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STOCK EXCHANGES AT THE CROSSROADS: COMPETITIVE CHALLENGES - REORGANIZATION - REGULATORY CONCERNS

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STOCK EXCHANGES AT THE CROSSROADS

COMPETITIVE CHALLENGES—REORGANIZATION—REGULATORY CONCERNS

Andreas M. Fleckner[*]

ABSTRACT

The world of stock exchanges—the very heart of our economy—is at a crossroads. Traditionally, stock exchanges were owned and managed solely by their traders. But with competition from other marketplaces getting stronger and stronger, stock exchanges are compelled to forgo their exclusivity and restructure as publicly traded corporations, a process referred to as *demutualization*. In the future, everyone will be able to own a piece of a stock exchange: Shares of stock exchanges will be traded on stock exchanges, like shares of any public company. But stock exchanges will remain unique insofar as they are vested with a public mandate to oversee the securities markets. Demutualization, listing, and self-listing of stock exchanges challenge this concept of self-regulation.

The article discusses the regulatory framework for stock exchanges, identifies the compelling reasons for their transformation into publicly traded companies, and addresses regulatory concerns raised by this reorganization. Based on this analysis, the article proposes amendments to the current regime that would mitigate and overcome the new structure's negative consequences without reducing its positive ones.

Keywords: *stock exchange; self-regulatory organization (SRO); regulatory powers; self-regulation; competition among marketplaces; demutualization; conflicts of interest; self-listing; non-profit and for-profit organizations; member regulation; market surveillance; listing requirements; going public*.

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STOCK EXCHANGES AT THE CROSSROADS

COMPETITIVE CHALLENGES—REORGANIZATION—REGULATORY CONCERNS

I. INTRODUCTION

Nemo iudex in sua causa—No one shall judge his own cause. Ancient Rome adhered to this principle,[1] the greatest writers emphasized it,[2] and the Founding Fathers contemplated it in the early days of the republic: *No man is allowed to be a judge in his own cause; because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity*.[3]

We might add to this well-known principle another idea: No one shall judge a *competitor's* cause. The reasoning is similar: If one passes judgment on a competitor, it will affect her own position in the competition and therefore bias her judgment.

When it comes to the future organization of our stock exchanges—the very heart of our economy—the application of both principles becomes complicated. As it turns out, we might very soon witness stock exchanges, empowered by Congress as judges over the securities markets, that are in a position to judge both their own causes and competitors'.

With increased competition caused by deregulation, technological advances, and globalization, the organization of stock exchanges is at a crossroads. Traditionally, stock exchanges were organized as not-for-profit organizations, founded and owned by brokers and dealers, who managed "their" stock exchange like an exclusive club, with high barriers for new entrants and a regional or even national monopoly. Today, domestic and international competition increasingly compel stock exchanges to give up their exclusivity, undergo restructuring, and become publicly traded for-profit companies, a process referred to as *demutualization*.[4] At first glance, it might seem incestuous that stock exchanges themselves issue stock. But in fact this development brings a kind of normalization: The public corporation—the most efficient organizational form for large enterprises—will help stock exchanges catch up with domestic and international competitors.

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[1] *See, e.g.*, LUCIUS A. SENECA, DE BENEFICIIS, 2,26,2 ("nemo non benignus est sui iudex"). *See also* CODEX IUSTINIANUS 2.2.1 ("nullus in sua causa iudex sit") and 3.5 ("ne quis in sua causa iudicet vel sibi ius dicat"); IMPERATORIS THEODOSII CODEX, CTh.2.2.0. ("ne in sua causa quis iudicet"); DIG.5.1.17 ULPIANUS 22 ("iniquum est aliquem suae rei iudicem fieri").

[2] *See, e.g.*, JOHANN W. VON GOETHE, IPHIGENIE AUF TAURIS, IV,4 ("auch wir sind nicht bestellt, uns selbst zu richten"). The principle has also been referred to in famous legal works, *see*, *e.g.*, LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY—AND HOW THE BANKERS USE IT 23 (1914) ("The weakness of human nature prevents men from being good judges of their own deservings.").

[3] FEDERALIST NO. 10 (by James Madison).

[4] The process has sometimes been referred to as "companization." *See* RUBEN LEE, WHAT IS AN EXCHANGE? 35/36 (1998) [hereinafter: EXCHANGE]; Ruben Lee, *The Future of Securities Exchanges*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 1, 18 (2002) [hereinafter: *Future of Securities Exchanges*]. In recent years, however, demutualization has become the standard term.

Nonetheless, Congress and the Securities and Exchange Commission (hereinafter: SEC or Commission) should not be indifferent toward this transformation. The prospect of bringing stock exchanges public challenges the traditional regulatory system. Well aware of the problems that come with demutualization, the SEC has put forward amendments to adjust the regulatory regime to the new organizational reality.[5] In developing these proposals, the Commission could draw on previous studies by the General Accounting Office,[6] the International Organization of Securities Commissions (IOSCO),[7] the World Bank[8], and the Asian Development Bank.[9] Wisely, however, the Commission so far has moved slowly in enacting the rules, allowing more time for thorough consideration.

Unlike earlier contributions, which merely described the global development of demutualization and its implications without going into regulatory details,[10] this article focuses on the organizational change and its challenges, particularly the conflicts of interest that arise when stock exchanges regulate themselves and their competitors. The article is structured as follows:

Part II gives an overview of the stock exchanges' function and organization. Exchanges are complicated and sophisticated institutions, not only organizing stock mar-

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[5] SEC, Release No. 34-50699 (File No. S7-39-04): *Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization* (November 18, 2004), 69 Fed. Reg. 71,126 (2004) [hereinafter: *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*]. The comment period was later extended by six weeks. *See* Release No. 34-51019 (File No. S7-39-04): *Fair Administration and Governance of Self-Regulatory Organizations;* … [same as previous] (January 11, 2005), 70 Fed. Reg. 2,829 (2005).

[6] UNITED STATES GENERAL ACCOUNTING OFFICE, SECURITIES MARKETS—COMPETITION AND MULTIPLE REGULATORS HEIGHTEN CONCERNS ABOUT SELF-REGULATION (GAO-02-362; May 2002).

[7] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, ISSUES PAPER ON EXCHANGE DEMUTUALIZATION (June 2001) [hereinafter: IOSCO ON EXCHANGE DEMUTUALIZATION]. *See also* INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, DISCUSSION PAPER ON STOCK EXCHANGE DEMUTUALIZATION (December 2000).

[8] John W. Carson, *Conflicts of Interests in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them*? (World Bank Policy Research Working Paper No. 3183, December 2003; available at http://ssrn.com/abstract=636602) (although the article does, pursuant to the disclaimer made at its beginning, not necessarily represent the World Bank's view, the article itself expressly says what the "Bank believes," *see, e.g., id.* at 1; in order to reveal the connection to the World Bank, the paper will hereinafter be cited as: Carson, *World Bank Paper*).

[9] DEMUTUALIZATION OF STOCK EXCHANGES—PROBLEMS, SOLUTIONS AND CASE STUDIES (ed. Shamshad Akhtar) (2002) (the most comprehensive work on demutualization, with contributions by eleven authors).

[10] *See particularly* Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 J. OF APPLIED CORP. FIN. 105 (2002); Caroline M. Bradley, *Demutualization of Financial Exchanges: Business as Usual?*, 21 NW. J. INT'L L. & BUS. 657 (2001); Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583 (2001). More focused on regulatory problems Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367 (2002) and Benn Steil, *Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 61 (2002).

kets but regulating them as well. Their regulatory mandate is the main source of tensions that arise when stock exchanges themselves become publicly traded.

Part III identifies increasing competition as the main force that drives the transformation of stock exchanges into for-profit companies. This Part outlines the factors that foster competition, examines the marketplaces that compete, shows what they compete for, and explains why demutualized and publicly traded stock exchanges have competitive advantages over marketplaces organized in the traditional mutual form.

Part IV discusses comprehensively the conflicts of interest that arise when stock exchanges demutualize and go public. Wearing two different hats, those of player and referee, creates tensions. The main concern is not that publicly traded stock exchanges will systematically under-regulate or over-regulate their markets, because this would put in danger the stock exchanges' core asset, their integrity and trustworthiness. Rather, the concern is that publicly traded stock exchanges will be too soft in regulating themselves and too severe in regulating competitors. Although stock exchanges are not expected deliberately to favor their own interests over others', we should nevertheless be concerned with the unconscious influences arising from conflicts of interest.[11] Like everyone else, stock exchanges "are not immune from governance missteps,"[12] as the former chairman of the New York Stock Exchange and of the SEC, William H. Donaldson, noted.

With that in mind, Part V puts forward some modest amendments to the current regulatory structure that would, without greatly diminishing the regulatory powers of stock exchanges, significantly mitigate the conflicts of interest that come with demutualization and going public. The proposal is three-pronged: *First*, the regulatory arm of the stock exchanges should be separated from the other business units. *Second*, this separated regulatory arm should report not to the board of directors of the stock exchange, but rather to the SEC. *Third*, self-listed stock exchanges and their affiliates should be required to have a second listing at another stock exchange.

To simplify matters, this article addresses only stock markets registered as national securities exchanges.[13] Similar problems arise when other stock markets go public (most notably the Nasdaq Stock Market).[14]

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[11] The U.S. Supreme Court has emphasized this in a slightly different context. *See* Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 187-92 (1963) (conflicts of interest of investment advisers).

[12] William H. Donaldson, *Open Meeting Regarding SRO Governance Rule Proposal*, Speech on November 9, 2004, Washington, D.C. (available at http://www.sec.gov/news/speech/spch110904whd.htm). *See also* Siobhan Hughes, *SEC Moves Ahead to Strengthen Governance of U.S. Stock Markets*, THE WALL STREET JOURNAL, November 10, 2004, p. C3.

[13] Securities Exchange Act § 6, codified in 15 U.S.C. § 78f.

[14] More than four years ago, the Nasdaq Stock Market filed an application with the SEC to become a stock exchange, which so far (as of September 7, 2005) has not been approved. *See* SEC, Release No. 34-44396 (File No. 10-131): *The Nasdaq Stock Market, Inc.; Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934* (June 7, 2001), 66 Fed. Reg. 31,952 (2001). Nasdaq is today a publicly traded company.

II. BACKGROUND

Because they offer financial services, stock exchanges belong to the financial sector. Within that sector, however, stock exchanges are out of the ordinary. Stock exchanges are both *regulators* and *regulated entities*: regulators insofar as they oversee the market they organize, and at the same time subject to regulation by the Securities and Exchange Commission (SEC), a federal agency established under the Securities Exchange Act.[15] The U.S. Supreme Court calls this hybrid system a "policy of self-regulation by the exchanges coupled with oversight by the SEC."[16]

This Part identifies the functions that stock exchanges perform [*infra* A.] and discusses their organizational structure [B.]. Within the latter section, the article provides an overview of the current form of all marketplaces in the United States, as well as of the most important competitors abroad.

A. FUNCTIONS OF STOCK EXCHANGES

The Securities Exchange Act defines an exchange as

> [an] organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the *functions commonly performed by a stock exchange as that term is generally understood*, and includes the market place and the market facilities maintained by such exchange.[17]

This circular definition helps little either in determining whether a certain marketplace is a stock exchange[18] or in understanding what functions a stock exchange actually performs. The circularity is an inevitable consequence of the modern stock exchange's complexity. Stock exchanges are intermediaries: they bring together sellers and buyers, investors and issuers, and, through information distribution, informed and uninformed market participants. Thus, stock exchanges have many constituencies—the main reason for the distinct conflicts of interest that are inherent to the exchanges' business and that are this article's core issue.

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[15] *See* Securities Exchange Act § 4, codified in 15 U.S.C. § 78d.

[16] Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 667 (1975).

[17] Securities Exchange Act § 3(a)(1), codified in 15 U.S.C. § 78c(a)(1) (emphasis added). The definition is further described in 17 C.F.R. § 240.3b-16.

[18] The question of what constitutes an exchange has been tested in the well-known dispute between the SEC and the Chicago derivatives markets. *See* Board of Trade of the City of Chicago v. Securities and Exchange Commission, 883 F.2d 525, 535-6 (7th Cir. 1989); Board of Trade of the City of Chicago v. Securities and Exchange Commission, 923 F.2d 1270 (7th Cir. 1991). For a general overview, *see* JOHN C. COFFEE & JOEL SELIGMAN, SECURITIES REGULATION 624-27 (9th ed. 2003). For more details, *see particularly* LEE, EXCHANGE, *supra* note 4; Therese H. Maynard, *What is an Exchange?—Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange*, 49 WASH. & LEE L. REV. 883 (1992).

In structuring their main activities, we might define stock exchanges as *market organizers* [*infra* 1], as *information distributors* [2], as *market regulators* [3], as *standards setters* [4], and finally, to an increasing degree, as *business enterprises* [5].

1. Market Organizers

The critical function of stock exchanges is to provide a marketplace where stocks, *i.e.*, shares in corporations, can easily be bought and sold. Like other parts of the financial market, stock markets serve the economy, and by extension the public, in at least three regards: They bring together those who demand (corporations) and those who supply capital (investors). They allow investors to reduce their risk by spreading their investments. And they make those investments liquid enough to invest and divest without significant price changes. We refer to these functions collectively as "providing liquidity."[19] Stock exchanges, by definition, have always and will always perform this role.

What has changed over the last two centuries is how stock exchanges organize the trade in stocks. An operator of a trading market needs to maintain facilities where buyers and sellers can easily come together, agree on prices, and exchange money for stocks. Until two decades ago, the central focus of the stock exchanges' market organization was the trading floors, where the so-called floor brokers met, negotiated and agreed upon the price for stock transfers, mainly executed for their principals. But—as will be seen throughout this article—trading floors are an obsolescent model. As in many other industry sectors, humans are with greater frequency replaced by computers. Instead of relying on brokers on trading floors, increasingly stock exchanges maintain electronic systems that match buy and sell orders automatically.[20] Indeed, the main expense of stock exchanges today is information and communication technology.

2. Information Distributors

Of increasing importance is the stock exchanges' function as information distributors. The information they generate in their price discovery has considerable economic value,[21] and takes two primary forms.

First are the stock prices themselves. Settled trades and their prices are of importance in many contexts. Information about settled trades is the basis of market surveillance. Moreover, information about previous trades is needed for numerous business

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[19] *See generally* COFFEE & SELIGMAN, *supra* note 18, at 8-9.

[20] The question of whether floor specialists are desirable is far beyond the scope of this article. For the purposes of this article, it is sufficient to recognize that marketplaces for stocks worldwide are to an increasing extent organized without floor brokers and that such marketplaces compete with traditional stock exchanges. For a recent contribution to the discussion, *see* Puneet Handa, Robert A. Schwartz & Ashish Tiwari, *The Economic Value of a Trading Floor: Evidence from the American Stock Exchange*, 77 J. OF BUS. 331 (2004).

[21] *See* J. Harold Mulherin, Jeffry M. Netter & James A. Overdahl, *Prices are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective*, J. OF LAW & ECON. 591 (1991).

purposes, the most important application being *derivatives*. A derivative is a financial instrument, the value of which is *derived* from an underlying asset, such as stocks.[22] For the price discovery of such stock-based derivatives, it is critical to get the latest stock prices.

The second kind of market data that stock exchanges offer is *quotes*. These are prices at which investors are willing to buy securities ("bid quotes") or sell ("ask quotes"). The difference between these two types of quotes is the *spread*. To some degree, the knowledge of quotes allows prediction of future stock prices, making that knowledge very valuable to traders. Moreover, quotes have a critical regulatory function in the U.S. securities markets: Brokers who want to execute their clients' orders are expected to choose the marketplace with the best available quotes (known as the duty of "best execution").[23]

3. Market Regulators

The key function to be addressed in this article is the stock exchanges' role as market regulators. Stock exchanges not only organize markets for stocks, but set the rules for these marketplaces. All market participants and affiliates, particularly the broker-dealers that trade on the market and the issuers of the traded shares, must adhere to these rules. Stock exchanges monitor their market participants' compliance with these rules (known as market surveillance) and thereby provide for fair price discovery, a critical component in fostering investor confidence. For the case in which someone fails to abide by the rules, the stock exchanges have numerous enforcement powers, namely fining traders and delisting issuers.

The stock exchanges' function as market regulators is—in contrast to market organization—not innate. There are two reasons for this. First, it is questionable whether stock markets need be regulated at all: other markets operate without any special rules, relying instead primarily on the traders' caution (*caveat emptor*) and secondarily on the common law rules concerning fraud. Second, market regulation, if deemed necessary, need not be vested in the stock exchanges themselves. Instead, it might be good policy to confer this mandate upon someone other than the market organizer. These issues are far from being clearly decided.[24] Indeed, some commentators even argue for *increasing* the stock exchanges' powers to regulate the market.[25]

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[22] *See generally* CASTAGNINO, DERIVATIVES: THE KEY PRINCIPLES 1 (2003); FIRTH, DERIVATIVES—LAW AND PRACTICE (February 2004), at 1.004; GROUP OF THIRTY, DERIVATIVES: PRACTICES AND PRINCIPLES 28 (1993).

[23] *See particularly* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, 135 F.3d 266 (3rd Cir. 1998); Newton v. Merrill Lynch, Pierce, Fenner & Smith, 259 F.3d 154 (3rd Cir. 2001). For an overview of the duty of best execution, *see* COFFEE & SELIGMAN, *supra* note 18, at 38, 657-60.

[24] *See recently* SEC, Release No. 34-50700 (File No. S7-40-04): *Concept Release Concerning Self-Regulation* (November 18, 2004), 69 Fed. Reg. 71,256 (2004) [hereinafter: *Concept Release Concerning Self-Regulation*]. *See also* SECURITIES INDUSTRY ASSOCIATION, REINVENTING SELF-REGULATION (January 5, 2000, updated October 14, 2003; available at http://www.sia.com/market_structure/html/siawhitepaperfinal.htm); Laurie P. Cohen & Kate

4. Corporate Governance Standards Setters

Stock exchanges regulate their issuers through so-called listing rules, the most famous of which is the NYSE Listed Company Manual. However, a considerable number of stock exchange listing rules are more than regulations providing for fair trading. Often they aim at increasing the quality of the traded products: the companies, the stocks of which are sold and bought. We call such listing rules "corporate governance rules."[26] Noteworthy examples are rules about continued disclosure,[27] takeover defense,[28] stockholder power,[29] the composition of the issuer's board,[30] and the establishment of specific board committees.[31] Hence, as former SEC chairman William H. Donaldson observed, stock exchanges play a "critical role in our securities markets as standard setters for listed companies."[32] One reason why stock exchanges are so critical in this regard is that their powers to regulate corporate governance issues reach significantly farther than the powers of the SEC, as held in the famous *Business Roundtable* case.[33]

Corporate governance listing rules are anything but a recent emergence; the New York Stock Exchange developed such rules no later than in the mid-nineteenth century.[34] The aim of such rules was, and still is, to improve the corporate governance of listed companies. Although one can trade stocks of badly managed companies just as well as the stocks of those well managed, usually investors are likely to prefer the latter. Therefore, stock exchanges have a strong incentive to look at the quality of the products offered on their markets.

Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, THE WALL STREET JOURNAL, December 31, 2003, p. A1.

25 Most noteworthy is Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

26 *See* NYSE Listed Company Manual §§ 301 et seq., *especially* NYSE Listed Company Manual § 303A (titled: "Corporate Governance Standards"). *But see* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards under the Securities Exchange Act*, 47 BUS. LAW. 1461 (1992). *See also recently* Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 S.M.U. L. REV. 325 (2001).

27 *See, e.g.*, NYSE Listed Company Manual § 203.00 et seq.

28 *See, e.g.*, NYSE Listed Company Manual § 308.00.

29 *See, e.g.*, NYSE Listed Company Manual § 312.03.

30 *See, e.g.*, NYSE Listed Company Manual §§ 303A.01 et seq.

31 *See*, *e.g.*, NYSE Listed Company Manual §§ 303.01, 303.02, 303A.06, and 303A.07 (audit committee); NYSE Listed Company Manual §§ 303A.04 (nominating/corporate governance committee); NYSE Listed Company Manual § 303A.05 (compensation committee).

32 Letter from the SEC's Chairman William H. Donaldson to relevant self-regulatory organizations. Cited pursuant to SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,129.

33 The Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406 (D.C.Cir. 1990).

34 GEORGE L. LEFFLER & LORING C. FARWELL, THE STOCK MARKET 138-43 (3 ed. 1963). For the origins of regulation, *see* STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION—CULTURAL AND POLITICAL ROOTS (1998). For the New York Stock Exchange's history, *see particularly* FRANCIS L. EAMES, THE NEW YORK STOCK EXCHANGE (1894) (probably the most authentic historical work of a contemporary witness); CHARLES R. GEISST, WALL STREET—A HISTORY, FROM ITS BEGINNINGS TO THE FALL OF ENRON (2004) (one of the most comprehensive).

5. Business Enterprises

By fulfilling the abovementioned functions (market organization, information distribution, market regulation, and standards setting), stock exchanges carry on a *business enterprise*. While the business of running an exchange is not necessarily a commercial (*i.e.*, for-profit) business, it is definitively a business.

Regardless of whether the business is for-profit or not-for-profit, those who run it and own it normally want to retain and improve its standing. The stock exchange management that fails to defend its exchange's market share or loses issuers to competing stock exchanges can expect to be ousted sooner or later (likely sooner if the business is for-profit). Even though stock exchanges have regulatory powers, they are still businesses rather than governmental bodies or agencies.

As in every business company, expenses and income matter. The main expenses of stock exchanges are in maintaining and regulating the marketplace, while their income is derived from various sources, the following being the most common:[35] (1) the issuers of the stocks that are listed and traded pay listing fees;[36] (2) depending on whether those listing fees are a flat rate or not, the issuers can also be charged for special services, such as information distribution during tender offers; (3) fees are received from the broker-dealers who are allowed to trade at the stock exchange (known as members or seatholders) and thereby use the stock exchange's facilities, particularly its trading floor and trading system; (4) for each transaction, investors can be charged transaction fees, as well as fees for clearing, settlement, custodian, and registration services; (5) stock exchanges can impose fines on regulated persons and entities; (6) stock exchanges can, and to an increasing extent do, sell market data; (7) stock Exchanges may charge for other ancillary services, such as information technology solutions and support, product licenses, and so forth.

The funding of stock exchanges raises considerable regulatory concerns. These worries increase when stock exchanges become for-profit companies, which fosters their focus on reducing expenses and enlarging income. Should Congress and the SEC stay idle when, for instance, stock exchanges slash their regulatory expenses and boost their fines, solely in order to make more profit?

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[35] Concerning the stock exchanges' sources of income, *see particularly* Sebastian Schich & Gert Wehinger, *Prospects for Stock Exchanges*, FINANCIAL MARKET TRENDS 91, 100 (October 2003) (table that shows the allocation between different sources) and *generally* IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 6. For recent overviews of the income of major exchanges, *see* their annual reports, *e.g.* NEW YORK STOCK EXCHANGE, ANNUAL REPORT 24 -27 (2004).

[36] *See, e.g.*, NYSE Listed Company Manual §§ 701.02 and 902.00 et seq. *See* Schich & Wehinger, *supra* note 35, at 94 (presenting an overview of the initial and annual listing fess on twenty-four stock exchanges worldwide). *See also* Jonathan R. Macey & Maureen O'Hara, *The Economics of Stock Exchange Listing Fees and Listing Requirements*, 11 J. FIN. INTERMEDIATION 297 (2002) (closing with the prediction that "either listing fees, or the exchanges, will not survive").

B. ORGANIZATION OF STOCK EXCHANGES

The organizational structure of stock exchanges has two notable landmarks: the Securities Exchange Act of 1934[37] and the Securities Acts Amendments of 1975.[38] Consequently, the following overview is separated into three periods: pre-1934 [*infra* 1], 1934 to 1975 [2], and post-1975 [3]. The overview will conclude with recent developments, most importantly with an overview of the current organizational structure of all domestic and the selected foreign stock exchanges [4].

Although stock exchanges were at all times at least partly self-regulated, one might bear in mind that the trend continuously moves toward centralized federal regulation.

1. Age of Self-Regulation (until 1934)

The stock exchanges' organizational history differs from that of other businesses in the financial sector and elsewhere. Most businesses are established by entrepreneurs who believe a promising market exists for their products and services. They start a business because they are convinced there is a demand they can profitably supply. Businessmen applied for bank charters in communities wherein they saw a demand for loans; they offered brokerage services, investment funds, and financial advice in regions and to people they expected would need such services.

In the earlier days of today's major economies, however, no one set up a marketplace for stocks, called it stock exchange, and offered the service to people who wanted to trade. Instead, stock exchanges were established the opposite way: The folks who wanted to trade in stocks—brokers and dealers—looked for a place and system that guaranteed reliable and permanent trading. As no such organized marketplace yet existed, they launched one—the birth of stock exchanges. Their intention was not to attract traders—they were themselves the traders—but to have a convenient forum to trade securities (with the prospective benefit of commission fees when they acted for others). So unlike other businesses, stock exchanges were founded by their customers,[39] and thus were customer-controlled from their very beginning.[40] In this traditional structure, known as the mutual or cooperative form, the broker-dealers wear three hats: they are (1) the main *customers* of the stock exchange; (2) the *owners* of the stock exchange; and finally, as it is a closely held entity, they are usually also (3) the *managers* of the stock exchange.

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[37] Securities Exchange Act of 1934, Ch. 404, 48 Stat. 881 (1934), codified in 15 U.S.C. § 78a et seq.

[38] Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975), codified in 15 U.S.C. § 78a et seq.

[39] To a certain degree, we find similar structures in the history of other branches of the financial industry, particularly mutual savings banks and mutual life insurance companies. *See* generally HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 246-286 (1996).

[40] *See generally* for the problems of customer-controlled entities HANSMANN, *supra* note 39, at 246-286. For stock exchanges, *see* Carmine Di Noia, *Customer-controlled Firms: The Case of Financial Exchanges*, in: CAPITAL MARKETS IN THE AGE OF THE EURO (ed. Guido Ferrarini, Klaus J. Hopt & Eddy Wymeersch) (2002), p. 173.

This organizational structure has important consequences for the stock exchange's business plan. As the primary customers, the founding traders were less concerned with the stock exchange making money, because the profits mainly derive from transaction fees paid by themselves (from their viewpoint, it is no more than moving money from the *own* left into the *common* right pocket). Thus stock exchanges across the world were traditionally organized as not-for-profit organizations. The brokers and dealers that ran the stock exchange did not raise prices higher than necessary to cover the expenses.[41] Technological advances that reduced the stock exchange's costs did not lead to increased profits but rather to decreased transaction fees.

Another remarkable feature of the history of stock exchanges is the approach to their regulation. Unlike most of the other financial institutions, namely banks and insurance companies, stock exchanges in the United States were for a long time nearly unregulated.[42] This is surprising considering their economic importance and monopoly power (at least regionally: it was hard to trade stocks between the East and West Coasts without modern communication). Congress instead relied on the members of the stock exchanges to ensure that the exchanges and their markets were well organized (concept of *self-regulation*). Although their success is questionable, stock exchanges clearly made some effort to regulate their markets.[43]

2. Inauguration of the Securities and Exchange Commission (1934)

From their inception, stock exchanges have attracted not only good faith entrepreneurs and investors but also fraudsters, impostors, and swindlers seeking easy money. This seamier element could be found among all of the stock exchange's constituencies: the issuers, the broker-dealers, and the investors. Stock exchanges, through their self-regulation, have always responded to such bad participants—much as a golf club does when members damage the clubhouse.

Despite these efforts, eventually the public—and finally Congress—were no longer content just watching how the stock exchanges handled (and sometimes tolerated)[44] violations. Proposals to regulate stock exchanges were made as early as at the beginning of the twentieth century, but nothing significant happened.[45] Public sentiment dramati-

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[41] *See, e.g.*, Richard Humphry (Managing Director, Australian Stock Exchange), *ASX Demutualisation: The First Four Months* (February 18, 1999) ("Organized in the mutual form some of our services were substantially underpriced, particularly those directed principally at stockbrokers") [hereinafter: *First Four Months*].

[42] *Cf.* Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 665 (1975) ("the exchanges remained essentially self-regulating and without significant supervision until the Securities Exchange Act of 1934").

[43] For an overview, *see* Mahoney, *supra* note 25, at 1459-62 (limited to the New York Stock Exchange).

[44] *See* Silver v. New York Stock Exchange, 373 U.S. 341, 351 (1963). The thesis that the stock exchanges failed to perform their regulatory function is challenged by Mahoney, *supra* note 25, at 1464-75. *But see also* COFFEE & SELIGMAN, *supra* note 18, at 4.

[45] For a brief overview, *see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 128 fn. 9 (1973).

cally changed with the crash in 1929, when investors incurred dramatic losses,[46] and during the subsequent Great Depression. With the belief that the latter was significantly caused by the crash beforehand, stock exchanges were increasingly identified as public goods with a critical impact on the overall economy.

Within a few years, Congress responded: the Securities Exchange Act of 1934[47] created the independent and non-partisan Securities and Exchange Commission (SEC) as a federal agency to oversee the securities market and, to a certain degree, the stock exchanges. The result was a two-tiered system: self-regulation by the stock exchanges coupled with governmental oversight.[48] While the stock exchanges' membership was still restricted, they lost part of their autonomy—formerly seen as "private clubs,"[49] they were now privately organized clubs vested with public responsibilities.

Nonetheless, the inauguration of the SEC did not change the self-regulatory system as such. Unlike most other financial institutions, stock exchanges retained both their status as self-regulatory organizations and their regulatory powers. That may seem surprising, given both the tremendous crash and the alleged reluctance of the stock exchanges to prevent securities fraud. But the tradition of self-regulation, the objections by market participants against significant changes, doubts as to whether government could handle the regulation, and changes in political sentiment helped preserve critical parts of the old system.[50]

3. Reinvigoration of the Securities and Exchange Commission (1975)

The second legislative landmark is the Securities Acts Amendments of 1975,[51] noteworthy for at least two reasons.

First, the amendments reinvigorated the SEC and gave it substantially more power over the stock exchanges. Although the exchanges remained self-regulatory organizations, they were now subject to tightened oversight by the SEC: a shift toward governmental regulation as important as the 1934 establishment of the Commission. In addition, the amendments imposed new duties on the stock exchanges and strengthened their

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[46] *Cf.* the famous note of the House Report in 1933: "Fully half or $25,000,000 worth of securities during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities" (H.R. Rep. No. 152, 73d Cong., 1st. Sess. (1933)).

[47] Securities Exchange Act of 1934, Ch. 404, 48 Stat. 881 (1934), codified in 15 U.S.C. § 78a et seq.

[48] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 127-8 (1973); Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 667 (1975).

[49] *See* WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 65 (James Allen ed. 1940).

[50] For some of the identified reasons, *see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 128 fn. 9 (1973). *See also* SEC, *Concept Release Concerning Self-Regulation*, *supra* note 24, at 71,256. *But see* Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 UNIV. RICH. L. REV. 1069, 1093 (2005) ("result of historical accident and political expediency").

[51] Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975), codified in 15 U.S.C. § 78a et seq.

corporate governance. With these amendments, the exchanges further lost their status as "private clubs" and grew closer to becoming public agencies. Most remarkably, they were required to make rule change proposals public for comment,[52] as federal agencies are required to.[53]

Second, the Securities Acts Amendments of 1975 established the controversial National Market System (NMS).[54] This system connects the various marketplaces that trade stocks in the United States, and is of critical importance for the allocation of orders and therefore for the marketplaces' competition.

4. Recent Developments (1993-2005)

In roughly the last decade, the world has seen dramatic changes in the organizational structure of stock exchanges. While the major marketplaces in the United States have been as yet unaffected by this development, they are about to catch up with global trends.

Two hundred years ago, stock exchanges did not offer much more than a large room, the exchange floor. Today, they provide their traders with high-end technology, state-of-the-art information systems, and trade settlement within seconds. Running modern stock exchanges has become expensive.

a) International Trend of Demutualization (starting 1993).

Before 1993, all relevant stock exchanges were owned by their members. Starting with the Stockholmsbörsen (Stockholm Stock Exchange) in 1993, stock exchanges worldwide transformed from member owned companies into publicly held companies, a development known as *demutualization*. In a publicly traded stock exchange, the members are no longer the sole owners of the stock exchange. The right to trade at the stock exchange unravels from the ownership, and the exchange usually becomes a for-profit company.

At the 1999 Annual Meeting of the World Federation of Exchanges,[55] as many as 15 out of 52 exchanges had demutualized, 14 exchanges had member approval for demutualization, and 15 were thinking about demutualization, which means that only eight ex-

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[52] Securities Exchange Act § 23(c), codified in 15 U.S.C. § 78w(c).

[53] 5 U.S.C. § 553.

[54] *See particularly* Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-improvement*, 70 VA. L. REV. 785 (1984); Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79 (1984). *But see also* Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315 (1985); Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981).

[55] For general information about the World Federation of Exchanges, *see* http://www.world-exchanges.org. The federation has currently 53 members (as of September 7, 2005).

changes were committed to retaining the mutual form.[56] In another survey in 2003, 42 out of 85 exchanges were demutualized, 16 were in the process of demutualization, and 27 had no plans to demutualize.[57] Eighteen out of the 42 demutualized exchanges were listed.[58]

b) Failed Attempts in the United States (1999/2000)

The United States is relatively late in the demutualization trend, and it is not completely clear why domestic exchanges have missed that global trend. The SEC has occasionally claimed that the Securities Exchange Act required stock exchanges to have a "traditional membership structure" and limit "exchange participation to registered broker-dealers."[59] Similar language has emerged from the U.S. Supreme Court[60] and the Seventh Circuit Court of Appeals[61] as well as influential commentators.[62] Such remarks are somewhat surprising because, if they were true, U.S. stock exchanges could not demutualize without an amendment to the Securities Exchange Act or at least an exemption by the SEC.

However, even though the Securities Exchange Act in fact limits membership to registered broker-dealers,[63] the Act does not, contrary to the foregoing authorities, expressly state that the stock exchange be owned by its members. It is therefore critical to distinguish between membership, which carries the right to trade on the stock exchange, and ownership, which gives entitlement to profits and the residual share. The Securities Exchange Act seems not to require that both occur together.

Another important issue is whether the Securities Exchange Act presumes that stock exchanges are not-for-profit organizations; the SEC casually gave the impression that it believed so.[64] However, as early as 1998, in its Rule on exchanges and alternative trad-

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[56] These numbers were informally reported at the mentioned meeting (cited pursuant to IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 3). It is unclear whether the numbers reflect exchanges in general or are limited to *stock* exchanges.

[57] Carson, *World Bank Paper*, *supra* note 8, at 5.

[58] Carson, *World Bank Paper*, *supra* note 8, at 5.

[59] SEC, Release No. 34-38672; International Series Release No. IS-1085 (File No. S7-16-97): *Regulation of Exchanges* (May 23, 1997), 62 Fed. Reg. 30,485, 30,487 (1997) [hereinafter: *ATS Concept Release*].

[60] *See* Silver v. New York Stock Exchange, 373 U.S. 341, 350 (1963) ("The exchanges are by their nature bodies with a limited number of members, each of which plays a certain role in the carrying out of an exchange's activities.")

[61] Board of Trade of the City of Chicago v. Securities and Exchange Commission, 883 F.2d 525, 528 (7th Cir. 1989) (stating that the Securities Exchange Act treats exchanges as "organizations created and run by broker-members"). *Similar* Board of Trade of the City of Chicago v. Securities and Exchange Commission, 923 F.2d 1270, 1272 (7th Cir. 1991) (stating that "the statute requires that an exchange be controlled by its participants, who must in turn be registered brokers or individuals associated with such brokers").

[62] COFFEE & SELIGMAN, *supra* note 18, at 630 ("the 1934 Act mandates a governance structure for exchanges based on a conception of them as not-for-profit organizations run for the benefit of participating dealers.").

[63] Securities Exchange Act § 6(c)(1), codified in 15 U.S.C. § 78f(c)(1).

[64] *See* SEC, *ATS Concept Release*, *supra* note 59, at 30,487 (stating that there are "exchange requirements that are *incompatible with the operation of for-profit*, non-membership alternative trading systems") (emphasis added).

ing systems (known as Regulation ATS), the Commission (surprisingly for many observers) stated that it had, under certain conditions, no objections against demutualized for-profit exchanges.[65]

Shortly thereafter, the New York Stock Exchange, at that time described as "die-hard traditionalists"[66] and as a "potential Titanic,"[67] announced plans to demutualize and go public.[68] In now well-known testimony, Richard A. Grasso, then chairman and CEO of the New York Stock Exchange, praised this plan as "critically needed to assure the continued competitiveness and position" of the exchange.[69] Arthur Levitt, then-chairman of the SEC, several times emphasized the importance of demutualization and warned the domestic stock exchanges not to miss the international trend of demutualization.[70] However, the demutualization plan of the New York Stock Exchange soon failed, due partly, it appears, to the larger than expected resistance of the members, who wanted to preserve the traditional structure that had served them so well over a long time.[71]

c) Demutualizations in the United States (2004/2005)

In outsourcing its equity business and establishing PCX Equities, Inc. as a corporate subsidiary in 1999, the Pacific Exchange created the first demutualized for-profit marketplace for stocks in the United States. In the same way, it set up PCX Options, Inc., which demutualized in June 2004. Finally, the Pacific Exchange itself demutualized in

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[65] SEC, Release No. 34-40760 (File No. S7-12-98): *Regulation of Exchanges and Alternative Trading Systems* (December 8, 1998), 63 Fed. Reg. 70,844, 70,848 (1998) [hereinafter: *Regulation ATS*].

[66] Richard Humphry (Managing Director, Australian Stock Exchange), *The Challenge of Financial Globalisation* (August 12, 1999) [hereinafter: *Challenge of Financial Globalisation*].

[67] (Without author) *A Home-Grown Revolutionary*, THE ECONOMIST, July 31, 1999.

[68] *See* New York Stock Exchange Press Release, *NYSE Chairman Richard A. Grasso's Letter to Members Concerning "Demutualization"* (September 2, 1999); New York Stock Exchange Press Release, *NYSE Appoints Committee on Market Structure, Governance and Ownership* (October 11, 1999). *See also* (without author) *A Home-Grown Revolutionary*, THE ECONOMIST, July 31, 1999; Mike McNamee, *Rethinking Wall Street*, BUSINESS WEEK, October 11, 1999, p. 146; Sandra Sugawara, *NYSE Must Change, Levitt Warns*, THE WASHINGTON POST, October 28, 1999, p. E1 [hereinafter: *NYSE Must Change*]; Sandra Sugawara, *NYSE May Drop Plans To Take Itself Public*, THE WASHINGTON POST, February 18, 2000, p. E1; *NYSE Unlikely to Go Public Until 2nd Half of 2001*, THE WALL STREET JOURNAL, May 25, 2000, p. 1.

[69] Richard A. Grasso, *Investor Ownership of Stock Exchanges*, Testimony before the Committee on Banking, Housing, and Urban Affairs (September 28, 1999).

[70] Arthur Levitt, *Dynamic Markets, Timeless Principles*, Speech on September 23, 1999, New York, N.Y., 2000 COLUM. BUS. L. REV. 1 (2000) (also available at http://www.sec.gov/news/speech/speecharchive/1999/spch295.htm) [hereinafter: *Dynamic Markets, Timeless Principles*]; Arthur Levitt, *Market Structure Issues Currently Facing the Commission*, Testimony before the Committee on Banking, Housing, and Urban Affairs, Subcommittee on Securities (October 27, 1999; available at http://www.sec.gov/news/testimony/testarchive/1999/tsty2599.txt) (stating that "today's global marketplace always stands ready to offer alternatives that are more responsive to investor needs") [hereinafter: *Market Structure Issues*]. *See also* Sugawara, *NYSE Must Change*, *supra* note 68 (citing Levitt with: "If they [the New York Stock Exchange] don't change their method of governance, they won't be here five years from now").

[71] Mara Der Hovanesian, *Put the Big Board On The Big Board*, BUSINESS WEEK, September 13, 2004, p. 90 [hereinafter: *Big Board On The Big Board*]; Sugawara, *NYSE Must Change*, *supra* note 68. The issue is nicely described (before the demutualization plan failed) in (without author) *A Home-Grown Revolutionary*, THE ECONOMIST, July 31, 1999.

August 2004.[72] In 2000, the Pacific Stock Exchange together with Archipelago Holdings created a new national securities exchange, Archipelago Exchange (ArcaEx).[73] Eventually, Archipelago Exchange replaced the equity trading arm of the Pacific Exchange, the abovementioned PCX Equities, Inc.[74] Archipelago Holdings went public in 2004.[75] In January 2005, Archipelago Holdings, Inc. announced that it wanted—depending on approval by the SEC—to acquire PCX Holdings, Inc., the parent company of the Pacific Exchange and PCX Equities, Inc.[76]

The Philadelphia Stock Exchange demutualized in 2004;[77] the Chicago Stock Exchange followed in 2005.[78] Neither is publicly traded.

d) New York Stock Exchange—Archipelago Merger (2005)

In the winter of 2005, the New York Stock Exchange made its next attempt to demutualize and go public.[79] After five years of deadlock, the sentiment about demutuali-

[72] SEC, Release No. 34-49718 (File No. SR-PCX-2004-08): *Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to the Demutualization of the Pacific Exchange, Inc.* (May 17, 2004), 69 Fed. Reg. 29,611 (2004).

[73] *See* Pacific Exchange Press Release, *Archipelago and the Pacific Exchange Announce Plan to Create a New National Stock Exchange* (March 14, 2000); Pacific Exchange Press Release, *Archipelago and the Pacific Exchange Close Transaction to Create National Stock Exchange* (July 13, 2000); Pacific Exchange Press Release, *Archipelago Exchange Approved by SEC* (October 25, 2001).

[74] *See* Pacific Exchange Press Release, *PCX Equities Floors Pass Into History* (March 19, 2001); Pacific Exchange Press Release, *Pacific Exchange's San Francisco Equities Floor Passes Into History* (March 20, 2002).

[75] SEC, Release No. 34-50170 (File No. SR-PCX-2004-56): *Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Certificate of Incorporation and Bylaws of Archipelago Holding, Inc.* (August 9, 2004), 69 Fed. Reg. 50,419 (2004).

[76] Archipelago Holdings News Release, *Archipelago Holdings Inc. Prices to Acquire the Pacific Exchange* (January 3, 2005); Pacific Exchange Press Release, *Archipelago Holdings Inc. to Acquire the Pacific Exchange* (January 3, 2005). *See also* Kate Kelly & Gregory Zuckerman, *Pacific Surf: Archipelago Takes the Ultimate Options Ride*, THE WALL STREET JOURNAL, January 5, 2005, p. C1. For the necessary adjustments, *see* SEC, Release No. 34-52249 (File No. SR-PCX-2005-90): *Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to the Certificate of Incorporation of PCX Holdings, Inc., PCX Rules and Bylaws of Archipelago Holdings., Inc.* (August 12, 2005), 70 Fed. Reg. 48,611 (2005).

[77] SEC, Release No. 34-49098 (File No. SR-PHLX-2003-73): *Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 Thereto Relating to the Demutualization of the Philadelphia Stock Exchange, Inc.* (January 16, 2004), 69 Fed. Reg. 3,974 (2004).

[78] SEC, Release No. 34-51149 (File No. SR-CHX-2004-26): *Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 by the Chicago Stock Exchange, Inc. Relating to the Demutualization of the Chicago Exchange, Inc.* (February 8, 2005), 70 Fed. Reg. 7,531 (2005).

[79] Gaston F. Ceron, *Big Board, Pondering Transition To For-Profit, Sets Review Panel*, THE WALL STREET JOURNAL, February 9, 2005, p. C3 [hereinafter: *Pondering Transition*]. *See also* Der Hovanesian, *Big Board On The Big Board*, *supra* note 71; (without author) *With 3 New Directors Nominated, NYSE Members Await April Vote*, THE WALL STREET JOURNAL, February 22, 2005, p. C3 (mentioning the appointment of a task force to consider demutualization); Gaston F. Ceron & Aaron Lucchetti, *NYSE Profit Dropped 50% Last Year*, THE WALL STREET JOURNAL, March 17, 2005, p. C3 (same) [hereinafter: *NYSE Profit Dropped*]; (without author) *The $1.5 Million Club: NYSE Seats Rebound*, THE WALL STREET JOURNAL, February 22, 2005 p. C3 (same).

zation among the members seemed to have changed. There are at least three events that may explain the altered attitude: investigations against the exchange and the specialist firms for securities fraud,[80] the corporate governance-related turmoil in the aftermath of chairman Grasso's widely noticed ouster, and the falling prices for seats at the exchange, which dropped by more than half since their peak in 2000.[81] All these incidents significantly weakened the New York Stock Exchange's members. Mr. Grasso, who had spent most of his life at the New York Stock Exchange, had for a long time been the specialists' guardian angel. With his dismissal, the members lost their closest ally against the electronic trading that makes floor specialists needless. The fraud investigations, among the largest in the exchange's history, were the next earthquake. In addition, revenues shrank and many firms ended up in the red.

It is no coincidence, then, that the New York Stock Exchange, with its members weakened, in April 2005 announced that it would merge with Archipelago Holdings and subsequently go public.[82] This landmark deal has drawn much public attention. That Archipelago, the successful start-up marketplace, would finally merge with the old New York Stock Exchange is something few commentators expected—as the following anecdote may illustrate: In early 2005, Archipelago's CEO spent one week mostly in New York. Analysts asked him whether he had visited the alternative trading system Instinet, a potential takeover target (Instinet ultimately was acquired by Nasdaq). His answer: "I was absolutely not in Instinet. Right hand in the air, Bible in my left."[83] Not one of the analysts who questioned him stopped to consider the possibility of a merger between Archipelago and the New York Stock Exchange.

On completion of the merger, the New York Stock Exchange will be a demutualized publicly traded stock exchange.

5. Overview of the Current Organizational Structure (2005)

The following tables give an overview of the current organizational structure of foreign and domestic stock exchanges:

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[80] *See infra* IV.A.3.

[81] *See* Chart Two *infra* II.B.5.

[82] Joint News Release by the New York Stock Exchange and Archipelago, *New York Stock Exchange and Archipelago Exchange Agree to Merge* (April 20, 2005) [hereinafter: *Joint News Release*]. *See also* Jerry Putnam (Chairman & CEO, Archipelago Holdings Inc.), *On Agreement to Merge NYSE and Archipelago* (April 20, 2005); John A. Thain (CEO, New York Stock Exchange, Inc.), *On Agreement to Merge NYSE and Archipelago* (April 20, 2005).

[83] Cited pursuant to THE WALL STREET JOURNAL, April 29, 2005, p. C4.

TABLE ONE
Foreign Stock Exchanges[84]

	Stock Exchange	*Demutualized*	*Listed*	*Market value*
1	Australian Stock Exchange	1998[85]	1998	$2.1 billion[86]
2	Deutsche Börse	2000[87]	2001	$9.9 billion[88]
3	Euronext	1997[89]	2001	$4.6 billion[90]
4	HK Exchanges and Clearing	2000[91]	2000	$3.3 billion[92]
5	London Stock Exchange	1999	2001	$2.7 billion[93]
6	OMX Group	1993[94]	1993[95]	$1.5 billion[96]
7	Tokyo Stock Exchange	2001	—	—
8	TSX Group	2000[97]	2001	$2.2 billion[98]

[84] Based on publicly available data. For an overview of twenty-six—more or less—important stock exchanges (the Chicago Mercantile Exchange is mentioned but does not list stocks) that have demutualized, *see* Schich & Wehinger, *supra* note 35, at 103. For exhaustive data on selected exchanges, *see* Alfredo Mendiola & Maureen O'Hara, *Taking Stock in Stock Markets: The Changing Governance of Exchanges* (working paper, August 2003; available at http://ssrn.com/abstract=431580).

[85] *See* Frank Donnan, *Self-regulation and the Demutualisation of the Australian Stock Exchange*, 10 AUSTRALIAN J. CORP. L. 1 (1999).

[86] As of September 7, 2005 (share price: AUD 26.63; number of issued shares: 102,702,190; exchange rate: AUD 1 = 0.7667 USD).

[87] Deutsche Börse itself is not an exchange but rather operates an exchange, the Frankfurter Wertpapierbörse (Frankfurt Stock Exchange). Neither Frankfurter Wertpapierbörse nor Deutsche Börse are demutualized stock exchanges under the normal definition. Together, however, they look like a demutualized and publicly traded stock exchange. Because the regulatory powers are vested with the exchange, which is a public entity under German law, the regulatory challenges that come with demutualization under U.S. law are less important in Germany (provided that both entities, the operator and the exchange, are truly separated).

[88] As of September 7, 2005 (market capitalization: EUR 7,942,850,000; exchange rate: EUR 1 = 1.2424 USD).

[89] Euronext is the result of a merger of the Amsterdam Exchanges (AEX), the Brussels Exchanges (BXS), the ParisBourse[SBF] S.A. and later the Bolsa des Valores de Lisboa e Porto (BVLP). The Amsterdam Exchanges (AEX), as a predecessor of today's OMX Group, demutualized in 1997.

[90] As of September 7, 2005 (market capitalization: EUR 3,714,389,000; exchange rate: EUR 1 = 1.2424 USD).

[91] The Hong Kong Exchanges and Clearing Limited is not an exchange but the parent company of the Stock Exchange of Hong Kong. For the demutualization, *see* Betty M. Ho, *Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward*, 33 LAW & POL'Y INT'L BUS. 283 (2002).

[92] As of September 7, 2005 (share price: HKD 23.85; number of issued shares: 1,061,836,846; exchange rate: HKD = USD 0.1287).

[93] As of September 7, 2005 (market capitalization: GBP 1,476,510,000; exchange rate: GBP 1 = USD 1.8367).

[94] OMX Group owns and operates the exchanges of Copenhagen (Denmark), Helsinki (Finland), Riga (Latvia), Stockholm (Sweden), Tallinn (Estonia), and Vilnius (Lithuania). The Stockholmsbörsen (Stockholm Stock Exchange), as a predecessor of today's OMX Group, demutualized as early as 1993. The Helsingin Pörssi (Helsinki Stock Exchange) demutualized in 1995; the Københavns Fondsbørs (Copenhagen Stock Exchange) in 1996

[95] OMX Group shares themselves are listed since 2003. The sharers of Stockholmsbörsen (Stockholm Stock Exchange), as a predecessor of today's OMX Group, were listed in 1993.

[96] As of September 7, 2005 (share price: SEK 97.50; number of issued shares: 118,474,307; exchange rate: SEK 1 = 0.112 USD).

[97] TSX Group owns and operates the Toronto Stock Exchange and the TSX Venture Exchange.

TABLE TWO
Domestic Stock Exchanges

	Stock Exchange	*Demutualized*	*Listed*	*Market value*
1	American Stock Exchange	—	—	—
2	Archipelago Exchange	2004	2004	$1.8 billion[99]
3	Boston Stock Exchange	—	—	—
4	Chicago Stock Exchange	2005	—	—
5	National Stock Exchange	—	—	—
6	New York Stock Exchange	Pending	Pending	$4.2 billion[100]
	—with Archipelago			$6.0 billion[101]
7	Philadelphia Stock Exchange	2004	—	—
8	*Nasdaq Stock Market*[102]	*2002*	*2002*	*$2.1 billion*[103]

[98] As of September 7, 2005 (share price: CAD 38.81; number of issued shares: 68,070,252; exchange rate: CAD 1 = USD 0.842).

[99] As of September 7, 2005 (share price: USD 38.35; number of issued shares: 47,145,000).

[100] As of September 7, 2005. The New York Stock Exchange is not yet a publicly traded company. The market value is an estimation: The former seatholders of the New York Stock Exchange will get 70 percent of the new company (*Joint News Release*, *supra* note 82). So the New York Stock Exchange's value, based on the merger agreement, is Archipelago's present value multiplied by 7/3. Another way to calculate the New York Stock Exchange's value is to multiply the number of seats (1,366) by the current seat price ($2.9 million, as of August 30, 2005), which totals $4.0 billion. Both numbers do not include extra benefits that the members will get as part of the merger. So far, the New York Stock Exchange has announced an extra payment of $ 300,000 per seat and an undisclosed amount of "excess cash" that will be distributed. For the latest announcement, *see* (without author) *NYSE Tells Members Suit Would Be Costly*, THE WALL STREET JOURNAL, September 16, 2005, p. C3.

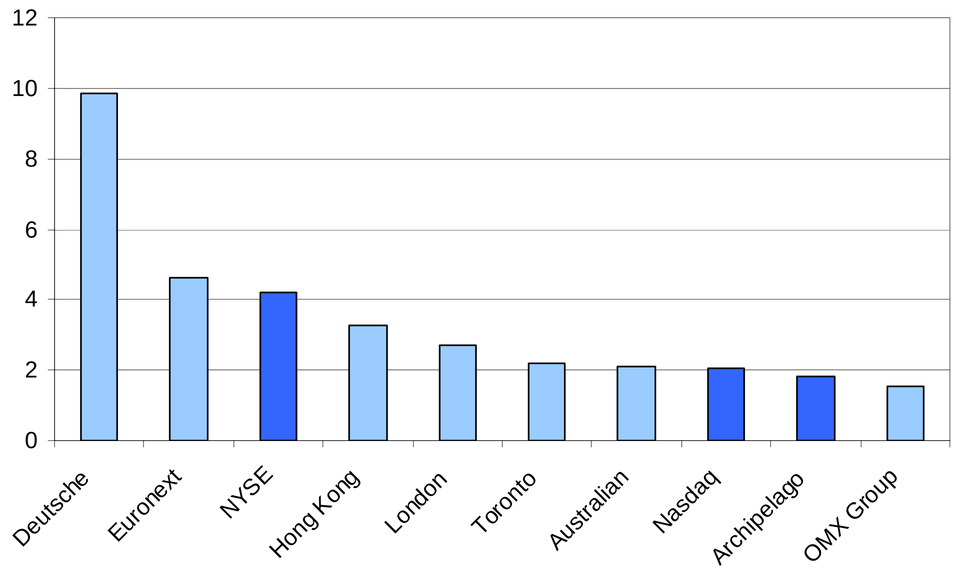
[101] As of September 7, 2005 (sum of Archipelago's and the New York Stock Exchange's value, based on the merger agreement).

[102] The Nasdaq Stock Market is not (yet) registered as national securities exchange under the Securities Exchange Act (Securities Exchange Act § 6, codified in 15 U.S.C. § 78f). Its demutualization progress, the private offerings, and finally the going public are therefore not further covered within this article.

[103] As of September 7, 2005 (share price: USD 25.35; number of issued shares: 81,636,000).

The following table compares the U.S. marketplaces (dark) with stock exchanges abroad (light):

CHART ONE
Market Value of the Market Operators
(in billion US-Dollars)



Although much could be said about these figures, one particular comparison shows clearly what is at stake for the United States.: Even after taking into account the merger with Archipelago, the New York Stock Exchange would have only 61 percent of Deutsche Börse's market value.[104] Before the merger announcement, at the seat price's low in January 2005, the New York Stock Exchange's market value reached only some 13 percent of Deutsche Börse's current market capitalization.[105] There are many reasons for that discrepancy, most notably that Deutsche Börse is a diversified company offering not only trading in stocks and derivatives but also ancillary services such as clearing, whereas the New York Stock Exchange still does virtually the same thing it has for the last two centuries: organizing a market solely for stocks.

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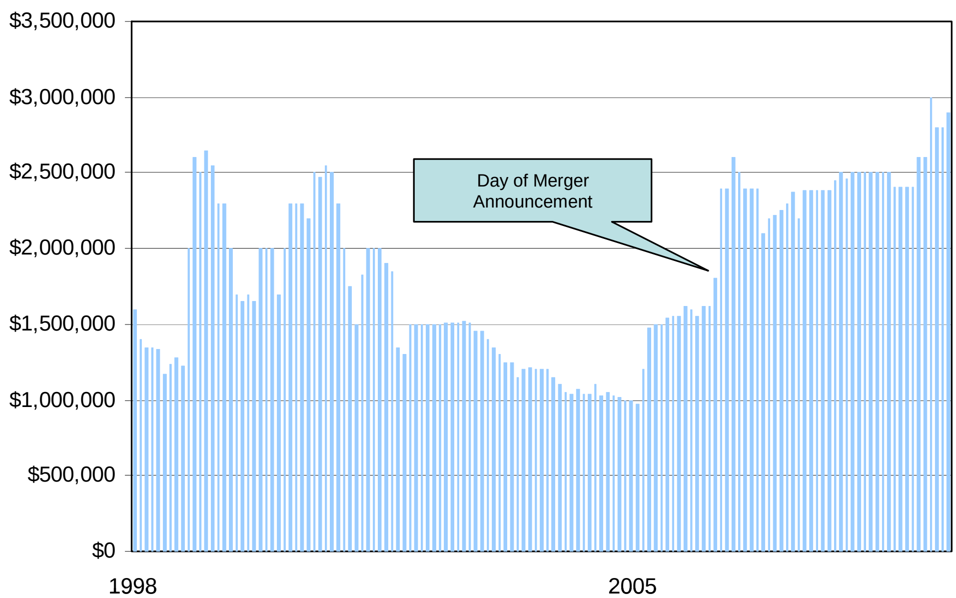
[104] $ 6.0 bn compared to $ 9.9 bn (*see supra* Table Two).

[105] $ 1.3 bn (1,366 seats multiplied by $ 975,000, the low as of January 11, 2005) compared to $ 9.9 bn (*see supra* Table Two). Earlier estimations for the New York Stock Exchange's market value were even lower. *See* Der Hovanesian, *Big Board On The Big Board*, *supra* note 71 ($0.9 bn). Concededly, Deutsche Börse's market value on January 11, 2005 was considerably lower.

The course of the seat prices since 1998 nicely illustrates the stormy period that the New York Stock Exchange has faced in recent history. Seats confer the right to buy and sell stocks at the New York Stock Exchange, both as agent (broker) and as principal (dealer). There are currently 1,366 seats on the New York Stock Exchange.[106] Seat prices performed as follows (up to September 7, 2005):

CHART TWO
(Trades in seats on the New York Stock Exchange)



On balance, the trend is clearly toward demutualization. In the short term, the exempting powers of the SEC may be sufficient to deal with demutualization. But for purposes of avoiding any kind of ambiguity, Congress would be well advised to amend the Securities Exchange Act and adjust it to the new organizational reality.

III. THE CASE FOR DEMUTUALIZATION AND GOING PUBLIC

Demutualization and subsequent going public are critical to any stock market's ability to compete with other marketplaces. While commentators sometimes identify distinct factors that drive demutualization, in fact they are all related to one single point:

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[106] *See* Certificate of Incorporation of New York Stock Exchange, Inc. § 13.

competition. [107] The stock exchanges themselves regularly emphasize the paramount importance of competition for their reorganization—for instance the New York Stock Exchange,[108] the Nasdaq Stock Market,[109] the Australian Stock Exchange,[110] the London Stock Exchange[111]—as well as neutral observers such as the SEC[112] and the International Organization of Securities Commissions.[113]

This part explains which forces drive competition [*infra* A], who competes [B], what markets are competing for [C], and most importantly, why demutualized and publicly traded stock exchanges can better compete than exchanges that are organized in the traditional mutual form [D].

A. FACTORS THAT FOSTER COMPETITION

This section outlines the factors that foster competition among marketplaces for stocks. The critical determinants are *deregulation* [a], *technology* [b], and *globalization* [c]. All three factors correlate with each other, but they can be identified as separate forces.

a) *Deregulation*. In recent years, we have seen several regulatory changes that foster competition in the stock markets. While it is hard to say whether the intensity of regulation overall has declined, there have been some critical acts of deregulation.[114]

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[107] The stock exchanges' decision to demutualize and to go public may also be influenced by selfish and therefore irrational reasons: Management profits from the higher prestige and compensation that it can earn when leading a for-profit company. The members of the stock exchange benefit by exchanging their illiquid seats for liquid stocks (the latter is a point that Bradley, *supra* note 10, emphasizes throughout her article; it is, however, unclear whether the seat on a stock exchange has enough value to influence the wealthy owners' decision to demutualize).

[108] During the latest move: *Joint News Release*, *supra* note 82; Thain, *supra* note 82; *see also* (without author) *The $1.5 Million Club: NYSE Seats Rebound*, THE WALL STREET JOURNAL, February 22, 2005 p. C3 (mentioning that members hope that changing to for-profit business would make the New York Stock Exchange more competitive); Carrick Mollenkamp, Edward Taylor & Aaron Lucchetti, *Europe May Offer a Glimpse Into Future of U.S. Exchange*, THE WALL STREET JOURNAL, April 22, 2005, p. C1 (mentioning the New York Stock Exchange's CEO stating that global competitors are all publicly traded companies) [hereinafter: *Europe May Offer a Glimpse*]. During the failed attempt in 1999: Grasso, *supra* note 69; New York Stock Exchange Press Release (October 11, 1999), *supra* note 68.

[109] Nasdaq Press Release, *Nasdaq to Become a Public Company* (April 26, 2001).

[110] Richard Humphry (Managing Director, Australian Stock Exchange), *ASX Demutualisation: Cause and Effect Address* (December 9, 1998) [hereinafter: *Cause and Effect*].

[111] *Cf.* Alan Cowell, *Old Exchange In London Tries A New Twist on Ownership*, N.Y. TIMES, July 31, 1999, p. C1 (about the London Stock Exchange).

[112] *See* Deborah Solomon, *Thrill Bill, 2: Donaldson Has Impact Again*, THE WALL STREET JOURNAL, May 2, 2005, p. C1 (quoting the SEC's Chairman William H. Donaldson in the context of the merger of the New York Stock Exchange and Archipelago as follows: "If you step back and look at what is in the process of happening now—the consolidation, the level playing field—this, I believe, is a prelude to *global competition*"; emphasis added).

[113] IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 3 (stating that "certain responses to competition, such as alliances and mergers between exchanges, may be facilitated by demutualization.").

[114] *See generally* (in an early assessment) Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J. LAW & ECON. 273 (1984).

The most important in fostering competition have been: (1) the end of fixed commissions;[115] (2) new order-handling rules;[116] (3) Regulation ATS, which should lower the entry barriers for new competitors;[117] and (4) decimalization, trading in decimals instead of eighths or sixteenths.[118] The most critical influence on competition in the near future will be the new National Market System.[119]

b) *Technology*. Notwithstanding the regulatory changes, the main reason that competition among stock markets has dramatically increased in the past few years is the astonishing technological progress of recent decades.[120] New communication and information technologies are driving the changes in the securities markets. The chairman of the Pacific Exchange's Board noted in 1999: "Technology—the lack of it—was the root of our problems 30 years ago. Today it is the source of both our challenges and our opportunities."[121] And yet more significantly: "Technology is a beast with an insatiable appetite for resources—faster processing speeds, greater capacity, bigger bandwidth, and more programmers."[122] New technologies have lowered the entry barriers and made it easier to establish alternative trading systems that compete with the established stock exchanges. The exchanges themselves have also invested heavily in new technology, so that we have seen continuously decreasing trading costs in recent years.[123] Even the New York Stock Exchange, the "dinosaur"[124] that even in the Internet age relied on humans to discover stock prices, finally hoisted the "white flag in the floor-trading war"[125] and announced creation of a hybrid market (which might be dispensable after the merger with Archipelago). Two factors here reinforce each other: Declining trading fees allow more frequent trades; more trades lead to huge economies of scale (once you have built

[115] Securities Exchange Act § 6(e), codified in 15 U.S.C. § 78f(e). Competition was believed to be in the best interest of all participants and the public. *See* Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 674 (1975).

[116] For an overview, *see* COFFEE & SELIGMAN, *supra* note 18, at 652-54.

[117] SEC, *Regulation ATS*, *supra* note 65.

[118] For an overview of the move to decimalization, *see* Karmel, *supra* note 10, at 373-75. *See also* COFFEE & SELIGMAN, *supra* note 18, at 655-56.

[119] For the National Market System, *see* the brief overview *infra* III.B.

[120] *See* IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 3. *See also* Carson, *World Bank Paper*, *supra* note 8, at 5; HKEx News Release, *Speech by Mr. Kwong Ki-chi at the HKEx News Conference* (March 6, 2000) [hereinafter: *Speech by Mr. Kwong Ki-chi*]. *See also* HKEx News Release, *Hong Kong Exchanges Starts a New Chapter Following Completion of Merger* (March 6, 2000) [hereinafter: *Chapter Following Completion*].

[121] Public Statement of Robert M. Greber (Chairman of the Board of Pacific Exchange, Inc.), *Moving Securities Exchanges into the 21st Century* (June 15, 1999).

[122] Greber, *supra* note 121.

[123] *See particularly* Ian Domowitz & Benn Steil, *Automation, Trading Costs, and the Structure of the Securities Trading Industry*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 33 (1999); Ian Domowitz & Benn Steil, *Securities Trading*, in: TECHNOLOGICAL INNOVATION AND ECONOMIC PERFORMANCE 314 (ed. Benn Steil, David G. Victor & Richard R. Nelson, 2002).

[124] Alan Murray, *Juvenile Antics Mar Fight Over NYSE Fate*, THE WALL STREET JOURNAL, April 27, p. A2.

[125] (Without author) *Really Big Board*, THE WALL STREET JOURNAL, April 22, 2005, p. A12. *See also* Peter A. McKay, *NYSE's Contrasts With Archipelago Need Reconciling*, THE WALL STREET JOURNAL, April 22, 2005, p. C14.

your trading system, it requires few if any additional funds to handle more orders), which in turn lead to further fee cuts and once again to more trades.

c) *Globalization*. Competition is to an increasing degree driven by foreign competitors.[126] Although the globalization of the financial markets is a relatively new development, it is nowadays a strong force in competition. Stock markets are no longer national monopolies, as investors easily cross borders today, forcing U.S. marketplaces to care about their global competitiveness.

B. MARKETPLACES THAT COMPETE

To understand why stock exchanges demutualize, one needs some basic understanding of the markets on which stocks are traded and of how those stocks are traded. The common term for this concept is *market structure*.

The structure of the U.S. stock market is a hot issue, driven mainly by the proposals of the SEC to amend the National Market System, which was created in 1975 to foster competition in the field of stock trading.[127] The Commission has recently adopted amendments to the National Market System.[128] Few proposals in the Commission's history have caused such intense public debate as these amendments.[129] For the purposes of this article, it is sufficient to outline the basic market structure.[130] As a simplified model, there are four main categories of marketplaces where stock is traded domestically:

a) *Stock exchanges*. Stock exchanges are those marketplaces registered as national securities exchanges under the Securities Exchange Act.[131] The number of stock ex-

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[126] *Cf.* Carson, *World Bank Paper*, *supra* note 8, at 5; *Speech by Mr. Kwong Ki-chi*, *supra* note 120. *New Chapter Following Completion*, *supra* note 120.

[127] For the goals of the National Market System, *see* Securities Exchange Act § 11A(a)(1), codified in 15 U.S.C. § 78k-1(a)(1). For an overview of the 1975 Amendments, *see supra* II.B.3. For bibliography on the original system, *see supra* fn. 54.

[128] S*ee* SEC, Release No. 34-513808 (File No. S7-10-04): *Regulation NMS* (June 9, 2005), 70 Fed. Reg. 37,496 (2005). For the first proposal, *see* SEC, Release No. 34-49325 (File No. S7-10-04): *Regulation NMS* (February 26, 2004), 69 Fed. Reg. 11,126 (2004). The comment period was extended and supplemental comment requested, *see* SEC, Release No. 34-49749 (File No. S7-10-04): *Regulation NMS* (May 20, 2004), 69 Fed. Reg. 30,142 (2004). Later, the SEC put forward a new proposal, *see* SEC, Release No. 34-50870 (File No. S7-10-04): *Regulation NMS* (December 16, 2004), 69 Fed. Reg. 77,424 (2004), corrected 70 Fed. Reg. 1,503 (2005).

[129] *See, e.g.*, Craig Pirrong, *The Thirty Years War*, REGULATION 54 (Summer 2005).

[130] For an overview and comparative analysis, *see* Stavros Gkantinis, *Reshaping the Global Securities Markets: A Comparative Study of the Proposed Regulation NMS in the U.S. and the EU Directive 2004/39/EC on Markets in Financial Instruments* (available at http://www.law.harvard.edu/programs/pifs/pdfs/stavros_gkantinis.pdf). For recent overviews of the former system, *see* Laura N. Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399 (2002); Marshall E. Blume, *The Structure of the U.S. Equity Markets*, BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 35 (2002).

[131] Securities Exchange Act § 6, codified in 15 U.S.C. § 78f.

changes has dramatically decreased in the last century. Whereas in 1900 we had more than one hundred stock exchanges in the United States,[132] this figure declined to thirty-four in 1934,[133] to fourteen exchanges registered with the SEC in 1962,[134] to the current seven, which will shrink by one when the merger of the New York Stock Exchange with Archipelago is completed, and increase by one if the Nasdaq Stock Market is finally granted stock exchange status. Compared to the other marketplaces, stock exchanges face a disadvantage insofar as they must regulate the securities markets while the other markets are not burdened with these expenses and free-ride on the stock exchanges' regulation.

b) *Over-the-counter markets*. Marketplaces that are not registered as national securities exchanges are called "over-the-counter" (OTC) markets. More than forty years ago, the U.S. Supreme Court described such trading as a market "established by traders in the numerous firms all over the country through a process of constant communication to one another of the latest offers to buy and sell."[135] The most important over-the-counter market is the Nasdaq Stock Market and the electronic bulletin board ("OTCBB").[136]

c) *Alternative Trading Systems*. A third category of marketplaces for stocks emerged in the last few years. We call these new marketplaces *alternative trading systems* ("ATS"). In its Regulation ATS, the SEC defines such trading systems as "any organization, association, person, group of persons, or system [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."[137] This definition is striking insofar as it properly describes what these trading systems offer an "alternative" for: they furnish execution services that traditionally were performed by a stock exchange. Hence, to determine whether a trading system is subject to the SEC's regulation, one has to refer to the term "stock exchange," a term which to date has not been precisely defined, and will, by its nature, most likely never be so defined.[138] The main category of such alternative trading systems is *electronic communication networks* ("ECN"),[139] such as INET, a sub-

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[132] COFFEE & SELIGMAN, *supra* note 18, at 23.

[133] Mahoney, *supra* note 25, at 1477.

[134] Silver v. New York Stock Exchange, 373 U.S. 341, 350 (1963).

[135] Silver v. New York Stock Exchange, 373 U.S. 341, 348 (1963).

[136] *See* http://www.nasdaq.com and http://www.otcbb.com, respectively. *See also recently* Nasdaq Press Release, *Nasdaq to Transfer OTCBB Business to the NASD* (July 8, 2005).

[137] *See* 17 C.F.R. § 242.300(a)(1). *See generally* SEC, *Regulation ATS*, *supra* note 65. For an critique before the Adoption of Regulation ATS, *see* Polly Nyquist, *Failure to Engage: The Regulation of Proprietary Trading Systems*, 13 YALE L. & POL'Y REV. 281 (1995).

[138] *See* Securities Exchange Act § 3(a)(1), codified in 15 U.S.C. § 78c(a)(1). The definition is further described in 17 C.F.R. § 240.3b-16. For more details, *see supra* fn. 17 and accompanying text.

[139] For a definition of electronic communication networks ("ECN"), see 17 C.F.R. § 240.11Ac1-1(a)(8).

sidiary of Instinet Group, Inc.,[140] which began operations as early as 1969.[141] Another example was Archipelago, which later was combined with two national securities exchanges and recently has announced its merger with the New York Stock Exchange.

d) *Block trading*. For trades in large blocks of stocks (generally over 10,000 shares or the equivalent of $200,000), there exist various markets and platforms that allow institutional investors to sell and buy such blocks.[142] The main advantage of such facilities is that investors can trade anonymously without attracting the notice of the market.[143] Technological developments might increase such direct trades in future.

Due to modern communications, foreign marketplaces of all four kinds can and increasingly do attract investors from the United States.[144]

When stocks of the same issuer are traded on different markets, there arise several regulatory concerns. Such market fragmentation leads to a loss of liquidity at each place and might cause the discovery of differing prices. Furthermore, the decision of the brokers about where to execute the customers' orders can be influenced by selfish motives, such as where the broker gets the highest kickback (often referred to euphemistically as "payment for order-flow").[145] It is such issues that the National Market System and other regulations address. And it is no coincidence that, considering the far-reaching consequences of the new National Market System, only two weeks after its adoption the New York Stock Exchange announced its merger with Archipelago and the Nasdaq Stock Market announced the takeover of Instinet's trading division.[146] Having been archrivals in different markets for a long time, in the new regime the New York Stock Exchange and the Nasdaq Stock Market will get closer to each other. It might be the beginning of a long-lasting duopoly.

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[140] Information available under http://www.inetats.com and http://www.instinet.com, respectively. Instinet is getting acquired by Nasdaq. *See, e.g.*, Gregory Zuckerman, Aaron Lucchetti & Dennis K. Berman, *Nasdaq Faces Head-On Assault From NYSE Deal*, THE WALL STREET JOURNAL, April 22, 2005, p. A1; Aaron Lucchetti, *Nasdaq Chief Plays Hardball In Instinet Deal*, THE WALL STREET JOURNAL, April 25, 2005, p. C1.

[141] COFFEE & SELIGMAN, *supra* note 18, at 625.

[142] JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 92 (4th ed. 2004); COFFEE & SELIGMAN, *supra* note 18, at 33.

[143] For an example, *see* COFFEE & SELIGMAN, *supra* note 18, at 38-42.

[144] For an overview, *see* Howell E. Jackson, Mark Gurevich and Andreas M. Fleckner, *The Controversy Over the Placement of Remote Trading Screens From Foreign Exchanges in the U.S.* (forthcoming; on file with author); S. Eric Wang, *Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities*, 10 U. MIAMI BUS. L. REV. 329 (2002).

[145] *See* Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675 (1994). These practices are nicely described by Michael Schroeder & Randall Smith, *Sweeping Change in Market Structure Sought*, THE WALL STREET JOURNAL, February 29, 2000, p. C1 ("[O]nline brokers keep control over their customers' order flow either by executing the orders within their own trading operations, or by shipping them out to firms that pay for such orders").

[146] Concededly, such transactions were planned long before, but they were planned taking into account the probable new regulatory environment.

C. SUBJECTS OF COMPETITION

The competition among marketplaces has two dimensions: Marketplaces compete for *listings* and for *orders*. To get more listings, stock exchanges have to attract issuers. To get more orders, stock exchanges have to attract traders. Both kinds of competition correlate: Marketplaces that have more listings attract more traders, and marketplaces with more traders catch the attention of more issuers. This correlation explains why stock markets tend to become oligopolies or even monopolies: The bigger a market is, the more it draws away the competitors' remaining customers. Liquidity is a magnet for more liquidity—a well-known insight discussed under the heading "network theory." Not surprisingly, the number of domestic stock exchanges declined over the last century from over one hundred to the current seven.[147]

On the other hand, as a factor that reduces the concentration tendency, stock exchanges no longer offer a unique product. Modern technologies reduce the entrance barrier to establishing marketplaces for stocks, and provide investors everywhere in the world with services that originally were reserved to stock exchanges. Congress intended to support this development through the introduction of the National Market System (NMS), which was supposed to ensure "fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets."[148] The last thirty years have certainly brought the desired competition, albeit perhaps different than expected: Competition for traders is strong, while competition for listings has so far been weak. It is difficult to judge whether this is good policy or not. Unlike in other areas, competition for issuers is only to a certain degree desirable in the stock markets, because it leads to fragmented markets and split liquidity. On the other hand, too much concentration hinders economic progress and raises antitrust concerns.

The following representation of the subjects of competition starts with the competition for listings [*infra* 1] and turns then to the competition for orders [2]. Both subsections distinguish between competition from domestic and from foreign marketplaces.

1. Competition for Listings

The major domestic competitors in the "battle for issuers" are the New York Stock Exchange and the Nasdaq Stock Market. Both compete heavily for new issuers, as was recently seen during the initial public offering of Google.[149] Once an issuer is listed, the competition is weak. Typically an issuer will start small, with a listing on the Nasdaq

[147] *See supra* III.B. a).

[148] Securities Exchange Act § 11A(a)(1)(C)(ii), codified in 15 U.S.C. § 78k-1(a)(1)(C)(ii).

[149] *See* Robin Sidel, *Google Plans to List on Nasdaq, Joining Ranks of Tech Notables*, THE WALL STREET JOURNAL, July 13, 2004, p. C5. For the discussion about the competition for listings, *see particularly* Jonathan R. Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORN. L. REV. 1007 (1990).

Stock Market, and then as a seasoned company move later to the New York Stock Exchange.[150]

Not surprisingly, the Nasdaq Stock Market tries to attack this seemingly natural rule by convincing seasoned issuers to list their stocks exclusively, or at least dually, on the Nasdaq Stock Market. So far, Nasdaq's efforts have been nearly without effect.[151] Dual listings are so rare that the Nasdaq Stock Market even places advertisements when a company decides to dual list on Nasdaq.[152] Another marketplace competing for dual listings is the Archipelago Exchange. It has been more successful and drawn some big companies for dual listing.[153] However, as Archipelago is now merging with the New York Stock Exchange, it will no longer be competing with the latter.

Increasing competition for international listings comes from marketplaces abroad.[154] Today, 451 foreign issuers are listed on the New York Stock Exchange, down from a peak of 473 in 2002.[155] In recent years, the U.S. markets seem to have lost their attractiveness to foreign issuers (for example, only eight new European issuers since 2002;[156] the number of Latin American issuers listed on the New York Stock Exchange has decreased from 103 in 2001 to currently 90).[157] There are different explanations for this development. Many observers blame the Sarbanes-Oxley Act and the increased regulatory costs that came with it.[158] Another explanation might be that in today's regulatory environment, issuers need not be listed in the United States. when they want to reach U.S. investors.[159]

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[150] COFFEE & SELIGMAN, supra note 18, at 26.

[151] *See* Gaston F. Ceron, *Nasdaq Gains Little in NYSE Fight*, THE WALL STREET JOURNAL, January 18, 2005, p. C3.

[152] *See, e.g.*, THE WALL STREET JOURNAL, May 2, 2005, p. C7 (announcing the dual listing of the Chicago Mercantile Exchange Holdings).

[153] *See, e.g.*, Theo Francis, *AIG, Long Traded on Big Board, Adds a Listing on Archipelago*, THE WALL STREET JOURNAL, January 12, 2005, p. C3. *See also* Joseph Weber, *Taking Aim at The Big Board*, BUSINESS WEEK, November 8, 2004, p. 42.

[154] For an overview of the share of foreign issuers on twenty-six exchanges worldwide, *see* Schich & Wehinger, *supra* note 35, at 93. *See generally* Stijn Claessens, Daniela Klingebiel & Sergio L. Schmukler, *Accessing International Equity Markets: What Firms from Which Countries Go Abroad* (working paper, March 2003; available at http://www.dise.unisa.it/PDF/Accessing%20International%20Markets_March13.pdf); Sofia B. Ramos, *Competition between Stock Exchanges: A Survey* (working paper, February 2003; available at http://ssrn.com/abstract=410727).

[155] *See* Andreas M. Fleckner, *Foreign Issuers on the New York Stock Exchange* (briefing paper prepared for the EU-US Financial Services Roundtable September 30 – October 1, 2005, Cambridge, United Kingdom; on file with author).

[156] Fleckner, *supra* note 155.

[157] Fleckner, *supra* note 155. *See also* Amy Guthrie, *Mexican Firms Leave NYSE*, THE WALL STREET JOURNAL, January 17, 2005, p. C14; Aaron Lucchetti & Craig Karmin, *Intensity to Be a 'Global' Stock Waned*, THE WALL STREET JOURNAL, May 10, 2005, p. C1.

[158] *See* (without author) *404 Tonnes of Paper*, THE ECONOMIST, December 18, 2004, p. 116; Daniel Epstein, *Goodbye, Farewell, Auf Wiedersehen, Adieu*, THE WALL STREET JOURNAL, February 9, 2005, p. A10; Lucchetti & Karmin, *supra* note 157.

[159] *See particularly* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part II* (unpublished manuscript) [for part I, *see* Howell E. Jackson & Eric J.

That foreign companies stay at home is only the first step. The next step is that U.S. companies will start to look abroad—as they did during the heyday of the new economy,[160] and as some kinds of businesses still do.[161] Globalization has made financing companies much more flexible, with the result that cross-border capital flows have increased dramatically.[162] Issuers today are willing and able to cross borders and raise money abroad. That means that in the middle and long term, the main competitors for exchanges in the United States will not be domestic marketplaces, but instead Frankfurt, Hong Kong, London, Paris, and Tokyo. Against this background, it is hardly unreasonable that the conservative New York Stock Exchange is considering breaking taboos and opening earlier to attract European issuers (as well as traders).[163] And even yet more revolutionary, the New York Stock Exchange considers trading other products such as derivatives, bonds, and exchange traded funds[164]—a clear sign that listing stocks alone is no longer considered sufficient. Derivatives especially offer interesting options, since the stock exchanges themselves "create" these securities. Put simply: unlike the situation with stocks, exchanges do not have to lure issuers but only traders.

On balance, domestic competition for issuers is still weak but increasing in strength, particularly given the overhauled National Market System. Meanwhile, developed marketplaces abroad remain a considerable threat.

2. Competition for Orders

The "battle for orders" is much more complex than the competition for issuers. The battle is fought among all four kinds of markets that trade stocks domestically and abroad.

Competition for orders is driven by various factors. Trading costs are in all cases a critical factor. Non-cost factors considered by most investors include liquidity, reliability, execution speed, and the quality of price discovery. Particularly for traders of huge blocks, anonymity is also a crucial factor (and one that stock exchanges oftentimes do

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Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I*, 56 BUS. LAW. 653 (2001)]. *See also* Jackson, Gurevich & Fleckner, *supra* note 144; Wang, *supra* note 144.

[160] The "new markets" in Europe, such as the *Neuer Markt* in Frankfurt, were able to attract a significant number of high tech companies that normally would have gone public on the Nasdaq Stock Market, but preferred the European alternatives.

[161] Jeff D. Opdyke, *Wall Street North: Listing in Toronto Piques U.S. Interest*, THE WALL STREET JOURNAL, March 24, 2005, p. C1.

[162] *See* COX, HILLMAN & LANGEVOORT, *supra* note 142, at 93-94 with impressive figures.

[163] Gaston F. Ceron & Aaron Lucchetti, *Big Board May Extend Trading Day*, THE WALL STREET JOURNAL, January 27, 2005, p. C3 [hereinafter: *Big Board May Extend Trading Day*].

[164] Ceron, *Pondering Transition*, *supra* note 79. *See also* (after the announcement of the merger with Archipelago) Aaron Lucchetti, Susanne Craig & Ann Davis, *NYSE to Acquire Electronic Trader And Go Public*, THE WALL STREET JOURNAL, April 21, 2005, p. A1; Peter A. McKay, *NYSE, Archipelago Plan to Offer a Variety of Financial Products*, THE WALL STREET JOURNAL, April 26, 2005, p. C1; Aaron Lucchetti, *NYSE Seat Price Increases 23%, Largest in 6 Years*, THE WALL STREET JOURNAL, January 25, 2005, p. C3.

not offer). Last but not least, *kickbacks* (also known as payments for order-flow) influence the allocation of orders.

Competition and fragmentation of the market for orders differ significantly among distinct groups of stocks. The New York Stock Exchange holds a market share of some 80 percent in the trading of stocks of issuers that are primarily listed on the New York Stock Exchange.[165] Conversely, the trade in stocks listed primarily on the Nasdaq Stock Market is much more fragmented. The Archipelago Exchange gives a good impression of this distinction: Archipelago holds a 25 percent market share in Nasdaq stocks, but only a 2 percent share in New York Stock Exchange listed issuers, despite some 230 dual listings.[166] Yet more threatening for the Nasdaq Stock Market is the competition by alternative trading systems. Although there are different estimations, the consensus is that electronic communication networks now handle roughly half of Nasdaq listed stock.[167]

As for the competition for issuers, domestic marketplaces increasingly feel the squeeze from foreign marketplaces and have to respond. Archipelago Exchange announced that it would start its trading at four o'clock a.m. Eastern Time to attract European investors.[168] And, as previously mentioned, even the New York Stock Exchange (which is merging with Archipelago) is considering opening earlier to attract European traders.[169]

D. COMPETITIVE ADVANTAGES OF PUBLIC STOCK EXCHANGES

Having outlined what fosters competition, who competes, and what the markets are competing for, the article turns now to the question of *why* demutualized and publicly traded stock exchanges will do better than exchanges under the traditional mutual structure: the new structure makes it easier to raise money [*infra* 1], facilitates decision making [2], and fosters consolidation [3].

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[165] SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,131 with general information and figures. *See also* William O. Brown, Jr., J. Harold Mulherin & Marc D. Weidenmier, *Competing with the NYSE* (working paper, August 2005; available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=785427).

[166] Weber, *supra* note 153; Lucchetti, Craig & Davis, *supra* note 164 ("about 25 % of trading volume in stocks listed on Nasdaq"). *See also* Van T. Nguyen, Bonnie F. Van Ness & Robert A. Van Ness, *Archipelago's Move Towards Exchange Status: An Analysis of Archipelago Trading in NYSE and NASDAQ Stocks* (working paper, May 2005; available at http://ssrn.com/abstract=720322).

[167] *See* SEC, *Concept Release Concerning Self-Regulation*, *supra* note 24, at 71,258.

[168] Pacific Exchange Press Release, *Electronic Exchange's Early Opening to Coincidence with European Trading Hours, Creating More Open, Transparent Markets* (November 23, 2004).

[169] Ceron & Lucchetti, *Big Board May Extend Trading Day*, *supra* note 163.

1. Raising Money

Raising money is one of the critical reasons for demutualization and going public. As explained in previous parts, technological advances represent one of the main forces that drive competition among stock markets. Marketplaces with state-of-the-art technology can cut costs and lower prices without incurring losses. However, having the trading system and other facilities up-to-date requires large amounts of money. The traditional mutual form cannot fulfill all capital needs because ownership is here restricted to brokers and dealers, which significantly limits the possible capital suppliers and makes it difficult to obtain the funds necessary to maintain modern trading systems. Stock exchanges regularly point to their capital needs when explaining their reasons for demutualization, as stressed for instance by the New York Stock Exchange,[170] the Pacific Exchange,[171] the London Stock Exchange,[172] and the Nasdaq Stock Market.[173]

2. Decision Making

Demutualization leads to dramatic changes in the management structure, a factor that has been somewhat neglected in *legal* scholarship.[174] Under the traditional structure, the broker-dealers are the key decision-makers. With demutualization and subsequent going public, however, ownership and control separate: Outside stockholders provide capital, nothing more. As in any other public company with dispersed ownership, small stockholders have a rational disinterest in actively contributing to the company's well-being. Thus the power over the daily business shifts from the broker-dealers to senior management when stock exchanges go public. This makes it much easier to run a business in a highly competitive environment than under the mutual structure. Said the chairman of the Pacific Exchange when the exchange demutualized:

> Membership organizations, especially exchanges, can be frustrating. It is difficult to implement new policies and new strategic decisions. The members, acting through committees or voting en masse on Constitutional amendments, must bless each significant change. Even where reform and enhancement is widely supported, the time necessary to secure committee and member approval can seem interminable.[175]

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[170] Grasso, *supra* note 69 (with respect to the failed attempt of 1999).

[171] Pacific Exchange Press Release, *Pacific Exchange Board approves Demutualization, Screen-Based Trading Plans* (December 13, 2000); Pacific Exchange Press Release, *SEC Approves Pacific Exchange Demutualization Plan* (May 20, 2004).

[172] Cowell, *supra* note 111.

[173] Nasdaq Press Release (April 26, 2001), *see supra* note 109. Nasdaq is not (yet) registered as a national securities exchange.

[174] *But see* Oliver Hart & John Moore, *The Governance of Exchanges: Members' Cooperatives Versus Outside Ownership*, 12(4) OXFORD REV. OF ECON. POL. 53 (1996); Craig Pirrong, *A Theory of Financial Exchange Organization*, 43 J. LAW & ECON. 437 (2000). *See also* Steil, *supra* note 10, at 68-71 (questioning the usefulness of both models).

[175] Greber, *supra* note 121.

Moreover, the interests of the members often conflict with the long-term interest of the exchange. For instance, floor brokers oppose electronic trading systems, which make their workplace obsolete, but in the long term, the stock exchange may need to invest in such a system to defend its market share. And for the stock exchange to succeed in drawing investors, it may need to reduce the spreads between ask and bid prices—a change that directly reduces the broker-dealers' income.

Managers of stock exchanges cautiously admit that one of the critical advantages in demutualized exchanges is the greater discretion they have. This has been acknowledged by all three demutualized exchanges in the United States —the Chicago Stock Exchange,[176] the Pacific Exchange,[177] and the Philadelphia Stock Exchange[178]—as well as during the New York Stock Exchange's failed attempt in 1999[179] and the demutualization of the Australian Stock Exchange[180] and the London Stock Exchange.[181] The need for demutualization of the other exchanges in the United States grows more pressing with every stock exchange that demutualizes, because more and more competitors will no longer be member organizations and will therefore have more flexibility in decision making.

The impact on the decision making within the stock exchange seems to be at least equally as important as raising money, given that publicly traded stock exchanges have only rarely raised money after demutualization. That the managers of stock exchanges put so much emphasis on raising money instead of the process of decision making might have an easy explanation: it is the members who make the decision to demutualize. Suggesting that the purpose of demutualization is to remove their powers would not help win their approval for demutualization.

3. Consolidation

Running a stock exchange is one of the best examples of *economies of scale*. Once an exchange has set up the trading facilities (such as floors and electronic systems), drafted the rules, formulated the corporate governance standards, and so forth, there are almost no further costs, regardless of the number of transactions performed at the exchange. Says the managing director of the Australian Stock Exchange:

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[176] Chicago Stock Exchange Press Release, *Chicago Stock Exchange Board of Governors Approves Demutualization Plan* (August 5, 2004); Chicago Stock Exchange Press Release, *Chicago Stock Exchange Members Approve Demutualization Plan* (November 11, 2004).

[177] Greber, *supra* note 121.

[178] Philadelphia Stock Exchange News Release, *Philadelphia Stock Exchange Board of Governors Authorizes PHLX Management to Pursue Demutualization Plan for the Exchange* (December 12, 2002).

[179] Grasso, *supra* note 69.

[180] Humphry, *Cause and Effect*, *supra* note 110.

[181] Cowell, *supra* note 111.

> [W]e have a very high proportion of fixed costs, much of it in computer and communications equipment, and a correspondingly low proportion of variable costs. The result is that, above a certain level, increased trading volumes in our markets don't just flow through to revenue, they largely flow through to profit.[182]

And the chairman of the Pacific Exchange:

> Drive more products over a single platform and you drive down the cost of each transaction.[183]

If two exchanges merge, they can almost halve most of their fixed expenses, like updating the trading system and reviewing their rules and corporate governance standards. Against this background, it is no wonder that stock exchanges oftentimes praise the advantages of consolidation and strategic partnerships when they demutualize and go public. Examples include the Chicago Stock Exchange,[184] the New York Stock Exchange,[185] the Pacific Exchange,[186] the Philadelphia Stock Exchange,[187] and, abroad, the Stock Exchange of Hong Kong.[188] As in other sectors, stock exchanges increasingly consider their stock as currency during takeovers.[189] We have already seen such consolidations: in Europe Euronext (built of four stock exchanges) and OMX Group (combined from five); in the United States Pacific Exchange and Archipelago, as well as Nasdaq Stock Market and BRUT (recognizing that Archipelago, Nasdaq, and BRUT are not registered as national securities exchanges). Nothing seems impossible: Even rumors about a merger of the Nasdaq Stock Market and the New York Stock Exchange found their way into the press.[190] After the CEO of the New York Stock Exchange said "We have too many exchanges,"[191] it took only six weeks until the announcement of the merger with Archipelago and of Nasdaq's takeover of Instinet.

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[182] Humphry, *First Four Months*, *supra* note 41.

[183] Greber, *supra* note 121.

[184] Chicago Stock Exchange Press Release (August 5, 2004), *supra* note 176.

[185] Grasso, *supra* note 69 (mentioning "strategic alliances") (with respect to the failed attempt of 1999).

[186] Pacific Exchange Press Release, *Pacific Exchange Demutualization Effort Advances* (September 29, 2000); Pacific Exchange Press Release (December 13, 2000), *supra* note 171; Pacific Exchange Press Release, *Pacific Exchange Board Unanimously Approves Corporate Restructuring, Demutualization* (September 16, 2003); Pacific Exchange Press Release, *Pacific Exchange Demutualization Plan Approves* (January 22, 2004); Pacific Exchange Press Release, *SEC Publishes Pacific Exchange Demutualization Proposal* (March 29, 2004); Pacific Exchange Press Release (May 20, 2004), *supra* note 171.

[187] Philadelphia Stock Exchange News Release (December 12, 2002), *supra* note 178.

[188] *See* HKEx News Release, *Speech by Mr. Lee Yeh-kwong, Charles at the HKEx News Conference* (March 6, 2000) [hereinafter *Speech by Mr. Lee Yeh-kwong*]; *New Chapter Following Completion*, *supra* note 120.

[189] Pacific Exchange Press Release (December 13, 2000), *supra* note 171; Werner Seifert (then CEO of Deutsche Börse), cited pursuant to (without author) *Deutsche Börse Shares Jump*, N.Y. TIMES, February 6, 2001, p. W1; Nasdaq Press Release (April 26, 2001), *see supra* note 109.

[190] *See* Kate Kelly & Susanne Craig, *NASDAQ Chief Approaches NYSE to Explore Merger*, THE WALL STREET JOURNAL, December 23, 2003, p. A1. *See also* Nasdaq Press Release, *A Statement From NASDAQ* (December 23, 2003) (denying this "unverified story based on rumors and speculation").

[191] John A. Thain, cited pursuant to (without author) *NYSE Seeks Approval for Changes*, THE WALL STREET JOURNAL, March 9, 2005, p. C4.

Consolidation among stock markets is a good example of how technology shapes the market structure: A century ago, it made economic sense to have separate stock exchanges on the West Coast and on the East Coast. Communication, restricted to phone calls, telegrams, and mail, was expensive and time-consuming. Today, in the Internet age, it does not matter where in the United States or the world you are based. The better the means of communication, the less efficient, comparatively, are regional exchanges.

IV. CONFLICTS OF INTEREST

Demutualization is far from free of challenges. Various regulatory problems arise when stock exchanges demutualize, go public, and list their stock. If we are unable to address the challenges that come with this progress, the traditional regulatory system—most importantly the concept of self-regulation—faces an uncertain future. This is why so many observers are worried about the progress of demutualization and the changes it brings.

All regulatory concerns related to demutualization arise from one source: the stock exchanges' regulatory powers. Without its public mandate, a stock exchange could be treated as any other financial institution. But with the far-reaching regulatory powers that Congress and the SEC have conferred on the stock exchanges, their organizational structure needs our utmost attention. Most worrisome are conflicts of interest that might divert the stock exchanges from fulfilling their regulatory duties and the trust that has been put into them. The possibility of conflicts of interest in publicly traded stock exchanges is not an invention of outsiders. The stock exchanges themselves are, though to a lesser degree, aware of these conflicts.[192] The chief regulatory officer of the New York Stock Exchange acknowledges that there are "undeniably" conflicts related to self-regulation.[193] The SEC repeatedly investigates cases in which self-regulatory organizations have shown enforcement deficits, apparently as a result of influence by business interests.[194] Stock exchanges "are not immune from governance missteps"—so says none other than William H. Donaldson, former chairman of both the New York Stock Exchange and the SEC.[195] To the extent that demutualization increases the likelihood of such "missteps," Congress and the SEC must intervene.

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[192] *Cf.* Carson, *World Bank Paper*, *supra* note 8, *passim* (with numerous sections about the "exchange view"). *See* expressly *id.* at 20 ("Some exchanges acknowledged that under competitive pressure, standards could slip without strong oversight").

[193] Richard G. Ketchum, cited pursuant to Der Hovanesian, *Big Board On The Big Board*, *supra* note 71.

[194] *See, e.g.*, the enforcement deficits that led to the separation of the regulatory arm of the National Association of Securities Dealers (SEC, Release No. 34-37538 (File No. 3-9056): *In the Matter of National Association of Securities Dealers, Inc.* (August 8, 1996), Fed.Sec.L.Rep. ¶85,525 (1996)) and the recently settled investigations against the New York Stock Exchange and its specialists (SEC, Press Release No. 2005-53: *SEC Charges the New York Stock Exchange with Failing to Police Specialists* (April 12, 2005)).

[195] Donaldson, *supra* note 12.

Before we come to the proposed amendments to the regulatory system, this Part examines the regulatory challenges that demand the proposed changes. The presentation commences with an overview of the regulatory powers of stock exchanges that cause the concerns [*infra* A] and turns then to the various conflicts of interests that arise when stock exchanges demutualize and go public [B – H].

A. REGULATORY ENVIRONMENT

Among the institutions that offer financial services, stock exchanges are out of the ordinary. Like other financial institutions—banks, insurance companies, and investment funds—stock exchanges are regulated. But unlike the other institutions, stock exchanges are also regulators, insofar as they have regulatory powers over their markets and the market participants, a concept known as *self-regulation.*[196]

This section is divided into three sections: it commences with a discussion of the idea of self-regulation [*infra* 1], and turns then to the governmental powers over stock exchanges [regulation *of* stock exchanges; 2] as well as the self-regulatory powers of stock exchanges [regulation *by* stock exchanges; 3].

1. Concept of Self-Regulation

The Securities Exchange Act establishes a two-tiered approach for the regulation of the stock markets: self-regulation, coupled with governmental oversight.[197]

Self-regulation is carried on by (1) national securities exchanges,[198] (2) registered securities associations,[199] (3) registered clearing agencies,[200] and (4) various other organizations.[201] This article is limited to national securities exchanges, which are often referred to simply as “stock exchanges.” The governmental oversight of such exchanges

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[196] The SEC regularly emphasizes this aspect. *See* recently the first (sic!) sentence of the SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations, supra* note 5, at 71,127: “The system of regulation for our Nation’s securities markets and market participants is grounded on the principle of *self-regulation*.” (emphasis added).

[197] Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 667 (1975). *See also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 127-8 (1973). *See generally* the (incomplete) definition in Securities Exchange Act § 3(a)(26), codified in 15 U.S.C. § 78c(a)(26).

[198] Securities Exchange Act § 6, codified in 15 U.S.C. § 78f.

[199] Securities Exchange Act § 15A, codified in 15 U.S.C. § 78o-3.

[200] Securities Exchange Act § 17A, codified in 15 U.S.C. § 78q-1. For the question of whether a system is a exchange or a clearing agency, *see* Board of Trade of the City of Chicago v. Securities and Exchange Commission, 883 F.2d 525 (7th Cir. 1989); Board of Trade of the City of Chicago v. Securities and Exchange Commission, 923 F.2d 1270 (7th Cir. 1991).

[201] The Municipal Securities Rulemaking Board (“MSRB”), established by Securities Exchange Act § 15B, codified in 15 U.S.C. § 78o-4, is treated as a self-regulatory organization solely for purposes of Securities Exchange Act §§ 19(b), 19(c), and 23(b), codified in 15 U.S.C. §§ 78s(b), 78s(c), and 78w(b). The Sarbanes-Oxley Act recently added the Public Company Accounting Oversight Board (PCAOB). *See* Sarbanes-Oxley Act §§ 101 et seq., codified in 15 U.S.C. §§ 7211 et seq.

is carried out by the Securities and Exchange Commission, a federal administrative agency that was, as discussed earlier, inaugurated in 1934 by the Securities Exchange Act.[202]

What does self-regulation mean? The standard definition describes self-regulation as a regulatory regime under which an organization or industry sector establishes its own rules and regulates itself accordingly.[203] Under the current system, stock exchanges are, to a considerable extent, self-regulators because they set the rules for the markets they organize. This regime is *self*-regulation because the market participants are involved in the rulemaking. In particular, representatives of the distinct constituencies must be on the stock exchange's boards,[204] namely executives representing member firms that deal with the public, specialists, floor brokers, lessor members, listed companies, institutional investors, and individual investors.[205] Therefore, the stock exchange's constituencies set the rules for themselves, or, to be more precise, through the stock exchange as a separate regulatory body.

The underlying idea of self-regulation is to benefit from the industry's wisdom and superior knowledge compared to the government. If anyone can best understand and identify fraudulent and illegal behavior, it is the industry itself. Furthermore, rules enacted by the affected persons tend to be accepted and observed sooner than rules set by outsiders.[206] Another acknowledged advantage of self-regulation is that self-regulatory organizations can rely on the industry's funds, and are therefore better and more efficiently funded than a governmental agency.[207]

Needless to say, resting solely on self-regulation bears some risks, because self-regulators are not disinterested but biased by their industry affiliation. That is where government comes in, providing, or at least threatening, impartial control. No one said it better than the former chairman of the SEC, Justice William O. Douglas:

> [Self-Regulation] is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.[208]

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[202] Securities Exchange Act § 4, codified in 15 U.S.C. § 78d. For a general introduction, *see supra* II.B.2.

[203] *Cf.* BLACK'S LAW DICTIONARY (ed. Bryan A. Garner; 8th ed. 2004).

[204] Securities Exchange Act § 6(b)(3), codified in 15 U.S.C. § 78f(b)(3). S*ee*, *e.g.*, NYSE Constitution Art. IV § 2 (Board of Directors) and Art. V § 2 (Board of Executives).

[205] *See, e.g.*, NEW YORK STOCK EXCHANGE, *supra* note 35, at 49.

[206] IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 6. In addition, self-regulatory organizations may be better able to response to misconduct that falls short of fraud (for this argument, *see* COFFEE & SELIGMAN, *supra* note 18, at 673-74).

[207] COFFEE & SELIGMAN, *supra* note 18, at 73, 673. For an overview of the said main advantages of self-regulation, *see* Dombalagian, *supra* note 50, at 1093-1100.

[208] DOUGLAS, *supra* note 49, at 82. Justice Douglas was Chairman of the SEC from September 21, 1937 to April 16, 1939 (*see* http://www.sec.gov/about/concise.shtml#history).

With this in mind, the following sections discuss the stock exchange's regulatory environment. This representation is a prerequisite for understanding and discussing the regulatory problems that arise when self-regulating stock exchanges demutualize and go public. The next section deals with the regulation *of* the stock exchanges (governmental powers), followed by regulation *by* the stock exchanges (self-regulatory powers).

2. Regulation of Stock Exchanges (Governmental Powers)

The governmental oversight of stock exchanges can be divided into two parts: First, there are certain requirements for registration as a self-regulatory organization. Second, the SEC continuously monitors and controls the stock exchanges' conduct.

Stock exchanges have to register with the Commission. Transactions on unregistered exchanges are, unless an exemption applies, unlawful.[209] An exchange will not be registered as a national securities exchange unless it is

> so organized and has the capacity to carry out the purposes of [the Securities Exchange Act] and to comply, and … to enforce compliance by its members and persons associated with its members, with the provisions of [the Securities Exchange Act], the rules and regulations thereunder, and the rules of the exchange.[210]

Congress has enacted a detailed catalogue of requirements that must be fulfilled.[211] For the SEC, the seven most important are:[212]

> (1) The rules of the national securities exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange or association respectively, broker, or dealer.[213]
>
> (2) The rules of the exchange or association respectively provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities and systems.[214]

Furthermore, the rules of the exchange or the association respectively are to be designed

> (3) to prevent fraudulent and manipulative acts and practices,

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[209] Securities Exchange Act § 5, codified in 15 U.S.C. § 78e.

[210] Securities Exchange Act § 6(b)(1), codified in 15 U.S.C. § 78f(b)(1).

[211] *See* Securities Exchange Act § 6(b)(2)-(9), codified in 15 U.S.C. § 78f(b)(2)-(9).

[212] *See* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,128-29. *See also* the list in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 128-29 (1973). The text stating the requirements borrows from the language of Securities Exchange Act § 6(b), codified in 15 U.S.C. § 78f(b). Variations are not highlighted.

[213] *See* Securities Exchange Act § 6(b)(3), codified in 15 U.S.C. § 78f(b)(3).

[214] *See* Securities Exchange Act § 6(b)(4), codified in 15 U.S.C. § 78f(b)(4).

(4) to promote just and equitable principles of trade,

(5) to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general,

(6) to protect investors and the public interest.[215]

And finally:

(7) The rules of the exchange provide that its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of the Securities Exchange Act, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction. Such rules must provide a fair procedure for the disciplining of members and persons associated with members.[216]

When an exchange fulfills these requirements and gets registered, the governmental powers over that exchange are far from exhausted. As explained in earlier parts of this article, the SEC has acquired increasing power over the stock exchanges in recent decades, making the stock exchanges more like subsidiaries of the Commission than the private clubs that they once were. It is this already existing power of the Commission that argues against much more regulation in the case of demutualization and going public of stock exchanges, as the article will point out later.

As a general guideline, the Commission has to take action whenever a self-regulatory organization does not sufficiently protect investors.[217] While in earlier days it could be said that the SEC's general function was supervisory,[218] the 1975 Amendments gave the Commission a significantly more active role. Out of the broad bouquet of powers that the SEC has over stock exchanges, most noteworthy are:

(1) Stock exchanges have to file with the SEC if they want to change their rules. Absent exemptions, changes do not take effect unless the Commission has approved the proposed rule change.[219]

(2) If the SEC does not like the existing rules of a stock exchange, the Commission is empowered to abrogate, add to, and delete from rules of the stock exchange.[220]

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[215] *See* Securities Exchange Act § 6(b)(5), codified in 15 U.S.C. § 78f(b)(5).

[216] *See* Securities Exchange Act § 6(b)(6) & (7), codified in 15 U.S.C. § 78f(b)(6) & (7). The SEC mentions only subsection (7). *See* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,129. This is apparently a mistake.

[217] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 130 (1973); SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,128.

[218] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 129 (1973).

[219] Securities Exchange Act § 19(b), codified in 15 U.S.C. § 78s(b). *But see* SEC, Release No. 34-49505 (File No. S7-18-04): *Proposed Rule Changes of Self-Regulatory Organizations* (March 30, 2004), 69 Fed. Reg. 17,864 (2004).

[220] Securities Exchange Act § 19(c), codified in 15 U.S.C. § 78s(c).

(3 The SEC can even amend a stock exchange's Constitution and Certificate of Incorporation.[221] For instance, as expressly stated, the Commission can increase the number of seats at a stock exchange if the current limit overly hinders competition.[222]

(4) The SEC can investigate whether persons regulated by the stock exchanges comply with the Securities Exchange Act, the rules or regulations thereunder, and the rules of the national securities exchange.[223]

(5) If stock exchanges do not fulfill their obligations under the Securities Exchange Act or the rules promulgated thereunder, the SEC is empowered to impose limitations on their business[224] or remove their officers and directors.[225] If such actions are not an adequate response to the misconduct, the Commission is authorized to suspend or revoke the registration of the non-complying stock exchange.[226]

(6) The SEC reviews the disciplinary actions that self-regulatory organizations impose on their members.[227]

(7) The SEC can demand all information necessary to fulfill its oversight function. Stock exchanges are required to keep records and to file reports with the Commission.[228] The records are subject to examinations by the Commission.[229]

Despite these broad powers, there remain areas in which stock exchanges have power that the SEC does not have, for the Commission's powers are limited to advancing the goals of the Securities Exchange Act. The best known example of such an area is the set of rules that governs the issuers' corporate governance.[230] As held in the famous *Business Roundtable* decision, the Commission lacks authority to initiate corporate governance rules or to intervene against them.[231]

In addition to the SEC there are two other major players in the governmental oversight of stock exchanges. The first is Congress. The facts of the landmark *Gordon* case

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[221] *See* the definition of "rules of an exchange" in Securities Exchange Act § 3(27), codified in 15 U.S.C. § 78c(27).

[222] Securities Exchange Act § 6(c)(4), codified in 15 U.S.C. § 78f(c)(4). For the number of seats at the New York Stock Exchange (1,366), *see* Certificate of Incorporation of the New York Stock Exchange, Inc. § 13.

[223] Securities Exchange Act § 21(a), codified in 15 U.S.C. § 78u(a). At any rate, the SEC can discipline brokers and dealers directly when they are, as usually, registered with the SEC (*see* Securities Exchange Act § 15(b)(4) - (6), codified in 15 U.S.C. § 78o(b)(4) - (6)). *Cf.* Board of Trade of the City of Chicago v. Securities and Exchange Commission, 923 F.2d 1270, 1276 (7th Cir. 1991) (dissenting opinion).

[224] Securities Exchange Act § 19(h)(1), codified in 15 U.S.C. § 78s(h)(1).

[225] Securities Exchange Act § 19(h)(4), codified in 15 U.S.C. § 78s(h)(4).

[226] Securities Exchange Act § 19(h)(1), codified in 15 U.S.C. § 78s(h)(1).

[227] Securities Exchange Act § 19(d)(2), codified in 15 U.S.C. § 78s(d)(2).

[228] Securities Exchange Act § 17(a)(1), codified in 15 U.S.C. § 78q(a)(1).

[229] Securities Exchange Act § 17(b), codified in 15 U.S.C. § 78q(b).

[230] For the stock exchanges as corporate governance trendsetters, *see supra* II.A.4.

[231] The Business Roundtable v. Securities and Exchange Commission, 905 F.2d 406 (D.C.Cir. 1990).

give a nice illustration of the interplay between the Commission and Congress.[232] Dissatisfied with the SEC's progress in banishing fixed commissions at the stock exchanges, Congress intervened and forbade fixed commissions through the Securities Acts Amendments of 1975.[233] And there is a second additional player: the courts. However, even though the courts have the final say, they often rely largely on the SEC's judgment.[234]

The powers by the SEC are not a theoretical threat; rather, the Commission is omnipresent in the stock exchange's life. One will hardly find an issue of the *Federal Register* without proposed stock exchange rule changes, approvals, etc. Moreover, the SEC regularly brings actions against stock exchanges. And, as will be discussed in the following section, it does not flinch from taking on the biggest player, the New York Stock Exchange.

3. Regulation by Stock Exchanges (Self-Regulatory Powers)

After the regulatory powers *over* stock exchanges, this section turns to the regulatory powers *of* stock exchanges. These powers are critical for the following discussion about demutualization, listing, and self-listing of stock exchanges, because it is the regulatory powers of stock exchanges that create various conflicts of interest if stock exchanges demutualize and go public.

As self-regulatory organizations, stock exchanges bear a "front-line" responsibility for regulation of their markets and for controlling their members' compliance with the provisions to which they are subject.[235] Emphasizing the importance of the self-regulatory organizations to the regulation of our securities markets, the SEC recently stated that the self-regulatory organizations are "charged with an important public trust to carry out their responsibilities effectively and fairly, while fostering free and open markets, protecting investors, and promoting the public trust."[236] In this context, it is important to note that self-regulation is not a right granted to the stock exchanges, but rather a statutorily imposed duty.[237] Stock exchanges have an obligation to regulate themselves.[238] If an entity fails to perform that function, it will not be registered as a

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[232] *See* Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 679-81 (1975).

[233] Securities Exchange Act § 6(e), codified in 15 U.S.C. § 78f(e).

[234] *See, e.g.*, Gordon v. New York Stock Exchange, Inc., 422 U.S. 659, 686 (1975).

[235] The term "front-line" is regularly used by the SEC, *see* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,128. *See also* Letter from the SEC's Chairman William H. Donaldson to relevant self-regulatory organizations, *supra* note 32.

[236] SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,129, referring to Securities Exchange Act § 6(b)(5), codified in 15 U.S.C. § 78f(b)(5) (national stock exchanges) and Securities Exchange Act § 15A(b)(6), codified in 15 U.S.C. § 78o-3(b)(6), respectively (registered securities associations).

[237] *See particularly* the obligations in the catalogue of Securities Exchange Act § 6(b), codified in 15 U.S.C. § 78f(b). *See also* Silver v. New York Stock Exchange, 373 U.S. 341, 353 (1963).

[238] Silver v. New York Stock Exchange, 373 U.S. 341, 356 (1963).

national securities exchange, and any previously granted registration will be revoked.[239] Regulation is a critical part of the stock exchanges' business. For instance, the New York Stock Exchange, as the largest stock exchange, employs some seven hundred employees for regulatory issues,[240] 40 (!) percent of its staff.[241]

The scope of the stock exchange's self-regulation has been somewhat neglected so far. That will presumably change when the conflicts of interest in publicly traded stock exchanges draw more attention. We often read that the stock exchanges' constituencies are subject to its regulatory powers, particularly the stock exchange's members and the listed issuers. In a simplified way this notion is correct, and is the basis for the following discussion, which distinguishes between powers over members and over issuers. However, as will be discussed in more detail later, the power over issuers is not a regulatory power in a literal sense, because its basis is not the Securities Exchange Act and the rules thereunder, but rather the contract between the stock exchange and the issuer (the so-called *listing agreement*). This distinction is especially important for demutualized and publicly traded stock exchanges.

(1) *Regulation of Members*. Stock exchanges have the power and the duty to enforce the compliance of their members with the Securities Exchange Act, the rules and regulations thereunder, and the stock exchange's rules.[242] The members are usually referred to as the *seatholders*. The same rules apply to persons associated with the stock exchange's members.[243] The stock exchanges' rulemaking powers are limited to matters related to the purposes of the Securities Exchange Act and the administration of the stock exchange.[244] For example, the New York Stock Exchange enforces the prospectus delivery duties that their members have under federal securities law when they sell certain securities.[245]

Within this scope, stock exchanges have the power and the obligation to ensure that their members are reliable, both financially and in regard to their conduct. Concerning the former, the regulation of the stock exchange covers the entire financial and operating compliance of its members. Brokers and dealers that are members of the stock exchange must meet the financial requirements set by the exchange.[246] Concerning the members'

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[239] Securities Exchange Act § 19(h)(1), codified in 15 U.S.C. § 78s(h)(1).

[240] Der Hovanesian, *Big Board On The Big Board*, *supra* note 71.

[241] New York Stock Exchange at http://www.nyse.com/regulation/.

[242] Securities Exchange Act § 6(b)(1) & (5), codified in 15 U.S.C. § 78f(b)(1) & (5); Securities Exchange Act § 19(g)(1)(A), codified in 15 U.S.C. § 78s(g)(1)(A). *See also* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,131. *See generally* COFFEE & SELIGMAN, *supra* note 18, at 674.

[243] *See* Securities Exchange Act § 19(g)(1)(A), codified in 15 U.S.C. § 78s(g)(1)(A). The term "person associated with a member" is defined in Securities Exchange Act § 3(21), codified in 15 U.S.C. § 78c(21).

[244] Securities Exchange Act § 6(b)(5), codified in 15 U.S.C. § 78f(b)(5).

[245] *See* Ann Davis, *No Prospectus? NYSE Blames Brokerage Firms*, THE WALL STREET JOURNAL, November 16, 2004, p. C1.

[246] Securities Exchange Act § 6(c)(3)(A), codified in 15 U.S.C. § 78c(c)(3)(A).

conduct, stock exchanges have to enact rules that establish expectations for training, experience, and competence on the part of brokers and dealers that trade at the stock exchange.[247]

In recent years, trust in the stock exchanges' willingness and ability to regulate their members has seriously suffered. Recently the SEC charged the New York Stock Exchange for failing to police its specialists for a period of almost four years.[248] In addition, the Commission instituted enforcement actions against twenty specialists allegedly involved in the violations,[249] after having settled enforcement actions against all seven specialist firms one year ago.[250] This failure of the New York Stock Exchange in monitoring its members is not the first incident; similar misconduct occurred in 1999.[251] This time, the New York Stock Exchange agreed to tighten significantly its oversight, for example by videotaping the members' conduct.

(2) *Market surveillance*. Closely related to the regulation of the members is the market surveillance carried on by the stock exchanges, because it is the members who trade on the market. However, where the general member regulation is directed toward the members' attributes and characteristics, market surveillance is directed toward the members' behavior. The classic focuses are insider trading and market manipulation, but there are numerous other forms of misconduct that conflict with the mandate to provide fair trading and treatment of investors. For instance, members of stock exchanges must not trade ahead of any order of a non-member.[252]

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[247] Securities Exchange Act § 6(c)(3)(B), codified in 15 U.S.C. § 78c(c)(3)(B).

[248] SEC, Press Release No. 2005-53 (April 12, 2005), *supra* note 194 (stating that the New York Stock Exchange violated Securities Exchange Act § 19(g), codified in 15 U.S.C. § 78s(g); Securities Exchange Act § 11(b), codified in 15 U.S.C. §78k(b), and Rule 11b-1 thereunder, codified in 17 C.F.R. 240.11b-1; NYSE Rule 92; NYSE Rule 104.10). *See also* Deborah Solomon, Kate Kelly & Gaston F. Ceron, *SEC Prepares to Charge the NYSE*, THE WALL STREET JOURNAL, January 13, 2005, p. C3; Kara Scannell & Aaron Lucchetti, *Ex-Specialists Face Indictment For NYSE Deals*, THE WALL STREET JOURNAL, April 12, 2005, p. C1; Aaron Lucchetti & Kara Scannell, *Fifteen Indicted in NYSE Case*, THE WALL STREET JOURNAL, April 13, 2005, p. C1.

[249] SEC, Press Release No. 2005-54: *SEC Institutes Enforcement Action Against 20 Former New York Stock Exchange Specialists Alleging Pervasive Course of Fraudulent Trading* (April 12, 2005) (alleging violations of Securities Exchange Act § 17(a), codified in 15 U.S.C. § 77q(a); Securities Exchange Act § 10(b), codified in 15 U.S.C. § 78j(b), and Rule 10b-5 thereunder, codified in 17 C.F.R. 240.10b-5; Securities Exchange Act § 11(b), codified in 15 U.S.C. §78k(b), and Rule 11b-1 thereunder, codified in 17 C.F.R. 240.11b-1; NYSE Rule 92; NYSE Rule 104; NYSE Rule 123B; NYSE Rule 401).

[250] (1) In the Matter of Bear Wagner Specialists LLC, Securities Exchange Act Rel. No. 34-49498 (March 30, 2004); (2) In the Matter of Fleet Specialist, Inc., Securities Exchange Act Rel. No. 34-49499 (March 30, 2004); (3) In the Matter of LaBranche & Co. LLC, Securities Exchange Act Rel. No. 34-49500 (March 30, 2004); (4) In the Matter of Spear, Leeds & Kellogg Specialists LLC, Securities Exchange Act Rel. No. 34-49501 (March 30, 2004); (5) In the Matter of Van der Moolen Specialists USA, LLC, Securities Exchange Act Rel. No. 34-49502 (March 30, 2004); (6) In the Matter of SIG Specialists, Inc., Securities Exchange Act Rel. No. 34-50076 (July 26, 2004); (7) In the Matter of Performance Specialist Group LLC, Securities Exchange Act Rel. No. 34-50075 (July 26, 2004).

[251] In the Matter of New York Stock Exchange, Inc., Release No. 34-41574 (June 29, 1999).

[252] *See* Securities Exchange Act § 11(a)(1)(G)(ii), codified in 15 U.S.C. § 78k(a)(1)(G)(ii), and rules thereunder. For investigations in this field, *see, e.g.*, Jed Horowitz, *NYSE Bars Former Specialist For Failure to Cooperate in Probe*, THE WALL STREET JOURNAL, December 9, 2004, p. C6.

(3) *Regulation of Issuers*. Stock exchanges regulate issuers for two purposes: First, they create rules to ensure that the stocks of the issuers can be reliably traded, and second, they create rules to ensure that the stocks are worth trading, namely that the issuers meet corporate governance standards. The first set of rules aims at the *quality of the trading*, the second set aims at the *quality of the traded stocks*. In regard to the former, stock exchanges require *minima* of stockholders, outstanding publicly traded shares, and market capitalization necessary to have a liquid market in the stocks.[253] In regard to the latter, stock exchanges demand minimum corporate governance standards—stock exchanges act thereby as corporate governance trendsetters, a function that was discussed at the beginning of this article.

The problem with the regulation of issuers is that their duties do not depend on the Securities Exchange Act, rules and regulations thereunder, or on the stock exchange's rules, but rather on a contract between the stock exchange and the issuer, the so-called listing agreement.[254] Therefore, stock exchanges have no *regulatory* power (in a literal sense) over non-complying issuers, but only the powers given in the listing agreement. For instance, if an issuer does not comply with the listing rules, absent special provisions in the listing agreement the stock exchange has no remedy to fine the issuer. Rather, the stock exchange is limited to admonishing and threatening to delist the issuer. This creates problems when demutualized stock exchanges list their stocks on their own market.[255]

For all kinds of regulation by the stock exchanges, it is important to remember from earlier parts of this article that the stock exchanges' regulatory powers are often only the first layer of oversight. With respect to many areas, the SEC has the powers to intervene mentioned above. For instance, if issuers of securities fail to file the reports required under the Securities Exchange Act,[256] the Commission has powers to suspend trading in such companies or even revoke the registration, which makes future trading unlawful.[257] This prohibition affects the stock exchanges' member, trading, and issuer regulation, or, put differently, all fields that are subject to self-regulation.

In addition to the SEC, important regulatory functions are performed by the National Association of Securities Dealers, the other main self-regulatory organization. For

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[253] *See, e.g.*, NYSE Listed Company Manual § 102.00 et seq.

[254] For an example of the basic structure of listing agreements, *see* NYSE Listed Company Manual §§ 901.01 et seq.

[255] *See infra* IV.E.2.

[256] *See particularly* Securities Exchange Act § 13, codified in 15 U.S.C. § 78m.

[257] The SEC has recently increased the use of such measures. *See* Judith Burns, *SEC Suspends Trading in Firms That Failed to Make Filings*, THE WALL STREET JOURNAL, December 2, 2004, p. C5. *See also* Karen Richardson, *Big Board Proposes Crackdown on Late Filers*, THE WALL STREET JOURNAL, February 11, 2005, p. C3.

instance, the National Association of Securities Dealers in 2004 barred 450 individuals from the securities industry and collected a record $102 million in disciplinary fines.[258]

With this regulatory system and the stock exchanges' role in mind, the article now turns to the conflicts of interest that arise when stock exchanges demutualize and go public.

B. REGULATING IN GENERAL

Stock exchanges serve distinct purposes and therefore different masters; the result is conflicts of interest. As the U.S. Supreme Court regularly asserts: "no man can serve two masters."[259] That's especially true when one of those masters is oneself, so that the choice is between pursuing one's own or another's interest—which leads over to the idea that *no man shall pass judgment on his own causes*, as stated at the article's beginning.

Apart from their critical public function, demutualized and publicly traded stock exchanges differ little from other businesses in their daily challenges. Conflicts of interest are inherent to all businesses. There are, as in any other company, four main constituencies that fight for the largest share of the pie, the company's profit: stockholders, creditors, employees, and customers. Before demutualization and going public, stock exchanges are owned by their main customers, the broker-dealers, so that the interests of customers and owners are to some extent aligned. With demutualization and going public, stock exchanges acquire another constituency: investor-stockholders, whose sole interest is to get the highest possible return on investment.

These stockholders can expect that the stock exchanges' management does its best to serve the stockholders, rather than other stakeholders. Just recall the famous holding in *Dodge v. Ford Motor Co.*:

> A business corporation is organized and carried on primarily for the profits of the stockholders. The powers of the directors are to be employed for that end. The discretion of the directors is to be exercised in the choice of means to attain that end.[260]

Admittedly, such stockholder primacy is a source of controversy even today.[261] But at least factually, the constraints by the stock markets let management of publicly traded

[258] *See* (without author) *NASD Collected Record Fines During 2004*, THE WALL STREET JOURNAL, December 30, 2004, p. C3.

[259] *Cf.* Supreme Lodge K. P. v. Withers, 177 U.S. 260, 269 (1900); United States v. Mississippi Valley Generating Co., 364 U.S. 520, 550 fn. 14 (1961); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196 fn. 15 (1963); N.L.R.B. v. Health Care & Retirement Corp. of America, 511 U.S. 571, 596 fn. 14 (1994). *See also* the famous words of BRANDEIS, *supra* note 2, at 56 ("No man can serve two masters"), at 69 ("Serve one Master only") and *passim* (*see particularly* at 50, 198-99, 202).

[260] Dodge v. Ford Motor Co., 204 Mich. 459, 507 (1919). Concededly, its precedent is questionable. *See* the authorities in the following footnotes.

companies focus primarily on stockholder value.[262] The stock exchanges themselves frankly admit that their business goals change with demutualization.[263] For instance, Hong Kong Exchanges and Clearing Ltd.'s chairman publicly announced from its very beginning that its corporate aim is to operate "in the best interests of its shareholders."[264]

With ownership separated from the customers, we see a new conflict within the exchanges: *stockholders vs. customers* competing for the corporation's profits. Customers demand low prices; stockholders the opposite. Stock exchanges will have to please both: if they overly favor one, the other will be deterred and change to a competitor (by trading on another marketplace or investing in another company). To make things more complicated, the stock exchanges' customers themselves have conflicting interests: issuers want low listing fees; traders want low trading fees; some customers might want a floor (particularly those who work on it), while others might prefer an automated trading system. However, these conflicts are not limited to publicly traded stock exchanges. Every company with owners different from the customers faces this challenge to the same extent. The reason that we are particularly aware of this conflict in the case of publicly traded stock exchanges is that for stock exchanges, it is a new conflict that is of less importance as long as the stock exchanges are owned by their main customers. Observers should be aware of the initial differences. But it is nothing regulators or commentators should be concerned about in the long term. Management will work to find the right approach to handle it, as it does in any other listed company.

However, with the regulatory functions that are conferred on them, stock exchanges have an important further constituency: the public. Although the public might have a stake in all companies, for tax, employment, and reputational reasons, in the case of stock exchanges there is considerably more. Marketplaces for stock have a critical macroeconomic function: They match suppliers of capital with companies that demand capital. Without well organized and efficient markets, companies will have difficulties finding capital to finance their business. That would raise capital costs and impede the entire economy. From the perspective of the capital suppliers, stock exchanges are important

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[261] For the classic statement for stockholder primacy, *see* Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931). For the opposite view, *see* the classic statement of E. Merrick Dodd Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). For a recent brief overview of the current debate, *see* Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002)

[262] *See generally* Henry Hansmann & Reinier H. Kraakman, *What is Corporate Law*, *in:* REINIER H. KRAAKMAN, PAUL DAVIES, HENRY HANSMANN, GERARD HERTIG, KLAUS J. HOPT, HIDEKI KANDA & EDWARD B. ROCK, THE ANATOMY OF CORPORATE LAW—A COMPARATIVE AND FUNCTIONAL APPROACH 24-25 (2004); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE—POLITICAL CONTEXT, CORPORATE IMPACT 43-46 (2003); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 264-66 (1977).

[263] Humphry, *First Four Months*, *supra* note 41. *See also* WORLD ORGANIZATION OF EXCHANGES, THE SIGNIFICANCE OF THE EXCHANGE INDUSTRY 2 (5th ed. 2004).

[264] *Speech by Mr. Lee Yeh-kwong*, supra note 188. This statement somewhat conflicts with the legally imposed mandate to prefer public goals in a conflict of interests (*see* Carson, *World Bank Paper, supra* note 8, at 12, 20).

because they provide for lucrative investments and simple risk diversification. Last but not least, major parts of the pension system depend on a functioning stock market. For all these reasons, stock exchanges are widely recognized as a *public good*.[265] As Congress wrote into the Securities Exchange Act in 1975: "The securities markets are an important national asset which must be preserved and strengthened."[266] To the extent that preserving this national asset creates costs without increasing shareholder value, there is a worrisome conflict of interest in the stock exchanges' management.

Under a profit-maximizing standard, over-regulation and under-regulation, or both, or neither, can be desirable. The following sections identify incentives both to under-regulate [*infra* 1] and to over-regulate [2]. This leads to the insight that the intensity and thoroughness of general regulation is indifferent toward the organizational structure of stock exchanges [3]. Publicly traded stock exchanges will fulfill their regulatory duties as well as exchanges organized in the traditional mutual form.

1. Incentives for Under-Regulation

Publicly traded stock exchanges have to focus on profits. Each expense must be scrutinized in terms of whether it will help achieve this goal.

Expenses for regulation are obviously problematic, as they generate little, if any, direct income in the short term. In the world of quarterly reports and short-dated executive compensation, stock exchange managers might forget that they trade not only stocks but also trust (in the long term, investors and issuers will turn away from marketplaces that are badly regulated). Therefore, publicly traded stock exchanges might be tempted to reduce regulation expenses and thereby increase profits. That incentive for under-regulation is not limited to a certain kind of regulation. Rather it could happen to issuer regulation as well as to trader regulation. And the temptation is significant: at the New York Stock Exchange, for instance, 42 percent of the workforce is regulatory staff, *i.e.*, well-paid investigators and lawyers.[267] In 2004 the New York Stock Exchange is said to have increased its budget for enforcement and market surveillance by $50 million,[268]

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[265] *See, e.g.*, Silver v. New York Stock Exchange, 373 U.S. 341, 349 (1963) ("Stock exchanges perform an important function in the economic life of this country.") *See also* IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 4, 10; Carson, *World Bank Paper*, *supra* note 8, at 1; WORLD ORGANIZATION OF EXCHANGES, *supra* note 263, at 6.

[266] Securities Exchange Act § 11A(a)(1)(A), codified in 15 U.S.C. § 78k-1(a)(1)(A). *See also* Securities Exchange Act § 2, codified in 15 U.S.C. § 78b, commencing with: "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest".

[267] Der Hovanesian, *Big Board On The Big Board*, *supra* note 71.

[268] Der Hovanesian, *Big Board On The Big Board*, *supra* note 71. For the tightened oversight and increased regulatory expenses, *see also* Davis, *supra* note 245; Ceron & Lucchetti, *NYSE Profit Dropped*, *supra* note 79; Jed Horowitz, *NYSE Posts Loss as Legal costs Rise and Trading Volume Slips*, THE WALL STREET JOURNAL, November 24, 2004, p. C3.

which equals the New York Stock Exchange's profit in 2003.[269] Put differently: the New York Stock Exchange could have doubled profits by not spending so much extra on regulation. The unsurprising result: In the next year, the New York Stock Exchange profit plummeted to its lowest level since 1991.[270] The litmus test will come when the choice is between losses and regulation: Will stock exchanges choose to eliminate regulation expenses when they are under financial pressure and have to cut costs? The incentive to under-regulate is considerable, as it would not hurt revenues in the short term.

Another reasonable incentive for general under-regulation might be the attracting of new customers and the pleasing of current ones. Under pressure by the stockholders to make profit, stock exchanges may be reluctant to take action against traders who are "good customers" and who generate significant income for the exchange.[271] However, under the traditional mutual structure, stock exchanges may be similarly reluctant, as those "good customers" are its owners. Related to this is the concern that stock exchanges may be hesitant to suspend trading in heavily traded stocks of non-complying issuers.[272] Such issuers are the "blockbusters" and "cash cows" of the stock exchange, because exchanges charge transaction fees according to the amount of traded stocks. History has already revealed such a habit of leniency toward issuers: the American Stock Exchange traditionally attracted issuers that failed to comply with the New York Stock Exchange's listing rules. A recent study by the General Accounting Office discovered that more than 20 percent of the new listings at the American Stock Exchange in the examined period did not meet the American Stock Exchange's own listing standards.[273]

Another—not so plausible—fear is that stock exchanges might be reluctant to enforce corporate governance listing standards, because the stock exchanges themselves do not comply with them and want to avoid attracting attention in certain regards. For instance, stock exchanges might ignore impermissible poison pills, because they have comparable ones of their own.[274] However, such conflicts, mainly limited to issuer regulation, seem far from likely. Even if the stock exchange does not want to apply certain standards to itself, such an exchange probably will not flinch from applying double standards and enforcing listing standards that the stock exchange itself ignores. One might argue that there would be a risk that issuers would point fingers at the stock exchange when it applies standards to them that it does not apply to itself. But considering the powers of the stock exchange over the issuers and the opportunities to damage the

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[269] NEW YORK STOCK EXCHANGE, *supra* note 35, at 26.

[270] Ceron & Lucchetti, *NYSE Profit Dropped*, *supra* note 79.

[271] *See*, *in general*, IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 7.

[272] *See*, *in general*, IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 7.

[273] UNITED STATES GOVERNMENT ACCOUNTING OFFICE, SECURITIES REGULATION—IMPROVEMENTS NEEDED IN THE AMEX LISTING PROGRAM (GAO-02-18; November 2001).

[274] Karmel, *supra* note 10, at 422. Defensive tactics for takeovers ("poison pills") are governed by, *e.g.*, NYSE Listed Company Manual §§ 308, 312.03. For an overview of demutualized markets' poison pills, *see* Bradley, *supra* note 10, at 699.

issuer's reputation, it is not likely that many issuers will complain and thereby compel the stock exchange to under-regulate them. That is especially true considering that the setting of corporate governance standards is one of the stock exchanges' main functions and trademarks.[275]

2. Incentives for Over-Regulation

There are also incentives for over-regulation. Under the traditional framework, stock exchanges have powers to fine persons and entities that do not comply with the law and rules set by the stock exchanges. As the fines and other kinds of payments go directly into the stock exchange's pockets, for-profit stock exchanges are tempted to over-regulate and increase the number as well as the amount of the fines. Although there may be a positive effect from seeing regulation as an income source, because stock exchanges have a further incentive to thoroughly regulate, it seems problematic to give entities regulatory power to impose fines that are to the benefit of the entity's stockholders.

Fines are a considerable source of income. The National Association of Securities Dealers (which is the single registered securities association and, admittedly, not a stock exchange) imposed fines of more than 100 million dollars in 2004.[276] Against that background, for-profit stock exchanges might make a simple calculation: They could compare the expenses of regulation with the revenue from fines. This incentive can be increased further if the compensation of management and particularly of the regulatory staff is linked to the stock exchange's performance.[277] Such a link, which is an important and usually reasonable corporate governance tool to constrain management,[278] increases the incentives of the responsible personnel to over-regulate. At least this is the theory; in practice, fines are anything but a reliable source of income. Fined persons can challenge the stock exchange's decision. That creates enormous costs for the stock exchange, particularly for legal advice and opinions. One might argue that fined persons might not dare to challenge the fine, as this creates bad publicity and the challenging person risks being even more intensively regulated in the future. However, both arguments are weak. First, a person already fined has little reputation to lose, if there is any good reputation left at all. Second, the risk of being more intensively regulated is most likely negligible in this context. As the stock exchange will in most cases not make any profits with challenged fines, due to the expenditures, the exchange is unlikely to over-regulate again.

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[275] *See supra* II.A.4.

[276] *See* (without author) *NASD Collected Record Fines During 2004*, THE WALL STREET JOURNAL, December 30, 2004, p. C3.

[277] For this concern, *see* Carson, *World Bank Paper*, *supra* note 8, at 14.

[278] *See generally* Hansmann & Kraakman, *supra* note 262, at 26-27 and at 51-52; ROE, *supra* note 262, at 41-43.

3. The Organizational Structures' Indifference Toward Regulation

The discussion of whether for-profit stock exchanges, competing for issuers and traders, will over-regulate or under-regulate calls to mind the discussion of whether state competition for corporate charters leads to a "race to the bottom" or a "race to the top," if there is a race at all.[279] Though the issues derive from two different contexts, the basic argumentation might be similar (both in its ideas and its futility).

There are incentives both for under-regulation and over-regulation, though the latter is not as promising as a source of income. So the main concern, if any, is that stock exchanges may under-regulate in order to cut costs and please the potentially-regulated persons who generate income. This, however, would be one of the worst business strategies that stock exchanges could pursue. It is like airlines saving money by cutting costs for airplane maintenance and security. The first crashed airplane costs the entire business, because no one will ever fly with that airline again, at least not under the same name (remember ValuJet).[280] The same applies to stock markets: As soon as investors realize that issuer regulation is lenient and fair price discovery no longer guaranteed, they will switch to another exchange. Demutualization does not change anything in that regard. Says the chairman of the Board of Pacific Exchange:

> Lose [investors'] confidence and it matters little whether you're trading on a floor or in front of a screen, through a member organization or a private or public corporation.[281]

And further:

> Nothing—nothing—is as essential to our ongoing viability—as and industry or an exchange—as public confidence.[282]

In addition, like airlines, stock exchanges are a heavily regulated industry. Demutualization and listing does not lessen any obligation under the Securities Exchange Act and the oversight of the SEC, as outlaid in previous parts. And finally, the incentive to under-regulate is not necessarily greater for publicly traded stock exchanges than for the traditionally organized exchanges.[283] To the extent that the stock exchanges' profit depends on properly regulated markets, we will see an alignment of the stock exchanges'

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[279] For the view that the competition among the states is a race to the bottom, *see particularly* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); more recently, *see* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992). For the opposite view (race to the top), *see especially* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Winter, *supra* note 262. However, some commentators question that there is a race at all, *see* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

[280] After the crash of one of its airplanes into the Everglades in 1996, ValuJet became AirTran, under which it still operates.

[281] Greber, *supra* note 121.

[282] Greber, *supra* note 121.

[283] *Accord* Steil, *supra* note 10, at 72-77 (guessing that demutualization might even reduce conflicts of interest).

owners' goals with macroeconomic goals that we do not necessarily see under the current system. For instance, broker-dealers as the traditional owners of stock exchanges may profit from a loosely supervised market, because it enables them to defraud investors. Those fraud profits can easily outweigh the proportional loss they incur because of the decline of the stock exchange's value. Hence, demutualization and going public does not inevitably lead to worse market supervision than under the current system.

On balance, there do exist incentives for stock exchanges to over-regulate and (perhaps more often) to under-regulate. Nevertheless, there are good reasons to believe that stock exchanges will in general not change their regulatory policy if they demutualize and go public. Rather, the organizational structure is largely indifferent toward the general quality of regulation. Against this background, there is no need to impose an additional duty on the stock exchange's management to favor the public's interests over the stockholders' interests.[284] Apart from the lack of enforceability of such a rule, it is neither necessary nor desirable. On the contrary, such a rule would give management a good excuse for any misconduct[285]—the contention that they acted in the public interest is hard to reject because the public interest is subject to different interpretations.

Therefore, although there might be some tensions between for-profit stock exchanges and their public mandate, which the SEC may be all too aware of,[286] these tensions are nothing that needs regulatory or legislative action.

C. REGULATING STOCKHOLDERS

Noteworthy and worrisome conflicts of interest arise when stock exchanges regulate their stockholders. That scenario is all but pure fantasy, however, since many investors that are likely to buy into stock exchanges are and will be regulated by stock exchanges.

To begin with, the former members as the owners of the stock exchange will get the first shares when the stock exchange demutualizes.[287] Even considering the usual increase of outstanding shares during the initial public offering or afterward, broker-dealers will retain a considerable share in the stock exchange. Theoretically, broker-dealers could abuse their powers as stockholders to make management be lenient toward them. But this is far from reality. First, their share in the exchange will sink over time,

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[284] Such provisions were enacted in Hong Kong and in Singapore. *See* Carson, *World Bank Paper*, *supra* note 8, at 12, 20.

[285] *See generally* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2065 (2001).

[286] SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,132.

[287] *See* in case of the New York Stock Exchange Aaron Lucchetti, *NYSE Deal Treats Insiders Unequally*, THE WALL STREET JOURNAL, May 11, 2005, p. C3; Aaron Lucchetti, *NYSE to Ease Restrictions On Members' Sales of Shares*, THE WALL STREET JOURNAL, May 12, 2005, p. C6. *See also* for the Stock Exchange of Hong Kong HKEx News Release, *The Merger Proposals for the Stock and Futures Exchanges and the Clearing Houses Take Effect* (March 6, 2000).

as mainly non-broker-dealers will buy the new shares. Second, their position as stockholders is much weaker than as members. Third, demutualization and listing do not affect the stock exchange's obligations under the Securities Exchange Act and the oversight by the SEC thereunder. It is therefore not likely that publicly traded stock exchanges *generally* will under-regulate the broker-dealers they are supposed to regulate (the arguments of the previous section also apply).

Matters change if the issue is not about the regulation of the broker-dealers in general, but about one or a few broker-dealers with a huge share. We can extend this to regulated issuers that hold large shares, such as listed financial holding companies. Let us assume that such a regulated broker-dealer or issuer holds 30 percent of the stock exchange. Now, management is in a significant *personal* conflict of interest. If management displeases this major stockholder, its days are numbered. That conflict is material. One might counter-argue that this conflict is not different from a conflict over whether the stock exchange could be tempted to under-regulate good customers. But it is different: First of all, customers are unlikely to have a share in revenues as large as stockholders have in the company. Second, displeasing customers threatens management only indirectly, if at all. Displeasing controlling stockholders, on the other hand, creates a direct threat. The watchful eye of the SEC and the market (both knowing of the large stockholder due to reporting requirements) would not be sufficient to avoid the risk of under-regulation of large stockholders: Outsiders eyes can only see what is presented to them. Whether the stockholders get special treatment such as extended deadlines or favorable surveillance is not always visible to someone who is not on-site.

One of the proposals to mitigate conflicts of interest related to the supervision of stockholders is to set forth restrictions and limits for ownership in stock exchanges.[288] As explained later, such ownership rules would not be good policy, but would lead to inefficiencies.[289] Under the regime that this article proposes, there would not be such a conflict of interest at all, because the regulatory arm of the stock exchanges would report to the SEC and not to management.[290] Management would have no influence over the regulation of the stockholder, and the stockholder would have no basis for blaming and consequently ousting management.

D. REGULATING COMPETITORS

Significant conflicts of interest arise whenever stock exchanges regulate competitors and thereby, as stated at the outset of this article, *pass judgment on a competitor's cause*. Although the conflicts that arise with regulating competitors also occur in case of mutual

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[288] *See particularly* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,143-46.

[289] *See infra* V.C.

[290] *See infra* V.B.2.

stock exchanges, because any business wants to maintain or improve the status quo, the pressure of stockholders to deliver profits may boost the incentive to treat rivals unfairly.

Such incentives can arise both in the context of trading regulation [*infra* 1; Nasdaq as broker-dealer regulated by the New York Stock Exchange] and issuer regulation [2; Nasdaq's stock listed on the New York Stock Exchange]. Neither case is fiction; both may occur soon. Depending on whether an issuer or a broker-dealer is involved, stock exchanges have plenty of ways to discriminate against them. Stock exchanges can, without needing to justify their actions, delay regulatory decisions, impose unjustified sanctions, excessive fees, and fines, and generally exaggerate surveillance. Especially in case of competing issuers, halting the trading in stocks of a competitor for an unreasonable period of time or without reasons may be quite damaging.[291]

Such discriminations are the likelier, the more discretion the stock exchange has and the more businesses the stock exchange pursues in addition to its core functions (*e.g.* clearing, settlement, index-services). That the competitors can appeal such actions and sue the stock exchange is no adequate remedy, since the competitor's reputation will be damaged anyway. The same is true for the threat to leave the exchange, because there will often be no adequate alternative market place.

1. Trading Regulation

If broker-dealers compete with the stock exchange, the stock exchange may be tempted to treat such competitors unfairly.

Recent history gives us a good example: Nasdaq Stock Market was at least temporarily planning to lease a seat at the New York Stock Exchange.[292] As a lessee, Nasdaq would be subject to the New York Stock Exchange's broker-dealer regulation. This absurd situation—the New York Stock Exchange's archrival regulated as a broker-dealer—is only understandable, if at all, against the backdrop of the regulatory environment: Under the SEC's Regulation ATS, alternative trading systems (ATS) can choose whether they want to be regulated as national securities exchanges or as broker-dealers.[293] The rationale, if any, behind this requirement is to provide for an oversight of alternative trading systems within the traditional regulatory framework.

As broker-dealers, alternative trading systems are required to become members of a self-regulatory organization.[294] The choice is basically between the National Association of Securities Dealers (NASD) or of a national securities exchange. With the SEC seeing insurmountable conflicts of interest if the National Association of Securities

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[291] For the power to halt trading, *see, e.g.*, NYSE Listed Company Manual § 202.07.

[292] Ceron, *Pondering Transition*, *supra* note 79.

[293] *See* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,130.

[294] *See* Securities Exchange Act § 15, codified in 15 U.S.C. § 78o.

Dealers supervises the Nasdaq Stock Market,[295] Nasdaq seems now to lean toward the New York Stock Exchange as its regulator, after having been regulated by the National Association of Securities Dealers, its founder, since its very beginning.

However, changing from the National Association of Securities Dealers to the New York Stock Exchange might be like jumping out of the frying pan into the fire. From a *regulatory* standpoint, the Nasdaq Stock Market is certainly better regulated by the New York Stock Exchange than by the partisan National Association of Securities Dealers. But from a *competitive* standpoint, such a move is disastrous and calls into question the reasonableness of the Regulation ATS that generates such bizarre results as the Nasdaq Stock Market leasing a seat on the New York Stock Exchange, its archrival.

More generally, any broker-dealer that competes for listings or transactions will bring the stock exchange that regulates the broker-dealer into significant conflicts of interest. One of the most common areas for such conflicts may be broker-dealers that engage in in-house crossing, *i.e.*, that match orders without routing them to the national market system, or organize other markets that compete with the stock exchange. Stock exchanges have considerable incentives here for unfair regulation.

2. Issuer Regulation

The potential conflicts of interest caused by the regulation of competitors are even greater with respect to issuers. Whereas the number and the business scope of broker-dealers is naturally and by law limited, issuers that are listed on a stock exchange can be engaged in any business. This means that there can be issuers competing in any business that the stock exchange is engaged in.

To the extent that U.S. exchanges expand their business, as their European counterparts already have, the opportunities for unfair issuer regulation will increase dramatically. Nasdaq listed on the New York Stock Exchange is only the easiest and most obvious example. Australia has seen a more complicated case that could happen in the United States as well: the takeover battle for the Sydney Futures Exchange.[296] The Australian Stock Exchange, then already a demutualized and self-listed stock exchange, made a bid for the Sydney Futures Exchange.[297] So did Computershare Ltd., a company

[295] Ceron, *Pondering Transition*, *supra* note 79.

[296] *See* IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 16-17; For general information about the Sydney Futures Exchange, *see* http://www.sfe.com.au.

[297] ASX Announcement, *ASX and SFE* (December 22, 1998); ASX Announcement, *ASX & SFE Merger—Progress Report* (February 19, 1999); ASX Announcement, *ASX and SFE Merger Proposal* (April 27, 1999); ASX Announcement, *ASX & SFE Merger* (May 19, 1999); ASX Announcement, *Merger Proposal* (May 25, 1999); ASX Announcement, *Merger Proposal* (June 3, 1999); ASX Announcement, *ASX Announces Revised $260 million SFE Merger Proposal* (June 11, 1999); ASX Announcement, *ASX and SFE Merger* (June 17, 1999); ASX Announcement, *ASX & SFE Merger* (July 29, 1999); ASX Announcement, *ASX & SFE Merger* (August 3, 1999).

that offers share registry and provides financial market services.[298] The problem: Computershare Ltd. was (and still is) listed on the Australian Stock Exchange and therefore subject to its regulatory powers. In other words, a stock exchange was competing with one of its regulated issuers for the takeover of another company. The affected parties took this conflict of interest very seriously. Finally, the Australian Securities and Investments Commission (the Australian Stock Exchange's regulator), the Australian Stock Exchange, and Computershare Ltd. entered into an agreement that addressed the conflict of interest.[299] Under this arrangement, the Australian Stock Exchange was for the period of the takeover battle forced to consult with the Australian Securities and Investments Commission before making any regulatory decision as to the listing of Computershare.[300] Eventually, for reasons that are not relevant here, neither acquired the Sydney Futures Exchange.[301]

However, the story gives us a further example of the possible conflicts: The Sydney Futures Exchange itself subsequently went public, and has been listed on the Australian Stock Exchange since April 2002. The problem is that the Australian Stock Exchange organizes a market not only for stocks but also for derivatives, and in this regard competes with the Sydney Futures Exchange. To avoid conflicts of interest, the Australian Securities and Investments Commission generally can step in and perform the Australian Stock Exchange's functions with respect to competing issuers.[302]

Although the United States is late in demutualization and listing of stock exchanges, there are already some early problems. For instance, the Pacific Exchange, now part of Archipelago, trades options on Instinet,[303] the alternative trading system already introduced above.[304] Instinet is a competitor of the Pacific Exchange’s and Archipelago’s stock market. Admittedly, the possible conflicts of interest in the supervision of the trade in options are smaller than in the case of stocks, but there are definitely some. Furthermore, Instinet is traded on the Nasdaq Stock Market. Although the Nasdaq Stock Market is not (yet) a stock exchange, the conflicts of interest are similar (after its merger with Nasdaq, Instinet will change from a competitor into an affiliate)

Thus, demutualization and listing of stock exchanges, particularly if they expand their business scope, increase the number of cases in which stock exchanges have to

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[298] For general information, *see* http://www.computershare.com.au. For the responses of the Australian Stock Exchange to Computershare’s bid, *see* ASX Announcement (May 19, 1999), *supra* note 297; ASX Announcement (June 3, 1999), *supra* note 297; ASX Announcement (August 3, 1999), *supra* note 297.

[299] ASX Announcement, *ASIC/ASX/Computershare Agreement* (May 28, 1999).

[300] *See* ASX Announcement (May 28, 1999), *supra* note 299.

[301] For the withdrawal of the Australian Stock Exchange, *see* ASX Announcement, *ASX & SFE Merger* (August 13, 1999).

[302] Carson, *World Bank Paper*, *supra* note 8, at 16.

[303] The trading began in 2001, *see* Pacific Exchange Press Release, *Pacific Exchange to Trade Options on Instinet Group Incorporated and USEC, Inc.* (May 30, 2001).

[304] *See supra* note 140 and accompanying text.

regulate competitors, either as broker-dealers or as issuers. This raises serious regulatory and competitive concerns. Under the regime that this article proposes, such conflicts would be mitigated by separating the stock exchange's regulatory arm from its business operations, so that management has no chance to unfairly regulate competitors.

E. REGULATING ONESELF

When stock exchanges demutualize and go public, they have to make another fundamental decision: where will the demutualized stock exchange's own stocks be traded, *i.e.* on which market will the stock exchange itself be listed? Consider the New York Stock Exchange as an example: if it goes public, as it again announced in April 2005, where should the stocks in the New York Stock Exchange be traded?

The answer seems obvious: predominantly on its own market. Just as auto producers use their own cars on their premises, airline employees their own flight connections, and computer producers their own laptops, so can stock exchanges use their own markets for organizing trading in their own stocks. And—not surprisingly—all demutualized stock exchanges have listed their stock or the stock of their holding companies on their own markets, usually referred to as *self-listing.*[305] Examples of self-listing include Archipelago and Nasdaq (although formally not yet a stock exchange) as well as the Australian Stock Exchange, the Frankfurt Stock Exchange (Deutsche Börse), Euronext N.V., the London Stock Exchange, OMX Group, and the Stock Exchange of Hong Kong (Hong Kong Exchanges and Clearing Limited).

Self-listing raises questions as to whether the stock exchange will be impartial enough to apply the regulatory framework to itself the same way as to others. This question leads back to the notion expressed in the first paragraph of this article: *no one shall judge in her own cause.*

Like previous parts, the following discussion distinguishes between conflicts that arise in the context of trading regulation [*infra* 1] and issuer regulation [2].

1. Trading Regulation

The first set of conflicts of interest arises in the regulation of the trading in the stock exchange's stock. These conflicts are related to two separate regulatory powers of stock exchanges: the power over the broker-dealers and the power over the trading as a whole.

To begin with the latter, the stock exchange can halt or delay the trading in stocks of companies that have material news pending.[306] The stock exchange also has discretion

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[305] IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 8; SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,132, 71,151.

[306] *See, e.g.*, NYSE Listed Company Manual § 202.07.

as to when to allow trading to resume.[307] These powers seem to give little basis for the fear of undue self-preferential treatment. Arguments that the stock exchange's management might be tempted to delay a halt in trading so that they can sell (bad news) or buy (good news) in advance of the news release, are not warranted: any member of management can commit such *securities fraud* (to give it a proper name) by not disclosing the information to the stock exchange. There is no increased risk.

Another area of possible conflicts of interest is *delisting*.[308] The stock exchange's power to delist issuers is based on both the listing rules[309] and the trading rules.[310] The conflicts of interest that arise with respect to the listing rules will be discussed in the next section. As to the trading regulation, there is a straightforward conflict of interests. Stock exchanges may refrain from delisting even though their rules require it. This risk is increased by the wide discretion that the stock exchange has in delisting decisions.[311]

Finally, regulatory concerns arise with respect to the stock exchange's powers over broker-dealers. Stock exchanges might misuse their broad powers over broker-dealers in order to influence positively the trade in their own stocks, *e.g.*, by apparently increasing the volume through "wash sales," by measures to artificially stabilize the price, or by discouraging trading practices that are presumed to have negative impacts on the stock price, such as short sales.

None of the foregoing conflicts arise when the stock exchanges' regulatory arm reports to the SEC, as proposed later herein.

2. Issuer Regulation

Conflicts related to the issuer regulation of self-listed stock exchanges represent the classic problem that comes with self-listing, which touches upon the question of where the shares of publicly traded stock exchanges should be listed.

As explained earlier, issuer regulation is based on listing agreements into which the stock exchanges enter with the issuers.[312] Such agreements lay down the whole set of listing requirements with which issuers have to comply when they are listed on the stock exchange. Listing agreements contain not only initial but also continuing obligations, so that stock exchanges are engaged in issuer regulation on an ongoing basis (even though

[307] *See*, *e.g.*, NYSE Listed Company Manual § 202.07.

[308] For a comprehensive overview, *see* Jonathan Macey, Maureen O'Hara & David Pompilio, *Down and Out in the Stock Market: The Law and Economics of the Delisting Process* (working paper, April 2005; available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=583401).

[309] *See*, *e.g.*, NYSE Listed Company Manual § 801.00

[310] *See*, *e.g.*, NYSE Rule 499.

[311] *See*, *e.g.*, NYSE Rule 499.10.

[312] For an example of the basic structure of listing agreements, *see* NYSE Listed Company Manual §§ 901.01 et seq. For an overview of issuer regulation, *see supra* IV.A.3.

the powers of stock exchanges to enforce the listing rules are not regulatory powers in a literal meaning, but based solely on the contract with the issuer).

Commentators doubt that stock exchanges will "negotiate listing agreements with themselves and then supervise continuing compliance with such agreements."[313] Those concerns that the stock exchanges will not honor the listing agreement are warranted, but on different grounds: which "agreement"? Stock exchanges cannot enter into listing agreements with themselves, because no one can make a contract with oneself. It does not work. You cannot establish a claim against yourself.

This means that listing requirements for self-listed stock exchanges cannot be governed by listing agreements, at least not with the stock exchange itself. Surprisingly, it seems that this article is the first to recognize this problem. It changes the focus of the discussion. In regard to the listing requirements, the question is not whether self-listed stock exchanges will be lenient toward themselves. Since there is no agreement, there is nothing to comply with, no binding rules that could be enforced. To be sure, stock exchanges will publicly announce that they feel themselves bound to their listing rules and will therefore be constrained by public scrutiny to follow those rules. But a considerable number of listing rules are subject to individual negotiation. That is why parties normally enter into individual listing agreements instead of using the same set of rules for all issuers.

Even if we found a substitute to the listing agreement, for example the public announcement mentioned in the last paragraph, most of the listing rules would not make any sense. Why should the stock exchange, as an issuer, submit annual and interim reports to itself, the stock exchange as the regulator?[314] Why should the stock exchange as issuer give notice to itself as the regulator?[315] There are dozens of such notice obligations, particularly for charter and by-laws amendments[316] and various material changes, such as in regard to directors and officers,[317] the auditor,[318] or the business purpose.[319] All these reporting requirements make sense if the issuer is not the stock exchange. But reporting to oneself is like a soliloquy. Is there any sense in reporting a change of directors within the same company? Is there any benefit in delivering the annual report from one department to another? The question in this context is not whether we can trust the stock exchanges to examine their own reports as thoroughly as the reports of the other issuers. Much of the benefit gained from reporting requirements is connected to the fact that material information gets from inside the company to *outsiders*, with the conse-

313 Karmel, *supra* note 10, at 421.
314 For this obligation, *see, e.g.*, NYSE Listed Company Manual § 203.00.
315 *See, e.g.*, NYSE Listed Company Manual § 204.00, which goes until § 204.33.
316 *See, e.g.*, NYSE Listed Company Manual § 204.03.
317 *See, e.g.*, NYSE Listed Company Manual § 204.14.
318 *See, e.g.*, NYSE Listed Company Manual § 204.05.
319 *See, e.g.*, NYSE Listed Company Manual § 204.06.

quence that an *outsider* puts a watchful eye on the information. All that is lost if a stock exchange reports to itself.

Further problems arise with respect to listing fees, which are normally part of the listing agreement.[320] At first view, it raises competitive concerns if the stock exchange charges its competitors higher fees than it charges itself. But at a closer look, it does not matter what fees the stock exchange itself pays: they are merely transferred from the left pocket into the right pocket. From a regulatory and a competitive viewpoint, self-listing fees do not matter (although they do maybe from an accounting and tax viewpoint). And finally, regulatory concerns arise in the context of the termination of the listing. Stock exchanges have the power at any time to suspend listed stocks from dealing ("delisting"). As already mentioned, this power has two foundations: it is based on both the listing rules[321] and the trading rules.[322] Stock exchanges may be tempted to allow themselves an easy way to delist that is not available for other issuers.[323]

On balance, the usual listing agreement regime does not work for self-listed stock exchanges. Since the main reason for that is the lack of *outside* control, any proposal to tighten the requirements placed on stock exchanges when regulating themselves misses the point. Instead, later parts of this article put forward the idea of mandatory dual-listing for stock exchanges. Implementing this would allow a competent outsider to have a closer look at the exchange. And there is no concern about bias: under the proposed regime, the regulatory arm of the other stock exchange would report to the SEC if it is itself a publicly traded stock exchange.

F. REGULATING AFFILIATES

A variant of the foregoing problems is the regulation of affiliates of the stock exchange. Such affiliates can be parent companies or subsidiaries. By nature, the incentive for the stock exchange's management to under-regulate such affiliates is the greater in the case of the regulation of the parent company, because the managers are personally affected: if they displease the parent company's management, their days as managers of the subsidiary are numbered.

The problems that arise in this context are similar to those concerning regulation of the stock exchange itself, and inverse to those concerning regulation of competitors. If the affiliate is listed on the stock exchange, both parties—the stock exchange and its affiliate—will formally enter into listing agreements. However, such a contract between "friends" is not of much worth. The proposed solution to conflicts arising from listing

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[320] *See, e.g.*, NYSE Listed Company Manual §§ 701.02 and 902.00 et seq.

[321] *See, e.g.*, NYSE Listed Company Manual § 801.00

[322] *See, e.g.*, NYSE Rule 499.

[323] *Cf.* Fleckner, *supra* note 155 (discussing the problems of foreign issuers to leave the U.S. securities markets, which requires delisting and deregistration).

affiliates is the same as for those arising from self-listing: mandatory dual-listing for the affiliates on another market and establishment of a separate regulatory arm that reports to the SEC.

The same is true with respect to the regulation of members and trading (needless to say, dual listing does not help in this regard). The recent merger between the New York Stock Exchange and Archipelago gives a nice illustration of the problems involved. Archipelago Holdings, the parent company of the Archipelago Exchange, wholly owned a brokerage firm, Wave Securities.[324] This did not raise regulatory concerns, since the Archipelago Exchange did not itself perform regulatory functions. Instead, this function was performed by the regulatory arm of the Pacific Exchange. But after the closing of the merger, this brokerage firm would be regulated by the New York Stock Exchange, its direct or indirect parent company. Needless to say, this would be problematic from a regulatory point of view. Accordingly, it was not surprising that one of the first things announced concerning the merger was the plan to sell Wave Securities.[325] At any rate, this might be a wise decision to avoid critiques of the merger, regardless of whether it is also a wise business decision. Under the proposed regulatory regime, however, such a move would not be necessary, for the regulatory arm of the New York Stock Exchange would be separated anyway and report to the SEC.

G. NON-REGULATION (ANTI-COMPETITIVE BEHAVIOR)

> Congress in effecting a scheme of self-regulation designed to insure fair dealing cannot be thought to have sanctioned and protected self-regulative activity when carried out in a fundamentally unfair manner.[326]

Thus said the U.S. Supreme Court when dealing with anti-competitive behavior by the New York Stock Exchange. Compare with that statement the following:

> The Exchange has broad discretion regarding the listing of a company. [T]he Exchange may deny listing or apply additional or more stringent criteria based on any event, condition, or circumstance that makes the listing of the company inadvisable or unwarranted in the opinion of the Exchange. Such determination can be made even if the company meets the standards set forth below.[327]

This excerpt is an official statement of the New York Stock Exchange, made in the introduction to the New York Stock Exchange's listed company manual. The Exchange

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[324] For general information, *see* http://www.wavesecurities.com.

[325] *See* Aaron Lucchetti, *NYSE, Archipelago Face Hurdles on Road to Combined Company*, THE WALL STREET JOURNAL, May 2, 2005, p. C3.

[326] Silver v. New York Stock Exchange, 373 U.S. 341, 364 (1963).

[327] NYSE Listed Company Manual § 101.00.

admits that it has broad discretion and that it may deny listing even if the applicant company meets the requirements of the listing rules.[328]

That creates significant problems. So far, the article has dealt with conflicts of interest in the regulation of stockholders, competitors, the exchange itself, affiliates, and in general. In contrast to those cases, the problem discussed in this section is not that the stock exchange may unfairly regulate but that it may, by rejecting the listing application, *refuse to regulate at all*. This is not a regulatory problem but a competitive and macroeconomic one. Let us assume Nasdaq files an application for a listing on the New York Stock Exchange. Let us, to dramatize matters, assume that Nasdaq together with its listing promotes new shares with the outlook of investing in a new trading system that will poach the issuers and traders on the New York Stock Exchange. Is the New York Stock Exchange free of conflicts of interest when it decides on the Nasdaq Stock Market's listing application? Can the New York Stock Exchange reject the application without cause? Or is the competitive threat a reasonable cause? Similar problems arise in regard to a delisting; for the stock exchange has broad discretion in either case.[329] And finally, with the traders no longer the owners of the marketplace, stock exchanges might use their oligopoly or even monopoly powers to seek extra rents from its main customers and former owners, the brokers and dealers.[330]

These are all considerable problems that, however, must be solved by antitrust law.[331] They are not so much regulatory problems, because the issue is not unfair regulation but unfair denial of regulation or misuse of economic power. Consequently, the regulatory proposal that is put forward in the next Part does not address these problems. The European Union recently solved the problem by transferring all listing decisions to agencies independent from the stock exchanges and other market participants.[332]

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[328] The listing application procedure is governed in detail in NYSE Listed Company Manual §§ 701.00 et seq. The listing agreements are reprinted in NYSE Listed Company Manual §§ 901.01 et seq., the application forms in NYSE Listed Company Manual §§ 903.00 et seq.

[329] *See*, *e.g.*, NYSE Listed Company Manual § 801.00 and NYSE Rule 499.

[330] For an early contribution to the widely neglected discussion, *see* Lee, *Future of Securities Exchanges*, *supra* note 4, at 21-23.

[331] Antitrust cases are nothing unfamiliar, considering the New York Stock Exchange's monopoly power. *See*, *e.g.*, the landmark cases Silver v. New York Stock Exchange, 373 U.S. 341 (1963) and Gordon v. New York Stock Exchange, Inc., 422 U.S. 659 (1975).

[332] Art. 21 DIRECTIVE 2003/71/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of November 4, 2003 ON THE PROSPECTUS TO BE PUBLISHED WHEN SECURITIES ARE OFFERED TO THE PUBLIC OR ADMITTED TO TRADING AND AMENDING DIRECTIVE 2001/34/EC, OJ L 345, December 31, 2003, p. 64, 79. Sentence 3 of Subsection (1) of Art. 21 reads as follows: "These competent authorities shall be *completely independent from all market participants*." (emphasis added).

H. OTHER CONFLICTS OF INTEREST

The world of stock exchanges is full of conflicts of interest. While the previous sections have mentioned many such conflicts, there are more conflicts that could and should be addressed. So far, this article has been limited to *stock* exchanges and the listing of *stock*. Exchanges, however, can list other securities, such as bonds.[333] Another, yet more common example is derivatives. As mentioned earlier, worldwide stock exchanges, in increasing numbers, list derivatives or are affiliated with derivatives exchanges. Even the New York Stock Exchange thinks about trading bonds, exchange-traded funds, and derivatives.[334] In all these cases, the conflicts related to self-listing and regulating competitors arise in a similar manner, although generally to a lesser extent, considering the fewer regulatory powers in this area. We have already seen a prominent example in the United States of a case of this type: the Pacific Exchange (part of Archipelago) trades options on Instinet,[335] the alternative trading system that competes with Archipelago's stock market and is about to merge with the Nasdaq Stock Market. Aside from its influence on the trading in these options, it is completely up to the Pacific Exchange what kind of options it offers. The Pacific Exchange might favor options for trading strategies that cause problems for the trading in Instinet's equity shares. And so forth.

Many other conflicts of interest may arise if, as is likely, the stock exchanges diversify and engage in other businesses. Such expansion has already been identified as conflict-increasing, because it leads to more competitors that may be unfairly treated. There is a second dimension: stock exchanges may use their powers over issuers and broker-dealers to compel them to use the exchange's other services, such as clearing and settlement.[336] Again, however, this is less a regulatory problem than an antitrust issue, and is therefore beyond the scope of this article.[337]

Worrisome from a regulatory standpoint, however, are cases in which stock exchanges abuse their powers over regulated entities and force them to further the stock exchange's policy interests. The recent conflict about the new National Market System nicely illustrates the concern: the New York Stock Exchange through mass emails con-

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[333] Admittedly, bonds are usually traded on unregulated markets (*see* COFFEE & SELIGMAN, *supra* note 18, at 15). But there is no reason why liquid bonds should not be traded at stock exchanges, and indeed to some extent they are, particularly in Europe. As the following remarks in the text reveal, U.S. stock marketplaces are about to expand their traded securities.

[334] *See infra* III.C.1.

[335] Pacific Exchange Press Release (May 30, 2001), *supra* note 303.

[336] *See generally recently* GROUP OF THIRTY, GLOBAL CLEARING AND SETTLEMENT: A PLAN OF ACTION (2003).

[337] Such anti-competitive behavior, however, is not so unlikely. For instance, the New York Stock Exchange forbade their members to trade at other marketplaces entirely until 1975, and to a lesser degree until 2000 (*see* former NYSE Rule 390, removed and rescinded May 5, 2000; interestingly, then Chairman of the SEC Arthur Levitt doubted that "such an anticompetitive rule" could be sustained when the New York Stock Exchange demutualizes, *see* Levitt, *Dynamic Markets, Timeless Principles*, *supra* note 70; *see also* Levitt, *Market Structure Issues*, *supra* note 70).

tacted the listed issuers to ask them to support the New York Stock Exchange's position.[338]

V. AMENDMENTS TO THE REGULATORY REGIME

Demutualization and subsequent listing of stock exchanges requires our greatest attention. The progress does not, however, require greater changes to the regulatory system. The challenges that come with the new organizational structure of stock exchanges are manageable.

This article puts forward a simple proposal that seems sufficient to address the emerging problems without overly hindering stock exchanges or throwing overboard the traditional regulatory system: *First,* the regulatory arm of the stock exchanges should be separated from the other business units. *Second*, this separated regulatory arm should not report to the board of directors of the stock exchange, but rather to the SEC. *Third*, self-listed stock exchanges and their affiliates should be required to have a second listing at another stock exchange.

The chief regulatory officer of the New York Stock Exchange correctly formulated what we must be able to expect from the traditional regulatory system: "*[i]f self-regulation is going to work, it must show that our decisions are irrelevant to whether it helps or hurts the [New York Stock Exchange] as a business.*"[339]

The offered proposal aims at nothing more than mitigating the conflicts of interest so that the impartiality of stock exchanges remains above doubt, without overly hindering the management of the stock exchanges. Demutualization and subsequent public listing are critical to help stock exchanges compete with other marketplaces. Overly regulating publicly traded stock exchanges, which would be the result of some institutions' and commentators' proposals, would erase the intended positive effects, cause the entire restructuring to be questioned, and cement the U.S. stock exchange's passive role in the worldwide consolidation. Needless to say, this result would not be good policy.

The argument commences with introductory remarks on the desirability and extent of regulation [*infra* A], introduces the proposed regulatory regime [B], and finally discusses why this proposal is superior to other approaches [C].

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[338] *See* Aaron Lucchetti, *Big Board Still Carries a Big Stick*, THE WALL STREET JOURNAL, April 5, 2005, p. C1.

[339] Richard G. Ketchum, cited pursuant to Der Hovanesian, *Big Board On The Big Board*, *supra* note 71.

A. INTRODUCTORY REMARKS

Any proposal of a regulatory framework for demutualized and publicly traded stock exchanges touches upon the general question of how much regulation of stock exchanges is desirable.

In a general remark on regulation, Alan Greenspan, the chairman of the Board of Governors of the Federal Reserve System, said some forty years ago in one of his early works:

> [I]t is in the self-interest of every businessman to have a reputation for honest dealings and a quality product. … Reputation, in an unregulated economy, is thus a major competitive tool.[340]

By this notion, Greenspan argued in favor of deregulation. The "quality product" that stock exchanges (the "businessman" in Greenspan's words) offer is organizing and regulating a market for stocks. Is selling this product like selling bread?[341] Is the incentive to sell the best bread to the investing customers big enough to abandon or at least reduce the regulation of stock exchanges by the SEC? Some commentators think so[342]—and not surprisingly the stock exchanges share this view.[343] They believe, as Greenspan suggested in his early work, that the competition for investors will constrain the stock exchange's management and let management focus on the stock exchange's most valuable asset: *integrity*. In this belief, these commentators argue in favor of more regulatory powers for stock exchanges and less governmental involvement. However, there are also opponents of more regulatory power on the stock exchange level.[344] One such opposing argument is that stock exchanges are hardly able to regulate the market in the age of globalization, with issuers and traders based all over the world.[345] Another, also not entirely unwarranted, concern is that stock exchanges may abuse their regulatory powers for anticompetitive behavior.[346] And finally, perhaps the strongest point, the stock exchange's track record is not above doubt.[347] For stock exchanges that have

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[340] Alan Greenspan, *The Assault on Integrity*, 2 THE OBJECTIVIST NEWSLETTER 31, 32 (1963, Issue 8).

[341] The bread example is taken from Mahoney, *supra* note 25, at 1459.

[342] *See particularly* Mahoney, *supra* note 25 (whose article is significantly titled "The Exchange as Regulator"). *See also* Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855 (1997).

[343] WORLD ORGANIZATION OF EXCHANGES, *supra* note 263, at 7. *See also* Carson, *World Bank Paper*, *supra* note 8, at 11.

[344] *See particularly* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509 (1997). *See also* Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853 (1985).

[345] *But see* Karmel, *supra* note 10, at 370, 427 (coming to the contrary conclusion). However, if the national authorities, such as the SEC, cannot accurately regulate in the age of globalization, as she argues, how can the stock exchanges? Put differently: If the *governmental* SEC cannot collaborate with foreign financial market authorities, why should the *private* stock exchange be able to do so?

[346] *See*, *e.g.*, the landmark cases Silver v. New York Stock Exchange, 373 U.S. 341 (1963) and Gordon v. New York Stock Exchange, Inc., 422 U.S. 659 (1975).

[347] *See supra* IV.A.3.

already lost their reputation (like American Stock Exchange for listing standards), there is no reputation at stake, a point that is sometimes neglected.

For the purposes of this article, however, that discussion is somewhat outdated and therefore only briefly summarized. Contributions so far have been based on the assumption that stock exchanges are organized in the mutual form. Commentators have not (yet) considered that stock exchanges may demutualize and go public. Their arguments can therefore be applied to publicly traded stock exchanges only with caution. Moreover, it is far beyond the purpose of this article to discuss whether the current system as a whole—most importantly the concept of self-regulation—is good policy, and if so, to what extent.[348] Notwithstanding doubts about the appropriateness of certain regulations and the general extent of regulation, the amendments put forward in this article go only so far as necessary to address the challenges that come with demutualization.

Before the article turns to these proposed amendments, it might be advisable to recapitulate and to emphasize that the current system of mutual stock exchanges is all but free of the conflicts associated with demutualized exchanges (except for self-listing, which is a new conflict).[349] And in addition, there are considerable conflicts of interest under the current system that would be solved under the new structure, particularly between the exchange and its members and among the members.[350] Congress knew of these conflicts of interest when it enacted the regulatory system in 1934. They seemed inevitable but outweighed by the benefits of vesting regulatory power with the stock exchanges.[351] Of course, we should not be indifferent toward conflicts of interest only because they have always existed; but with the legislative and regulatory history in mind, we should be confident that we can handle the challenges that come with demutualization without questioning the whole system.

B. ELEMENTS OF THE PROPOSED REGIME

The proposed regulatory regime for publicly traded stock exchanges has three prongs: segregation of the regulatory arm from the business operations [*infra* 1], reporting to the Securities and Exchange Commission [2], and mandatory dual listing for stock exchanges and affiliates [3].

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[348] *See* SEC, *Concept Release Concerning Self-Regulation*, *supra* note 24; SECURITIES AND EXCHANGE COMMISSION, MARKET 2000—AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (1994). *See also* SECURITIES INDUSTRY ASSOCIATION, *supra* note 24. For a discussion in a broader context *see* Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES L. 649 (2001) (discussing the allocation of regulatory power in the area of corporate law, securities regulation, and the regulation of financial institutions).

[349] *See particularly* SEC, *Concept Release Concerning Self-Regulation*, *supra* note 24, at 71,259-75.

[350] These conflicts are nicely described by Grasso, *supra* note 69. *See also* Schroeder & Smith, *supra* note 145.

[351] *See* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,132 fn. 69.

1. Segregation of the Regulatory Arm

Publicly traded stock exchanges should separate their regulatory arm from the other business units. Though details differ, there seems to be a broad consensus for such segregation.[352] And regulators have indeed required demutualizing stock exchanges to do so. The Stock Exchange of Hong Kong, for instance, spun off its regulatory arm with demutualization.[353] The New York Stock Exchange announced that it would separate its regulatory arm as part of the merger of Archipelago and the subsequent going public.[354]

The proposed separation mitigates all incentives and conflicts that are related to the regulatory intensity in general, the regulation of stockholders, of competitors, of oneself, and of affiliates. It also precludes hidden cross-subsidization, which some commentators and organizations are concerned about.[355]

2. Reporting to the Securities and Exchange Commission

The second prong supplements the segregation of the regulatory arm: The head of the regulatory arm should not report to senior management or the board of directors of the stock exchange, but to the SEC.

The rationale behind this amendment is that separation itself does not change much if the head of the regulatory arm is still responsible to the general management of the stock exchange. Under such a system, the regulatory arm is only one division among others. The conflicts of interest that require the separation are hardly mitigated if the regulatory arm continues to report to senior management. The latter, for instance, could require the regulatory arm to meet the company's income targets. In this case, the regulatory arm would focus on fines and neglect areas that create little income, regardless of whether this is good policy from a regulatory standpoint.

The stock exchanges themselves are aware of this problem. For instance, as a consequence of its corporate governance problems, the New York Stock Exchange changed its regulatory structure so that the chief regulator now reports to a committee of independent directors instead of the chairman.[356] That is a significant improvement over reporting to senior management. If one believes that independent directors are the long-sought-after panacea for various corporate governance issues, one will probably say that reporting to them is sufficient to ensure a proper separation of the regulatory arm from

[352] SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,141-43; Carson, *World Bank Paper*, *supra* note 8, at 17; Levitt, *Dynamic Markets, Timeless Principles*, *supra* note 70.

[353] *See* the description in HKEx News Release, *A Transcript of the Address by HKEx Chairman Charles Lee at the Legislative Council's Financial Affairs Panel* (July 31, 2002).

[354] *Joint News Release*, *supra* note 82; Thain, *supra* note 82. *See also* Lucchetti, Craig & Davis, *supra* note 164.

[355] IOSCO ON EXCHANGE DEMUTUALIZATION, *supra* note 7, at 13.

[356] Der Hovanesian, *Big Board On The Big Board*, *supra* note 71. The New York Stock Exchange wants to keep this structure after its merger with Archipelago. *See Joint News Release*, *supra* note 82; Thain, *supra* note 82.

the other business units. However, if one believes that independent directors are to some degree dependent on management and tend to fraternize with management, reporting to independent directors does not adequately mitigate the conflicts on interest. Particularly in this context, it is questionable whether independent directors will have the necessary regulatory knowledge and the understanding of the stock exchange's daily business to qualify as contact persons for reporting abuses of regulatory power.

It seems therefore worth considering a requirement that the head of the regulatory arm report to the SEC. This reporting requirement would not mean that the Commission gets the power to make any decisions within the stock exchange, concerning for instance their hiring of additional regulatory staff. Such decisions should be left to the stock exchange, because there is no reason to believe, as explained in earlier sections, that the stock exchange *generally* will under-regulate or over-regulate. The requirement of reporting to the SEC will ensure only that the regulatory staff has someone impartial to whom to report single abuses of regulatory powers, particularly over-regulation of competitors and under-regulation of oneself and affiliates. The WorldCom case tellingly shows us how important it is that employees be able to report to someone who is not part of the corrupt system.[357]

To be sure, implementing such governmental intervention requires good reasons. The conflicts of interest that are outlined in Part III are such good reasons. Particularly the conflicts of interest that arise in regard to the regulation of competitors, oneself, and affiliates require a clear separation of business interests and regulatory functions. And it might be advisable to consider that the proposed reporting will not change much, but rather will codify what virtually already exists: if stock exchanges fail to perform their regulatory functions, the SEC can step in under the current system anyway.[358] Taking into account the numerous other powers of the Commission, the reporting requirement is relatively modest. That is particularly true if compared with the frequently supported proposal to entirely outsource the regulatory functions, a proposal that will be considered and rejected later.

3. Mandatory Dual Listing for Stock Exchanges and Affiliates

The first and the second prongs of the regulatory proposal do not address the challenges that come with self-listing. As explained above, the problem here is that stock exchanges cannot enter into a listing agreement with themselves, and even if we find substitutes for surveillance and enforcement, most of the listing requirements would miss their underlying purpose.

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[357] WorldCom's business "culture" almost entirely suppressed control by employees. *See* SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC., REPORT OF INVESTIGATION 18-24 (March 31, 2003).

[358] Securities Exchange Act § 21, codified in 15 U.S.C. § 78u. *See particularly* Securities Exchange Act § 21(f), codified in 15 U.S.C. § 78u(f).

To overcome this problem, we should require stock exchanges and their affiliates who want to list their shares at their own markets to choose another market for a second listing (a concept which will be referred to as *mandatory dual-listing* hereinafter). The rule would not apply to stock exchanges and affiliates that do not want to list the stocks on their own market and therefore not rely on self-listing. So for example, if the New York Stock Exchange goes public *and* wants to list its stock on its own market, under the proposal put forward it will have to apply for listing at another stock exchange, such as the American Stock Exchange. In the age of globalization, dual listing at a well-organized foreign stock exchange should also fulfill the dual listing requirement. The SEC could make a list of such eligible foreign exchanges (at least Frankfurt, London, and Paris/Euronext). The Nasdaq Stock Market should also be expressly included until it has stock exchange status, when it will fall under the first category, domestic stock exchanges.

At first view, one could counter-argue that listing at competing marketplaces is not better than self-listing. To be sure, the second stock exchange faces conflicts of interest when it regulates competitors, particularly if the second stock exchange itself is demutualized and publicly traded, as discussed in earlier parts.[359] Such competitor-regulating stock exchanges, however, would be subject to the first two prongs of the proposed regulatory system: their regulatory arm would be separated and would report to the SEC. The Commission could require similar procedures by foreign stock exchanges and the Nasdaq Stock Market if they want to qualify for dual listing.

Concededly, dual listing creates downsides for the stock exchange. First of all, there are listing fees that the stock exchange has to pay to the second exchange. Secondly, the listing on two exchanges will lead to market fragmentation and reduce liquidity. However, there are also benefits of dual listing; otherwise companies would not voluntarily dual-list, as some do.[360] Even without such benefits, the downsides of dual listing constitute no basis for rejecting the proposal of mandatory dual listing. If the costs of dual listing are too high, the stock exchange can avoid them by forgoing self-listing and listing solely at another stock exchange—as all companies do that are not stock exchanges. It would be just a cost-benefit analysis of whether the costs of self-listing outweigh the benefits.

Trickier is the problem of fragmentation. It depends on the market structure and the linkages between the stock exchanges whether dual listing leads to fragmentation at all. If there is evidence that dual listing of stock exchanges indeed leads to fragmented and illiquid markets, the proposed regime would need a slight amendment: It would be suf-

[359] Bradley, *supra* note 10, at 685, 701, sees a problem of listing on a competing market insofar as it might look like a lack of confidence of the market to list its own shares. She does not raise any regulatory concerns connected to regulating competitors.

[360] Investors profit from dual listing at least insofar as it increases the competition among stock exchanges, which might lead to better service at lower prices.

ficient to make dual *listing* mandatory, rather than dual *trading*. The rationale behind that distinction is that the regulatory concerns with respect to the regulation of the trading in the stock exchange's own stocks are mitigated by the separation of the regulatory arm and the reporting to the SEC. Therefore, the new regime could allow that the stock exchange is listed at another marketplace but not actually traded there. Based on its dual listing, the stock exchange would be subject to the other marketplace's issuer regulation. But without trading at this marketplace, there would be no fragmentation in the trading of the stock exchange's shares. Put simply, mandatory listing would mean that the shares of stock exchanges are dual listed without being dual traded.[361]

In conclusion, mandatory dual listing for publicly traded stock exchanges and their affiliates is an effective, efficient, and quite simple way to ensure that they are as thoroughly regulated as any issuer.

C. ARGUMENT FOR THE PROPOSED REGIME

The regulatory system that this article puts forward has advantages over other proposals that have been offered so far, including the amendments proposed by the SEC.[362]

The proposed three prongs amend the current regulatory regime only to the extent that is necessary to address the regulatory challenges that come with demutualization. If more is desirable, this should be discussed openly and not under the guise of demutualization.[363] For a demutualized and publicly traded stock exchange working under a profit-maximizing standard, over-regulation and under-regulation, or both, or neither, can be desirable. This fact, as well as further arguments, lead this article to conclude that regulation as such will not suffer from demutualization and listing of stock exchanges. Therefore, the challenges that need to be addressed are limited to the conflicts of interest that have been identified in Part IV: that stock exchanges might abuse their regulatory powers in certain fields to promote their own business; that they might be too soft on themselves (under-regulation) and too hard on competitors (over-regulation). Naturally, such specific abuses are harder to detect and prevent than general regulation deficits, particularly if they offset each other, and the overall regulatory figures like personnel, actions, and fines remain unchanged. But these problems are manageable without overhauling the traditional regulatory system with stock exchanges as front-line regulators.

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[361] Interestingly, the temporarily exceedingly successful *Neuer Markt* of the Deutsche Börse rested exactly on this model: issuers were listed on the officially regulated market ("Geregelter Markt"), but not traded. Rather, the trading took place on the Neuer Markt. *See* Andreas M. Fleckner, *Die Lücke im Recht des Devisenterminhandels*, 57 ZEITSCHRIFT FÜR WIRTSCHAFTS- UND BANKRECHT 168, 171 (2003).

[362] *See* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5.

[363] The SEC discusses the issue openly. *See* SEC, *Concept Release Concerning Self-Regulation*, *supra* note 24.

Under the proposed system, market and issuer regulation would remain in the hands of the stock exchanges. The advantages of self-regulation, particularly the closeness and the expertise of the stock exchanges, would not be lost. Furthermore, leaving the stock exchanges their regulatory powers would allow them to use regulation to place themselves in the competition. Regulation is something that a stock exchange can emphasize, strengthen, and use for marketing. Its name can become a brand name for thorough regulation. Regulation, reputation, and integrity are values for which stock exchanges can compete. Says the former chairman of the New York Stock Exchange: "The money we spend on regulatory oversight … builds equity in our brand."[364] We find such statements all over the world.[365] A critical part of competition would be lost if we outsourced regulation to a single regulator or the SEC.[366]

Another advantage of the proposed regulatory system is that we would not have to be worried if persons that are regulated by the stock exchange hold a significant share in the stock exchange. Without any amendments one might be worried that the stock exchange may be unwilling to enforce independently and effectively the broker-dealers' and issuers' obligations, if both are the stock exchange's major stockholders.[367] Under the proposed regime, however, there would not be such a risk because the regulatory arm would report to the SEC and not to management. This approach is much smoother than the arbitrary ownership restrictions that some commentators and organizations propose, most notably the Commission.[368] Such restrictions are nothing other than *poison pills* that protect stock exchange's management against takeovers. They are not in the interest of the stock exchange and its stockholders, because they will increase its capital costs. And they are not in the interest of the economy, because they may prevent efficient ownership structures.[369]

The smartest move seems to be the mandatory dual listing (which does not necessarily require dual trading). That would be much less onerous than the reporting requirements that the SEC has proposed and those Nasdaq has implemented.[370]

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[364] Grasso, *supra* note 69. *See also* Greg Ip, *Grasso, Zarb Differ on Self-Regulation of Stock Markets*, THE WALL STREET JOURNAL, September 29, 1999, p. C17.

[365] *See, e.g.*, Humphry, *Cause and Effect*, *supra* note 110. *See also* ASX Media Release, *World's Stock Exchanges Map Out Action Plan* (October 5, 2000).

[366] Proposals for partially or completely outsourcing regulation to a new regulatory organization or the SEC have been made by Dombalagian, *supra* note 50, at 1146-53; Der Hovanesian, *Big Board On The Big Board*, *supra* note 71 (arguing that merging the regulatory arms of the NASDR and the New York Stock Exchange would save $100 million a year); Schroeder & Smith, *supra* note 145.

[367] *See supra* IV.C.

[368] *See particularly* SEC, *Proposed Rule on Fair Administration and Governance of Self-Regulatory Organizations*, *supra* note 5, at 71,143-46.

[369] Possible antitrust issues, again, are not to be solved by securities law.

[370] NASD Listing Manual § 4370, titled "Additional Requirements for Nasdaq-Listed Securities issued by Nasdaq or its Affiliates" (most importantly requiring Nasdaq to file a monthly report with the SEC and to engage an independent accounting firm every year to review and prepare a report). *See* SEC, Release No. 34-51123 (File No. SR-NASD-004-169): *Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Grant-*

VI. CONCLUSION

More than forty years ago, the U.S. Supreme Court held in the widely-recognized *Silver* case:

> It requires but little appreciation of the extent of the Exchange's economic power and of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail as to every aspect of the Exchange's activities. What is basically at issue here is whether the type of partnership between government and private enterprise that marks the design of the Securities Exchange Act of 1934 can operate effectively to insure the maintenance of such standards in the long run.[371]

Demutualization and subsequent public listing once again challenge the partnership to which the Court refers, known as the concept of *self-regulation*. As always in case of dilemmas, there is no panacea, no way out that circumvents all problems. With the proposals made in this article, however, the regulatory challenges that come with demutualization, listing, and self-listing are manageable without jeopardizing the benefits of this process. The modest amendments put forward here would help preserve the stock exchanges' integrity without overly hindering their management in responding to increasing competition. Congress and the Securities and Exchange Commission would be well advised to not go further. At the cusp of a new era, adhering to regulatory restraint is a wise decision.

There is much at stake. While marketplaces abroad have gone through demutualization a couple of years ago and since then benefited from that transformation, U.S. stock exchanges are forced to watch the global development from afar. Still organized in the mutual form, they play no role in the global consolidation, for most of them neither are acquirable nor have the money to acquire others. Nothing less is in danger than the long U.S. predominance in the stock markets. Its lead in futures trading has already been lost.[372] And competition does not halt at the derivatives markets. As an example, at the apex of the internet boom, markets for start-up companies such as the German *Neuer Markt* were able to win over U.S. issuers from the "new economy" that normally would have gone public on the Nasdaq Stock Market.

Arthur Levitt, then-chairman of the SEC, as early as 1999 pointed out that the United States could fall behind overseas markets if it missed the trend toward demutu-

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ing Approval to Proposed Rule Change and Amendment No. 3 Thereto To Adopt Additional Listing Standards Applicable to the Securities of the Nasdaq Stock Market, Inc. or an Affiliate (February 2, 2005), 70 Fed. Reg. 6,743 (2005).

371 Silver v. New York Stock Exchange, 373 U.S. 341, 366 (1963).

372 The leading derivatives exchange is now Eurex, which is jointly owned and operated by Deutsche Börse and the SWX Swiss Exchange. Most importantly, no other exchange trades more contracts: On Eurex, 1.014 billion contracts were traded in 2003 (*see* THE HANDBOOK OF WORLD STOCK, DERIVATIVE & COMMODITY EXCHANGES 37 (2004)). None of the various U.S. derivatives exchanges reaches this volume: 640.2 million at the Chicago Mercantile Exchange (*id.* at 744); 454.2 million at the Chicago Board of Trade (*id.* at 728); 283.9 million at the Chicago Board Options Exchange (*id.* at 701); 244.9 million at the International Securities Exchange (*id.* at 780); 180.1 million at the American Stock Exchange (*id.* at 685). Smaller marketplaces omitted.

alization and going public.[373] Mr. Levitt correctly noted that "today's global marketplace always stands ready to offer alternatives that are more responsive to investor needs."[374] Mr. Levitt drastically warned that if the people at the New York Stock Exchange do not change "their method of governance, they won't be here five years from now."[375] At the same time, observers described the New York Stock Exchange as being led by "die-hard traditionalists"[376] and as a "potential Titanic."[377]

That is six years ago. Not much has changed since then. The Wall Street Journal, disinclined to defame a U.S. icon without reason, has recently characterized the New York Stock Exchange as a "rinky-dink" company,[378] a "dinosaur,"[379] an "anachronism,"[380] and the "queen of slow markets."[381]

It is not too late to catch up with global competition—but it will require prompt action to defend the long U.S. preeminence in stock trading. Recent announcements of mergers are an important step, but it is only the very first.

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[373] *See supra* note 70.

[374] Levitt, *Market Structure Issues*, *supra* note 70.

[375] Cited pursuant to Sugawara, *NYSE Must Change*, *supra* note 68.

[376] Humphry, *Challenge of Financial Globalisation*, *supra* note 66.

[377] (Without author) *A Home-Grown Revolutionary*, THE ECONOMIST, July 31, 1999.

[378] Holman W. Jenkins, *Antique for Sale*, THE WALL STREET JOURNAL, April 27, 2005, p. A15.

[379] Murray, *supra* note 124. *See also* (without author) *Donaldson's Dinosaur*, THE WALL STREET JOURNAL, April 4, 2005, p. A14.

[380] Murray, *supra* note 124.

[381] (Without author) *SEC Loves NYSE*, THE WALL STREET JOURNAL, December 6, 2004, p. A14.