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PANEL DISCUSSION

Regulation of the Securities Markets:
How Can Regulation More Effectively Facilitate
Capital Formation in the Next Decade?

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Regulation of the Securities Markets: How Can Regulation More Effectively Facilitate Capital Formation in the Next Decade?

The panel was asked to address the following questions:

- What is the economic basis for the statutory mandate that markets be transparent and linked, and that orders receive best execution?
- How should regulation of the U.S. securities markets be changed to accommodate a changing marketplace and technological innovation?
- How can regulation better accommodate diverse market structures such as traditional member-owned exchanges, for-profit exchanges, electronic communications networks (“ECNs”), and foreign marketplaces?
- How should the traditional roles of self-regulation be adapted to a marketplace in which traditional member-owned exchanges compete with for-profit exchanges and ECNs?

The panel discussed whether technological improvements to market and exchange linkages have undermined the congressional mandate to develop a national market system (the “national market mandate”) which was embodied in the 1975 amendments to the Securities Exchange Act of 1934 (the “Exchange Act”). At that time, Congress believed that a national market system—one in which individual markets and exchanges would be linked by interconnected communications and data processing systems—would improve efficiency in the securities markets and promote fair competition between brokers and dealers, and between exchanges and over-the-counter (“OTC”) markets. Congress and the SEC envisioned that a national market system would improve the quality of securities pricing information and enhance “best execution” by brokers. The panel focused on whether regulation or market forces were the best means to achieving a national market system. The panel addressed whether certain developments—such as alternative trading systems (“ATSs”), the globalization of securities markets, and new technology for connecting markets and expediting transactions—should compel the SEC to reconsider its national market mandate. The panel also addressed whether changes to the mandate would be consistent with the SEC’s role as investors’ advocate.

PANEL CHAIR

Annette L. Nazareth, Director,
Division of Market Regulation, U.S.
Securities and Exchange
Commission

PANELISTS

Douglas Atkin, President and
Chief Executive Officer, Instinet
Group, Inc.

Philip D. DeFeo, Chairman
and Chief Executive Officer,
Pacific Exchange

Robert R. Glauber, Chairman and
Chief Executive Officer, NASD, Inc.

Richard G. Ketchum, President
and Chief Operating Officer,
Nasdaq, Inc.

Edward A. Kwalwasser, Group
Executive Vice President, New York
Stock Exchange

Andrei Shleifer, Professor,
Department of Economics,
Harvard University



The National Market Mandate

Ms. Nazareth argued that the national market mandate remains relevant today. The SEC should regulate consistently with that mandate because the inefficiencies that remain between markets, market intermediaries, issuers, and the investing public cannot be resolved by unfettered competitive forces. Director Nazareth identified those inefficiencies as:

- the lack of transparency of information;
- collective action problems that prevent investors from bargaining with markets for best execution and better information, including principal-agent conflicts;
- internalization of pricing information by market intermediaries, which frustrates public price discovery;
- anti-competitive uses of dominant market power; and
- the costs of standardizing and coordinating trading protocols and pricing information, which prohibit market-based solutions.

Professor Shleifer explained that securities regulations arose from the failure of market forces and the courts to create a fair investment environment. Since those problems persist, there can be no honest ideological objection to the national market mandate, even if some changes are necessary.

Mr. Ketchum agreed with the need for the market and exchange linkages that comprise the national market system, and noted that certain SEC decisions (e.g., orders segregating brokerage and dealer activity and characterizing Instinet as a broker) have, along with the advent of ATSS, promoted liquidity and competition, but have undermined the national market mandate. However, Mr. Ketchum stressed that in many ways, the SEC decisions were the right ones and that the benefits of increased liquidity and competition may outweigh the benefits of a well developed national market with one centralized quote and pricing system.

Mr. Atkin challenged the mandate's continuing validity. He argued that it has frustrated technological improvements that would make securities pricing more competitive. For example, electronic communications networks ("ECNs")—marketplaces that match buy and sell orders—can only be accessed through Nasdaq and can only offer Nasdaq prices. Once Nasdaq becomes a for-profit exchange, this aspect of the national market system will increase the likelihood of anticompetitive activity. Before that occurs, the SEC should permit investors to access ECNs through means other than Nasdaq. Mr. Atkin further argued that decentralized access would increase competition between markets, as was the case in Europe during the 1990s. Thus, in reshaping the national market system, the SEC should maintain ECN linkages while abolishing the requirement that they offer securities at the same price.

“Our paper argues, however, that the key rationale for authorizing regulatory intervention – to eliminate anti-competitive burdens and assure cross-market access to market information and trading opportunities – remains as important today as it was in 1975. Despite the rapid changes in the marketplace resulting from new technology and competition, the commercial incentives of markets and broker-dealers remain sufficiently misaligned from the interests of investors and issuers that a market structure dictated solely by competitive forces would be inadequate. While the precise approaches to implementing a national market system naturally must change with the times, I believe there is a role for regulation in assuring that the marketplace evolves in a manner that protects investors and serves the public interest. Clearly, in a free market society, there is a preference for allowing market-based approaches to determine market structure. Market forces acting alone, however, may fail to ensure that markets produce an efficient level of services in certain circumstances.”

– ANNETTE NAZARETH

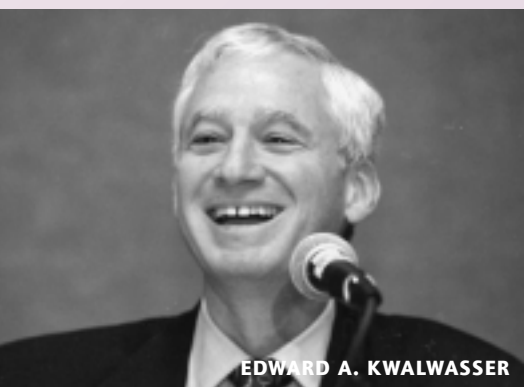
“I also am not sure that the problems that Annette is raising will be resolved by competition. And I say that despite the recognition that, in the United States, the benefit of competition for the securities industry for the reduction in transaction costs or the increase in participation in financial markets and so on have been tremendous in the last 20 or 25 years. Yes, competition has done an enormous amount of good but I think one should not make a jump from that to saying that competition will solve all the problems. I don't think that competition in the securities industry has brought better information to investors. It has brought more information but I'm not sure it has brought

more accurate information to investors on which to base informed judgments. I think the incentives to distort information that is presented to investors have been tremendous. I think, as importantly, we're seeing some very significant problems in the private incentives to provide liquidity which is fundamentally a public good. So I think that, again, while the forces of competition and litigation should not be neglected, I don't think that's the whole story.”

– ANDREI SHLEIFER

“The environment and ECN environment in Nasdaq stocks where they provided tremendous value added in the '80's and early '90's also led to an environment in which retail orders were not effectively integrated into that, in part because those prices weren't part of the consolidated best bid and offer. The result was that there were significant differences in prices. The SEC could have solved that in different ways. It could have said brokers have a responsibility to get those better prices for their customers even if they may not all have a link to each of the places that give the quote, even if they may not have an easy way down at a decentralized level of knowing what that best price is because it's not consolidated. They chose to say that the broker should have that responsibility in an evolving definition of best execution but it should come with a guarantee that there would be some linkage from someone and some ability to access consolidated information. Having lived through a pretty painful experience in part of Nasdaq's history as a result of the early environment I think that those were good decisions.”

– RICHARD KETCHUM



Mr. Kwalwasser disagreed with allowing ECNs to list prices like exchanges. Unless ECNs undertake the greater regulatory obligations required of exchanges (they are currently regulated as broker-dealers), ECNs should not have the access to quote streams that de-linking with Nasdaq would require.

Mr. DeFeo suggested that the SEC should help regional exchanges become the avant garde of the national market system. If the SEC centralized certain regional exchange responsibilities such as rule enforcement, they could expend their resources in more innovative ways. To help facilitate such experimentation, the SEC should streamline the approval process for rules proposed by regional exchanges.

Access and Linkage within the National Market System

Messrs. Kwalwasser and Ketchum responded favorably to Director Nazareth's suggestion that the SEC consider an "open access standard" to replace the current intermarket linkage system, ITS. According to Mr. Kwalwasser, ITS is no longer integral to the national market system because smart routing provides best execution. Eliminating ITS would make securities pricing more competitive by ending the "free ride" smaller markets enjoy through linkages with the larger, dominant markets. Mr. DeFeo disagreed, arguing that ITS allows regional exchanges to compete with the larger markets and exchanges.

Additional Considerations

The panelists agreed that the SEC and self-regulatory organizations do not need to address payment for order flow and intermediaries' internalization of price information, as those practices are being arbitrated out of the markets. Electronic markets are leading this effort by using total execution quality. The panelists also agreed that the SEC's decimalization initiative has helped address payment for order flow by so reducing the spread that the practice is not likely to be economical. The panel's consensus was that SEC must become a "real time" regulator if it wishes to fulfill the national market mandate. For example, the SEC must handle rule proposals more quickly.

"My view is that, if you are an exchange, you are a storer and an end point of liquidity and it's the broker's job to go to wherever the best price is. An exchange competes as an endpoint of liquidity but I do not think an exchange should be forced to link up with another exchange at that level. I think there are far more efficient ways for that to happen. And that will really breed lots more competition at the exchange level in our opinion."

– DOUGLAS ATKIN

"To the extent it makes sense for the market and improves the market then the things we do over time will strengthen the market in general. And if we do a good job for our customers then we think that we'll get our fair share. We are advocates of effective, proactive regulation. We're advocates of very clear standards for investors so they have the ability to choose. We talk about standards but they're not clearly understood. I think the SEC's responsibility is to ensure there is fairness through clarity, consistency and transparency of information."

– PHILIP DEFEO

"One of the big market failures we're talking about is the existence of entry barriers and the necessity of sponsoring competition to overcome those inherent entry barriers. My read is that we've done a pretty job of sponsoring competition. The other side of competition, of course, is fragmentation. And now what we have to do is deal with that consequence of sponsoring competition and make sure that the cost of fragmentation that comes with the competition doesn't overwhelm the benefits of the competition. And I think that that's to a great extent what we're talking about throughout all of the detailed arguments."

– ROBERT GLAUBER

"We think that technology has advanced so much that with smart routing the member firm or the broker/dealer should be able to go to the market that provides its customer for its type of order best execution. Even if it gets down to the floor we know that our members can re-route it. It's easy. We don't know of anybody who's not connected who wants to be connected to the New York Stock Exchange. And I think Doug said let them come in the front door. We see no reason that another market should be able to free ride off of our prices. We think that if there wasn't ITS, that regional and other exchanges would actually have to compete on quotes and try to make a much better market which is what the SEC thought when ITS was first put into place. Well, it turned out for whatever reason that there isn't any competition based on quotes, that many regional markets auto quote a price away from the market and guarantee customers that they will do a trade at the price of the primary market if the customer comes in. So you can't actually see what the liquidity is in the U.S. even though everybody is linked and all of the quotes are up there because those aren't real quotes from a lot of the participants in ITS. And we think that's bad. And that if there wasn't this linkage there would be an incentive to put real quotes up so that people would draw liquidity to their markets."

– EDWARD KWALWASSER