government handle the "practical problem of administration." 1934 House Hearings, supra note 7, at 514.


however, does not resolve the question of how to allocate regulatory responsibility for other than the administration of perfunctory matters.

Although guidelines do not exist for allocating responsibility for major regulatory concerns, the Commission does retain ultimate authority over trading market regulation. Possession of ultimate control, however, while resolving questions of which entity may dictate allocation of regulatory responsibility, does not resolve upon what criteria that allocation should be made or in what instances an allocation needs to be made.

IV. THE NEED FOR PRINCIPLES FOR ALLOCATING REGULATORY RESPONSIBILITY

The development of a dual regulatory system with overlapping authority and no reasoned principles for allocating that authority, other than with respect to purely administrative matters, creates a number of impediments to the proper functioning of our securities markets. Some of these impediments are tangible, existing problems that can be observed and reported. Others are more difficult to observe but, nonetheless, remain as potential threats to the future effectiveness of securities market regulation.

V. THE PROBLEMS RESULTING FROM REGULATORY OVERLAP

1. The absence of guidelines for the assumption of responsibility for initiating market regulatory policy development has meant that very similar regulatory issues have received different treatment depending upon whether the regulatory initiative was assumed by the Commission or by one of the SROs. At times, the Commission will all but ignore certain regulatory concerns, allowing the SROs to assume regulatory initiative. At other times, the Commission has reversed its posture and has assumed the regulatory responsibility and imposed its own perspective on the issue in question. This inconsistency in regulation makes regulatory policy unpredictable and may discourage SROs from taking the initiative in developing market structure improvements. An example in point is the regulatory treatment that has been afforded the SROs in the development of their respective automatic small order execution systems.

The automatic small order execution systems were one of the trading de-

47. In the Senate Report accompanying the bill that was to become the 1975 Reform Act, it was emphasized that although the responsibilities of the Commission and the SROs fit into a pattern of partnership and cooperation, the SROs and the Commission do not "enjoy the same order of authority or deserve the same degree of deference, whether by firms, courts or the Congress. The self-regulatory organizations exercise authority subject to SEC oversight." 1975 SENATE REPORT, supra note 25, at 23.
vices developed by the SROs in the 1970's and early 1980's and were designed to encourage order flow to the respective exchanges (or to the over-the-counter market). 48 Although there are a number of variations in the operation of these systems, they basically provide brokerage firms with a routing device to send orders, up to a specific number of shares, 49 from the firm’s trading room directly to the appropriate trading post on the floor of the exchange utilizing the execution systems. Regardless of the current quotation on that exchange, the order is guaranteed by the specialist at the trading post at an execution price equal to the best (or “inside”) consolidated quotation. This quotation represents a composite of all of the quotations currently available on a specific listed security on the major exchanges as well as in the over-the-counter market.

These automated execution systems at first blush appear to be consistent with the 1975 Reform Act provisions that call for the establishment of a national market system. 50 This legislation directs that the national market system be capable of assuring “economically efficient execution of securities transactions” 51 and “the practicability of brokers executing investors’ orders in the best market.” 52 Indeed, the automatic small order execution systems provide both efficient execution and the best execution price among the quotations of a multiple number of markets. However, on closer examination, these execution systems work at cross-purposes with major national market systems goals.

The regional exchanges, 53 coveting increased order flow, do not provide

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49. As an example, SCOREX today can execute orders of up to 1099 shares. SEC. WEEK, Aug. 13, 1984, at 9.


53. The “regional exchanges” are all the major exchanges other than the NYSE and the AMEX, both of which are considered primary exchanges. For the most part, the regionals
through their small order execution systems a mechanism for routing orders to the market offering the best available quotation. Rather, these execution systems are designed to "match" the best available quotation and to execute orders received on the recipient exchange at that best available quotation. As a result, the market center that promulgated the best quote from which the automated system derives its execution price is not rewarded with order flow corresponding to its attractive bid or offer. Without that reward, the incentive to promulgate attractive quotations is removed. Thus, a major national market system goal of encouraging better bids and offers by ensuring order flow to market centers in response to attractive quotations54 is thwarted by automatic small order execution mechanisms with derivative pricing mechanisms.

In addition, although automatic execution systems will match the best available quotation, they do not necessarily guarantee customers executions at the best available price. One of the three automatic execution systems in place on regional exchanges—PACE on the Philadelphia Stock Exchange—has historically not provided any mechanism to allow orders routed by the automatic system to interact with trading on the floor of the exchange.55 Thus, although orders routed through PACE will be executed at the best quotation available on a multiple number of market centers, if there were trading interest on the floor of the Philadelphia Stock Exchange that would otherwise better the consolidated quotation, the automatically transmitted order would not benefit from this trading interest. For example, consider the situation in which the best consolidated bid (that is, offer to buy) for a security might be 40 \(\frac{\text{V}}{8}\). Assume a market sell order was transmitted through the automatic execution system on the Philadelphia Stock Exchange. Even if there were a broker on the floor of the Philadelphia Stock Exchange with a willingness to buy at 40 \(\frac{1}{4}\), the automatically transmitted sell order would still be executed at 40 \(\frac{\text{V}}{8}\).

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54. An essential assumption underlying the national market system was that better prices would be offered investors if market makers (securities dealers who disseminate quotations) knew that they would get increased business (order flow) in response to the offer of better prices (higher bids and lower offers). For a discussion of the assumption, see Lipton, supra note 48, at 457-58 nn.36-40 and accompanying text.

55. Both SCOREX and MAX are programmed to allow trading interest on the floor of the respective exchanges in which these trading devices exist to interact with the automatically routed order just prior to execution. If either the specialist or the brokers on the exchange floor want to execute against a market order at a price superior to the consolidated quotation, such opportunity is provided during a 30-second interval just prior to automatic execution. PACE does not provide this opportunity for interaction from trading interest on the floor of the exchange. R4 Extension Proposal Release, supra note 48, at 18.
Further, none of the automatic execution systems on the regional exchanges permit automatically transmitted orders to interact with superior bids and offers in trading crowds on other exchanges. Thus, on none of the regionals would automatically transmitted orders necessarily receive the best available price for their execution. Rather, they typically would receive the best of the consolidated quotations. In addition, with some execution systems, there would also be an opportunity for improvement in the consolidated quotation from the trading crowd on only one regional exchange, not the trading crowds on all exchanges.

The Commission has not been unaware of the challenges to the national market principles presented by the automatic execution systems. As early as June 1980, the Commission stated: "[O]rders sent to regional exchanges . . . are often executed in those markets without any intermarket exposure . . . [at times] because they are executed, on an automated basis, based on a derivative pricing formula [the composite quotation]." Although the Commission was not unaware of the problems presented by the automatic execution systems, it did not initiate any regulatory response to those problems. Further, there was no statutory requirement demanding that the Commission initiate a regulatory response. The Commission's responsibility for the national market system, as with its responsibility for other regulatory matters, is a joint one with the SROs. The Commission's mandate specifically is to "facilitate the establishment of a national market system for securities." This lack of direction in requiring Commission initiative with regard to a critical national market system component leads to an inconsistent application of regulatory principles. Such inconsistencies can work to discourage self-regulatory initiative by the SROs.

By 1982, the New York Stock Exchange (NYSE) had come to realize that it was not entirely competitive in the field of small order execution systems and it began to perceive that it might be losing order flow as a consequence. The NYSE had a small order routing system—the Designated

58. See Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change, SEA Release No. 19,047 (Sept. 14, 1982), 26 SEC DOCKET (CCH) 147, 148 (Sept. 29, 1982) ("the Commission recognizes the NYSE's need to provide competitive alternatives to the automatic execution systems developed by certain regional exchanges"). The securities industry media reported that "the reason behind the RRRR [the NYSE small order execution system discussed infra at text following note 59] pilot is NYSE's desire to entice back small-order flow which may have left the exchange because of regional exchanges small-order automatic execution systems and prevent further order-flow erosion." SEC. WEEK, April 5, 1982, at 1.
Order Turnaround, or DOT.\textsuperscript{59} This system routes small orders directly to a specialist but does not guarantee an execution price. Instead, DOT relies upon interaction with exchange floor trading to determine an execution price. To compete with the automatic execution features of the regional exchanges' small order execution systems, the NYSE developed the Registered Representative Rapid Response Service or R4.

The R4 was not intended as a routing system as much as it was a mechanism for guaranteeing a customer a specified execution price (at the best consolidated quotation) at the moment the order was placed. Through R4, a customer would be told by his registered representative (broker) that the customer has received an immediate execution based upon the best consolidated quotation at that moment. After guaranteeing the customer the transaction at the specified price, the registered representative would send a report of the transaction to the exchange floor where the specialist would insure that the transaction was executed at the specified price even if it required that the specialist accept the execution for his own account.\textsuperscript{60} As with all of the automatic execution systems, R4 would "internalize" (that is, execute on the floor of the recipient exchange without opportunity for interaction with orders on other market centers) the order flow coming through the system and would price match rather than send the order to an exchange with a superior quotation. And as with the PACE execution system, R4 would not provide interaction with the trading crowd on the floor of the NYSE nor with trading crowds on other exchanges.

These limitations of R4 were inconsistent with the national market system goals of encouraging price competition and achieving best executions. However, they were identical to the limitations of the automatic execution systems already in operation on the regional exchanges in regard to which the Commission had not initiated corrective action. The message that the Commission had sent the NYSE through its failure to object to the regional exchanges' automatic execution systems might well have been read as saying that such systems were acceptable. As a practical matter, it is likely that the Commission had just not assumed responsibility for initiating a solution to a regulatory problem that could have been resolved by the SROs themselves or by the Commission.

When the NYSE sought to adopt the R4 system, initially on an experimental basis,\textsuperscript{61} the Commission decided that the regulatory problems

\textsuperscript{59} For a description of DOT, see R4 Extension Proposal Release, \textit{supra} note 48, at 18.
\textsuperscript{60} For a description of the R4 system, see Notice of Filing Order Granting Accelerated Approval of Proposed Rule Change, SEA Release No. 19,047 (Sept. 14, 1982), 26 SEC DOCKET (CCH) 147 (Sept. 29, 1982).
\textsuperscript{61} \textit{Id.}
presented by the automatic execution systems were a regulatory concern that it would address. In response to a rule change request by the NYSE for temporary implementation of the R4 system, the Commission raised concerns about the failure of the R4 system to achieve best execution because of the lack of interaction between the orders sent and the trading crowd on the floor of the exchange.  

Because the R4 system at that point was going to be implemented only in a pilot stage, the Commission chose to approve the proposed rule.  

However, the signal had been sent that (i) the Commission was indeed choosing to focus on this regulatory problem, and (ii) the Commission might come out against R4 when permanent approval was sought. It is of interest to note that, in this instance, although the Commission was working in a purely oversight mode, that is, review of rule proposals, it was using its oversight position to initiate a solution to a regulatory concern.  

A year later, when the NYSE sought to expand and extend its R4 program through a new rule filing, the Commission expounded further upon its concerns with automatic execution systems. It raised the possibility that the rule proposals might be disapproved as being inconsistent with the goals of the national market system. Again, the Commission noted that R4 does not necessarily provide best execution. In addition, the Commission expressed its concern with the impact of the R4 price matching mechanism on price competition among market centers. Both of these drawbacks to R4 existed with the other automatic execution systems already approved by the Commission. Admittedly, the magnitude of trading volume on the NYSE and the primacy of that market as a price setting center as compared to the regional markets would give the Commission greater discomfort with limitations when found in R4 as opposed to other automatic execution systems. However, it undoubtedly had always been apparent that a grant of approval by the Commission for small execution systems on regional exchanges would inevitably lead to a request for such a system by the NYSE. To permit the regional exchanges to operate automatic execution systems and not to permit the same privilege to the NYSE would be perceived as an inconsistent application of regulatory principles. 

62. Id. at 148.  
63. Id. at 149.  
64. See R4 Extension Proposal Release, supra note 48.  
65. Id. at 19.  
66. Id. at 20.  
67. The Commission questioned whether the diversion of such a magnitude of order flow to a derivative pricing mechanism (based upon the consolidated quotation) would skew the market pricing mechanism. Id. at 20.  
68. In a letter to the SEC, reported upon in the securities industry media, the NYSE
Although the Commission ultimately permitted the NYSE to continue the R4 experiment for another year, it did so only tentatively and with threats of a future *quid pro quo* that the NYSE would unlikely want to pay. The Commission indicated that it would closely monitor R4 operations, and it required that brokers using R4 inform their customers that they might be missing better executions. In addition, the Commission indicated that if it ultimately approved R4, it might, to be consistent, also require the NYSE to abandon its restrictions on trading by its members in the over-the-counter market, restrictions that artificially augment the NYSE's volume and revenues. The NYSE, however, has not proceeded to seek a permanent approval for the R4 system.

Arguably, the Commission's attention to the limitations of the R4 system was warranted. However, if attention is warranted when customers fail to get the best available price through an automatic execution mechanism on the NYSE, surely attention is warranted to identical limitations of execution systems on the regional exchanges. The problem with R4 is clearly of a greater dimension than with automatic execution systems on the regional exchanges because of the magnitude of trading on the NYSE. It would seem to be an untenable position, however, for the Commission to hold that failure to achieve best execution is not a regulatory problem when arrived at through trading on regional exchanges but that it is a problem when arrived at through trading on the NYSE. It is more likely that the Commission chose not to assume regulatory responsibility for the trading problem when it first appeared on the regional exchanges but did choose to assume regulatory responsibility for the trading problem when it later appeared on the NYSE.

The statutory directives for the Commission in initiating regulatory responses do not demand greater consistency. The mutuality of regulation in the existing oversight system permits both the Commission and the SROs to respond to perceived problems of the nature created by automatic execution systems. One can speculate about the impact of such inconsistent regulation on the willingness of an SRO to develop other innovative execution systems. The speculation clearly might be that an SRO would, in the future, be less willing to develop such innovative systems. Regardless of the certainty of

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indeed raised the issue of inconsistent application of regulatory principles. The NYSE was reported as writing: "Frankly we do not see how the Commission could justify using its authority to sanction the array of execution systems operated by our competitors, while simultaneously discriminating against the NYSE's efforts to develop an innovative, competitive . . . [automatic execution system]." *SEC. WEEK*, Aug. 22, 1983, at 4.

such speculation, the regulatory scheme lacks an element of predictability and a defined sense of order as a result of the absence of clear guidelines as to when responsibility should be assumed.

2. The absence of authority-allocating guidelines based upon principles of effective market regulation has also led to situations in which regulatory responsibility has been assumed by or assigned to inappropriate regulatory bodies. A good example was the allocation to the securities industry of the responsibility for developing an "order exposure" rule and also for linking the intermarket trading systems. The exposure rule had been proposed as a means of preventing large retail brokerage houses from executing customer orders, in certain exchange-listed securities, internally or "in-house," without first affording other brokers an opportunity to interact with these orders. This in-house execution of customers' orders without market exposure is referred to as "internalization." The order-exposure rule proposal would

70. The Commission in 1980 first began publicly to discuss a possible need for an order exposure rule. See Off-Board Trading Restrictions, SEA Release No. 16,888 (June 11, 1980), 20 SEC DOCKET (CCH) 334, 343 (June 24, 1980). In SEC Release No. 16,888, the Commission adopted rule 19c-3, which removed off-board trading restrictions for exchange members trading as principal in certain securities listed after April 26, 1979. Off-board trading restrictions prevent exchange members from trading securities listed on their exchange on the over-the-counter market.

71. With the elimination of off-board trading restrictions in regard to securities listed after April 26, 1979, see supra note 70, it now was possible for firms to effect transactions for their customers against the firm's own inventory in specified securities without ever exposing those customers' orders to the give and take of a trading floor.

72. The Commission has stated that the term 'internalization,' when used with respect to the activities of an integrated broker-dealer making markets over-the-counter, refers to the withholding of retail orders from other market centers for the purpose of executing them 'in-house,' as principal, without exposing those orders to buying and selling interest in those other market centers.

73. The Commission eventually proposed alternative possible order exposure rules. See Order Exposure Rules, SEA Release No. 18,738 (May 13, 1982), 25 SEC DOCKET (CCH) 358 (May 26, 1982) [hereinafter cited as Order Exposure Proposal Release]. The specific proposals presented by the Commission were developed by the NYSE and the Securities Industry Association. Although the proposals differed, their central characteristics were similar and are described in the text above. After extensive public comment, the Commission refined its proposal and again sought public comment. See Reproposal of an Order Exposure Rule, SEA Release No. 19,372 (Dec. 23, 1982), 26 SEC DOCKET (CCH) 1549 (Jan. 11, 1983). Ultimately, the Commission decided to defer action on its proposed order exposure rule. See Request for Comment on Off-Board Trading Pursuant to Rule 19c-3, SEA Release No. 20,074 (Aug. 12, 1983), 15 SEC. REG. & L. REP. (BNA) 1669 (Aug. 19, 1983).
have required that, before a broker internalizes a customer's order, the order essentially be advertised in an electronic intermarket trading system that would allow the customer the benefit of having his order interact with other buying and selling interests. Only if no other interest developed within a specified period of time would an internalized execution be permitted.

The primary exchanges stood to suffer a decline in trading volume and a deterioration in the quality of their market if sufficient numbers of transactions were "internalized" in brokerage houses and not transacted on the floor of an exchange. Predictably, these exchanges were in favor of some kind of order exposure rule. The NASD, which represents the interests of the brokerage houses that would have reaped the benefits of the "off-board" trading, did not agree that there was a need for the rule and found the specific rule proposals that had been made to be unfair and unworkable.

Closely related to the internalization issue had been the question of when and how to link together the electronic intermarket trading system (ITS), which serves the exchanges, and a newly developed trading system (CAES) which facilitates trading over the counter. The exchanges believed that linking these two systems would exacerbate the internalization problem because the linkage would provide additional order flow to those brokers who would execute customer orders in-house. Consequently, the exchanges were opposed to linking the two systems prior to the Commis-

74. See infra note 79.
76. The intermarket trading system is an electronic routing system that links the seven major national securities exchanges and permits executions to be made in any of the linked market centers by a broker physically present in another market center. Through ITS, a broker, standing at the post for security ABC on exchange 1, can examine the quotations for security ABC on exchanges 2, 3, and 4. If he finds a more attractive quotation on another exchange, he can effect his execution in ABC stock on that exchange without leaving the trading post on exchange 1.
77. The NASD has also developed an order routing and execution mechanism that links certain over-the-counter market makers trading in specified securities. The NASD's trading system is referred to as the Computer Assisted Execution System or CAES. For a description of CAES, see Lipton, supra note 48, at 496-98.
78. When the Commission ordered the NASD and the ITS participants to effect a linkage, it acknowledged that "several commentators have argued strenuously that implementation of the Automated Interface . . . will increase the degree of internalization." Notice and Order Requiring Implementation of an Automated Interface, SEA Release No. 17,744 (Apr. 21, 1981), 600 SEC. REG. & L. REP. (BNA) G1, G6 (Apr. 22, 1981) [hereinafter cited as Linkage Order].
sion's resolution of the internalization problem.\textsuperscript{79} The NASD, seeing no need for an order exposure rule in the first place, did not believe linkage needed to be delayed.\textsuperscript{80}

As a matter of regulatory authority, both the SEC and the collective SROs had the authority to initiate rulemaking efforts to address the concerns created by internalization and to accomplish the linkage of ITS and CAES. The SROs, however, were subject to powerful conflicting self-interests that one might have predicted would prevent them from cooperating with one another in any attempt to resolve the internalization and linkage issues. Only the SEC would be free from conflicts with self-interests in responding to these matters.

Unfortunately, the Commission did not initially assume responsibility for linkage and internalization. Instead, in April 1981, it ordered the exchanges and the NASD to work out a scheme for linkage and, at the same time, expressed its support for "industry efforts to address internalization concerns."\textsuperscript{81} No meaningful public discussion as to why responsibility for these matters was assigned to the self-regulators was provided by the Commission.

Disagreements among the self-regulators concerning internalization and linkage were well advertised before the Commission ordered the linkage, and the disagreements continued to plague the industry after the Commission's order.\textsuperscript{82} The Commission was twice compelled to delay the implementation of the linkage because the industry was unable to resolve its differences on how the linkage should be effected.\textsuperscript{83} In March 1982, the Commission re-

\textsuperscript{79} "[T]he one fundamental rule which must be required to precede commencement of any test linkage . . . is a rule which appropriately addresses internalization." Letter from J.E. Buck, Secretary of the NYSE, to George A. Fitzsimmons, Secretary of the SEC (Mar. 13, 1981), SEC File No. 4-208 at 4-5. The Commission was aware of, and had previously noted, the NYSE's expectation that linkage would not occur prior to the implementation of a "preliminary" rule addressing internalization concerns. Intermarket Trading System, SEA Release No. 17,516 (Feb. 5, 1981), 46 Fed. Reg. 12,379, 12,382 (1981) (release proposing the linkage order).

\textsuperscript{80} Linkage Order, supra note 78, at G4. The NASD supported the Commission's proposal to require linkage of the ITS and the NASD execution systems and did not request an order exposure rule prior to linkage.

\textsuperscript{81} Id. at G8.

\textsuperscript{82} Nearly a year after the Linkage Order, a commercial securities industry newsletter reported that: "[A]lmost no progress on substantive issues dividing the parties [the exchanges and the over-the-counter traders] has been made since the Commission ordered the link last April [1981]." I-T-S Link Delayed with New Internalization Rule in the Works, SEC. WEEK, Mar. 7, 1981, at 2.

\textsuperscript{83} In the Linkage Order, supra note 78, the Commission set March 1, 1982 as the implementation date of the linkage. This date was already five months later than the September 30, 1981 date that the Commission had set when it formally proposed the linkage in its February 1981 release. Intermarket Trading System, SEA Release No. 17,516 (Feb. 5, 1981), 46 Fed. Reg. 12,379 (1981). The Commission then delayed the implementation date until May 1,
versed itself and finally assumed responsibility for adopting rules to allow ITS and CAES to be linked. Three months later it assumed responsibility for proposing alternatives for an order exposure rule.

In essence, when the Commission ordered the industry to effect an ITS-CAES linkage, it allocated regulatory responsibility for this matter to the self-regulators. The allocation rationale, however, was not explicit, and Commission attention did not appear to be focused upon the desirability of the specific allocation. A reasonable conclusion could be drawn that authority was allocated to entities that were predictably unable to cooperate in devising regulatory solutions because of irreconcilable conflicts. This misallocation of responsibility led to delays in the implementation of the linkage of the two intermarket trading systems. Ultimately, the Commission reallocated responsibility and assumed the leadership role for implementing linkage and resolving the order exposure rule question. Arguably, explicit guidelines for allocating authority based upon principles of effective market regulation would have dictated the Commission’s assumption of responsibility in the first instance.

3. In other situations, the lack of an explicit allocation system based on principles of effective regulation has led to the assumption of regulatory responsibility by a regulatory entity that proved ultimately ineffective for reasons other than conflicts of interest. The 1934 Act, as amended, does not require that general rulemaking, whether affecting market structure or some other technical area of market regulation, be initiated only by that entity with the greatest expertise for the undertaking. Although the Commission seeks and obtains public comment on its rule proposals, the issues upon which the Commission focuses are formulated by a market regulation staff that, prior to employment at the Commission, typically has either limited or


Just prior to the rescheduled implementation date, the press reported: “[C]ontinued industry squabbles likely will force another delay in the planned electronic trading link between stock exchanges and the over-the-counter market.” Wall St. J., Apr. 29, 1942, at 25, col. 1. On May 6, 1982, the Commission put off the date of implementation one last time. Order Deferring Implementation of an Automated Interface, SEA Release No. 18,712 (May 6, 1982), 25 SEC DOCKET (CCH) 242 (May 18, 1982).


85. In May 1982, the Commission sought public comment on two alternative order exposure proposals. See Order Exposure Proposal Release, supra note 73.

86. An example of a particularly effective effort by the Commission to elicit comment on its rule proposals was the proposal of the order exposure rule. The Commission received more than 450 comment letters in response to its proposed order exposure rules. Reproposal of an Order Exposure Rule, SEA Release No. 19,372 (Dec. 23, 1982), 26 SEC DOCKET (CCH) 1549 (Jan. 11, 1983).
This same staff analyzes the information gathered during the comment period and suggests solutions to the Commission. This lack of "hands-on" industry experience places the Commission staff at a relative disadvantage to industry personnel in addressing certain technical market regulatory issues.

In some instances, it has appeared that the Commission staff has not had the familiarity with market operations to appreciate fully the impact of its market structuring activities. As an example, in 1978, the Commission, at the urging of its staff, adopted a "firm quote" rule (rule 11Acl-1). The object of the rule was to provide quotation information for certain frequently traded securities. This was to be achieved in part by requiring that all broker-dealers who make bids or offers in these securities report "promptly" these quotations to their exchange or to the NASD. The firm quote rule was to be a central element of the national market system since it would promote intermarket competition by providing accurate and current information as to the price at which securities could be bought and sold on various exchanges.

Less than three years after implementation of the firm quote rule, the Commission essentially reversed itself and nullified the impact of the rule by removing the mandatory reporting requirement for most categories of broker-dealers. What the Commission staff discovered during those three years was that many broker-dealers, who were not active traders in the sub-

87. Typically few or none of the higher ranking staff members of the Division of Market Regulation have had employment experience within the securities industry prior to their service with the Commission.


89. In 1973, the Commission described the quotation reporting element of the national market system as being "[a]t the heart of the [national] market system." SEC, STRUCTURE OF A CENTRAL MARKET SYSTEM (1973), reprinted in Hearings on H.R. 5050 & 340 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate and Foreign Commerce, H.R. REP. No. 52, 93d Cong., 1st Sess. 912 (1974). It was believed that the quotation system would allow brokers to route orders to markets providing attractive quotations. This price responsive order flow would encourage price competition among market makers, each of whom would attempt to put out competitively attractive quotations in order to attract order flow. Quote Rule Release, supra note 88, at 4346.

90. See SEA Release No. 18,482 (Feb. 11, 1982), 24 SEC DOCKET (CCH) 876 (Feb. 23, 1982) [hereinafter cited as Quotation Modification Release]. Instead of requiring all brokers and dealers who communicate quotations on exchange floors or over the counter to report such quotations into the quotation system, and instead of requiring the exchange or securities association to collect such information, the Commission now requires that brokers and dealers report, and exchanges and securities associations collect, the information only in regard to "subject securit[ies]." Rule 11Acl-1(c)(1), (b)(1), 17 C.F.R. §§ 240.11Acl-1(c)(1), 240.11Acl-1(b)(1) (1984). The term "subject security" in turn was defined to exclude any security for which the market center upon which the security was traded was not the primary
ject securities, used machines to both compute and communicate what essentially amounted to artificial quotations. The machine-generated quotations were always at prices that were somewhat worse than ("away from") the quotations reported by the active markets. Such quotations allowed non-active broker-dealers to comply with the firm quote rule but were not intended to attract customers. They consequently made the quote rule relatively meaningless.

The Commission's staff did not appear to be sufficiently familiar with the intricacies of the securities industry either to foresee the problem with the quote rule or to structure the quote rule so as to avoid the problem of meaningless quotations. In this instance, it is possible that the Commission staff lacked the expertise to assume regulatory responsibility for the quote rule. But again, no explicit allocation system existed that would have dictated that the Commission allocate responsibility for the quote rule to the entity with the greatest relevant expertise. Allocating responsibility to the self-regulators could have been accomplished without the sacrifice of desirable Commission goals encompassed in the firm quote rule. The Commission has the authority pursuant to section 11A(a)(3)(B) of the Act to direct the self-regulators to develop a rule that complies with those national market system objectives that the Commission seeks to accomplish. The use of this "indirect" authority would have allowed the Commission to utilize the expertise of the self-regulators in devising a rule while still guaranteeing the Commission's ability to maintain control over the direction of the rule.

4. The absence of allocating principles also creates a number of intangible problems, the manifestations of which cannot be readily demonstrated through case study, but which, nonetheless, raise regulatory concerns. Specifically, a dual regulatory system with pervasive overlapping authority that can be exercised either by the Commission or by the self-regulatory bodies diminishes the sense of responsibility experienced by the self-regulators. It also injects an element of uncertainty into the governance of our trading

91. See Dissemination of Quotations for Reported Securities, SEA Release No. 18,482 (Feb. 11, 1982), FED. SEC. L. REP. (CCH) ¶ 83,098, at 84,852 (adopting changes to the quote rule). See also Dissemination of Quotations for Reported Securities, SEA Release No. 17,583 (Feb. 27, 1981), 22 SEC DOCKET (CCH) 269 (Mar. 17, 1981) (proposing the changes adopted). The Commission cited two other problems with the quote rule: (i) the lack of reliability of the quotations; (ii) the difficulty in processing the voluminous quotation information. Both of these additional problems can be significantly attributed to the use of machine-generated quotations.

markets. The present regulatory system contains no guidelines that allow self-regulators to know which regulatory problems they are expected to focus upon and which will fall within the province of the Commission.

Long-term marshalling of resources is made difficult by the knowledge that many regulatory problems to which the self-regulators might choose to devote resources are matters that the Commission also might choose to regulate. The self-regulatory bodies might hesitate to expend the resources necessary to develop an effective all market trading surveillance system knowing that the Commission might at some point either direct the creation of a surveillance system with specified capabilities or develop such a system on its own. (In the early 1980's, the Commission developed an intermarket oversight system—the Market Oversight and Surveillance System (MOSS)—which reduced the Commission's dependence upon the surveillance systems of the SROs). A self-regulatory body might be reluctant to engage in the resource-consuming efforts involved in revising rules governing brokers' duties to customers, such as the “know your customer” rule (which directs brokers to investigate the financial welfare of their customers), if it believes that the Commission might ultimately compel the adoption of a replacement rule of its own devise. The New York Stock Exchange indeed did spend some time in the late 1970's and early 1980's working on revisions to the NYSE's “know your customer” rule. During this time, the Commission reversed its position toward this rule.


95. In 1977, the Commission instituted disapproval proceedings when the NYSE proposed a revision to its rule 405, which revision would have eliminated any “know your customer” duties for “carrying” firms with respect to an account introduced on a fully disclosed basis. See Order Instituting Proceedings to Determine Whether Proposed Changes to Rule 405 Should be Disapproved, SEA Release No. 14,143 (Nov. 7, 1977), 13 SEC DOCKET (CCH) 639 (Nov. 22, 1977). A carrying broker can provide execution, clearing and bookkeeping services for generally smaller firms which are referred to as introducing firms, and which accept the actual orders from customers. The Commission initiated the disapproval proceedings in part because it was concerned that under the proposed rule the carrying firm would bear no responsibility to know the customers for which it performs clearing duties.

A perhaps less concerned Commission in 1981 was willing to approve rule changes by the NYSE that had virtually the identical impact. The approved changes permit the carrying and introducing parties to allocate responsibilities among themselves. See Notice of Filing of Pro-
Self-regulatory organizations are discouraged from exercising diligence in responding to certain regulatory problems for which responsibility is not clearly mandated because the self-regulators know that if the problem is left unresolved long enough, the Commission will ultimately have to initiate regulatory action to deal with it. This lack of diligence by self-regulators might be particularly encouraged when the problem at issue is especially difficult or when the appropriate resolution to a specific problem will be costly or unpopular or both.

Finally, without guidelines for allocating responsibility, the regulatory system loses its inherent order. The integrity of the system becomes suspect when the exercise of authority appears quixotic. Market regulatory procedures are developed by one regulatory body as opposed to another without any apparent reason. Overall confidence in the regulatory system must suffer as a consequence.

VI. CONCLUSION

The above described regulatory conflicts arising out of the dual nature of the governing and oversight mechanism of our securities markets obviously impact upon the effectiveness of the system. They came into existence primarily as a result of the 1975 Securities Reform Act, which expanded the Commission's authority to initiate direct regulatory action. This augmentation of authority was not accompanied by a corresponding establishment of an explicit mechanism for determining to whom regulatory responsibility should be allocated.

For a regulatory scheme based upon joint authority to continue to be a completely successful method for governing our securities markets, attention must be focused on the above difficulties and mechanisms must be explored for satisfactorily allocating regulatory responsibility. The problems that exist in the absence of explicit guidelines for allocation are varied. Some relate to the lack of predictability in the present system. Others relate to the fact that, in the absence of reasoned guidelines, allocations have been made to regulators that were inherently inefficient in responding to particular matters.

96. In a previous article, this author explored a number of proposals for allocating regulatory responsibility. Lipton, The SEC or the Exchanges: Who Should Do What And When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets, 16 U.C. DAVIS L. REV. 527 (1983). The proposals presented therein as well as the discussions in this article were and are intended as bases for further discussions.
ters. Whatever allocatory guidelines are ultimately chosen, consideration must be given to the ability of these guidelines to provide predictability and to assure efficient regulation.