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SHIRKING AT THE SEC: THE FAILURE OF THE NATIONAL MARKET SYSTEM†

Jonathan R. Macey*  
David D. Haddock**

I. INTRODUCTION

Deregulation, much like regulation itself, is a rational political response to pressure from discrete economic groups that benefit from such deregulation. Such pressures explain many, if not all, of the actions and inactions of the Securities and Exchange Commission (SEC) with respect to implementing a national market system in the United States. For example, Gregg Jarrell, the chief economist at the SEC, recently relied upon such a "political support theory,"¹ to explain the SEC's abolition of fixed-rate commissions on the New York Stock Exchange (NYSE).

The abolition of fixed-rate commissions was an early, and possibly the sole, aspect of the SEC's discharge of its responsibilities under a major piece of deregulatory legislation. The 1975 legislation called upon the Commission to implement a competitive market for securities trading by developing a national market system. Despite such deregulatory legislation, Jarrell posits that the SEC, acting as a "political support maximizing regulator,"² only acted to abolish fixed commissions rates after the market forces had so eroded the economic rents flowing to the NYSE cartel that the Exchange drastically reduced its "political demand" for such commissions. At the same time, the political power of groups op-

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2. Jarrell, supra note 1, at 281, 300.
posing the fixed rates was growing through the continuing consolidation of diverse small stockholdings into a more compact, politically agile group of larger "institutional" holdings by mutual funds, insurance companies, and the like.

This article investigates the SEC's failure to take any significant additional steps to deregulate the securities markets, despite Congress's express mandate in 1975 that such deregulation take place. All the other important competitive restrictions, such as rules against exchange delisting and restrictions on off-board trading, still exist. This article examines the major American exchanges, the national market system legislation, and the SEC's failure to administer this law as written, and concludes that one can expect the remaining restraints on trade to prove more long-lived than the fixed-rate commissions.

As was long the case with fixed-rate commissions, the SEC has justified its refusal to implement the remaining national market system legislation by arguing that the public might be harmed by such deregulation. This article considers and rejects the SEC's arguments against deregulation, and suggests that a political support maximization theory provides a more complete explanation for the failure of the national market system legislation. In brief, the SEC is not motivated by some "public interest," but rather by the changing strength of competing, well-organized special interests. This article concludes that a proper understanding of what motivates the SEC bodes ill for the national market system.

II. THE ORIGINS AND ACTIVITIES OF THE STOCK EXCHANGES OF THE UNITED STATES

On May 17, 1792, twenty-four stockbrokers signed a contract called the "Buttonwood Agreement," creating a trading group that became the New York Stock Exchange. The contract survived completely intact until 1975, and remains largely intact today.\(^3\) The agreement read:

We, the subscribers, brokers for the purchase and sale of public stocks, do hereby solemnly promise and pledge ourselves to each other that we will not buy or sell from this date, for any person whatsoever, any kind of public stocks at a rate less than one-quarter of one percent commission on one specie value, and that we will give preference to each other in our negotiations.\(^4\)

The Buttonwood Agreement sounds much like a naked cartel agreement, designed to reap profits for the signatories in excess of those necessary to keep them in the brokerage business.\(^5\) However, such an

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4. F. Eames, supra note 3, at 14.
5. C. Welles, The Last Days of the Club 3-40 (1975); Baxter, NYSE Fixed Commission Rates: A Private Cartel Goes Public, 22 Stan. L. Rev. 675, 676-79 (1970). The exchanges are considered to be immunized from antitrust liability for what would otherwise be per se violations of § 1 of the Sherman Act because Congress has impliedly repealed the antitrust laws by imposing the
agreement may well have been quite beneficial to both consumers and exchange members at a time when stockholding was exceptional and communications systems were primitive. Under the circumstances existing in 1792, a physically centralized exchange was the only plausible way to bring the buyers and sellers of common stock together on a dependable, continuing basis. An agreement among only twenty-four men could continue to be effective on a nearly national basis for a century and a half before regulatory intervention only if the agreement fulfilled a socially beneficial function. In fact, after signing the Buttonwood Agreement, the NYSE confronted and dominated a flow of competing new exchanges. The few competitors that have survived are small relative to the NYSE. Any argument that the Buttonwood Agreement fulfilled no socially beneficial function would thus require a parallel argument accounting for the failure of competing exchanges to use arrangements that the public found more palatable. This latter argument is not in evidence.

Immediately, one is struck by the similarity of the Buttonwood Agreement to modern resale price agreements, and arguably the exchange members' motivation was also similar: regular, dependable brokers who stood ready to trade on both good (busy) days and bad (slack) days decided to give preference, if all else were equal, to other regular dependable brokers. The regular brokers thereby protected themselves from "free riding" brokers who rushed in on the good days, then out on the bad days. Only by rewarding the brokers who chose to stand by their posts on a regular basis could the market be assured that traders would be available to trade whenever stock sellers wished to alter their portfolios, not just when recent events or new information created a temporary upsurge in trading activity.

The New York Stock Exchange was predicated on the belief that public knowledge that trades could be made whenever desirable, rather than only under exceptional circumstances, would increase the willingness of investors to hold stocks rather than other assets such as bonds, or real property. Consequently, the size of the brokerage business would increase, and almost everyone involved would benefit. Brokers would do


The Securities Exchange Act was intended by Congress to leave the supervision of the fixing of reasonable rates of commission to the SEC. Interposition of the antitrust laws, which would bar fixed commission rates as per se violations of Sherman Act... would preclude and prevent the operation of the Exchange Act as intended by Congress and as effectuated through SEC regulatory activity. Implied repeal of the antitrust laws is, in fact, necessary to make the Exchange Act work as it was intended; failure to imply repeal would render nugatory the legislative provision for regulatory agency supervision of exchange commission rates.

__Id. at 691.__

6. __See infra notes 54-56 and accompanying text for a list of the American exchanges and trading volumes.__

7. __For a discussion of the modern "free rider problem," common to resale price maintenance agreements and stock exchanges, see R. Posner, Economic Analysis of Law 351, 468-69 (2d ed. 1977).__
more business in the long-run, albeit at the expense of having to hang around the exchange on slack days. Asset holders would have available superior instruments among which to choose. Securities issuers would find that their issues had become relatively more attractive to buyers when contrasted with alternative assets.

Over the years, the NYSE has taken on other socially valuable functions. Those brokers who handle specific securities daily find it worthwhile to know substantially more about the companies issuing those securities than do investors who, having other pursuits to occupy their hours, manipulate their portfolios only occasionally. This is a straightforward application of the economics of information. Consequently, investors commonly turn to their broker for information about those securities with which the broker is familiar. The NYSE effectively pooled the information of all its members by refusing to trade certain securities when relatively well informed Exchange members decided the securities under scrutiny had attributes unattractive to the usual Exchange customers. Thus, listing on the NYSE came to represent a sort of “NYSE-seal-of-approval,” which conveyed valuable information to investors even when the particular broker with whom an investor dealt knew little or nothing about the company issuing the security. To facilitate judgment in this regard, the NYSE ultimately began to specify certain minimum behavioral and reporting requirements that each issuer must meet before the Exchange would even consider listing the issuer’s securities. To list a security on the NYSE today, an issuer must place before the Exchange:

the information essential to its determination as to the suitability of the securities for public trading on the Exchange and, equally important, of providing for the investing public such information as it may reasonably be presumed to require as an aid to its judgment as to the merits of the security.


Since 1926, the NYSE has refused to list companies that create a class of nonvoting common stock. In addition, the NYSE will delist a class of stock of a company that fails to solicit proxies for meetings of its shareholders. N.Y.S.E. Manual, supra, at xxi, A-280, A-134. Similarly, the NYSE will not list a company whose board of directors is divided into more than three classes for purposes of election. Id. at A-280. Nor will the Exchange list a company whose stock is subject to “unusual restrictions.” Id. at A-280.

There is some evidence, however, that the NYSE will not enforce its own listing rules when
By reducing the cost of information to the NYSE, such requirements have increased the precision of the Exchange's judgment, as manifested in the listing seal-of-approval.\footnote{Over time the Exchange's demands evolved as investors' preferences changed. After June 30, 1978, for example, the NYSE required that all issuers maintain an audit committee "comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment by a committee member." \textit{Securities Exchange Act Release No. 13,346, 11 SEC Docket 1945 (1977).}}

Many commentators now argue, however, that the Buttonwood Agreement has served its purpose, and that such an agreement is a naked restraint on trade,\footnote{See C. Welles, \textit{supra} note 5, at 9-10; Baxter, \textit{supra} note 5, at 675; Garney, \textit{Rivals and Interlopers in the History of the New York Security Market}, 52 J. Pol. Econ. 128 (1944).} fundamentally inefficient, and incompatible with Congress's stated goal of creating a national market system for securities.\footnote{See supra text accompanying note 2.} According to the argument, certain aspects of the Buttonwood Agreement survive to this day not because they fulfill socially beneficial functions in this age of modern communications, but rather because the SEC came into existence, allegedly for other reasons, between the time of Buttonwood and the present "electronics revolution." In addition, the commentators assert that the SEC has effectively policed the cartel agreement among the major exchanges and discouraged potentially competing institutions, thereby enabling the major exchanges to survive at their present sizes far beyond their useful lives.\footnote{See supra note 5.}

The notion that the SEC behaves as if one of its principal duties is to police a cartel of exchanges and brokers is consistent with the modern economic theory of regulation.\footnote{Jarrell, \textit{supra} note 1. Jarrell argues that "the NYSE was a cartel, and the SEC its enforcement arm." Jarrell, \textit{supra} note 1, at 1. See H. Stoll, \textit{Regulation of Securities Markets: An Examination of the Effects of Increased Competition} (1979); Tinic & West, \textit{The Securities Industry Under Negotiated Brokerage Commissions: Change in the Structure and Performance of New York Stock Exchange Member Firms}, 11 Bell J. Econ. 29 (1980); Schwert, \textit{Public Regulation of the National Securities Exchanges: A Test of the Capture Hypothesis}, 8 Bell J. Econ. 129 (1977).} Indeed, the economic theory of regulation is not in the interest of the Exchange. The NYSE is fearful of losing customers to the American Stock Exchange and the over-the-counter market, and is therefore prepared to amend its rules to avoid delisting companies that wish to amend their charters to violate the exchange rules. See Blumstein, \textit{Big Board Panel Urges Eased Listing Standard}, N.Y. Times, Jan. 4, 1985, at D4 (Business), col. 4. The NYSE has a rule that prohibits firms from issuing more than one class of common stock with different voting rights. Several corporations, including Dow Jones & Company, the Coastal Corporation, General Cinema Corporation, and Hershey Foods have all said that they would leave the NYSE if its rules were not amended to enable them to issue a second class of common stock. \textit{Id.}

In one instance, the NYSE announced it was willing to consider amending its rules rather than delisting Dow Jones Corporation stock. Dow Jones proposed to create a new class of common stock with different voting rights than its other class of stock. Proxy Statement of Dow Jones Corporation 12-14 (Mar. 16, 1984). Unlike the NYSE, the National Association of Securities Dealers has no rule prohibiting firms from issuing more than one class of common stock. See Blumstein, \textit{supra}, at D4. The NYSE responded with a proposed rule that would allow companies to issue a class of stock with up to 10 times the voting power of current shares if two-thirds of the shareholders and a majority of the board agreed to the new issue. The proposal came from a subcommittee of NYSE members appointed to examine the NYSE rules after several companies proposed to issue special classes of common stock. \textit{Id.}
tion predicts that the owners of investments particular to an industry—in the present case, the investments consist of the infrastructure and human expertise of the exchanges and their members—will seek regulation whenever innovations make potential new forms of competition threatening. The legislative body usually gives a regulatory agency powers that enable the agency, allegedly in the “public interest,” to require universal behavior that before regulation only the “most reputable” members of the regulated industries practiced. This policy has the political advantage of appearing to retard “unethical” practices. But, in a way not nearly so apparent, the policy hampers the innovation of techniques that new entrants otherwise may have introduced. Indeed, these new techniques may have been the principal attraction of the entrants from the consumer’s viewpoint.

The company disclosure requirements of the Securities Exchange Act of 1934 (1934 Act) closely track those of the New York Stock Exchange. As Professor Benston has pointed out, most of the companies on the NYSE already disclosed the most significant financial information that the 1934 Act later required to be disclosed. The securities laws of the 1930’s thus institutionalized the long standing practices of the NYSE and its members: a “prospectus prepared by a leading Wall Street house in 1928 could, with really insignificant differences in financial disclosures, led the Commission to monitor and enforce price-fixing by brokers. Jarrell concludes that the SEC’s implementation of exchange rules is consistent with predictions generated by a “capture theory” of regulation. See id. at 274, 281-82, 300. See also Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669, 670-72 (1984). Cf. P. MACAVOY, THE ECONOMIC EFFECTS OF REGULATION (1965); Stigler, supra note 1; Peltzman, supra note 1 (or almost any recent economic textbook on industrial organization or regulation).

Note that the theory of regulation does not necessarily imply that employees of the SEC know or believe that they are policing a cartel. It is enough that one side of the market that the SEC regulates, i.e. the exchanges and brokers, have an advantage in presenting timely arguments and information before the Commission. The advantages arise because each exchange and broker is sensitive to the activities of the SEC on a daily basis, whereas few investors can afford to track the arcane workings of an institution that is of marginal concern for their private affairs.

The odd investor who does become especially vexed by some ruling of the Commission is apt to find that the investor’s reform efforts will be dwarfed by a mass of evidence and testimony emanating from the exchanges, or, barring that, vitiated by substitute rulemakings or subsequent reconsideration of the original proposal. Even if the reformer is successful for a time, most of the benefits of those efforts will accrue to other investors, not to the reformer, whereas all the costs were borne by the reformer. The exchanges, in contrast, bear the costs of opposition, but also stand to reap most of the benefits of their efforts.

16. See R. NOLL, M. PECK & J. McGOWAN, ECONOMIC ASPECTS OF TELEVISION REGULATION 124-26, 148, 151-52 (1983); E. KITCH, REGULATION, FEDERALISM, AND INTERSTATE COMMERCE 37-42 (1981); L. HARTZ, ECONOMIC POLICY AND DEMOCRATIC THOUGHT: PENNSYLVANIA, 1776-1860 (1948); G. MILLER, RAILROADS AND THE GRANGER LAWS (1971); Benham, The Effect of Advertising on the Price of Eyeglasses, 15 J.L. & ECON. 337 (1972). See also Olson, supra note 1, at 63 (“Special interest groups also slow growth by reducing the rate at which resources are reallocated from one activity or industry to another in response to new technologies or conditions.”); Stigler, supra note 1, at 36 (Stigler’s central thesis is that regulation is “actively sought by an industry”).


obtain a clearance from the Corporate Finance Division of the SEC today.” Hence, the SEC began requiring firms to compile and disseminate NYSE-style information just when the improving communications and information technologies were beginning to make it possible to create faster and cheaper ways of getting similar information to investors.

Two sides of a debate have now been laid bare. One set of arguments focuses on the original strengths of the NYSE vis-a-vis its competitors and argues that the exchange practices are efficient, and survive and prosper with no particular aid from the SEC. The opposing set of arguments focuses on the now burgeoning “electronic revolution” that was only beginning when the SEC was formed, and argues that for the benefit of existing exchanges the SEC artificially institutionalized a form of organization that is now obsolete—a format, however, with which the existing exchanges were already well practiced.

The next section considers various restrictions on where securities trading may take place, catalogues the restrictions presently in place, and speculates about the contours of the market that will exist if the SEC removes such restrictions. Abandonment of the current regulatory scheme probably will be accompanied by a “shake out” of the securities market. Many stocks currently traded on organized exchanges may move to the over-the-counter market, and certain other stocks, now traded over-the-counter, may gravitate to the organized exchanges. The securities markets may also evolve as this article envisions even if the SEC fails to aid that move, but the change will occur much more gradually in that event. The change will occur as the natural evolution of the economy displaces some of today’s major stocks and replaces them with newer issues that, even now, are subject to less far-reaching regulations.

III. THE NATIONAL MARKET SYSTEM CONCEPT

In 1975, Congress amended the Securities and Exchange Act of 1934 by adding section 11A, ostensibly to foster the creation of a national market system. 20 While observers considered the 1975 amendment a major change in the securities laws, 21 Congress made the statute remarkably vague. “To allow maximum flexibility,” 22 Congress did not even define the term national market system, but directed the SEC to “facilitate the establishment” of this ephemeral concept. 23
The 1975 amendment declared the securities markets to be an "important national asset which must be preserved and strengthened." The national market system legislation also articulated certain objectives and directed the Commission to carry them out. These objectives were to assure economically efficient securities transactions; fair competition between brokers and dealers, and between exchanges and markets; the availability of information; the execution of investors' orders in the best market; and an opportunity to execute orders without the participation of dealers.

Ten years later, Congress's vision of a complete revamping of the securities markets has hardly begun to be realized. Calls are being made to abandon the costly project, and the SEC has done little to implement the congressional plan. Simply put, the world looks little different now than it did when Congress originally passed the legislation. The SEC cannot blame this failure on congressional refusal to give the SEC sufficient rulemaking authority to implement the system. In fact, under this chapter to facilitate the establishment of a national market system for securities . . . ."

Id.

25. Id. § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C). The legislation specifically said it was in the public interest to assure:
   (i) economically efficient execution of securities transactions;
   (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
   (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
   (iv) the practicability of brokers executing investors' orders in the best market; and
   (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.

Id.

27. Poser, supra note 26, at 958 ("Congress and the SEC should reconsider the desirability of [the] project that has already cost millions of dollars of government and private resources . . . .")

Even prior to the enactment of the national market system proposals, the SEC had the authority to alter market or industry relationships in the securities markets. Werner, Adventure in Social Control of Finance: The National Market System for Securities, 75 COLUM. L. REV. 1233, 1254-55 (1975); but see Poser, supra note 26, at 887 n.10. Whether the SEC would retain its apparent far-reaching authority if it actually tried to use that authority remains an open question. During an interview, Arthur Burns, then Chairman of the Federal Reserve Board, remarked that so-called independent agencies risk losing their independence unless they act (non-independently) in ways consistent with the interests of Congress and the President. Interview on the CBS Evening News (June 13, 1972). If congressional interest predicated establishing, as opposed to merely endorsing,
the SEC enjoys sweeping authority to guide the development of the national market system. This authority includes "a mandate to eliminate existing anticompetitive rules of the stock exchanges and the ability to require the development of national market system facilities." Rather, the failure may arise from recognition by the SEC and the exchanges that the proposal implicitly is one to replace personnel, both in the SEC and in the securities markets, with electronics. Alternatively, the national market system concept possibly is failing because the organized securities exchanges are simply the most efficient means of organizing stock trading activity. If so, the national market system was doomed from the start because the market has already reached its most efficient configuration. However, statistics on those few stocks that can be traded without restrictions imply that this later alternative is not the case.

Achieving a genuine national market system seems to require a two-step process. The first step is to remove certain exchange rules and SEC enforcement procedures. For example, the continued existence of off-board trading restrictions, which prohibit exchange members from trading "listed" stocks outside the confines of an organized exchange, are a primary obstacle to a national market system. A related set of impediments to a national market system are SEC and exchange prohibitions on delisting. When a stock is listed on an exchange, sometimes without the approval of the parent corporation, exchange members may trade the stock only on an exchange. Once a stock is listed, however, delisting is virtually impossible. Finally, the exchange specialists' trading advantages, which the SEC has protected, must be stripped away to create a level playing field among competing market participants. Once the SEC has implemented such policies and a truly national market system is in place, the second step in the process will consist of monitoring a simple set of rules to ensure that traders are reporting transactions as they occur, and that communications systems are effectively linking the market participants.

The SEC has set about its work of facilitating the establishment of a

the NMS, the task could be forced on a reluctant SEC through legislation that has not yet been forthcoming.

29. Indeed, the SEC's involvement in the project is, in all likelihood, the cause of the legislation's failure. Market forces would achieve the correct configuration of trading activity without regulatory supervision, but the apparent public "need" for an SEC bureaucracy would then be substantially curtailed. See infra text accompanying notes 114-23.

30. Letter of Transmittal from Representative Bob Eckhardt (Chairman, Subcommittee on Oversight and Investigation) to Representative Harley O. Staggers (Chairman, Committee on Interstate and Foreign Commerce) (Aug. 26, 1980), reprinted in OVERSIGHT STUDY, supra note 26, at III. This report indicates the Commission's failure to take steps toward developing competition in a national market system. Representative Eckhardt also questions the adequacy of the current communications system between markets.

31. See infra text accompanying notes 211-17.
32. See infra text accompanying notes 88-113.
33. See infra text accompanying notes 57-58.
34. See infra text accompanying notes 163-82.
35. See infra text accompanying notes 229-35.
national market system in precisely the wrong order. First, it has attempted halfheartedly to establish communications systems between markets. Such systems are of little value, however, as long as regulations force transactions through the old channels anyway, and therefore the systems are seldom used. The SEC then justifies continued restraints on trade by claiming that the absence of such communications systems dictate maintaining the status quo rather than deregulating, a process that, of course, would reduce the SEC's own importance and authority. If the SEC is going to establish a national market system, the proper process seems to be to eliminate the restrictions on market participation, then to allow the market to dictate the evolution of the appropriate communications systems. This has been the pattern in the foreign exchange, the United States government securities, and the municipal securities markets. Not surprisingly, the SEC's actions have permitted vested interests—such as certain members of the various stock exchanges, and members of the SEC's own bureaucracy—to impede the development of a national market system.

IV. EXPECTED BENEFITS OF A NATIONAL MARKET SYSTEM

Several members of Congress claimed to expect "substantial benefits" for the marketplace from successful implementation of a national market system. Specifically, they argued that investors would be more likely to get the best available prices when buying or selling stock, and the whole market would become a single efficient price-setting mechanism. Although the House Subcommittee on Commerce and Finance recognized the strength of the nation's securities markets, the subcom-

36. See Poser, supra note 26, at 918-27 (reviewing attempts to develop market linkage systems).

37. The SEC's position is that the lack of adequate communications systems will lead to a problem known as fragmentation. See infra text accompanying notes 123-34 (discussing fragmentation).

38. There is certainly nothing new about alliances between the SEC and the exchanges on policy issues that affect the exchanges' profitability. See S. PHILLIPS & J. ZECHER, THE SEC AND THE PUBLIC INTEREST 53-87 (1981) (observing that the SEC's role in the abolition of fixed commissions on the NYSE had no impact but imposed heavy costs on the deregulatory plan); see also Jarrell, supra note 1.

39. As the OVERSIGHT STUDY, supra note 26, at 8, noted:

The anticipated benefits of a National Market System, developed in accordance with the requirements of the 1975 Amendments, were substantial. Investors would have the ability to get their orders executed at the best price available anywhere in the United States when they bought or sold stock. The pricing mechanism would be more efficient and investors could more easily sell or buy stock. Fees, or commissions, charged by their brokers would be based on a cost structure related to a more efficient marketplace. And, better services would be provided by the marketplaces.

Securities firms would also benefit in a number of ways. To the extent the manual, paper intensive order execution process would be automated and the number of unknown or questioned trades reduced, the costs associated with executing orders would decrease. Further, a firm's income would be enhanced by the ability to produce revenue in the business of dealing in listed securities. Such reduced costs and enhanced income would help improve securities firm's return on equity.

40. Id.
committee "was convinced that without change, the world's finest market would decline to a lesser status, with a significant adverse economic impact on the country."\textsuperscript{41} The subcommittee wanted to prevent the securities markets from fading from world prominence.\textsuperscript{42} Thus, Congress did not intend to eliminate the distinctions between the over-the-counter and the exchange markets, or to force all trading into one forum. Instead, the congressional action plainly mandated that competitive forces dictate the future configuration of the trading markets.\textsuperscript{43}

\section{A. Modern Securities Markets}

Two distinct but related markets are combined within our modern trading system, the new issue market and the secondary market. The new issue market gives companies investment capital while simultaneously giving the public investment opportunities. In contrast, the secondary, or trading, market provides a forum through which traders may later buy and sell the investment vehicles created in the new issue market. The economic functioning of the secondary markets is closely related to the success of the new issue market, for if investors expect the secondary markets to work poorly, issuers will have to heavily discount the new securities.\textsuperscript{44} It is the efficiency of these secondary markets that Congress intended the national market system to enhance directly.

The existence of an organized secondary market for a security enhances the security's value by increasing its liquidity. Liquidity is a market characteristic that assures investors that they can promptly dispose of or purchase securities at a price reasonably related to the immediately preceding price for that security\textsuperscript{45} and to the anticipated succeeding prices.\textsuperscript{46} Moreover, competition among participants in a liquid market assures even the more ignorant investors that these market prices reflect all the publicly available information about the firms behind the securities. If the price momentarily is too low, the knowledgeable market par-

\begin{itemize}
  \item \textsuperscript{41} \textit{Id}. at 5.
  \item \textsuperscript{42} \textit{Id}; see also \textit{Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 92d Cong., 2d Sess., Securities Industry Study 1} (Subcomm. Print 1972); \textit{H.R. Rep. No. 123, 94th Cong., 1st Sess. 51} (1975).
  \item \textsuperscript{43} Gillis & Dreker, \textit{Securities Law and Regulation, Fin. Analysts J.}, Sept./Oct. 1982, at 13. These authors glean this interpretation from legislative history: "from the point of view of preserving the competing markets for securities that have developed, breaking down all barriers to competition that do not serve a valid regulatory purpose, and encouraging maximum reliance on communication and data processing equipment consistent with justifiable costs." \textit{Id}. (quoting \textit{S. Rep. No. 75, 95th Cong., 1st Sess. 8} (1977)).
  \item \textsuperscript{44} See Poser, \textit{supra} note 26, at 886. ("For the sale of a new issue of securities to succeed, prospective purchasers must have a reasonable assurance of liquidity" in the secondary market.)
  \item \textsuperscript{45} \textit{Id}.
  \item \textsuperscript{46} \textit{2 Constitution and Rules, N.Y.S.E. Guide (CCH) \S\ 2704, Rule 704.10}. See J. Stone, \textit{One Way for Wall Street} 43 (1975);
\end{itemize}

Liquidity can best be defined as that characteristic which permits any amount of a good to be sold in any given length of time at a price equal to the true value. The more the price is found to vary from intrinsic value as the speed or size of transactions increases, the less liquid a market may be said to be.
participants compete for the bargain and quickly drive the price up to appropriate levels. If the price is too high, the well informed participants sell until the price falls to appropriate levels. In either event, the aggregated value of a firm's securities closely reflects the firm's true economic value as currently known to the market. This competition among knowledgeable investors makes it possible for all investors to know at all times the approximate value of their holdings. Only with such knowledge can individual investors estimate their wealth constraints, and only by estimating their wealth constraints can they optimally allocate consumption and investment throughout their lives.47

Liquidity is valuable48 to purchasers only to the extent they are confident that the market still will be liquid when they become sellers. For a new issue to succeed, purchasers must have a reasonable assurance of liquidity in the secondary market. Moreover, increased liquidity changes the relationship between a shareholder and a corporation by allowing shareholders to react to corporate decisions, thus increasing management accountability.49 The greater the liquidity of a corporation's shares, the greater the opportunity for the marketplace to express an opinion about corporate management through the buying and selling of shares, thus enabling the market to influence corporation decisions to replace inept or dishonest managers. In general, a smoothly functioning market enables economic resources of all sorts to be drawn into firms where the resources are of higher than average value, and expelled from firms where the resources are of lower than average value. Knowledgeable investors and investment companies consequently will consider a security for which there is a continuous two-sided buy and sell market a better investment than an otherwise identical security for which there is no such market.50

A related congressional concern also embraced in the national market system legislation is that of reducing transaction costs.51 While the mere existence of such costs "has no direct relevance to economic efficiencies,"52 artificial enhancement of such costs does. Absent government interference, market pressures will organize the markets "in ways that economize on the cost of transacting."53 In terms of buying and selling stock, the transaction costs consist of the costs of information

47. In addition, the characteristics of increased liquidity create value in other ways. Increased liquidity permits companies to ascertain readily the cost of incurring new debt. Increased liquidity also lowers borrowing costs by allowing securities to be used as collateral for loans. S. ROBBINS, THE SECURITIES MARKETS: OPERATIONS AND ISSUES 33 (1966); Poser, supra note 26, at 886.
48. See Knauss, Corporate Governance—A Moving Target, 79 MICH. L. REV. 478, 481 (1981) (liquidity is of "overriding" importance to the investor).
49. See id. at 481 (the existence of a marketplace for shares changes the relationship of the shareholder to the corporation by giving the shareholder flexibility comparable to a partner's right to dissolution).
50. See Poser, supra note 26, at 886.
51. Id. at 905-06.
53. Id. See also A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS 49-50 (1967).
about the market and the underlying asset, brokerage fees, the spread between bid prices and offer prices, and transfer taxes.  

In contrast to 1792 when the Buttonwood Agreement was signed, current technology permits a choice among several trading forums. If brokerage fees and the spread between bid and offer prices can be reduced in one particular forum without any concomitant increase in information costs, then transactions should gravitate to that forum. If one of the national market system legislation's goals is to ensure that such gravitation takes place, the SEC would seem to have a legal obligation to require the removal of all artificial barriers to the creation of a system that allows such gravitation to occur.

B. Liquidity on the Stock Exchanges

A stock exchange is simply an organized forum where the buying and selling of securities takes place. Historically, the New York Stock Exchange accounted for eighty to ninety percent of the total dollar volume on all organized exchanges. The NYSE has maintained its primacy; more than eighty percent of stock trading on United States exchanges still takes place on the NYSE. One cannot easily trade stocks listed on an organized exchange over-the-counter because of the "off-board trading restrictions" that prevent exchange members from trading exchange listed stocks outside of an organized exchange on which the security is listed. All of the United State's securities exchanges

54. Demsetz, supra note 52, at 33.
55. There are ten stock exchanges presently operating in the United States: the American, Boston, Chicago Board of Options, Cincinnati, Intermountain, Midwest, New York, Pacific, Philadelphia, and Spokane.
56. From 1935 through 1962, the dollar volume of transactions on the New York Stock Exchange, as a percentage of transactions on all exchanges, "ranged from a high of 89.24% in 1938 to a low of 82.44% in 1961." R. Jennings & H. Marsh, supra note 21, at 481 n.1; see also REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS OF THE SEC, H.R. DOC. NO. 95, 88TH CONG., 1ST SESS. (PT. 2) 1076-77 (1963) (hereinafter cited as SPECIAL STUDY). By 1966, the NYSE volume had declined to 80.1% of all exchange transactions. Securities Exchange Act Release No. 8239, at 4 n.2 (Jan. 26, 1968), reprinted in 33 Fed. Reg. 2393 (1968). But by 1979, the NYSE had rebounded to 83.65% of all exchange transactions. SEC ANNUAL REPORT 130 (1980).
57. Jarrell, supra note 1, at 274; R. Jennings & H. Marsh, supra note 21, at 481:

The operation of the New York Stock Exchange was historically based upon four interrelated principles or rules, all of them designed to protect the economic position of the members of that exchange... 1) [limited membership and exclusive dealing;... 2) [the prohibition against members executing trades in listed securities off the board;... 3) [the minimum commission schedule;... 4) [the uniform commission schedule for all transactions, regardless of size. Id. at 481-82.

From 1963 until fixed commission rates were abolished in 1975, the organized exchanges lost a significant amount of trading volume to the "third market." The term third market refers to over-the-counter trading in exchange-listed securities by broker-dealers who are not exchange members. The decline in market share ended with the elimination of fixed commissions, and by 1981 the SEC concluded that the "competitive significance of the third market has been reduced to de minimis levels." In re American Stock Exchange, Securities Exchange Act Release No. 17,744 (Apr. 21, 1981) (note 13); [1981 Transfer Binder] FED. SEC. L. REP. (CCH) 82,866 n.13 (1981). But see infra text accompanying notes 209-18.
58. See infra text accompanying notes 86-123.
have rules that restrict their members from trading off the exchange or "off-board." These rules protect the so-called exchange specialists from competition from other aggressive members of the same exchange.

Some commentators maintain that liquidity is enhanced when one exchange member, known as a specialist trader or specialist, provides a continuous market in the security in which he specializes. A specialist performs two functions on an exchange. First, he makes a continuous two-sided market in a particular stock. To do so, he must provide a sort of "shock-absorber" for his special security, either in the form of actual inventory holdings, or of willingness to move automatically into and out of the futures market as required to clear the spot market. The specialist is required to maintain "in so far as is reasonably practicable... a fair and orderly market on the exchange in the stocks in which he is so acting." Assuring a fair and orderly market "implies the maintenance of price continuity with reasonable depth" and the specialist's market quotation "should be such that a transaction effected thereon... will bear proper relation to preceding transactions and anticipated succeeding transactions." Second, the exchange specialist handles "limit orders," open orders to buy or sell at prices other than the current market price. For example, if the market for stock $X$ is $10.00 bid, $10.50 offered, an exchange member might place an order to sell at $11.00. The specialist

59. See, e.g., [1978] 2 N.Y.S.E. GUIDE (CCH) 3651 (rule 390); [1981] 2 AM. STOCK EX. GUIDE (CCH) 2419 (rule 5); see also SEC Exchange Act Release No. 11,628, 40 Fed. Reg. 41,808, 41,809-10 (1975) (describing the off-board trading restrictions on the Boston Stock Exchange, the Chicago Board Options Exchange, the Cincinnati Stock Exchange, the Detroit Stock Exchange, the Intermountain Stock Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange, the PBW Stock Exchange, and the Spokane Stock Exchange).

60. See infra text accompanying notes 229-35.

61. The term spot market is "[i]ndustry jargon for trades in commodities either for immediate delivery (the same or the next business day) or for trades in futures contracts that will expire this month." A. PESSIN & J. ROSS, WORDS OF WALL STREET 241 (1984).

62. 2 Constitution and Rules, N.Y.S.E. GUIDE (CCH) ¶ 2104.10, rule 104.10 (Aug. 1983).

63. 2 Constitution and Rules, N.Y.S.E. GUIDE (CCH) ¶ 2104.10(1), rule 104.10(1) (Aug. 1983). This rule also notes that maintaining a fair and orderly market implies minimizing the effects of temporary disparities between supply and demand. Id.

64. Id. at rule 104.10(4). See supra note 46 (citing text of rule).

65. The specialist has two obligations regarding his stewardship of the limit order book. First he must not execute any orders at a price inferior to any price in the book. If, for example, a customer has indicated a desire to sell stock at $11.00 per share, the specialist may not sell stock at a price greater than $11.00 before executing the $11.00 trade recorded in the book. In addition, the specialist must discharge the orders in the book on a first come, first served basis. See Poser, supra note 26, at 927 n.237.
enters this order in his book, and he will execute the order automatically if the bid price for X reaches $11.00 (plus applicable commissions).

The ideal of an organized exchange is a continuous auction, where buyers and sellers meet in a centralized location and continuously exchange price information. But, since sellers and buyers rarely appear simultaneously, the specialist system emerged to provide continuity and to prevent abnormal fluctuations in the price of a security that are unrelated to the value of the firm behind the security.66 In effect, specialists hold and manage the inventories in the security market in much the same way that a warehouse handles inventory for real commodities.

C. Securities Trading

The securities of a single company may be traded on more than one stock exchange. A security comes to be traded on an exchange in one of two ways. A company may file an application with the exchange and be accepted for listing.67 Alternatively, subject to SEC approval,68 an exchange unilaterally can trade securities not listed on that exchange, regardless of whether the issuer has applied for or even desires a listing with the exchange. Once an exchange grants such "unlisted trading privileges," no member of that exchange may trade the security except on an exchange.69 The SEC has discretion to approve or disapprove an exchange's decision to grant unlisted trading privileges.70 Axiomatic to the idea of a national market system is the SEC's ability to eliminate all needless restrictions on the trading of securities among markets and between exchanges. Unlisted trading privileges usually create unwarranted trading restrictions.71

D. Liquidity on the Over-the-Counter Market

The over-the-counter market is not a place at all, but just a phrase that refers to three thousand firms with six thousand branch offices that deal in securities transactions that do not take place on a stock exchange.72 There are no listing requirements for issues traded, and all registered securities are entitled to participate.73 Brokers trade securities over-the-counter via a complex telephone and telex communications sys-

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67. In order to be accepted, the company must meet certain requirements regarding such things as the extent of the public distribution of its shares and a minimum amount of assets. See, e.g., 2 Constitution and Rules, N.Y.S.E. Guide (CCH) ¶¶ 2495, 2501, 2502, 2505 (1980); 2 Constitution and Rules, Am. Stock Ex. Guide (CCH) ¶ 10,001-10,010 (1974).
71. See infra text accompanying notes 86-113 (discussing off-board trading restrictions).
tem, by which information is transmitted and trades are consummated. 74 As Professor Loss has pointed out, “over-the-telephone” would be a more accurate description of this market. 75 The stocks of ninety percent of all publicly held companies trade over-the-counter although the dollar volume of such trading is only about five percent of the dollar volume of organized exchanges.76

Virtually all brokerage firms that trade over-the-counter also are members of at least one organized exchange. Because of the off-board trading restrictions of the exchanges, a brokerage firm can only trade over-the-counter shares of those companies that are not listed on the exchanges to which the brokerage firm belongs. Moreover, if a certain stock is listed on any exchange, it can be listed (“dually traded”) without the company's request by other exchanges. Most important stocks, therefore, are traded by all the major exchanges. The SEC's long-standing policy “has been to grant applications by stock exchanges for unlisted trading privileges freely if the class of securities is already listed on another exchange.”77 Superficially, this dual trading seems to be a pro-competitive policy. But a less obvious result of dual trading is that an important stock, to be traded over-the-counter, can be traded no other way, with rare exceptions. By the same token, if the stock is listed on an exchange, it can only be traded on an exchange. Consequently, the seemingly pro-competitive SEC policy actually divides stock trading into an exchange segment and an over-the-counter segment, and the two segments cannot easily compete with each other to handle the securities of any specified corporation.

The liquidity providing function that specialists perform on the exchanges is performed by market makers in the over-the-counter market. In theory, market makers are individuals who hold themselves out as willing to buy and sell a specific security for their own accounts “on a regular or continuous basis.”78 To be a market maker for securities of any notable importance, however, traders must do more than merely hold themselves out as occasionally willing to buy and sell. The traders must actually provide operational bid and asked quotations for reasonably sized blocks of securities on a continuous basis, which means the traders must undertake the same sort of inventory management that the specialists do on an exchange. If a “market maker” does not perform such functions, clients—other brokers who in turn deal directly with private holders—will quickly turn to other market makers who do not waste the clients’ time through frequently fruitless contacts.

74. Id.
76. R. SOBEL, INSIDE WALL STREET 67 (1982).
77. Poser, supra note 26, at 888-89; see also 1973 SECURITIES INDUSTRY STUDY, supra note 22, at 129-33.
78. 1934 Act § 3(a)(38), 15 U.S.C. § 78c(2)(38) (1976). “The term ‘market maker’ means any . . . dealer who, with respect to a security holds himself out . . . as being willing to buy and sell such security for his own account on a regular or continuous basis.” Id.
E. The Black Box Concept

Complete automation through computerization is a third means by which secondary market trading could take place. Potential buyers and sellers could telephone-in their prices and the quantities they are prepared to transact. Or, investors could enter that information directly into the system from their offices or home computer terminals providing there is assurance that they will stand behind their commitments. When a purchase offer with a price exceeding that of a sales offer enters the computer network, the transaction would be executed automatically. Potential buyers and potential sellers could revise their offers at any time. In addition, anyone could be a market maker, either by monitoring a computer display, or by maintaining large limit buy and sell orders below and above recent transactions.

On an experimental basis, the Cincinnati Stock Exchange (CSE) organized and maintains a completely computerized system. An SEC report has noted that "[t]he NSTS [National Securities Trading System] enables members of the CSE to participate in the system by entering bids and offers into computer terminals for securities for their own account and as agent for their customer's accounts." Furthermore, "[s]pecialists on the floor of an exchange linked to the NSTS can . . . enter bids and offers into the system in any NSTS Stock for which the specialist is registered on [his own] exchange." The NSTS computer system matches orders by price. The highest bid is matched with the lowest offer. If two traders enter orders at the same price, the computer will execute the orders on a first come, first served, time priority basis.

V. The National Market System As A Congressional Free Market Solution

In a pre-Carter fit of deregulatory zeal (or noise, at least), Congress apparently tried to deregulate the securities marketplace by enacting the Securities Acts Amendments of 1975. Interestingly, Congress never defined the term national market system, which played such an important role in the amendments. Instead, Congress articulated the basic

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80. Id. at 3.
81. Id. Presently only specialists on the floor of the Boston Stock Exchange participate in this manner because only the Boston Exchange has NSTS terminals on its floor. Id.
82. SEC DIRECTORATE OF ECONOMIC AND POLICY ANALYSIS, A MONITORING REPORT ON THE OPERATION OF THE CINCINNATI STOCK EXCHANGE NATIONAL SECURITIES TRADING SYSTEM 4-5 (May 1981). A fully automated computer system, commonly referred to as an "exchange without walls," is technologically feasible, yet might not be an acceptable replacement for today's exchanges. For some stocks, trading activity is insufficient to insure that a buyer will be matched with a seller. It is in this scenario that a system of specialists and market makers is necessary to provide liquidity to the securities markets. See Poser, supra note 26, at 927.
goals of the legislation, predicated upon congressional findings that new
data processing and communication techniques create the opportunity
for more efficient and effective market operations.

Ironically, Congress entrusted the SEC, the organization responsible
for governing the present system, with the responsibility for dismantling
that very system. The actions that the SEC must take to achieve a na­
tional market system can be divided into two categories. First, the SEC
must eliminate exchange trading restrictions, so that market participants
will be able simultaneously to survey the conditions in multiple markets.
Second, the SEC must implement communications technology to facili­
tate trading activity among multiple markets. In essence, one can inter­
pret these goals as a congressional mandate that the free market govern
the manner in which securities are traded.

The SEC's efforts to implement the national market system are in­
consistent with Congress's stated intent. The SEC has not lifted the re­
strictions on intermarket competition. To the extent that the SEC has
implemented its mandate to facilitate a national market system at all, it
has done so in an ineffective fashion. If the effort is to succeed quickly,
the SEC will have to lift trading restrictions first, and then permit the
market participants to develop whatever communications technology the
needs of the market mandate. Instead, the SEC has attempted first to
oversee and control the development of these communications systems,
and then to lift trading restrictions. So long as the SEC prohibits market
participants from certain trading activities in the first place, the traders
have little incentive to use the newly developed communication facilities
to carry out the prohibited activities. This is true even in the unlikely
event that the SEC somehow is able to create the type of communications
system that would evolve naturally absent the SEC prohibitions.

A. Off-Board Trading Restrictions

Perhaps the most blatant example of the SEC's toleration of effi­
ciency inhibiting rules were the fixed commission rates set by the NYSE
until 1975. The commission rules required brokerage firms to charge
the same percentage commission for each share of a block of stock re­

kets to be an "important national asset which must be preserved and strengthened").
86. SPECIAL STUDY, supra note 56, at 21-1153. The SEC's enforcement of exchange fixed
commissions had long made the commission a target of criticism. See Demsetz, Perfect Competition,
Regulation, and the Stock Market, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE
SECURITIES 1-23 (H. Manne ed. 1969); Stigler, Public Regulation of the Securities Markets, 37 J.
Bus. 117 (1964); West & Tinic, Minimum Commission Rates on New York Stock Exchange Transac­
tions, 2 Bell J. Econ. (1971); Baxter, supra note 5. For a careful analysis of the demise of fixed
commissions, see Jarrell, supra note 1. Jarrell suggests that applying the political support maximiza­
tion theory of Stigler and Peltzman suggests that the SEC, as a "support maximizing regulator"
abandoned its defense of fixed rate commissions because the maximum net political support obtaina­
ble from redistributing the available wealth fell below "the political opportunity cost of the incre­
mental resources expended in implementing the regulations." Id. at 201.
regardless of whether the block consisted of 100 shares or 10,000 shares.\footnote{87} Unfortunately, even though the SEC has abolished fixed-rate commissions, other similarly intrusive exchange rules, such as off-board trading restrictions, mean that a national market system has had little opportunity to evolve.

Off-board trading restrictions presently are in place at all the securities exchanges.\footnote{88} These rules, which prevent exchange members from

\footnote{87. Since the costs of processing these blocks of stock on the exchange is roughly equivalent, or, at least, increases much less rapidly than the order size, the fixed commission rules prevented sellers of large blocks of stock from realizing any scale economies. See Special Study, supra note 56, at 295-312; see also Poser, supra note 26, at 896.}

The fixed commission rules transferred real wealth from the people who bought and sold securities to the exchange members. The effect of these rules could have been ameliorated by allowing institutions that bought and sold large quantities of securities to become exchange members. However, a rule, effective until 1980, limited NYSE membership to persons engaged primarily in the business of trading securities. \textit{2 Constitution and Rules}, N.Y.S.E. GUIDE (CCH) 3072, 3077 (1980). Thus, insurance companies, mutual funds, and pension funds could not join the exchange to reduce the costs of commissions. Between 1970 and 1976, fixed rate commissions disappeared. \textit{Securities Exchange Act Release No. 9079}, [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,955, at 80,124; \textit{Securities Exchange Act Release No. 9007}, [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,918, at 80,047. The SEC first prohibited any minimum commissions on orders in excess of $500,000. In 1975, commission rates paid by public customers became subject to negotiation and in 1976 minimum commission rates paid by exchange members were abolished.

During the halcyon days of fixed rate commissions there was a marked increase in the extent to which securities listed on the NYSE were bought and sold on the regional stock exchanges and in the "third market." (Over-the-counter trading in securities listed on stock exchanges is commonly referred to as "third market" trading.) See [1973] SEC ANNUAL REPORT 156. The reason for this migration of trading was that these alternative forums provided a greater opportunity for price cuts to institutional investors, i.e. they were a means of avoiding exchange rules. \textit{4 SEC INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 64, 92d Cong., 1st Sess. 11,822-24 (1971); SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 93D CONG., 1ST SESS., SECURITIES INDUSTRY STUDY 89, 92-93 (Comm. Print 1973).} In 1971, more than 17% of the trading in NYSE listed stocks occurred outside of that exchange. \textit{Id.}

The effect of the NYSE's loss of business was, according to the Exchange, detrimental to the marketplace generally. Specifically, members expressed concern that the marketplace for securities was becoming "fragmented" because "investors and broker dealers increasingly had to consider multiple trading forums" to execute a single order. Parker & Becker, \textit{Unlisted Trading Privileges}, 14 REV. SEC. REG. 853, 856 (1981). By forum shopping broker-dealers "transported trades" to regional exchanges to effect various reciprocal arrangements with institutions. \textit{Id.} This market shopping allegedly took time due to poor communications between markets. The Exchange allegedly worried that smaller investors might not receive prompt attention to their orders. Also, traders who were unaware of market activity in a particular stock, would be unwilling to quote competitive or "tight" markets for these securities due to a lack of sufficient information. (A tight market is one with a narrow spread between the bid and offered sides.) \textit{Id.}

\footnote{88. The NYSE required that: "Except as otherwise provided by this Rule, no member [or] member organization . . . shall effect any transaction in any listed stock in the over-the-counter market, either as principal or agent." \textit{2 Constitution and Rules}, N.Y.S.E. GUIDE (CCH) ¶ 2390, rule 390(a) (Jan. 1983). On the American Stock Exchange: "Except as hereafter provided by this Rule, no (i) member, [or] (ii) member organization . . . shall effect any transition in the over-the-counter market in any equity security admitted to dealings on the exchange." \textit{2 Constitution and Rules, Am. Stock Ex. Guide (CCH) ¶ 9225, rule 5(a) (Feb. 1981). See also O\textit{VERSTUDY, supra note 26, at 13. ("The other exchanges have similarly restrictive rules.") Securities Exchange Act Release No. 7628, Amendment or Abrogation of Exchange Off-Board Trading Rules, 40 Fed. Reg. 41,808 (1975) (Notice of Rulemaking Proceeding) [hereinafter cited as Exchange Off-Board Trading Rules] ("All the nation's registered securities exchanges have rules which are specifically intended to limit or condition the ability of a member to effect transactions over-the-counter in securities listed, or admitted to unlistered trading privileges on the exchanges.").}
trading exchange-listed stocks off of the exchange, severely limit, and in some cases prohibit, outside market makers from competing with the specialists on the organized exchanges.\textsuperscript{89} Off-board trading rules prevent firms from executing trades privately, such as over the telephone. Traders must bring all trades to the floor of an exchange where the transactions are subject to the exchange’s commissions.\textsuperscript{90} When traders negotiate transactions before bringing them to the exchange floor, and only bring the transactions to the exchange because of off-board trading restrictions, the traders must nonetheless pay the specialist’s commission. The only effect of such off-board trading restrictions is an artificial transfer of wealth, from nonexchange members to the exchange member who receives a commission on the transaction.

These off-board trading rules have several effects on trading. First, if a broker-dealer has a customer willing to sell a security for $1,000, and another customer willing to buy that security for $1,000, the broker cannot simply execute the transaction in-house, but must go through an exchange. Second, if a customer is willing to sell shares of a security for no less than $1,000, but the exchange’s bid is only $999, the broker cannot sell the customer’s shares to an over-the-counter market maker whose bid is higher. Finally, the rule prevents a third market maker from selling directly to a member of the exchange.

Although these off-board trading rules increase transactions costs and transfer wealth to exchange members, Congress did not eliminate the rules in 1975 when it passed the national market system legislation. Instead, Congress directed the SEC to review the rules,\textsuperscript{91} report the results of the review to Congress within ninety days,\textsuperscript{92} and amend any rule imposing a burden on commerce that did not appear to be necessary or appropriate,\textsuperscript{93} including all rules that limit or condition the ability of members to effect transactions in securities other than on exchanges.\textsuperscript{94} The SEC’s ninety day review catalogued the exchanges’ off-board trading practices and opined that “[t]he rules of the exchanges . . . appear to engender anticompetitive effects in certain important respects.”\textsuperscript{95}

Thus, the SEC has concluded that off-board trading restrictions are incompatible with the concept of a competitive national market system.\textsuperscript{96}

\textsuperscript{89.} \textsc{Oversight Study, supra} note 26, at 13.
\textsuperscript{90.} \textit{See Special Study, supra} note 56, at 316-18.
\textsuperscript{91.} \textsc{1934 Act § 11A(c)(4)(A), 15 U.S.C. § 78k-l(c)(4)(A) (1976).}
\textsuperscript{92.} \textit{Id.}
\textsuperscript{93.} \textit{Id.}
\textsuperscript{94.} \textit{Id.}
\textsuperscript{95.} \textsc{Exchange Off-Board Trading Rules, supra} note 88, at 41,811. \textit{See also id.} at 41,808 (“[t]he Commission has concluded that off-board trading rules of exchanges impose burdens on competition”).
\textsuperscript{96.} \textit{See Oversight Study, supra} note 26, at 14 (emphasis added): Despite the fundamental purpose of the 1975 Amendments to eliminate unnecessary restraints on competition, these restrictive rules and practices, though modified, continue in place today. This is inconsistent with a central thrust of the legislation and the manner contemplated for bringing a national market system into being. Not only is it at odds with the underlying legisla-
If there are prohibitions on members of one exchange from trading freely in a security with nonmembers—even if the nonmember is offering a better price— the market cannot achieve the basic goals of the national market system legislation. Off-board trading restrictions also prevent other exchange members from competing with specialists and nonmember market makers in making two-sided markets in exchange-listed securities. Therefore, as the SEC has previously recognized, off-board trading rules “deprive the securities markets of the benefits that might otherwise accrue from enhancement of competition among market makers and the commitment of additional capital and professional skill to the market making function.” Despite the SEC’s recognition that off-board trading restrictions unnecessarily or inappropriately burden competition in conflict with the purposes of the 1934 Act, the SEC continues to impose such restrictions.

The 1975 national market system legislation empowers the SEC to amend the rules of any exchange or other self-regulatory organization at will “to insure the fair administration of the self-regulatory organization, [or] to conform its rules to requirements of this title . . . .” This means, of course, that the SEC has the plenary authority to eliminate off-board trading restrictions. The SEC, however, has eliminated few of these restrictions.

In 1976, the SEC took a step towards deregulation by passing rule 19c-1, which required the exchanges to eliminate rules restricting traders to executing agency transactions on the exchange. Unfortunately, this change had virtually no effect on the marketplace, because broker-dealers still could not purchase stock for their own accounts, as a princi-

tive technique—to enhance competition—but the data regarding trading indicates competition has not grown.

97. And, of course, even if the basic price is the same but the transactions costs are lower, the trade is best consummated “off board.”
102. In fact, it is likely that the SEC has had such authority since 1934. In promulgating the Securities Exchange Act, Congress intended to give the Commission expansive regulatory authority. Werner, Adventure in the Social Control of Finance: The National Market System for Securities, 75 COLUM. L. REV. 1233, 1254-55 (1975) (arguing that the Securities Exchange Act of 1934 gave the SEC the “economic authority” to fundamentally alter “market or industry relationships”).
103. Rule 19c-1 provides that:
the rules of each national securities exchange shall provide that no rule, stated policy or practice of that exchange shall prohibit or condition . . . the ability of any member acting as agent to affect transactions on any other exchange or over-the-counter with a third market maker or nonmember block positioner . . . .
pal, and could not execute in-house agency crosses. In other words, the exchanges still barred the broker-dealers from providing the inventory management functions necessary in a continuous market. Trades may take place outside of the confines of the exchange only as long as the number of middlemen is not reduced—hardly an effective means of decreasing transaction costs or enhancing liquidity. Therefore, exchange members still cannot compete with specialists as market makers. Rule 19c-1 did permit a market maker, who wanted to buy a stock through an exchange member, to choose between going directly to the exchange or going to the exchange member. The exchange member, however, could only act as agent for some other party. Exchange members who receive orders rarely have at hand offsetting orders, so they still have to obtain the securities on the exchange. Thus, rule 19c-1 is of little value, and traders seldom use it.

Rule 19c-2, which the SEC proposed on June 27, 1977, would have removed all remaining off-board trading restrictions. The rule would have eliminated restrictions on principal transactions and in-house agency crosses by January 1, 1978. Lifting the exchanges’ restrictions on principal transactions was particularly significant in improving the liquidity of the secondary market for securities. Allowing exchange members to consummate trades as principals would permit them to become market makers, and to compete with the specialists of the exchange. For example, if the exchange specialist was quoting a market of $19 bid and $21 offered, and an exchange member was willing to buy the stock at $19-1/8 as principal outside of the exchange, the transaction at 19-1/8 would seemingly enhance liquidity and avoid any needless transaction costs.

105. One who purchases stock “as principal” purchases such stock “for his own account and risk.” A. PESSIN & J. ROSS, supra note 72, at 184.
106. 17 C.F.R. 240 (1976) ("Rule 19c-1 will not prevent exchanges from having rules restricting exchange members from effecting transactions 'in-house' as agent for both buyers and sellers or with persons other than a qualified third market maker or block positioner.").
109. Proposed Rule 19c-2 provided that:
After December 31, 1977, the rules of each national securities exchange shall provide as follows:
(a) No rule, stated policy or practice of this exchange shall prohibit or condition, or be construed to prohibit, condition or otherwise limit, directly or indirectly, the ability of any member acting as agent for both buyer and seller to effect any cross transaction otherwise than on this exchange in any reported exchange security.
(b) No rule, stated policy or practice of this exchange shall prohibit, condition, or be construed to prohibit, condition, or otherwise limit, directly or indirectly, the ability of any member acting as principal to effect any transaction otherwise than on this exchange with any person in any reported exchange security.
(c) For purposes of this rule, the term “reported exchange security” shall mean any equity security listed on this exchange or to which unlisted trading privileges on this exchange has been extended as to which last sale information is reported in the consolidated transaction reporting system.

Id.
However, the SEC withdrew proposed Rule 19c-2 in June 1980, and instead adopted a more restrictive rule. Rule 19c-3 totally eliminated off-board trading restrictions for a limited number of stocks on an experimental basis. The SEC, even when proposing rule 19c-2, was concerned that too much freedom in the marketplace might be detrimental. The Commission was particularly concerned with three phenomena: fragmentation of orders, overreaching, and market surveillance. These considerations are the only policy reasons that the SEC has advanced in defense of its failure to ban off-board trading restrictions.

B. A Stigler-Peltzman Analysis of SEC Action

Interestingly, the SEC’s stated concerns about the national market system, which mirror the NYSE’s policy arguments, are identical to the arguments that were posited in favor of retaining fixed-rate commissions. One naturally wonders why the SEC's actions vis-a-vis the national market system have been so sluggish, compared to their prompt moves to abolish fixed-rate commissions. At this point, a careful examination of the findings of the SEC's chief economist, Gregg Jarrell, provides some insight.

The Stigler-Peltzman model that Jarrell uses envisions political equilibrium in an environment where every force for change is resisted by an exactly equal counterforce. If this were not true, then political institutions would continue to change, whereas they seem to move rarely, but abruptly, compared with market fluctuations. To be concrete, Jarrell argues that brokers as a group favored even higher and more rigid fixed-rate commissions than the SEC would enforce. The SEC's counterforce arose from opposition to higher rates by traders and a subset of brokerage firms.

To illustrate the force-counterforce analysis a simple diagram may help. Figure 1 shows the demand for brokerage services and the marginal cost of the resources consumed to produce the services. In an unregulated competitive industry, the quantity produced would be C, and the equilibrium commission charged would equal marginal cost. A well-known economic truism asserts that the competitive outcomes do not maximize industry profits. This can be readily demonstrated by exam-

112. 17 C.F.R. 240 (1977). See Poser, supra note 26, at 935. (The Commission acknowledged that elimination of these restrictions might be accompanied by adverse effects on the markets.)
114. See supra note 87.
115. See Jarrell, supra note 1.
116. See supra note 1 and accompanying text.
117. Jarrell, supra note 1, at 284-86, 298.
118. See A. ALCHIAN & W. ALLEN, EXCHANGE & PRODUCTION: COMPETITION, COORDINA-
ining the marginal revenue curve. If the commission rate is increased sufficiently to curtail one transaction, the industry saves more in cost than it loses in revenue, because the marginal revenue is less than marginal cost. Indeed, as drawn in Figure 1, brokerage industry revenue actually increases at first as transactions fall below the competitive level because the percentage increase in price is large relative to the percentage fall in transactions. Hence, one can measure the marginal increase in brokerage profits by the distance between the marginal cost and marginal revenue curves, and this can serve as a proxy for measuring the enthusiasm of brokers in seeking SEC enforcement of higher rates. Clearly, the broker support becomes relatively weak before the commission rates are driven all the way to the level at which cartel profits will be maximized.

At the same time, with SEC enforcement of ever higher rates, there is increasing opposition from traders to further increases in rates. The traders bear a cost from increased rates that exceeds the transfer to brokers, because noncompetitive commission rates create the well-known deadweight efficiency costs usually associated with cartelization. The independent traders must be more difficult to organize than the ex-

\[ V_M = \text{Profit Maximizing Volume} \]
\[ V_R = \text{Regulated Volume} \]
\[ V_C = \text{Competitive Volume} \]
change-member brokers, or the SEC-enforced broker cartel would never have begun. The reduced interests of the well-organized brokers in ever higher commissions, coupled with the increased resistance from the poorly-organized traders, yields some political equilibrium commission rates that are between marginal cost and the profit-maximizing level. This equilibrium will persist as long as the political environment remains unchanged.

The political environment did change in ways that were adverse to fixed commissions. First, institutional investors, such as mutual funds, grew rapidly in importance as security holders.120 The institutional investors were a more easily organized group than the smaller, more widespread members of the public who held securities. Thus institutional investors could more easily mobilize their opposition to the SEC enforcement of high commissions. Second, the institutional members had better substitute markets than did the public. For example, institutional holders can afford to contact each other directly when they want to trade tens of thousands of shares, whereas an individual wishing to buy or sell a few hundred shares can rarely afford such time or telephone bills. The ability to trade shares directly between institutions reduced the interest of brokers in high commission rates as Figure 2 demonstrates. The demand curve became more elastic, leading to the brokers' reduced interest. High rates were driving some institutional business off the exchange. Clearly, the marginal cost-marginal revenue difference, which drives the broker's interest in artificially high commissions, was reduced. Third, some brokerage firms were becoming hostile to the fixed commissions. The rule constrained brokers who were better able to service the low commission rate yet high volume business. Moreover, the rules put such brokers at a competitive disadvantage vis-a-vis firms that were better equipped to compete by providing non-price related attributes, such as investment advice.121 Eventually, the combined strength of these forces induced the SEC to abolish the fixed-rate commissions.122

No similar fate seems likely in the near future for the rules that hamper the development of the national market system. In particular, the national market system would primarily benefit small-holding mem-

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120. Jarrell, supra note 1, at 277-79; see Figure 1.

121. Jarrell, using the capital asset pricing model, shows that the national full-line firms—Bache, E. F. Hutton, Merrill Lynch, Paine Webber, and Dean Witter Reynolds—benefited from the 1975 deregulation of fixed commission rates. Jarrell's results "imply a cumulative gain from deregulation of about 150%." Jarrell, supra note 1, at 298. This is not surprising. When fixed commissions were abandoned, commissions to institutions declined sharply, and commissions to individual (public) customers rose sharply. In the case of off-board trading restrictions, these firms would be joined by firms such as Salomon Brothers, Morgan Stanley and Lehman Brothers, all of which derive significant revenue from trading activity. Securities Exchange Act Release No. 16,889, 45 Fed. Reg. 41,156 (1980) (withdrawing proposed rule 19c-2).

bers of the public, not large institutional investors, for two reasons. First, the holdings of institutional investors are so massive that these investors already have incentive to monitor the entire market privately. While a centralized system might be somewhat cheaper even for institutional investors, the cost savings to these large investors would be more modest than the savings for members of the public, who presently have no good alternative to broker-provided information. Second, institutions deal in such massive transactions that they frequently can transact only with each other. They would probably turn to a market maker only when they need to put together, or disperse, a block from, or to, the general public. Consequently, information detailing public transactions prices are of minor interest to institutional investors because the volumes are too small to generate institutional interest.

Consequently, the only well-organized interest that strongly favors the national market system is a subset of brokerage firms, probably the large national brokerage houses that do not man the specialist posts on the various exchanges. While it is certainly not impossible that these houses will someday gain political superiority over the specialist houses, the lack of institutional allies has delayed the national market system.
reforms. \footnote{123} Consistent with this analysis, the Commission has announced that it does not plan to take any further steps "in the near future" toward repeal of the remaining off-board trading restrictions. \footnote{124}

\section{C. SEC Reservations About Removing Off-Board Trading Restrictions}

\subsection{1. Fragmentation of Orders}

The first of the SEC's fears about removing off-board trading restrictions is "fragmentation," \footnote{125} which reflects a variety of concerns about the consequences of a significant amount of trading occurring outside of the organized exchanges. Particularly, the SEC noted that increased market making outside the exchanges will divert the flow of orders in listed securities away from existing market centers, including particularly the primary exchanges. \footnote{126} The SEC apparently thinks that such a diversion of order flow is necessarily bad. The SEC alleges that this diversion will impair pricing efficiency and lead to a decline in the quality of brokerage services as it becomes unclear where a buyer can obtain the best price. \footnote{127} But even with off-board trading restrictions, orders flow from one exchange to another (although usually not from one exchange to an over-the-counter trader) because orders naturally gravitate to the best prices. If there is no problem with one exchange supplanting another—and the SEC does not allege one—then the SEC should allow, or even encourage, an off-exchange market maker who is willing to pay more for a security to divert sell orders away from the exchange. One can even question whether assuring investors that they have the best price available is in their interests, given that the cost of that assurance directly depreciates that best price; in other words, when the assurance increases prices when the investors buy and depresses prices when the investors sell.

Moreover, without off-board trading restrictions, certain brokerage firms will inevitably hold themselves out as offering the best available prices for securities because of the advantages such a policy offers in competing for clients. Competitive pressures will force other firms to follow suit. Merely requiring market makers to list their bid and asked prices on the computerized quotation systems already in place will solve both the problems of impaired pricing efficiency and the declining quality

\footnote{123} Another very strong indicator of the lack of uniformity of interests among exchange members with respect to the NMS is the Commission's behavior with regard to certain stocks that it has exempted from off-board trading restrictions. Certain large traders objected strenuously to exchange listing, and the concomitant application of off-board trading restrictions for certain securities, because such listing would result in a diminution of profitable trading activity by such firms. Ultimately these objections led the SEC to implement rule 19c-3. \textit{See infra} notes 189-96 and accompanying text.


\footnote{125} Sometimes the word \textit{fragmentation} is used more specifically to refer to the dispersion of orders among market centers. \textit{SEC Exchange Act Release No. 16,888}, at 1 n.32 (1980).


\footnote{127} \textit{Id.}
of brokerage services. Obviously firms acting as market makers must have accurate, up-to-the-minute information on transactions. Consequently they will have every incentive to communicate with one another, as happens in the markets that function without exchanges. For example, both the municipal bond and the United States government securities markets function quite well with dozens of market makers spread from coast to coast. The markets for major issues are highly liquid and communication has not been a problem.\(^{128}\)

The January 1, 1984 split up of the American Telephone and Telegraph Company (AT&T) into eight holding companies,\(^{129}\) provides further support for the proposition that the SEC's fragmentation argument is without merit. The split up provided a bonanza of trading activity in rule 19c-3 stocks. The high volume of trading activity resulted from millions of shares "changing hands as investors rearrange their portfolios."\(^ {130}\) Owners of "old" AT&T stock received a mix of shares in the regional companies.\(^{131}\) While all these stocks are traded on the New York Stock Exchange and five regional exchanges,\(^{132}\) seven of the eight new stocks are not subject to off-board trading restrictions.\(^{133}\) Consequently, large trading concerns can trade these stocks without going through a specialist on the exchange.

A comparison by price and time of every trade in these seven stocks reveals that fragmentation is an unwarranted fear. Round lot blocks of a particular stock traded at any given time sold at precisely the same price regardless of whether it was traded over-the-counter, on the New York Stock Exchange, or on a regional exchange.\(^{134}\) These results are not surprising. If a price differential had existed between exchanges, arbitrage between these markets would have eliminated such differentials. Clearly, not everyone needs separate price quotations from every market; a few self-interested arbitragers assure that traders need only worry about one national price.

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\(^{128}\) See C. Henning, W. Pigott & R. Scott, Financial Markets and the Economy 307 (2d ed. 1978) (bids for "intermediate-size and large-size" municipal bond issues are "quite competitive"); id. at 248 ("treasury bills . . . have a high degree of liquidity").

\(^{129}\) See infra text accompanying notes 208-17.

\(^{130}\) Blumstein, Trade Set in 8 Companies, N.Y. Times, Nov. 18, 1983, at D1 (Business), col. 3.

\(^{131}\) For every 10 shares of "old" AT&T stock owned, investors received one share in each of the regional holding companies and 10 shares of the "new" AT&T. Investors were not given a choice as to the mix of shares he or she would like to receive, although owners of fewer than 10 shares of the "old" AT&T received cash rather than shares in the regional holding companies. See Main, AT&T's Holiday Gift to Wall Street, FORTUNE, Nov. 28, 1983, at 67.

\(^{132}\) Blumstein, supra note 130, at D17, col. 1.

\(^{133}\) See supra text accompanying notes 86-100 (discussion of off-board trading restrictions).

\(^{134}\) Information on the price, time, and trading volume of the seven regional holding company stocks was compiled by Francis Emory Fitch, Inc., 130 Cedar Street, New York, N.Y. 10006 [hereinafter cited as Fitch Research]. The right to use this information covering the month of February 1984 was purchased with research funds provided by the Emory University School of Law. The conclusions in the text are based on this extensive data, which covers every trade in those stocks during the relevant period.
2. Overreaching or The "Internalization of Order Flow" Fallacy

The SEC has also voiced concern over the possibility of "internalization," which refers to "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 interests in those other market centers." Commentators have cited the fear that relaxing off-board trading restrictions will result in internalization of orders as the major reason the SEC should keep such restrictions in place. Proponents of this argument consider the danger of internalization to be that "[i]nternalizing order flow might create a conflict of interest between the broker's 'legal responsibility to seek best execution for their customers' and their desire to maximize profits from market making activities." Furthermore, this conflict might cause some firms to 'overreach' their customers by executing retail transactions as principal at prices less favorable to those customers than if the firm had acted as agent.

For example, a customer might call up a broker-dealer and ask to buy 500 shares of stock X. A market maker at another firm might be offering the stock for $12.00 per share, but the broker-dealer, who has the stock in inventory, might sell the stock to the customer for $14.00 rather than selling as agent for $12.00 (plus the broker's commission of less than $2.00).

This simple analysis, to which the SEC subscribes, ignores several factors, however, that mitigate the danger of such overreaching. First, the SEC already requires that the broker-dealer disclose both the amount of any "mark-up, mark-down, or similar remuneration" if the broker-dealer acts as principal but not as a market maker and whether the broker-dealer is a market maker in that security. These requirements enable customers to identify those instances in which overreaching is a danger. Second, the broker-dealer's failure to disclose knowledge of a lower price elsewhere would clearly violate rule 10b-5, the SEC's stringent antifraud provision. Curiously, the SEC apparently believes that off-board trading can be policed, but that this sort of fraud cannot.

Furthermore, sensible brokers will not jeopardize a long-standing relationship with a customer for the chance to turn a quick profit on one dubious transaction, particularly when the brokers likely will be discovered, damage their reputations, and possibly lose their licenses. Finally, the market already adequately disperses relevant information in a way

136. See Parker, supra note 107, at 919-20.
137. Id. at 920.
139. See Parker, supra note 107, at 920.
141. Id. 240.10b-10(a)(8)(ii).
that enables customers to know the relevant prices at which trades were made, enabling customers to detect and prosecute overreaching quickly. Newspapers print stock prices, and institutional investors have up-to-the-minute price information from a large variety of sources, most notably institutional salesmen. For modest cost, any suspicious public small-holding investor can, even now, obtain nearly current price quotations for major securities.¹⁴³

In the face of all these checks, presumably at least some firms will establish and maintain a reputation for not engaging in questionable practices. If the natural evolution of the brokerage business provides some "honest firms," one must question whether there is adequate reason to employ people at the SEC merely to prevent some investors from using "dishonest" firms. The legal system might function more cheaply if the customers handled the occasional damages from internalization retrospectively through tort suits, rather than having a regulatory agency handle all such possible damages prospectively. Obviously agency suicide is unappealing to the SEC, but that distaste ought not concern the public, nor a public-spirited Congress.¹⁴⁴

A related problem associated with both internalization and fragmentation¹⁴⁵ is that "a number of the largest, best capitalized member firms could seize the opportunity to make regular two-sided over-the-counter markets in the most actively traded exchange-listed securities, withdrawing the major portion of their order flow from [the] exchanges."¹⁴⁶ How a firm could profit from making such massive inroads on the exchanges is unclear, but why the public should care if a firm could succeed in this fashion is even more unclear. The strategy would succeed only if the firm could offer the public a better deal through internal sources than other firms could offer over an exchange.

The SEC has further hypothesized that a firm might only execute customer's orders in relatively inactive stocks if the firm could line up a customer on the other side of the transaction in advance, and thereby

¹⁴³. These current price quotations are obtained simply by calling one's stockbroker and asking for the current bid and asked spread for the security in question. The stockbroker has an incentive to provide a competitive spread in order to maximize the probability of consummating a trade through which a commission can be earned.

¹⁴⁴. In implementing the national market system legislation, the SEC implicitly is taking the position that the optimal number of "dishonest" transactions in the securities market is zero, but it is not. Starting with the most blatant cases of abuse, an efficient legal system will try to ferret out dishonesty only as long as the cost of preventing the next abuse (the economist's term here is the marginal cost of prevention) is no greater than the expected damage that will be done to society by that abuse (the marginal benefit of prevention). The marginal cost in the SEC's scenario presumably includes substantial sums funneled through the SEC budget, although in a more efficient system the resources will likely be concentrated in private tort suits instead. Consequently, seeking optimal prevention of abuse, rather than total prevention, will admittedly reduce the influence of the SEC, but that is a legitimate concern only of SEC employees. The small amounts that the public would lose in the occasional abuses the SEC predicted, it would more than recoup in reduced expenditures on the regulatory bureaucracy.

¹⁴⁵. See supra text accompanying notes 125-34.

execute the deal on a risk free basis. Why a firm would be motivated to do this is unclear, however. There are only three possible ways for a brokerage firm to react to buyer requests. First, a firm might make a market in a particular security, rendering the SEC's concern unfounded, for the firm itself will handle any transactions involving that security. Second, a firm might not make a market in that security, but some other firm will. If so, the first firm will have no incentive to refuse the customer's order and commission, as all the risk is borne by the second firm, the market maker. Indeed, there is no evidence that firms currently refuse to broker one-sided business in securities presently handled by market makers over-the-counter. Finally, if the initial firm does refuse the business, nothing prevents the customer from going to another firm (presumably in a huff). If no firm makes a market in a certain security, customers still will have to go to the exchange specialist, but not because of SEC regulations. Rather, the exchanges will be natural monopolies in such securities.

Natural monopolies would invariably involve small, obscure (need we say unexciting) securities with markets too thin to attract market makers. Rather ironically, the present exchanges began operation with such securities; in colonial times all securities were thinly traded compared to modern securities. It is for these modern thinly traded securities that the exchanges still have a clear function to serve. Paradoxically, it is just such securities that the largest exchanges now refuse to list. If the exchanges are not listing thinly traded securities today, the fact that perhaps they may continue not to list such securities even if the SEC changes the rules merely trivializes the whole premise for the SEC's argument.

In sum, internalizing orders is actually a positive aspect of removing off-board trading restrictions. Such internalization reduces transaction costs, and thereby increases the efficiency of the market, so long as the trading records are made public. If internalization does not reduce costs, no firm competing with all the other firms in the market will be able to attract or keep clients while forcing on them an inefficient and costly policy of internalization.

3. Market Surveillance

Industry groups, particularly the exchanges, have vociferously argued that if the SEC removes off-board trading restrictions and large numbers of transactions move off the organized exchanges, such changes will diminish the SEC's ability to police the markets. The SEC pre-
ently has sophisticated "market monitoring techniques designed to identify instances of unusual trading activity" in exchange transactions. In essence, this means that the SEC has computers that record stock transactions. When a corporation makes an episodic announcement, such as a tender offer bid or a dramatic quarterly earnings report, the SEC tracks previous trading activity in the relevant stock in the hope of ferreting out insider trading.

The SEC claims that eliminating off-board trading restrictions will require it to develop transactional audit trail procedures sufficient to fulfill the SEC's monitoring responsibilities. Perhaps a complete answer to this concern is that the SEC has never claimed that it could not develop such procedures and, in fact, the SEC has argued on other occasions that "it is unclear that over-the-counter transactions are intrinsically more difficult to monitor than exchange transactions." Thus, stocks presently traded over-the-counter seemingly do not now pose market surveillance problems of greater magnitude than exchange-traded stocks. Even the small minority of exchange-listed stocks that the SEC does not currently subject to off-board trading restrictions, the so-called 19c-3 stocks, do not pose monitoring problems. The National Association of Securities Dealers, Inc. (NASD) has a Market Surveillance Department with computer facilities that monitor all transactions reported on the consolidated tape through the National Association of Securities Dealers Automated Quotations (NASDAQ) system. Under the NASD's bylaws, all transactions in securities executed "otherwise than on exchange" must be reported through the NASDAQ Transaction Reporting System. All off-board dealer transactions are subject to the NASD's Market Surveillance Department's regulatory monitoring program. Therefore, if such surveillance is even necessary, the SEC can look to the ample monitoring facilities already in place.

Finally, the plethora of private remedies under the securities laws provides a veritable army of potential plaintiffs to insure that firms will not cheat purchasers in off-exchange transactions. If a dishonest bro-

150. Id.
152. Securities Exchange Act Release No. 11,942.41, 41 Fed. Reg. 4507, 4512 (1976). The Association's current ability to amass information on the place, price, and time of off-exchange transactions is testimony to the fact that there is ample market surveillance for over-the-counter stocks. Moreover, this information is publicly available, for a price. See supra note 134.
153. See supra note 111.
155. Id.
156. The most well known private remedy is SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979).
ker should slip through the SEC surveillance, for example, the injured customer could, under the right circumstances, bring a rule 10b-5 fraud suit.\textsuperscript{157}

\textbf{D. Efficient Markets}

The real potential danger from both market fragmentation and internalization of order flow is that the securities markets might become less efficient because only a fraction of trading activity would be reported. The efficiency of a market for a particular stock refers to the speed at which the available information about that stock is incorporated into the price per share.\textsuperscript{158} In an efficient market, competition among market participants results in a price that is a close approximation of the actual value of the security.\textsuperscript{159}

Off-exchange and in-house transactions pose no threat to market efficiency, because the consolidated transaction reporting system would still publicize both types of activity, and these trades would still exert an appropriate influence on price levels in all markets.\textsuperscript{160} The SEC has full authority under section 15(c)(5) of the 1934 Act to prescribe rules necessary or appropriate "to remove impediments to and perfect the mechanism of a national market system."\textsuperscript{161} Accordingly, the Commission can impose whatever requirements it deems necessary to enhance the flow of information among trading centers and thereby alleviate all of the alleged dangers associated with removing barriers to competition.


Ironically, researchers have found that listing a stock on an organ-

\begin{footnotesize}
\begin{itemize}
\item Rule 10b-5 was promulgated under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) (1976). Rule 10b-5 forbids, in connection with the purchase or sale of any security, any person from making an untrue statement of a material fact or employing any device, scheme, or artifice to defraud, or engaging in any act that would operate as a fraud or deceit upon customers. 17 C.F.R. § 240.10b-5 (1979). Section 9(e) of the Securities Act of 1934 creates a private right of action against persons who engage in the manipulation of securities prices by creating the false appearance of trading activity. 15 U.S.C. § 78i(e) (1980). Section 18 of the Securities Act of 1934 creates a private cause of action against persons who "make or cause to be made" materially misleading statements or reports or other documents filed with the SEC. 15 U.S.C. § 78r(a) (1980).
\item 157. See, e.g., Wachovia Bank & Trust Co. v. National Student Mktg. Corp., 650 F.2d 342 (D.C. Cir. 1980) (granting an implied private right of action for damages under rule 10b-5, in a different context).
\item 159. Competition should lead to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events, which, as of now, the market expects to take place in the future. In other words, in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value. \textit{Id.} at 56.
\item 161. See supra text accompanying notes 28-30.
\end{itemize}
\end{footnotesize}
ized exchange may decrease the liquidity for that stock.\textsuperscript{162} This finding runs directly counter to the position of the exchanges' proponents, who see exchange listing as a goal which can be attained only by large, high net worth companies, the stock of which the proponents consider liquid.\textsuperscript{163} For example, exchange listing dictates that issuers meet stringent financial requirements as to number of shares outstanding, number of shareholders holding one hundred or more shares, and earning power in excess of a stated minimum.\textsuperscript{164}

A recent empirical study, using multiple regression and several different measures of liquidity, analyzed the relationship between liquidity and exchange listing\textsuperscript{165} for certain stocks listed between 1979 and 1982.\textsuperscript{166} The authors noted that because the management of the issuing company presumably made the decision to list only after analyzing the benefits and costs of listing, the decision apparently reflects the company's expectation that listing will increase stock liquidity while reducing the risk and cost of equity.\textsuperscript{167} But the study results suggested just the opposite result. The researchers did not find evidence that listing contributes to greater liquidity; moreover, the researchers also found that the multiple regression analysis suggested that listing reduces liquidity a substantial degree.\textsuperscript{168}

While these empirical results are somewhat counter-intuitive, over-the-counter trading has some obvious advantages over exchange trading—at least for certain stocks. As Judge Friendly has pointed out, a firm acting as market maker in the over-the-counter market "serves a highly desirable purpose in reducing . . . spreads . . . ."\textsuperscript{169} Commenta-

\textsuperscript{162} See infra notes 165-68 and accompanying text.
\textsuperscript{163} Letter from William Batten to the Editor, Wall St. J., June 18, 1982, at 28.
\textsuperscript{164} The NYSE has repeatedly raised its minimum numerical standards so that it now looks in general for 1 million publicly held shares; 2,000 holders (including beneficial holders of stock held in "street name") of 100 shares or more; demonstrated earning power under competitive conditions of $2.5 million before taxes during the latest year and $2 million during the preceding two years; and an aggregate market value of $8 million for the publicly held shares.
\textsuperscript{165} D. Fraser & J. Groth, Listing and the Liquidity of Bank Stocks (1983) (unpublished manuscript on file with the University of Illinois Law Review).
\textsuperscript{166} Id. at 1. The stocks in the study were commercial bank and commercial bank holding companies. The number of these stocks traded on organized exchanges has increased dramatically in recent years. Id.
\textsuperscript{167} Id.
\textsuperscript{168} Id. If the organized stock exchanges perform a valuable service to the marketplace by providing information about the quality of exchange listed stocks, evidence about liquidity, such as that compiled by Fraser and Groth, is not conclusive about the desirability of off-exchange trading. See supra text accompanying notes 166-67. If the New York Stock Exchange is providing a valuable certification service to consumers about the stocks it lists, then off-exchange trading permits non-member traders to "free ride" by trading in listed securities without paying for this certification service.
\textsuperscript{169} Chasins v. Smith Barney & Co., 438 F.2d 1167, 1176 (2d Cir. 1971) (Friendly, J., dissenting from denial of reconsideration en banc).

Similarly, since different market makers will have different perceptions of the market over time, price spreads will decrease through overlapping market quotations. For example, if trader $X$ quotes a market of $10$ bid, $11$ offered, and trader $Y$ quotes a market of $10-1/4$ bid, $11-1/4$ offered, the market spread falls from $1$ point (the difference between $10$ and $11$, or $10-1/4$ and $11-1/4$) to $3/4$ point (the difference between $10-1/4$ and $11$). And, if there are other market makers quoting markets, spreads may be reduced even further. Because there are an average of $7.4$ market makers\footnote{NASDAQ Securities Fact Book 91 (1983); see also Lee, Off the Boards: Why OTC is Favored Over NYSE, Barrons, Sept. 12, 1983, at 42, cols. 1 & 5.} for each over-the-counter stock, compared with the single exchange specialist, perhaps it should not be surprising that over-the-counter stocks are more liquid than exchange traded stocks.

A final advantage of over-the-counter trading over exchange trading concerns the relative infrequency of trading halts. This advantage arises because the over-the-counter market makers are free of regulation by any exchange. The exchanges, particularly the NYSE, frequently stop trading in exchange-listed stocks when bad news causes shareholders to flood the exchange with sell orders.\footnote{Id. See Lee, supra note 171, at 43, col. 1 (trading halts are not unusual).} Exchange members, who conduct most of the research and selling activity associated with exchange-listed stocks, are prohibited by off-board trading restrictions from making a market in these stocks during a trading halt. Accordingly, would-be buyers and sellers frequently have nowhere to turn during a halt.

A recent widely reported example concerned Warner Communications stock.\footnote{Id. See N.Y. Times, Oct. 12, 1983, at 73 (Magazine).} Warner Communications and its shareholders had expectations of high sales figures from the company's Atari division. When the company announced significantly lower sales figures than expected, the stock price plummeted one and three-quarters points in just eight minutes and then the NYSE stopped all trading. As one financial writer succinctly remarked, "[a] lot of people wanted to unload Warner stock... too bad for them."\footnote{See Lee, supra note 171, at 43, col. 1.} Only when a brokerage firm that did not belong to any exchange began making a market in Warner stock did trading in Warner resume.\footnote{Id.} The NYSE followed more than a day later.

But if firms do better in the over-the-counter market, one must ques-
tion why firms listed on the organized exchanges do not voluntarily delist. One answer is that exchange rules, with full SEC support, make it extraordinarily difficult for a listed company to delist voluntarily. The 1934 Act provides that upon application to the Commission by the issuer or an exchange, a “security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors . . . .”

The NYSE delisting guidelines, which an issuer must satisfy under section 12(d) of the 1934 Act before applying to the SEC for deregistration, provide that two-thirds of the issuer's shareholders must vote to delist, and no more than ten percent can oppose such delisting. Furthermore, the Commission sometimes requires a majority vote of the shareholders per capita. These requirements make it particularly difficult for those institutions with large stock holdings to obtain delisting. Also, even if institutional investors wish to delist a corporation in which they have large holdings, a minority of small shareholders can block the delisting.

Of course, organized stock exchanges may serve a useful purpose for thinly traded issues. Specialists who provide a continuous market for a stock receive access to the limit order book and certain other trading advantages in return. These specialists may provide liquidity for stocks for which there is little interest among market makers. The problem with this hypothetical example is that current exchange listing restrictions prohibit these thinly traded securities from enjoying the advantage of having an exchange specialist provide a continuous market. Some large companies are finding that “the over the counter market offers its clients . . . a better deal.” But large firms, which might benefit from having their stock traded over-the-counter, cannot readily get off the organized exchanges, while the small firms that might benefit from being

177. Most exchanges have a similar requirement. See L. Loss, supra note 75, at 493 n.8.
179. Shawmut Ass'n, 15 S.E.C. 1028, 1040 (1944), aff'd sub nom. Shawmut Ass'n v. SEC, 146 F.2d 791 (1st Cir. 1945), motion to modify terms of vote denied, 19 S.E.C. 719 (1945) (per capita voting requirements imposed for issuer who wanted to delist from the Boston Stock Exchange, which did not have its own voting requirements).
180. Delisting may occur if a corporation is insolvent, or goes private, or fails to meet specific criteria established by the N.Y.S.E. See 2 Constitution and Rules, N.Y.S.E. GUIDE (CCH) ¶ 2499.20 (1983).

In Intercontinental Indus., 44 S.E.C. 273 (1970), [CCH] Sec. 77,827 (1969), the court granted an application for delisting from a securities exchange because the issuer violated its listing agreement by providing false information about company operations, rules, and earnings. Section B4 of the N.Y.S.E. Manual notes the required fees that listed companies must pay to the Exchange. Presumably, a violation of this fee agreement might also result in involuntary delisting. But see supra note 10 (observing that violation of Exchange listing rules may not result in delisting where the NYSE would be harmed by such delisting).
181. See supra text accompanying note 147.
182. See Lee, supra note 171, at 42.
183. Id. at 42, col. 3.
traded on the organized exchanges, cannot obtain exchange listing. Once the SEC withdraws obstacles to delisting, exchanges may be forced to turn their attention to smaller issuers as the larger companies delist in favor of the over-the-counter market. If so, the exchanges will have an incentive to revise their listing standards to attract these smaller issuers.

**F. The Rule 19c-3 Stocks**

When the SEC withdrew rule 19c-2, it simultaneously adopted rule 19c-3 and announced that it planned to do nothing more towards repealing off-board trading restrictions "in the near future." Rule 19c-3 prohibits off-board trading restrictions for two types of stocks. First, it prohibits restrictions on stocks that the exchanges listed for trading as of April 26, 1979, but delisted at some future date. Second, it prohibits restrictions on stocks that became listed on an exchange after that date. Thus, the term 19c-3 stock refers to those stocks for which off-board trading restrictions do not apply because they were delisted, or became listed for the first time, after April 26, 1979.

Significantly, the Commission supported the adoption of the more limited rule 19c-3 with the comment that the rule does not "involve the potential for the kind of dramatic and radical effects on the existing exchange markets which have been predicted with regard to total repeal of the off-board trading rules." Interestingly, this remark refers only to the rule's effects on existing exchange markets, not to the rule's effect on the general public or on potential competitors of the existing exchanges. The SEC has never explained why the "dangers" of fragmentation and overreaching are less for these rule 19c-3 stocks. If such dangers did exist for stocks listed on an exchange as of April 26, 1979, why should the dangers magically disappear upon delisting? Moreover, why should such dangers not exist for newly listed stocks? The most plausible explanation is that the SEC's political opportunity cost of protecting the exchange cartel simply became too high. The SEC realized it had to buy off the more vocal of the opposition, the large national brokerage firms who wanted to make markets, and rule 19c-3 seems to have worked—at least for the moment.

188. Cf. Jarrell, supra note 1, at 281.
1. Rule 19c-3 and the Economics of Regulation

The April 26, 1979, line of demarcation for rule 19c-3 stocks is both peculiar and arbitrary. The administrative process by which the rule evolved is a telling commentary on the SEC's "capture" by members of the organized exchanges. In 1977, the American Stock Exchange (Amex) asked the SEC's permission to make a variety of foreign companies eligible for listing on that exchange.\(^{189}\) The SEC recognized that listing these companies would subject the stocks to the Amex's off-board trading restrictions.\(^{190}\) Nonetheless, the SEC approved the Amex's request.\(^{191}\) The extension of off-board trading rules to these previously unlisted stocks meant that exchange members who were acting as market makers in the stocks had to cease such market making activity or else resign from exchange membership.\(^{192}\) These market makers "objected strenuously and publicly" to the Commission's decision.\(^{193}\) Only when the SEC saw that some of the exchange's own members—the major trading firms—opposed extension of off-board trading restrictions, did the SEC propose the limited liberalization of competitive restraint that rule 19c-3 represents.\(^{194}\) Thus, rule 19c-3 represents a political compromise between those exchange members manning the specialist posts and the national market-making firms, with the SEC acting as a kind of moderator standing between these special interests. Noticeably, this compromise between the two powerful special interest groups ignores the rest of the public.

It is helpful at this point to look more closely at how the major trading firms caught the SEC's attention and forced this modification of off-board trading restrictions. The losses to these firms from the listing of the foreign stocks was immediate and calculable, and the firms placed considerable pressure on the SEC to change its mind. The firms made the SEC understand that the SEC's political opportunity cost of the incremental resources expended in enforcing the anticompetitive regulation outweighed the net political support that the SEC could obtain by enforcing the off-board restrictions.\(^{195}\) The SEC's resulting behavior is con-

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\(^{192}\) Apparently, the profitability of exchange membership is greater than the profitability of over the counter market-making activity, because the exchange members usually cease market-making activity, rather than withdrawing from the Exchange. With the off-board trading rules, resignation from exchange membership would be a viable alternative for most firms only if a sufficient number of other members resigned simultaneously to permit such a firm to have access to a suitable number of trading partners.


\(^{194}\) See Poser, supra note 26, at 937 ("once the Commission found that the stock exchange community did not fully support the off-board trading rules, it . . . proposed Rule 19c-3").

\(^{195}\) This analysis is consistent with the theory of deregulating the New York Stock Exchange that Jarrell applied to eliminating fixed rate commissions. See Jarrell, supra note 1, at 281.
sistent with what one would expect of a political support maximizing regulator.

Apparently, however, the major trading firms' potential gains from trading in exchange listed securities is more speculative, or the interests of the specialist firms more entrenched, than was the case with the rule 19c-3 stocks. The net political pressure for complete elimination of off-board trading restrictions brought to bear on the SEC is correspondingly less. Thus, one can expect the SEC to abandon the remaining off-board trading restrictions only if and when the potential gains to these trading firms from removing the restrictions becomes more certain. This abandonment may occur when the major trading firms gain experience and scale in market making, or alternatively, when the economic rents to the exchange diminish, thus reducing the net political demand for these off-board trading restrictions.196 Only when one of these conditions occurs can one expect the SEC to move to a new regulatory equilibrium.

2. The Fate of the Rule 19c-3 Stocks

During the first year in which rule 19c-3 stocks could be traded, only 83 of the 167 rule 19c-3 common stocks were traded outside of an organized exchange.197 The remaining 84 issues were traded exclusively on organized exchanges.198 Moreover, only 15 issues had 10% or more of their trades consummated outside of an exchange.199 In sum, the first year of over-the-counter trading in rule 19c-3 stocks was "very limited."200 The market's lackadaisical reaction to the relaxation of off-board trading restrictions for rule 19c-3 stocks does not imply, however, that rule 19c-3 is ineffective. The problems with the rule are that the analysis of it has been too superficial and that the sample of stocks to which it applies is too small.

Of far more importance than considering where the securities transactions take place is considering under what conditions they take place. Assuming equivalent transaction costs, a trader should have no preference for consummating a trade either on or off an exchange. Moreover, most of the rule 19c-3 stocks are relatively minor issues, not the sort apt to attract a lot of market makers even with total deregulation of the industry. What is relevant is the increased potential for competition created by rule 19c-3. If the potential for competition from outside markets

196. In the case of fixed-rate commissions, the net political demand by the Exchange for regulatory protection declined as institutions turned away from the Exchange to consummate trades. Off-board trading restrictions appear to offer the exchanges stronger advantages in holding trading activity than the fixed-rate commissions.
198. Id.
199. Id.
keeps traders’ transactions costs low even though trades are concentrated on the market, rule 19c-3 has had its intended effect. In brief, the same sort of potential competition that keeps the prices of Harold Demsetz’s natural monopoly utility companies\textsuperscript{201} in line is capable of disciplining securities exchanges as well—if the SEC does not fetter the potential competition—even though there may be natural monopoly aspects to exchange dealing when the market for a particular security is thin.\textsuperscript{202} Therefore, the SEC’s figures on where particular trades occur provide little evidence of rule 19c-3’s effectiveness.

However, exchange specialists may retain certain advantages that discourage entry. First, only exchange specialists have access to the limit order books that give the specialists a tremendous trading advantage over any nonspecialist market makers.\textsuperscript{203} Second, as long as specialists receive large flows of orders, they can serve as market participants almost without making a market in a stock, merely by standing at their posts and putting orders together. To be a market maker, on the other hand, a trader must be able to serve as a participant who stands ready to execute orders promptly.\textsuperscript{204} This difference is a distinct disadvantage; only the specialists get market information free—while other traders must run risks to obtain similar information.

Interestingly, while securities traded exclusively over-the-counter have an average of 8.2 market makers, 68% of the rule 19c-3 stocks have no market makers at all.\textsuperscript{205} There is an equilibrium number of market makers for any given stock, just as there is an equilibrium number of competing firms in any other industry. Demand and the nature of the production function determine this number in conjunction with such other factors as relative prices and licensing restrictions. For example, large, actively-traded corporation stock, such as International Business Machines (IBM) and Exxon, both of which consistently rank among the exchanges’ most active stocks, might well attract a multitude of market makers.\textsuperscript{206} Most rule 19c-3 stocks, however, do not have any of the characteristics that support a large number of market makers. In 1981, the NYSE listed 1534 common stocks.\textsuperscript{207} Not a single rule 19c-3 security appears among the NYSE’s 200 most actively traded stocks. Although most rule 19c-3 stocks are at the very bottom of the heap in reported share volume, those few rule 19c-3 stocks that are more actively traded have attracted a number of market makers. MCI, for example, is an

\begin{thebibliography}{10}
\bibitem{202} See supra text accompanying note 147. \textit{See also infra} text accompanying notes 231-35.
\bibitem{203} See Demsetz, supra note 52, at 33.
\bibitem{204} See Poser, supra note 26, at 895.
\bibitem{205} See supra note 171. Of the 167 original 19c-3 stocks, 113 had no market makers at all. \textit{See Effects of 19c-3}, supra note 197, at 10.
\bibitem{206} Larger corporations that are traded over-the-counter have significant numbers of market makers. \textit{Newsweek}, Oct. 3, 1983, at 79. The average number of market makers for over-the-counter firms is eight, and one firm, MCI Communications has 29. \textit{Lee}, supra note 171, at 42.
\bibitem{207} \textit{New York Stock Exchange Fact Book} 70 (1982).
\end{thebibliography}
actively traded rule 19c-3 stock and it boasts twenty-nine market makers.\textsuperscript{208}

3. \textit{Rule 19c-3 Stocks and the AT&T Experience}

An important test of the specialist's ability to retain a dominant status in an open marketplace came from the split up of the American Telephone and Telegraph Company (AT&T) into eight new firms. The company that is legally considered to be the successor firm of the original AT&T, which is still called AT&T, continues to operate interregional long-distance facilities, among other things, but is not covered by rule 19c-3.\textsuperscript{209} The other seven splitoffs are rule 19c-3 stocks. The seven companies are American Information Technology (Ameritech), which in addition to being a regional operating company received most of the research and development functions of the original AT&T, and the other six regional operating companies.\textsuperscript{210} The trading in stocks of these latter seven companies, at least in the initial stages, indicates how over-the-counter market makers fare against exchange specialists for relatively high volume securities.

We have examined the securities transactions involving the shares of common stock of the seven AT&T derivative companies that have rule 19c-3 status. Our examination covered the month of February 1984, the first full month of spot trading for those securities.\textsuperscript{211} From the data, one cannot ascertain the exact number of over-the-counter market makers for each stock. Clearly, however, there were several market makers for the stocks of each of the seven rule 19c-3 splitoffs because shares of each company traded over-the-counter on every trading day during February.\textsuperscript{212} Shares of each of the seven also traded during February on five organized regional exchanges—Boston, Cincinnati, Midwest (Chicago), Pacific (San Francisco), and Philadelphia.\textsuperscript{213}

Table 1 gives a detailed summary of the findings. Only one percent of the transactions involving the new AT&T stock, which does not have rule 19c-3 status, occurred over-the-counter. Because of off-board trad-

\begin{itemize}
\item \textsuperscript{208} NASDAQ SECURITIES FACT BOOK 6 (1983).
\item \textsuperscript{209} \textit{See supra} text following note 185 (explaining the contours of rule 19c-3 status).
\item \textsuperscript{210} The regional companies in addition to Ameritech are: Bell Atlantic, BellSouth, NYNEX, PacTel Group, Southwestern Bell, and US WEST.
\item \textsuperscript{211} \textit{See Fitch Research, supra} note 134.
\item \textsuperscript{212} \textit{Id.}
\item \textsuperscript{213} If we multiply the seven distinct kinds of splitoff common stock times the 20 trading days in February 1984, we find 140 "trading opportunities" during the month. Cincinnati seized just over half the trading opportunities, 79 (56%), and the daily volumes were usually small. Philadelphia exercised 123 of its 140 opportunities (88%), while Boston (138), the Midwest (139), and the Pacific (139) traded at nearly every opportunity, \textit{i.e.}, every splitoff traded on those exchanges on virtually every day the exchange was open. The volume figures are roughly parallel; the Midwest was the highest volume regional exchange for each of the securities over the month (but not every day of the month), and usually by a wide margin. For all seven splitoffs, Cincinnati handled the smallest volume, again usually by a substantial margin. Boston, Pacific, and Philadelphia fell between in no permanent order.
\end{itemize}
### TABLE 1
February, 1984 Trading Activity (in thousands of shares)

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Status</th>
<th>NYSE</th>
<th>Total Regional</th>
<th>Total Over-the-counter</th>
</tr>
</thead>
<tbody>
<tr>
<td>A T &amp; T</td>
<td>non-19c-3</td>
<td>32,058</td>
<td>7,057</td>
<td>393</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(81.1%)</td>
<td>(17.9%)</td>
<td>(1.0%)</td>
</tr>
<tr>
<td>Ameritech</td>
<td>19c-3</td>
<td>4,032</td>
<td>392</td>
<td>307</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(85.2%)</td>
<td>(8.3%)</td>
<td>(6.5%)</td>
</tr>
<tr>
<td>Bell Atlantic</td>
<td>19c-3</td>
<td>4,510</td>
<td>411</td>
<td>319</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(86.1%)</td>
<td>(7.9%)</td>
<td>(6.1%)</td>
</tr>
<tr>
<td>BellSouth</td>
<td>19c-3</td>
<td>4,777</td>
<td>398</td>
<td>363</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(86.3%)</td>
<td>(7.2%)</td>
<td>(6.6%)</td>
</tr>
<tr>
<td>NYNEX</td>
<td>19c-3</td>
<td>3,863</td>
<td>485</td>
<td>615</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(77.9%)</td>
<td>(9.8%)</td>
<td>(12.4%)</td>
</tr>
<tr>
<td>PacTel Group</td>
<td>19c-3</td>
<td>6,067</td>
<td>471</td>
<td>544</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(85.7%)</td>
<td>(6.7%)</td>
<td>(7.7%)</td>
</tr>
<tr>
<td>Southwestern Bell</td>
<td>19c-3</td>
<td>4,298</td>
<td>591</td>
<td>573</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(78.7%)</td>
<td>(10.8%)</td>
<td>(10.5%)</td>
</tr>
<tr>
<td>US WEST</td>
<td>19c-3</td>
<td>6,464</td>
<td>377</td>
<td>360</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(89.8%)</td>
<td>(5.2%)</td>
<td>(5.0%)</td>
</tr>
<tr>
<td>TOTAL 19c-3</td>
<td></td>
<td>34,012</td>
<td>3,124</td>
<td>3,080</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(84.6%)</td>
<td>(7.8%)</td>
<td>(7.7%)</td>
</tr>
</tbody>
</table>

ing restrictions, this one percent must represent direct swaps by institutional investors, or trades using brokerage houses that are not members of any exchange. In contrast, for the seven splitoffs, nearly eight percent of the shares went over-the-counter, roughly the same number as went through the regional exchanges. The lowest percentage of over-the-counter shares was five percent for US WEST, but that was roughly equal to the percent of US WEST shares transacted through regional exchanges. 214

Our firm-by-firm daily breakdown reveals that on eight of twenty trading days, more Ameritech shares went over-the-counter than through all regional exchanges combined. Similar statistics for the other splitoffs are nine of twenty trading days for US WEST, ten of twenty for NYNEX, eleven of twenty for Bell Atlantic and BellSouth, and twelve of twenty for PacTel Group and Southwestern Bell. On only six days out of twenty did any single regional exchange handle as many shares of Ameritech as went over-the-counter. A single regional exchange surpassed over-the-counter activity on only five days for Bell Atlantic, NYNEX,

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214. If it is proper to use the surviving corporation as a baseline, then one must conclude that the over-the-counter inroads by volume came entirely at the expense of the regional exchanges. The NYSE actually handles a slightly higher percentage of transactions for the 19c-3 splitoffs than for the surviving corporation. This interesting observation may motivate an entire study to more clearly define the diversity of interests across brokerage houses, but that lies beyond the scope of this article. Notice, however, that an increase in volume percentage for the NYSE does not imply an improvement in commissions earned on the NYSE. The bid-ask spread should be expected to fall as the number of market-making competitors for the NYSE specialist increases.
PacTel Group, and Southwestern Bell, for three days for BellSouth, and for only two of the twenty trading days for US WEST. 215

The data implies that the market for shares of the splitoffs is large enough to support several over-the-counter market makers. After all, the five regional exchanges that handle these securities support five specialists, for a volume of transactions similar to the volume handled over-the-counter. 216 Thus, if the national market system fails, it clearly is not because the market has already reached its most efficient configuration. 217 Because legally-sanctioned entry barriers are less extreme for over-the-counter market makers than regional specialists, the AT&T breakup data is consistent with the notion that these market makers, and not the regional markets, are the most potent competitors of the NYSE specialist for handling the shares of these major rule 19c-3 securities. This potential for increased competition explains the continued strong demand from the exchanges for the SEC to protect against over-the-counter market makers. This demand, and not market forces, is impeding the development of a national market system.

The problem with drawing conclusions, as the SEC attempts to do, from the trading patterns of the limited number of rule 19c-3 securities, is that expecting active trading in all stocks to take place under all circumstances is simply unrealistic. A more valuable test of the effect of free entry by market makers would be to remove off-board trading restrictions for some of the exchange's most active stocks, on a temporary basis, to see how trading patterns in these issues develop. The AT&T splitoffs provide the most useful sample to date, but the SEC might reasonably augment the sample by asking other candidates to apply for a status similar to rule 19c-3.

The data seems inconsistent with the SEC contention that ineffective communication between the exchanges and the over-the-counter markets accounts for the failure of rule 19c-3. 218 The SEC's explanation goes something like this: imagine that a client asks a broker to buy 500 shares of XYZ stock at the best price obtainable. The broker informs the firm's

215. This information is on file with the University of Illinois Law Review.

We undertook a more detailed study of trading the shares of one randomly selected splitoff, NYNEX. From that study, if one conceptualizes a unitary over-the-counter "exchange," that exchange ranked first on 15 days, second on 4, and third on 1. The Midwest ranked first on four days, the Pacific ranked first on one day, and was second the day the over-the-counter market was third. Invariably, the days that the regional exchange supplanted the over-the-counter "exchange" were characterized by large block transactions on the regional exchange. Indeed, in several instances more than half the volume handled by the regional arose from a single transaction. Fitch Research, supra note 134.

216. For NYNEX, an average 30,425 shares per day traded over-the-counter compared to an average for the combined regional exchanges of 24,535—roughly 81% of the over-the-counter volume. At the other extreme, 15,930 shares per day of Bell Atlantic went over-the-counter while the combined regionals handled 20,560, or 129% of the over-the-counter volume. Even here the largest regional, the Midwest, with 11,320 shares per day, had only 71% of the over-the-counter volume. Id.

217. See supra text accompanying note 31.

trading department of this order, and the department checks its computer screen for price listings in XYZ stock. The exchange specialist is offering XYZ stock at $11.00, but an over-the-counter market maker is offering it at $10.50. Upon checking with the market maker, however, the trader finds that the market maker has simply not bothered to change the price on the computer screen for some time, and is now quoting an offering price of $11.50 because the market has been moving up all morning. So, the trader calls the exchange specialist back only to find that the specialist has made several sales at $11.00 and is now selling at $12.00. By trying to get the best price, the trader now must pay $1.00 more than if he had simply taken the specialist's order in the first place.

The SEC and the stock exchanges both point to this hypothesized phenomenon as a reason why the exchanges are indispensable. But if such a phenomenon does occur, then brokers will stop canvassing the supposedly unreliable market makers, and the exchanges will remain dominant with or without the SEC's regulation. Thus, any resources spent on the SEC are redundant, and hence wasted. Moreover, even under the SEC scenario, the problem, best described as an execution problem, is short term in duration, and will exist in any system until the industry "shakes down" and the appropriate firms ultimately emerge as market makers. This is exactly what has happened in the airline industry following deregulation. Finally, the SEC is perfectly capable of insisting that market makers stand behind their quotes. Better yet, Congress could give disappointed investors private tort protection against such carelessness without the need for any SEC action.

Thus far, the SEC's efforts to insure that market makers stand behind their published bids and offerings, which began as early as July 1976, have been unsuccessful. A rule known as the "quote rule" required market makers to execute any order at a price as good as or better than the advertised price, in any round lot amount up to the published size of the quotation. The SEC adopted the quote rule in 1978, but only after it had amended the rule sufficiently to make it virtually useless. Instead of displaying an individual market maker's quotations, the system only displayed a single quotation supplied by each exchange. Such a system, of course, prevented direct contact with the market maker, and made it impossible to identify the party obligated to meet the system price. A purchaser or seller still had to go through the specialist on the exchange, because the investor had no other means of discovering who

222. Id. at 32,858.
was making the bids and offerings. The quote rule proved a dismal failure. Market makers frequently would not honor the published quotations upon which the investor was relying, because there was a time lag as the orders went through the specialist on the floor of the exchange. Consequently, before the investor could indirectly contact the market maker, the market maker often had altered the quote.

The expectation of success would have increased had the SEC both permitted individual firms as well as exchange specialists to quote bids and offerings directly on the system on a voluntary basis, and required the firms who used the system to honor their quotations. Currently, the SEC only requires that already completed transactions be reported on a consolidated tape system. This requirement is of limited value.

Critics might suggest that requiring firms to honor the price that they quote on the system would discourage the firms from becoming market makers. But the firms can change the bids and offering prices instantaneously or delete them altogether. The market makers can also select maximum volume limits to increase their protection. The only cost to the market maker consists of monitoring the screen, probably by computer software rather than manually, and updating the information. If this cost to a firm is greater than the benefits of acting as a market maker, the firm will simply choose not to act as a market maker. In fact, even without a specific rule, the practice in several markets—the United States Government Securities Market, the Municipal Bond Market, and the Foreign Exchange Markets—is identical to the rule posited above. Respectable firms in these markets stick to their bid and offered prices. Even in the municipal bond market, which does not use a computerized system, and where traders communicate all bids and offerings orally, firms are willing to stick by their prices until they give notice of changes.

G. Rent Seeking On the Exchange: The Exchange Specialist’s Role Defined

Although already mentioned several times, the role of the exchange specialist deserves special attention because the specialist is the direct beneficiary of the protection afforded by the SEC enforcement of ex-

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225. This simply means that if a firm is displaying a bid of $11.00 and refuses to honor its bid, so that a seller must sell elsewhere at $10.75, the firm displaying the bid is responsible for honoring its displayed quotation by paying 25¢ per share to its erstwhile customer.
226. The consolidated tape system was not part of the SEC’s planned implementation of the national market system legislation. The SEC proposed such a system, which allows disclosure of the volume and price of trades soon after consummation, in 1972. Securities Exchange Act Release No. 9530, 37 Fed. Reg. 5761 (1972) (proposing rule 17a-15). This system merely expanded to the regional exchanges and the over-the-counter market the “ticker tapes” that the NYSE has used since the late nineteenth century. Special Study, supra note 56, at 43. The consolidated tape has proved of limited value since the tape does not provide any “indication of present trading interests.” Poser, supra note 26, at 918.
change rules. The specialist system is the heart of the traditional stock
exchange, and the founders designed it to serve two functions. First,
the specialist provides a mechanism for handling limit orders—sell or­
ders above or buy orders below the current market price. Second, the
specialist should provide continuity and liquidity in the market and re­
duce random price fluctuations.

The specialist system actually handles the first function quite poorly.
Suppose, for example, a security is trading at $40-1/2 bid, $41-1/2 of­
fered, and a customer places an order to sell if the market moves to
$42.00 bid. Presently, the specialist enters this information in his book
and no one else knows the market's interest for this security. Suppose
further that there are many sell orders at the $42.00 level, but few limit
buy orders above $35.00. The specialist will know that a purchase of the
stock at the current $41-1/2 price would be foolish, since the stock price
not only has little chance of rising above $42.00 when all of the limit
orders to sell are activated, but also has a real chance of dropping several
dollars per share. Furthermore, other potential market makers know
that the specialist is privy to such valuable market information, and thus
are impeded from entering the arena; there is no “level playing-field.”

Other factors also give the specialist an advantage over other poten­
tial traders. For instance, the specialist decides the price at which the
stock opens on each trading day, determines whether the stock should
be traded at all, and holds a monopoly position as sole trader for “her”
or “his” security on the exchange floor. None of these specialist func­
tions are essential in a computerized market, and in fact the functions
actually seem undesirable. A fully computerized market could operate
non-stop around the clock, so that the opening price would be a moot
question. The specialist’s monopoly position would disappear if a variety
of market makers were permitted to trade the security. Limit orders
could be handled by individual market makers, subject to the applicable
principles of disclosure, or by a consolidated computerized limit order
book.

Furthermore, even the actual services that the specialist performs
are often less valuable than they immediately appear. For example,
agency principles mandate that stockbrokers obtain the best price possi­
ble when consummating securities transactions on a customer's behalf.
Most orders are “at the market” rather than limit orders, but the same
agency principles apply to both kinds of orders. When a customer places

228. See R. Jennings & H. Marsh, supra note 21, at 490.
229. Id. Because specialists reduce the attractiveness of the security to other potential market
makers, whether specialists enhance continuity and liquidity in the marketplace is unclear.
230. Id. at 490.
231. See Note, The Downstairs Insider: The Specialist and Rule 10b-5, 42 N.Y.U. L. REV. 695,
697 (1976).
232. Id. See also Special Study, supra note 56, at 57.
233. See Restatement (Second) of Agency § 424 (1958).
an order with an exchange specialist, however, the customer is "protected" only in that market. The customer is assured that the specialist will execute the limit order when the stock reaches the specified price, before the specialist makes any transactions at a more favorable price, but this protection does not extend beyond the market where the customer's order is held. For example, if the current market for a stock that is listed on the Cincinnati exchange is $10 bid, $11 offered, and a customer places an order to sell when the stock reaches $12, transactions may still take place at the $12 level or even higher in other markets without triggering the customer's limit order. In the event that the customer placed the order with a stockbroker affiliated with a brokerage house that belongs to the Cincinnati Stock Exchange, that exchange's off-board trading rule will sometimes prohibit the broker from consummating the trade at the best possible price because of the restriction on in-house agency crosses. The exchange rules do not allow a broker to legally cross a buyer's limit order on one market with a seller's limit order on another market.

VI. CONCLUSION

What the SEC needs to do, then, is to promulgate rules that relax restrictions against off-board trading, so that there is only one market—a national market—rather than a number of "independent" markets competing against each other. This is the necessary first step, and once the SEC takes it, market forces will take care of the next step—developing the necessary reporting and communication systems to guarantee the success of a truly competitive, truly national market system for securities. If the established exchanges do provide a needed service at a competitive price, they will survive; if they do not, more efficient alternatives will replace them.

Presently, there is no national market system in this country, and indeed there is little promise of one in the near future, despite Congress's clear directive. The SEC has chosen to disregard Congress and instead support inefficient rules that grant favors to special interests, such as the exchange specialists, and to the exchanges themselves. The mere existence of these rules will continue to impede progress toward developing a workable national market system, and for no socially beneficial reason. Rather, the SEC is acting to protect entrenched institutions. The SEC has done virtually nothing besides talk about the need to develop more advanced intermarket communications systems. Congress anticipated that removal of SEC restrictions on trading would cause the appropriate

234. Harman, The Evolution of the National Market System, 33 BUS. LAW 2275, 2286 (1978) (although a limit order is protected in the market where it is placed, transactions may take place elsewhere at a more favorable price). Our own argument about arbitrageurs, see supra text following note 134, implies this is unlikely to be a serious problem in practice, however. Prices across exchanges were identical at any moment for the seven AT&T spinoffs.
communications systems to develop through market forces, leading inexorably to a healthy national market system with the concomitant benefits of lower transactions costs and increased liquidity. Unless the SEC shows a change of direction, however, it will not soon give the participants in the American securities markets the type of national market system Congress envisions.