

# **The Dangerous Territoriality of American Securities Law: A Proposal for an Integrated Global Securities Market**

by

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## *Abstract*

*Market participants, academicians, and governmental officials debated how the United States government should structure multiple securities exchanges for several years before Congress mandated the establishment of the National Market System in the 1975 Amendments to the Securities Exchange Act of 1934. During the intervening twenty-five years, recurring issues concerning the transparency, fragmentation, and fairness of the National Market System have not been resolved. Recently, the globalization of securities markets and the development of Internet technology that permits cost-effective transnational securities trades and markets have exacerbated these issues. In fact, Internet technology makes the development of an integrated global securities market not only feasible, but optimal.*

*This essay reviews the SEC's approach to the National Market System with an emphasis on developments since the advent of the Cyber-age. The review shows that, despite technological developments that have propelled markets towards globalization, the SEC has taken a distinctly territorial approach in creating a safe harbor from registration for foreign stock exchanges that utilize the Internet. At present, the SEC is considering the conditions under which such a foreign exchange must register. This essay argues that the SEC should focus more on the systems architecture of foreign securities exchanges and less on its present territorial approach. While maintaining the National Market System and the existing safe harbor, this essay argues that market participants should apply for, and the SEC should consider, granting registration to an Internet-based securities market. This grant of registration should not be based upon the geographic locus of the exchange, or of its members or issuers. Rather, it should be granted upon the showing that the exchange's systems architecture furthers the objectives of the federal securities laws.*

*The proposed integrated global securities market ("IGSM") would be an SRO/exchange that would accept listings from an issuer as long as the issuer met the disclosure requirements of its home jurisdiction. An issuer listed on the IGSM could not be traded on another exchange, unless that exchange participated in the price/time priority order book of the IGSM. This condition would resolve many of the difficulties that have plagued the National Market System. The IGSM proposal takes account of considerations of regulatory competition, because: (1) an issuer's home country standard of disclosure would be reflected in the price of its shares traded on the IGSM; (2) the IGSM would compete for listings against other exchanges with higher or lower mandatory levels of disclosure, including those in the National Market System; and (3) the IGSM prevents listing of an issuer from a strict regulatory regime being traded on an exchange from a lax regulatory regime—regulatory free riding.*

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## I. INTRODUCTION

On January 14, 2000, the EASDAQ<sup>1</sup> announced that it would begin trading the ten largest NASDAQ-listed issuers within one week, “a move that does not require the consent of the companies involved.”<sup>2</sup> The “NASDAQ Ten”<sup>3</sup> represent a combined market capitalization of US\$2.34 trillion.<sup>4</sup> This constitutes a substantial portion of domestic market capitalization, and it is an amount comparable to the total market capitalization of each of the five U.S. regional exchanges: the Boston, Chicago, Cincinnati, Pacific, and Philadelphia Stock Exchanges. This watershed development illustrates several existing difficulties inherent in the National Market System [hereinafter, “NMS”], because transactions in these new “household name” issuers take place in a foreign jurisdiction and are not necessarily reported on the NMS. This essay’s analysis of the NASDAQ Ten is applicable to all public issuers: domestic and foreign, large and small cap, and liquid and illiquid.

Congress mandated that the Securities and Exchange Commission [hereinafter, “SEC” or “Commission”] facilitate the development of the NMS in the 1975 Amendments<sup>5</sup> to the Securities Exchange Act of 1934.<sup>6</sup> Although observers have long debated issues of market fragmentation, payment for order flow, and transparency with regard to the NMS, these issues have become exacerbated by the globalization of securities markets in a high-technology environment that permits investors and market intermediaries to make cross-border transactions quickly and inexpensively. This debate has been grounded in the fact that, as noted above, public issuers exercise no choice over the securities market in which their shares are traded.

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<sup>1</sup> The EASDAQ stands for European Association of Securities Dealers Automated Quotation System. The EASDAQ, established in 1996, is a self-styled “independent pan-European stock market offering international growth companies and investors seamless cross-border trading, and clearing and settlement within a unified market structure.” <<http://easdaq.com/easdaq.htm>> (site visited, March 23, 2000).

<sup>2</sup> *Easdaq to Trade 10 Leading Stocks Listed on the Nasdaq*, WALL STREET J. at C6 (January 14, 2000).

<sup>3</sup> The “NASDAQ Ten” issuers are comprised of Microsoft Corp., Cisco Systems, Inc., Intel Corp., Oracle Corp., Sun Microsystems, Inc, MCI WorldCom Inc., Dell Computer Corp., Yahoo! Inc., Amgen Inc., and Amazon.com, Inc. *See id.*, *see also* <[http://www.easdaq.com/pe/ene\\_](http://www.easdaq.com/pe/ene_)> (site visited January 24, 2000).

<sup>4</sup> This figure is derived from the sum of the market capitalizations at the market close on March 21, 2000, as reported on <<http://finance.yahoo.com/q?s={ticker symbol}>>. The market capitalizations (in US\$ billions) were: Microsoft Corp. (534.8), Cisco Systems, Inc. (488.6), Intel Corp. (462.5), Oracle Corp. (227.7), Sun Microsystems, Inc. (173.4), MCI WorldCom Inc. (124.4), Dell Computer Corp. (148.8), Yahoo! Inc. (101.0), Amgen Inc. (62.6), and Amazon.com, Inc. (24.7).

<sup>5</sup> *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975)(codified in scattered sections of 15 U.S.C).

<sup>6</sup> 15 U.S.C. § 78a *et seq* [hereinafter, the “Exchange Act”].

This essay examines the territorial character of the NMS despite the existence of technology that has created a global securities market. Part II provides background for the dilemma faced by the SEC in developing a regulatory policy for addressing global Internet stock trading by summarizing the legal, market and technological background of the problem. A review of the SEC's approach to regulating market structure yields three conclusions. First, the SEC's policy has been to modify the regulation of market structure incrementally since passage of the 1975 Amendments. Second, this approach has had a decided bias towards the regulation of a territorial, rather than a global, market structure. Supporting this conclusion is the Commission's recent Internet Release<sup>7</sup> in which the Commission addresses the offer of services by a stock exchange over the Internet. The Internet Release relies on the "Targeting Approach." Pursuant to the Targeting Approach, the Commission will not require a foreign exchange with a Web site to register as long as it does not target its services to residents of the U.S., and it takes steps reasonably designed to prevent U.S. residents from directing orders to the exchange through its Web site. Such steps include placement of a disclaimer on the Web site stating that the exchange's services are not available to U.S. residents. Third, Part II reveals that the Commission's incremental approach to the regulation of market structure has not resolved issues of order fragmentation, payment for order flow, and transparency presented by the NMS. The Commission's Regulation of Exchanges Release<sup>8</sup> indicates that the Commission is favoring an approach that will not only keep open the issues which have beset the NMS, but will extend the NMS to global securities market linkages.

Although the Commission's regulation of market structure has been a slow and incremental process over the last twenty-five years, Part II summarizes how relevant changes in global securities markets have been rapid and revolutionary. Cross-border listings and transactions in securities are increasing at an extraordinary rate. Physical stock exchanges are consolidating domestically and abroad, while electronic trading systems are proliferating. It is not surprising that technology, particularly the Internet, is driving many of these changes. We have long known that due to technological advances, "markets no longer are, or need to be, physical places."<sup>9</sup> The territorial focus of the Targeting Approach; however, runs counter to the borderless global securities market created by the Internet.

Part II further reveals that, contrary to popular belief, the Internet is readily subject to regulation for the purposes of creating efficient securities markets. A summary of Internet architecture indicates that although it is a medium not prone to regulation with

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<sup>7</sup> See SEC, Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities Transactions or Advertise Investment Services Offshore, Release Nos. 33-7516, 34-39779, IA-1710, IC-23071 (March 23, 1998) [hereinafter, "Internet Release"].

<sup>8</sup> SEC, Concept Release on Regulation of Exchanges, Release No. 34-38672; International Series Release No. IS-1085 (May 23, 1997) [hereinafter, "Regulation of Exchanges Release"].

<sup>9</sup> Letter from Richard Breedon, Chairperson of the SEC, to Edward Markey, Chairperson, Subcommittee on Telecommunications and Finance. (July 11, 1991)(announcing the MARKET 2000 REPORT, *infra* note 42, at I-1).

respect to geo-political borders, a regulator can control access to information, interaction among participants, and surveillance of financial transactions within a partially “closed” systems architecture—the same activities that securities regulators presently exercise over exchanges.

Part III of this essay is a critique of the current policy approach towards transnational trading of securities over the Internet. Part III analyzes the Targeting Approach in light of the findings in Part II about globalized securities markets and technological developments. This analysis is timely, because the International Organization of Securities [hereinafter, “IOSCO”]<sup>10</sup> has adopted the Targeting Approach, as have several regulators of developed securities markets. The implication for global securities markets of the Targeting Approach is a dangerous territoriality: if every national securities regulator applied this approach to stock exchanges that offer trading capacity over the Internet, the result would be regulatory uncertainty for domestic and foreign exchanges, fragmentation of the global securities market, and the limitation of Internet-based stock exchange services to each exchange’s home jurisdiction.

As the Targeting Approach presents a narrow safe harbor of territorial character, Part IV proposes a solution to the problem of fragmented global markets via the Internet by recommending that the Commission consider systems architecture in the regulation of exchanges. One means of so doing would be for market participants to propose, and for the Commission to consider, the high regulatory objective of registering an exchange of transnational membership, disclosure and listings that utilizes systems architecture to protect investors and promote efficiency. For the purposes of this essay, such a proposed exchange is termed an “Integrated Global Securities Market” [hereinafter, “IGSM”]. Part IV proposes that the IGSM would be an exchange, depository, and self-regulatory organization that is on an automated order-match systems platform with remote access for intermediaries and investors. Under this proposal, the IGSM applicant would seek approval for “home country” levels of disclosure for issuers, but maintain the high standards of transparency, execution, recordkeeping, membership, and surveillance that are equal or better to those found within the NMS. Issuers, participants and investors would be bound by arbitration agreements in order to reduce difficulties arising out of foreign court processes. Issuers, participants and investors could be located in any country and trade securities on the IGSM over the Internet or other suitable communications medium as long as they adhered to the federal securities laws and the rules of the IGSM. The members of the IGSM and the location of the IGSM’s computerized trading system could also be located in any country as long as the SEC, directly or indirectly through a Memorandum of Understanding, had clear regulatory capacity over the IGSM and all its operations.

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<sup>10</sup> IOSCO is comprised of securities regulators and exchanges from 158 countries. The objectives of IOSCO are the cooperation among regulators to set high standards of securities regulation and the exchange of information among members. Most of IOSCO’s work is carried out by the following special committees: Disclosure and Accounting, Secondary Markets, Intermediaries, Enforcement, and Investment Management. IOSCO also has several executive and regional committees. The General Secretariat of IOSCO is staffed by six people. *See* IOSCO, 1998 Annual Report. Available at <[http://www.iosco.org/annual\\_report](http://www.iosco.org/annual_report)> (site visited Mar. 22, 2000).

Part IV argues that an IGSM presents an efficient alternative to extending the NMS's regulatory obligations to foreign exchanges through the Targeting Approach. An IGSM creates an environment for regulatory competition by various jurisdictions having differing disclosure requirements and by preventing regulatory "free riding." Moreover, the concept of an IGSM correlates to the efficiencies produced by the low-cost, transnational medium of the Internet. Finally, because an IGSM consolidates order execution in a price/time priority book, the proposal resolves several of the issues regarding the NMS that are surveyed in Part II. There are several possible objections to the IGSM proposal, which Part IV addresses.

The essay concludes by directing its recommendations to market participants and issuers to make a concrete IGSM proposal to the SEC.

## II. BACKGROUND: THE SEC'S TERRITORIAL APPROACH TO REGULATING MARKET STRUCTURE IN A GLOBAL MARKETPLACE

The SEC's approach to modifying the NMS to meet market and technological conditions has been slow and incremental. In contrast, advances in market globalization and technology have been dramatic. Indeed, technology has driven the evolution of market structure before and after the creation of the NMS.<sup>11</sup> The advent of the ticker tape spawned the notorious bucket shops<sup>12</sup> and expensive long-distance telephone tolls supported the development of regional exchanges.<sup>13</sup> This Section will argue that the development of widespread Internet use for order flow and the proliferation of Alternative Trading Systems [hereinafter, "ATs"] have created a paradigm for efficient global securities market structure that the territorial nature of domestic securities regulation ignores.

### A. *Legal Background: An Incremental Approach to Extending the National Market System*

This Section provides summary background of the 1975 Amendments and the SEC staff's first major assessment of the NMS, the Market 2000 Report. Then, focusing on more recent regulatory activity, this Section describes the Commission's Releases on the Regulation of Exchanges, the Internet and ATs. This survey indicates that Professor

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<sup>11</sup> See generally Donald Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L.REV. 747 (1985); Lewis D. Solomon & Louise Corso, *The Impact of Technology on the Trading of Securities: The Emerging Global Market and The Implications for Regulation*, 24 JOHN MARSHALL L. REV. 299 (1991)(arguing for prompt regulatory action in light of advances in technology at the time); Corinne Bronfman, Kenneth Lehn, and Robert A. Schwartz, *The SEC's Market 2000 Report*, 19 J.

CORP. L. 523, 524 (1994).

<sup>12</sup> See Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1484-85 (1997).

<sup>13</sup> See Dale A. Oesterle, *Comments on the SEC's Market 2000 Report: On, Among Other Things, Deference to SROs, the Mirage of Price Improvement, the Arrogation of Property Rights in Order Flow, and SEC Incrementalism*, 19 J.CORP. L. 483, 506 (1994).

Langevoort's observation of fifteen years ago holds true today: "in 1975 [Congress] directed the SEC to oversee the implementation of a 'national market system' that would enlist information technology as a means to move to a more efficient and competitive marketplace. To date, however, the regulatory efforts in that direction have been less than revolutionary. Rather than remake the market system, the SEC has concentrated on reforms within the existing structure, particularly in regard to communications and order-routing among competing exchanges."<sup>14</sup> The legal background of the NMS sets the stage for the Commission's present dilemma in the Cyber-age. The Commission has adhered to the same regulatory schemata for twenty-five years during which global markets and technology have evolved radically.

1. *The 1975 Amendments<sup>15</sup> and Creation of the National Market System*

The 1975 Amendments to the Exchange Act created the NMS. Congress intended the 1975 Amendments to prevent several negative consequences resulting from inefficiencies in the domestic securities market at the time.<sup>16</sup> These inefficiencies arose because securities exchanges had become increasingly interdependent due to technological innovations but lacked the flexibility to meet the challenges of changed economic conditions since passage of the Exchange Act.<sup>17</sup> After five years of study, Congress found that the lack of coordination between markets caused misallocation of capital, widespread inefficiency, and potentially harmful trading fragmentation.<sup>18</sup>

In the 1975 Amendments, Congress specifically endorsed the development of the NMS, and set forth its objectives as: (i) economically efficient executions of securities transactions; (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets; (iii) public availability of quotation and transaction information; (iv) investor access to the best markets; and (v) **an opportunity, consistent with clauses (i) and (iv) for the orders of investors to be executed without the intermediation of a dealer.**<sup>19</sup>

Due to the uncertainty over how technological and economic changes would affect the securities markets over time, Congress explicitly rejected an approach that mandated specific components of the NMS. In contrast, the 1975 Amendments granted the Commission with flexible powers to ensure "that the securities markets and the regulations of the securities industry remain strong and capable of fostering [the] fundamental goals [of the Exchange Act] under changing economic and technological

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<sup>14</sup> Langevoort, *supra* note 11, at 754-55.

<sup>15</sup> See Public Law No. 94-29, *supra* note 5.

<sup>16</sup> The concept of a national market system was initiated by the findings of the Commission's 1971 Institutional Investor Study. See generally SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. 64, 92<sup>nd</sup> Cong., 1<sup>st</sup> Sess. (June 29, 1971).

<sup>17</sup> See H.R. Rep. No. 123, 94th Cong., 1<sup>st</sup> Sess. 44 (1975).

<sup>18</sup> See S. Rep. No. 75, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 1 (1975).

<sup>19</sup> See Exchange Act § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C)

conditions.<sup>20</sup> Certainly, technological innovations played a substantial role in the 1975 Amendments. The hallmark of the 1975 Amendments, new Exchange Act Section 11A, directed the Commission to implement the NMS in accordance with Congressional findings that “[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations” and that “[t]he linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, [and] increase the information available to brokers, dealers, and investors.”<sup>21</sup>

After passage of the 1975 Amendments, the Commission made fundamental market structure changes in the U.S motivated by “the most important objective of the [NMS,] to foster the development of strong competition among its members.”<sup>22</sup> The NMS led to three major changes in the regulatory structure of U.S. trading markets: abolition of fixed commissions, elimination of anti-competitive trading restrictions on exchange members, and creation of information linkages between markets constituting the NMS. The most prominent of these changes was the abolition of the NYSE Rules that, from 1792 until May 1, 1975, fixed commission rates and prohibited members from discounting commissions.<sup>23</sup>

For the purposes of this essay, the second change is more relevant. This change eradicated exchange rules that restricted off-exchange trading by members.<sup>24</sup> Significantly, the Commission sought to eliminate boundaries between the market centers and to create a unified structure of competing market centers.<sup>25</sup> In so doing, the SEC targeted for elimination “any and all rules of national securities exchanges which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges.”<sup>26</sup>

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<sup>20</sup> S. Rep. No. 75, *supra* note 18, at 3.

<sup>21</sup> Langevoort, *supra* note 11, at n.27.

<sup>22</sup> SEC, Policy Statement on the Structure of a Central Market System, 8 (Mar. 29, 1973); *see also* Joel Seligman, *The Future of the National Market System*, 10 J. CORP. L. 79, 117, 118 (1984).

<sup>23</sup> *See generally* Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J. L. & ECON. 273, 276 (1984).

<sup>24</sup> *See generally* Laura N. Beny, *A Survey of Current Regulatory and Structural Issues U.S. Secondary Markets and a Reform Proposal* [hereinafter, “Survey”]. Working Paper. Harvard Law School. Available at <<http://cyber.law.harvard.edu/rfi/papers/index.html#tm>>(site visited Mar. 23, 2000).

<sup>25</sup> According to Professors Davis and Lightfoot, in creating the design of the NMS, “the efforts of individual marketplaces to achieve consolidation at the expense of other marketplaces were to be displaced by a much grander effort that would no longer recognize marketplace boundaries.” Jeffrey L. Davis and Lois E. Lightfoot, *Fragmentation versus Consolidation of Securities Trading: Evidence from the Operation of Rule 19c-3*, 41 J. L. & ECON. 209, 211 (1998).

<sup>26</sup> *Id.* at 211.

The NMS's third and most relevant change to pre-1975 market structure was the establishment of a highly complicated network of information technology systems that connected different market centers throughout the country. These systems include the Consolidated Tape, the Consolidated Quotation System [hereinafter, "CQS"], and the Intermarket Trading System [hereinafter, "ITS"].<sup>27</sup> The Consolidated Tape reports securities transactions within 90 seconds of completion for most securities listed on an exchange, regardless of whether the trades occur on an exchange or on the OTC market.<sup>28</sup> The Automated Confirmation Transaction Reporting Service (ACT), a NASDAQ-operated reporting system supplements the Consolidated Tape, which disseminates last sales information in real time for most non-exchange-listed securities (*i.e.*, NASDAQ securities).<sup>29</sup>

In contrast to the transaction reporting that takes place on the Consolidated Tape and the ACT, the CQS publicly distributes pre-transaction quotation information; that is to say, it disseminates highest bid and lowest offer prices [hereinafter, "NBBO"] for almost all exchange-listed securities based on the quotations furnished by exchanges and OTC dealers.<sup>30</sup> Exchanges are required to submit the price quotations and trade sizes at which their members have indicated a willingness to trade.<sup>31</sup> Similarly, the NASD must provide the NBBO prices and quotation sizes at which member broker-dealers are willing to trade.<sup>32</sup> In addition to the CQS, the NASDAQ Quotation Dissemination Service [hereinafter, "NQDS"] reports the NBBO information for NASDAQ National Market System and Small Cap securities at which OTC dealers are obligated to fill their bids and asks.<sup>33</sup>

The ITS enables members of one market center to route their orders to another

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<sup>27</sup> See generally Allen Ferrell, *The Problem of Small Investors and Inefficient Market Competition: A Deregulatory Proposal*, Working Paper, Harvard Law School, at 39-42 (presented to Seminar on Corporate Law Policy, Harvard Law School, November 23, 1999) [hereinafter, "Inefficient Market Competition"]; see also Morris Mendelson and Julius Peake *Intermediaries' or Investors': Whose Market is it Anyway?*, 19 J. CORP. L. 443, 463 (1994).

<sup>28</sup> See *Inefficient Market Competition*, *supra* note 27, at 39.

<sup>29</sup> See NASD Manual—The NASDAQ Stock Market (CCH) ¶¶ 4630-42 at 5871-5904.

<sup>30</sup> See *Inefficient Market Competition*, *supra* note 27, at 39. (citing MARKET 2000 REPORT, *infra* note 42, at Appendix III, p.3).

<sup>31</sup> See *id.* (citing 17 C.F.R. § 240.11Ac1-1(b)(1)(i)).

<sup>32</sup> See *id.* (citing 17 C.F.R. § 240.11Ac1-1(b)(1)(ii) and noting the existence of exceptions to this requirement).

<sup>33</sup> See *id.* at 39-40 (citing 17 C.F.R. § 240.11Ac1-1(c)(1), (2), (10) and MARKET 2000 REPORT, *infra* note 42, at Appendix III, p.2 n.10).

market center for execution by linking OTC dealers and the exchanges through a linkage from the ITS to the NASDAQ linkage, the NASD's Computer Assisted Execution System [hereinafter, "CAES"].<sup>34</sup> The CAES also allows OTC dealers to transfer orders for exchange-listed securities among themselves for execution through the ITS/CAES linkage.<sup>35</sup>

Unfortunately, this complicated series of systems linkages has failed to ensure that orders for securities are always executed at the NBBO,<sup>36</sup> and "[a]lmost everyone agrees that the ITS is flawed, but for different reasons."<sup>37</sup> As a result of these flaws, securities markets have not competed for order flow by revealing the highest bid or lowest offer for a security that is possible. This proposition is supported by statistical evidence comparing the spreads of listed securities before and after implementation of the ITS<sup>38</sup> and a comparison of spreads for ITS versus non-ITS stocks<sup>39</sup>. The reasons for the phenomenon of exchanges not competing though exposure of the best NBBO are generally cited as the ability of markets to cross orders inside the NBBO spread, the reluctance of dealers or specialists to risk posting quotes on the CQS or NQDS when the market might move against their quotes, and a basic inability of the NMS linkages to capture all trading interests instantaneously, thereby making the future of those systems quite uncertain.<sup>40</sup>

In summary, the NMS reporting systems are far from seamless. The various reporting linkages attempt to operate across different types of markets (order-driven v. broker-driven), to disseminate information on products subject to different listing requirements, and to capture bid/ask as well as transactional data. Such an overview of NMS reporting systems lends support to the observation that the Consolidated Tape, ITS and CQS are "a Byzantine set of systems which would have put Rube Goldberg's fertile imagination to shame...[The] 'ITS, which links the New York with some regional exchanges, is a communications device and nothing more. It is as far from the concept of an automated, efficient marketplace as a tom-tom is from a communications satellite."<sup>41</sup>

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<sup>34</sup> See *id.* at 40.

<sup>35</sup> See SEC, Adoption of Amendments to ITS System Plan to Expand the ITS/CAES Computer Assisted Linkage to all Listed Securities, Release No. 34-42212 (Feb. 14, 2000).

<sup>36</sup> See Inefficient Market Competition, *supra* note 27, at 41-42.

<sup>37</sup> See *NYSE in Break With Heavyweights Call For End to System Linking Markets*, WALL ST. J., Apr. 1, 2000, at C1.

<sup>38</sup> See Inefficient Market Competition, *supra* note 27, at 42 (citing SEC, Directorate of Economic Policy and Analysis, A Monitoring Report on the Operation of the ITS System: 1978-1981, 40 (June 1982)).

<sup>39</sup> See *id.* at 42 (citing M. Blum and M. Goldstein, *Quotes, Order Flow and Price Discovery*, 52 J. FIN. 221, 235 (1997)).

<sup>40</sup> See Inefficient Market Competition, *supra* note 27 at 43-44 (collecting sources). Recently, the NYSE has asked to withdraw from the Consolidated Tape and CQS, arguing that technological advances have provided broker-dealers with the ability to obtain similar information without those systems. See *NYSE Tells Regulators It Wants to Quit Stock-Data Distribution Organization*, WALL ST. J., Apr. 12, 2000, at C8.

<sup>41</sup> Mendelson and Peake, *supra* note 27, at 447 (quoting JOINT HEARINGS BEFORE THE SUBCOMM. ON INVESTIGATIONS AND THE SUBCOMM. ON CONSUMER PROTECTION AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96<sup>th</sup> CONG., 1<sup>st</sup> SESS. 70 (1979)).

2. *The Market 2000 Report—January 27, 1994*<sup>42</sup>

The Market 2000 Report, announced in 1992<sup>43</sup> and released in 1994, set forth the findings of the SEC’s Division of Market Regulation [hereinafter, the “Staff”] on the NMS. The Market 2000 Report was the first major assessment of the NMS by the Staff or the Commission since its establishment. The Staff believed an assessment was warranted because the domestic securities markets had changed dramatically due to advances in technology, globalization of markets, and innovation of products; and these developments had caused market participants to question the efficacy of the NMS.<sup>44</sup> The Market 2000 Report addressed whether the NMS had fostered the competition that resulted in efficient pricing, effectively disseminated market information, improved execution of orders, and improved customer service by broker-dealers.<sup>45</sup> Significantly, the Staff found that “today’s equity markets are operating efficiently within the existing regulatory structure,”<sup>46</sup> “[r]ecord amounts of trading activity are processed smoothly and efficiently;”<sup>47</sup> therefore, the Staff did not “believe that a major revision in equity market regulation is needed.”<sup>48</sup>

In the Market 200 Report, the Staff assessed and rejected two proposals for revolutionary modification to the NMS, the “single market approach” and a deregulatory approach.<sup>49</sup> The Staff found a preferable approach to be “discrete, incremental market improvements within the ambit of its historical regulatory role: protecting investors, facilitating fair market competition, and promoting full disclosure.”<sup>50</sup> The Staff continued that the Commission should continue to provide guidance on where improvements are needed in certain areas. In most instances, responsibility for action should rest with “the markets themselves.”<sup>51</sup>

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<sup>42</sup> See U.S. Securities and Exchange Commission, Division of Market Regulation, *MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS*, Washington, D.C.:

U.S. Government Printing Office (1994) [hereinafter *MARKET 2000 REPORT*]. For a symposium on the Market 2000 report, see *SYMPOSIUM: MARKET 2000*, 19, *J. CORP. L.* 437 *et seq.* (1994).

<sup>43</sup> See SEC, Concept Release on Equity Market Structure Study, Exchange Act Release No. 34-30920 (July 14, 1992), 57 Fed. Reg. 32,159 (July 22, 1992).

<sup>44</sup> See *MARKET 2000 REPORT*, *supra* note 42, at 1.

<sup>45</sup> See *MARKET 2000 REPORT*, *supra* note 42, at 1.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 2. The Division of Market Regulation reported that minor regulatory revisions were needed in the areas of: 1) fair treatment to investors; 2) dissemination of market information; 3) fair competition among markets and participants; and 4) open access to markets. See generally *MARKET 2000 REPORT*, *supra* note 42, at Studies II-VII.

<sup>49</sup> See *MARKET 2000 REPORT*, *supra* note 42, at III 5-7. For a discussion of the single market approach, see Section IV.A. *infra*.

<sup>50</sup> *MARKET 2000 REPORT*, *supra* note 42, at III-7.

<sup>51</sup> *MARKET 2000 REPORT*, *supra* note 42, at III-15.

To this conclusion, one contemporaneous observer stated that the Staff's conclusion ran counter to its ongoing regulatory practice:

The Staff's restraint, a hallmark of the *Report*, seems admirable until it is put in context. The existing structure of the equity markets in the United States is excessively complex, *and it has been created by, or with the approval of the SEC*. So, the SEC, after having created a cumbersome, overly regulated system, with multiple tiers and sub tiers, now says it will let markets work and act "incrementally."<sup>52</sup>

As discussed further *infra*, other Commentators also have not been as positive as the Staff in their overall assessment of the NMS,<sup>53</sup> and the unified market approach has continued to have its adherents.<sup>54</sup>

### 3. *The Regulation of Exchanges Release – May 23, 1997*

On May 23, 1997, the Commission issued a "Concept Release on the Regulation of Markets in Light of Recent Advances in Technology and Transnational Development of Securities Markets" [hereinafter, the "Regulation of Exchanges Release"].<sup>55</sup> This Release examined the significant challenges to the existing regulatory framework created by technological advances. The Regulation of Exchanges Release stated that two primary developments highlighted the need for a more forward-looking, flexible regulatory framework. These developments were the exponential growth of ATSS<sup>56</sup> that presented comparable alternatives to traditional exchanges and the development of technology that facilitated access to foreign markets from the U.S.<sup>57</sup>

Although the lack of ATS participation in the NMS "call[ed] into question the fairness of current regulatory requirements, the effectiveness of existing NMS mechanisms, and the quality of public secondary markets,"<sup>58</sup> the Regulation of

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<sup>52</sup> Oesterle, *supra* note, 13 at 505 (emphasis in original).

<sup>53</sup> See, e.g., Mendelson and Peake, *supra* note 27 (arguing that the NMS currently favors intermediaries at the expense of investors; Oesterle, *supra* note 13 (arguing that the NMS stifles competition by concentrating too much power in the SRO's); Bronfman, Lehn and Robert Schwartz, *supra* note 11 (arguing that the Commission should not be intervening in the current competitive environment with the NMS); see also Section II.A.6. *infra*.

<sup>54</sup> See Section IV.A. *infra*.

<sup>55</sup> See Regulation of Exchanges Release, *supra* note 8.

<sup>56</sup> This matter is dealt with in Sections II-VI of the Regulation of Exchanges Release, *supra* note 8. The results of the Commission's consideration of these matters is the ATS Release discussed *infra* notes 81 to 91 and accompanying text.

<sup>57</sup> See Regulation of Exchanges Release, *supra* note 8 at 8. The latter issue is addressed in Section VII of the Release. Although the latter development is the focus of this essay, the regulation of ATSS in the Release sets the stage for further analysis. At the time of the Regulation of Exchanges Release, ATSS were not fully integrated into the NMS. See *id.* at 9. Consequently, the trading activity on ATSS was not necessarily disclosed to, or accessible by, investors. This trading activity, moreover, was not necessarily under regulatory surveillance for market manipulation and fraud. See *id.* at 9. Finally, the ATSS had no obligation to ensure that their trading systems could withstand periods of high volume. See *id.* at 9.

<sup>58</sup> *Id.* at 9.

Exchanges Release recognized that the impact of technological change was not limited to the U.S. markets. The Commission recognized the fact that foreign markets, information vendors, and broker-dealers had developed automated systems which enabled U.S. persons to trade directly on foreign markets from the U.S. presented issues similar to those presented by unregulated ATs.<sup>59</sup> The Commission stated that because it had not addressed this issue:

many foreign markets have been reluctant to provide these services directly to U.S. investors. This has highlighted the need to establish standards that can accommodate U.S. investors' growing interest in cross-border trading, and better ensure that this type of cross-border trading is subject to appropriate safeguards. At the same time, improved foreign market access would mean that U.S. investors can trade securities of companies listed solely on foreign markets as easily as securities of companies that satisfy the Commission's disclosure and reporting requirements. This would raise additional questions as to how to craft a regulatory scheme that provides sufficient information to investors about the securities they trade.<sup>60</sup>

The Commission began its analysis for proposing a solution to this problem by dismissing two approaches that lied at the regulatory extremes: requiring foreign markets to register domestically and relying solely on the home country regulation of foreign exchanges.<sup>61</sup> The former approach was dismissed because domestic regulation was not necessarily designed to accommodate foreign exchanges with only limited operations in the U.S.<sup>62</sup> Moreover, domestic regulation could conflict with the home country market regulation or create unnecessarily duplicative or expensive regulatory obligations.<sup>63</sup> The latter approach was dismissed because U.S. persons may incorrectly assume that they would receive the same level of investor protections that they would receive when trading on a U.S. market. In contrast, when compared to a U.S. market, a foreign market may: provide less information about the risks that accompany trading on a foreign market; operate under reduced levels of market surveillance, transparency and integrity; and provide less opportunity for civil relief.<sup>64</sup>

The Regulation of Exchanges Release requested comment on a third proposed approach, one which regulates two basic categories of "access providers to foreign markets."<sup>65</sup> The first category consisted of "entities that distribute or publish information regarding transactions on a foreign market, and provide a direct electronic link on behalf of the U.S. members of that foreign market" as "securities information processors."

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<sup>59</sup> *See id.* at 9-10.

<sup>60</sup> *Id.* at 10.

<sup>61</sup> The Commission stated that any regulatory approach should address the relative lack of disclosure about the securities of issuers that do not file reports pursuant to the Exchange Act, whether U.S. investors would receive sufficient disclosure of the risks of trading on a foreign market, and the ability of the Commission to enforce the federal securities laws in a foreign jurisdiction. *See id.* at 14.

<sup>62</sup> *See id.* at 181.

<sup>63</sup> *See id.*

<sup>64</sup> *See id.* at 175-180.

<sup>65</sup> *Id.* at 191-94.

[hereinafter “SIPs”].<sup>66</sup> The second category consisted of foreign and domestic broker-dealers that “provide U.S. persons who are not members of a foreign market with the technological capability to trade directly on a foreign market.”<sup>67</sup> The Commission reasoned that because such access is functionally equivalent to the access provided by SIP access providers, it presents the same risks to U.S. investors. Consequently, similar requirements for recordkeeping, reporting, disclosure, and fraud should apply to both SIPs and broker-dealer access providers.<sup>68</sup> Both categories of intermediaries would be subject to NMS trade reporting requirements.

The questions posed by the Regulation of Exchanges Release concerning the regulation of domestic access to foreign markets by SIPs, access providers, broker-dealers, and exchanges remain unresolved, because the Commission has not provided further guidance on the matter. However, the Regulation of Exchanges Release indicates the preference of the Commission to expand the NMS to capture these linkages to foreign markets, rather than to devise a new regulatory regime to account for technological developments.

#### 4. *The Internet Release – March 23, 1998*<sup>69</sup>

In its release on *The Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore*. [hereinafter, “Internet Release”], the Commission delivered its views on the circumstances in which a securities exchange that offers its services over the Internet must register.<sup>70</sup> The Internet

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<sup>66</sup> *Id.* at 195-99. Section 3(a)(22)(A) of the Exchange Act provides the definition of a SIP. *See* 15 U.S.C. § 78c(a)(22)(A). Section 11A(b) of the Exchange Act requires SIPs to register with the Commission. *See* 15 U.S.C. § 78k-1(b). Section 11A(b)(1) exempts non-exclusive SIPs from registration until such time as the Commission finds that the registration of such non-exclusive SIPs is necessary or appropriate in the public interest, for the protection of investors, or for the achievement of the purposes of Section 11A. *See* 15 U.S.C. § 78k-1(b)(1). The Commission has not yet promulgated any such rules or orders. *See* Regulation of Exchanges Release at n.236. In 1975, the Commission adopted Rule 11Ab2-1, which provides that each SIP that is required to be registered pursuant to Section 11A(b)(1) of the Exchange Act (*i.e.*, exclusive SIPs) must file an application for registration on Form SIP. *See* Securities Exchange Act Release No. 34-11673 (Sept. 23, 1975). Currently, five exclusive SIPs are registered under Section 11A: (1) the Consolidated Tape Association; (2) the Consolidated Quotation System; (3) the Securities Industry Automation Corporation; (4) NASDAQ; and (5) the Options Price Reporting Authority. *See* Regulation of Exchanges Release, *supra* note 8, at n.237.

<sup>67</sup> Regulation of Exchanges Release, *supra* note 8, at 183.

<sup>68</sup> *See id.* One commentator has observed that the definitions in the Release provide several loopholes that could become problematic, such as e-mail and major service providers, as well as online communications firms that provide data, but not an electronic link to foreign markets. *See* John C. Coffee, *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1230 (1997).

<sup>69</sup> *See* Internet Release, *supra* note 7.

<sup>70</sup> *See id.* at 2. The Internet Release similarly covers internet-based solicitations of securities-related services and products by offshore issuers, investment companies, broker-dealers, and investment advisors without triggering the registration requirements of the Securities Act of 1933, 15 U.S.C. § 77a *et seq* [hereinafter, the “Securities Act”], the Exchange Act, *supra* note 6, the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq* [hereinafter, the “Advisers Act”], and the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq* [hereinafter, the “Investment Company Act”]. For a general analysis of the Internet Release, see Michael M. Mann, Donna I. Dennis, Steve T. Kang, *The Limits of Regulatory Jurisdiction in*

Release promised to answer the question of when “sponsorship of an online trading system may give rise to the illegal operation of a private exchange.”<sup>71</sup> The Commission’s general approach to the problem was that “when offerors implement adequate measures to prevent U.S persons from participating in an offshore Internet offer we would not view the offer as targeted at the United States and thus would not treat it as occurring in the United States for registration purposes.”<sup>72</sup> The Commission further stated that the determination whether “adequate measures” have been taken depends on the facts and circumstances of the particular situation.<sup>73</sup>

Based upon the jurisdictional language of the securities laws,<sup>74</sup> the Internet Release focused on the “targeting” or “soliciting” of U.S. investors to determine whether Internet activity is taking place “in the United States.”<sup>75</sup> In adopting the Targeting Approach, the Commission recognized that the Internet operates globally without regard to political or geographic boundaries and that this characteristic of the Internet presents significant issues for the administration of the U.S. securities laws.<sup>76</sup> According to one commentator, the Targeting Approach “eschew[s] the knee-jerk exercise of jurisdiction over all Internet transactions simply because of the Internet’s inherently cross-border nature.”<sup>77</sup>

The Internet Release provided the safe harbor from registration for a foreign exchange sponsoring a Web site that advertizes its services, disseminates quotes (including in real time), or permits orders to be directed to the exchange through its Web site. The Internet Release stated that the Commission will not require such an exchange to register as long as “the exchange takes steps reasonably necessary to prevent U.S. persons from directing orders to the market from its Web site.”<sup>78</sup> The Commission stated that it would consider “reasonably necessary steps” to be taken, if the exchange:

- Posts a disclaimer on the Web site affirmatively stating either the countries in which the exchange’s services are directly available, or that the exchange’s services are not directly available to U.S. persons;

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*Cyberspace: Emerging Guidelines for Managing the Risk of Enforcement Action Based On Website Activity*, 225 in 1 *SECURITIES LAW & THE INTERNET: DOING BUSINESS IN A RAPIDLY CHANGING MARKETPLACE*, Practising Law Institute (June-July 1999) [Hereinafter, “*SECURITIES LAW & THE INTERNET*”].

<sup>71</sup> Brandon Becker and Soo J. Yim, *Trading Securities Online: Internet and Other Electronic Media*, in *SECURITIES LAW & THE INTERNET* at 298 (summarizing Commission Releases on the issue).

<sup>72</sup> Internet Release, *supra* note 7, at 9.

<sup>73</sup> *See id.*

<sup>74</sup> The Section 5 of the Exchange Act requires an exchange to register with the Commission if “it make[s] use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction....” 15 U.S.C. § 78e.

<sup>75</sup> Internet Release, *supra* note 7, at 2-3.

<sup>76</sup> Internet Release, *supra* note 7, at 4-6.

<sup>77</sup> Mann, et al., *supra* note 70, at 227.

<sup>78</sup> Internet Release, *supra* note 7, at 31.

- Requires potential members or direct participants in the exchange to state their residence and mailing address;
- Refuses to allow trading on the exchange through any Web site by any person that the exchange has reason to believe, or that indicates it, is a U.S. person; and
- Refrains from making arrangements to provide U.S. persons with access to the exchange over the Internet indirectly through its members.<sup>79</sup>

Significantly, the Internet Release only created a safe harbor from registration. The Internet Release stated that the Commission is considering the circumstances in which a foreign exchange that provides U.S. persons with direct trading privileges must register, referring to the Regulation of Exchanges Release, discussed *supra*.<sup>80</sup> In the event that a foreign exchange is required to register due to Web site transactions with U.S. investors, it will be subject to the regulatory obligations of the NMS. Therefore, the Internet Release indicates the Commission's willingness to extend the NMS to offshore Internet-based exchanges under certain circumstances.

##### 5. *The Alternative Trading Systems Release – December 2, 1998*<sup>81</sup>

The SEC adopted final rules regarding the regulation of alternative trading systems [hereinafter, "ATS Release"] which became effective, with certain exceptions, on April 21, 1999. The ATS Release, which responded to the proliferation of ATSS further indicates the Commission's preference to work within the parameters of the NMS, rather than propose significant reform in the face of revolutionary technology. Before issuance of the ATS Release, ATSS were a private trading systems that centralized and executed orders, but were not registered with the SEC as exchanges.<sup>82</sup> The growth of ATSS, made possible by technological advances, has been dramatic. The SEC estimated that over 40 ATSS were in operation at the time of the Release, and they executed approximately 20% of the orders to trade NASDAQ-listed securities and 4% of the orders for exchange-listed securities, an increase from 13% and 1.4% respectively only four years earlier.<sup>83</sup> It was not inconceivable, therefore, that an ATS could become the primary market for some issues. However, ATSS were private markets, were regulated as broker-dealers, and were not registered as exchanges or national associations. The Commission found that because ATSS functioned as exchanges, but were not part of the NMS, disparities were created that affected investor protection and the operation of the markets as a whole. The Commission found that the NMS's liquid and competitive markets were created by linking them together in order to make the NBBO publicly known, but ATSS were operating outside the NMS.

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<sup>79</sup> *Id.* at 31-32.

<sup>80</sup> *Id.* at n.58. For a discussion of the Regulation of Exchanges Release, see notes 55 to 68 and accompanying text.

<sup>81</sup> SEC, Regulation of Exchanges and Alternative Trading Systems, Release No. 34-40760 (Dec. 8, 1998), 63 Fed. Reg. 70844 (Dec. 22, 1998) [Hereinafter, "ATS Release"].

<sup>82</sup> For an analysis of the ATS Release, see Howard L. Kramer and Andre E. Owens, *SEC Adopts New Rules Governing Alternative Trading Systems*, in *SECURITIES LAW & THE INTERNET*, *supra* note 70, at 599.

<sup>83</sup> See ATS Release, *supra* note 81, at 3-4.

The ATS Release assessed the activity of ATSS in light of the goals of the NMS set forth by Congress in the 1975 Amendments.<sup>84</sup> For example, ATSS had no obligation to provide investors a fair opportunity to participate in their systems or to treat their participants fairly. The Commission found that trading on ATSS may not have been adequately surveilled for market manipulation and fraud. In addition, ATSS were not required to have systems capacity sufficient to handle rapid increases in trading volume that can take place during periods of market stress.

The SEC's solution to these problems was to bring ATSS under the regulatory umbrella of the NMS. The Commission accomplished this by promulgating new Exchange Act Rule 3b-16, which interprets broadly the statutory definition of "exchange" under Section 3(a)(1) of the Exchange Act.<sup>85</sup> Pursuant to Section 3(a)(1), the definition of "exchange" included 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."<sup>86</sup> In the ATS Release, the Commission revised Rule 3b-16 to define these terms to mean any organization, association, or group of persons that: (1) brings together the orders of multiple buyers and sellers; and (2) uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.<sup>87</sup> As a result, ATSS fell within the definition of an exchange, whereas they had not before issuance of the ATS Release. The Commission then gave existing ATSS the choice to register as an exchange, or to register as broker-dealer and comply with new Regulation ATS.<sup>88</sup>

ATSS that opt to register as an exchange would be fully incorporated into the NMS. For ATSS that opt to be regulated as broker-dealers pursuant to new Regulation ATS, their regulatory obligations correspond to the percentage of volume they transact in covered securities (generally, listed or NASDAQ securities). Regulation ATS requires an ATSS with five percent or more of the trading volume in any covered security during four of the last six months to display the NBBO on the NMS.<sup>89</sup> Moreover, Regulation ATS requires that ATSS with this level of volume also to display the NBBO of institutional

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<sup>84</sup> See *id.* 5.

<sup>85</sup> See *id.* at 8.

<sup>86</sup> Exchange Act Section 3(a)(1). 15 U.S.C. § 78c(a)(1).

<sup>87</sup> See Rule 3b-16(a), 17 C.F.R. § 240.3b-16(a). In new Rule 3b-16, the Commission excluded traditional broker-dealer activities. The new Rule 3b-16 expressly excludes "the following systems from the revised interpretation of 'exchange': (1) systems that merely route orders to other facilities for execution; (2) systems operated by a single registered market maker to display its own bids and offers and the limit orders of its customers, and to execute trades against such orders; and (3) systems that allow persons to enter orders for execution against the bids and offers of a single dealer." 17 C.F.R. § 240.3b-16.

<sup>88</sup> See ATS Release, *supra* note 81, at 8-10. Regulation ATS is found at 17 C.F.R. § 242.300-303.

<sup>89</sup> See ATS Release, *supra* note 81, at 10. Pursuant to Regulation ATS, a system with less than five percent of the trading volume in all securities it trades is required only to: (1) file with the Commission a notice of operation and quarterly reports; (2) maintain records, including an audit trail of transactions; and (3) refrain from using the words "exchange," "stock market," or similar terms in its name.

orders on their systems. These ATSs must comply with the rules governing execution priorities and obligations that apply to members of a registered exchange or national securities association to which the ATS is linked.<sup>90</sup> ATSs with twenty percent or more of the trading volume in any single security, are subject to access requirements similar to those imposed upon an exchange within the NMS.<sup>91</sup>

In summary, the existing structure of recent Commission pronouncements on the matter of regulation of global securities market vis-à-vis the Internet is: (1) the Regulation of Exchanges Release presents the question of how global markets should be regulated and suggests expansion of the NMS to global market linkages by proposing registration of broker-dealer access providers and SIPs; (2) the ATS release defines various types of domestic electronic trading systems and suggests that some be regulated as part of the NMS; and (3) the Internet Release creates a very narrow and territorial safe harbor for foreign exchanges by utilizing the Targeting Approach. However, the Internet Release leaves open an important issue, stating that the “Commission is currently considering the question of under what circumstances a foreign market that provides the ability in the United States for a U.S. person to trade directly in the market must register as a U.S. exchange.”<sup>92</sup>

#### 6. *The Ongoing Debate Over the National Market System*

The NMS presents several issues that have been debated on a domestic level, especially leading up to the 1975 Amendments, when the Market 2000 Study was released, and during the development of the ATS Release. **The issues under debate are market consolidation/fragmentation, payment for order flow [hereinafter, “POF”], and transparency. This Section of the essay provides an overview of these relevant issues from a recent Survey.**<sup>93</sup> This essay summarizes these issues in order to illustrate that the listing of domestic securities on a foreign exchange, such as the NASDAQ Ten being traded on the EASDAQ, presents serious inefficiencies due to market fragmentation. Although these issues concerning the NMS remain unresolved at a domestic level, they are clearly problematic when viewed from a global perspective.

#### *Consolidation/Fragmentation*

The consolidation/fragmentation debate is based on the inherently diametric effects of a multi-market trading environment. At once, such a trading environment promotes efficiency through competition among markets, but multiple market centers also harm liquidity due to the fragmentation of order flow.<sup>94</sup> The primary objection to

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<sup>90</sup> See ATS Release, *supra* note 81, at 9-10.

<sup>91</sup> Such ATSs must: (1) grant or deny access based on objective standards established by the trading system and applied in a non-discriminatory manner; and (2) establish procedures to ensure adequate systems capacity, integrity, and contingency planning. See ATS Release, *supra* note 81, at 10-11.

<sup>92</sup> Internet Release, *supra* note 7, at n.58. (citing the Regulation of Exchanges Release, *supra* note 8).

<sup>93</sup> See Survey, *supra* note 24, at 19-35, 38-49.

<sup>94</sup> See Yakov Amihud and Haim Mendelson, *A New Approach to the Regulation of Trading Across*

market fragmentation is straightforward—the greater the fragmentation of orders, the less likely they are to interact. The result is reduced trading volumes and liquidity, and increased price impact of trades and bid-ask spreads.<sup>95</sup> Moreover, one market center has observed that market fragmentation reduces the likelihood of obtaining “best execution” for investors’ orders.<sup>96</sup> Finally, other commentators have observed that relative price discovery and transparency among various market centers may cause a free rider problem for market centers with high standards.<sup>97</sup>

Despite these views, there has existed support for the NMS among the Commission and its staff. The Market 2000 Report takes a favorable view of efficiencies and service improvements promoted by market competition.<sup>98</sup> There is also scholarly support for the proposition that inter-market competition promotes innovation and the improvement of service for investors.<sup>99</sup> Another commentator has pointed out that ancillary trading centers would not be receiving their current amount of order flow from primary markets were they not efficient.<sup>100</sup>

The empirical evidence on the consolidation/fragmentation debate has yielded mixed conclusions.<sup>101</sup> Statistical studies of relative quality of price execution on markets linked by the ITS<sup>102</sup> and studies of NYSE execution compared to OTC and regional

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*Securities Markets*, 71 N.Y.U. L. REV. 1411, 1434 (1996). Market fragmentation has been defined as the inability of an order in one market to interact with an order in a competing market. See Hans Stoll, *Principles of Trading Market Structure*, 6 J. FIN SERVICES RES. 75, 92 (1992). A consolidated market has been described as one in which all orders interact regardless of who enters the orders. See Mendelson and Peake, *supra* note 27, at 454.

<sup>95</sup> See Amihud and Mendelson, *supra* note 94, at 1434-35.

<sup>96</sup> See Letter from the NYSE to SEC in response to Market 2000 Study. See MARKET 2000 REPORT, *supra* note 42, at VII-12. The Commission has stated that “[i]n its purest form, best execution can be thought of as executing a customer’s order so that the customer’s total cost or proceeds are the most favorable under the circumstances.” Release No. 34-902 (Oct. 27, 1994), 59 Fed. Reg. 55,006 (1994). The Third Circuit went even further in *Newton* by stating “the broker-dealer is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.” *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998) (*en banc*). However, the Commission never has stated that a broker-dealer is bound exclusively by price considerations in satisfying its best execution obligations. See Exchange Act Release No. 37,619A (Sept. 6, 1996), 61 Fed. Reg. 48,290 (1996).

<sup>97</sup> See Amihud and Mendelson, *supra* note 94, at 1438.

<sup>98</sup> See MARKET 2000 REPORT, *supra* note 42, at III.

<sup>99</sup> See Maureen O’Hara and Johnathan Macey, *Regulating Exchanges and Alternative Trading Systems: A*

Law and Economics Perspective, Response to 1997 SEC Regulation of Exchanges Release, p. 8 (available at <<http://sec.gov/rules/concept/S71679/ohara/htm>> (site visited Apr. 23, 2000)); see also Hans Stoll, *The Causes and Consequences of the Rise in Third Market and Regional Trading*, 19 J. CORP. L. 509, 516 (1994).

<sup>100</sup> Stoll, *supra* note 99, at 514.

<sup>101</sup> See Survey, *supra* note 24, at 25-29.

<sup>102</sup> See Charles Lee, *Market Integration and Price Execution for NYSE-Listed Securities*, 48 J. FIN. 1009 (1993).

market execution<sup>103</sup> do not support the Staff's positive assessment of the NMS's efficiency. Additional studies find that ancillary markets free ride off the price discovery of major market centers.<sup>104</sup> However, other market studies have concluded that market fragmentation has reduced the cost of trading<sup>105</sup> and that trading on ancillary exchanges provide services to investors that are not available on primary markets.<sup>106</sup>

*Payment for Order Flow ("POF")*

The debate over POF has been described as "one of the most intractable and pressing issues in securities regulation today."<sup>107</sup> The multi-market environment of the NMS permits the existence of POF, a practice in which a securities market will pay a broker between one and three cents for each order a broker routes to it.<sup>108</sup> While one group of commentators deride these payments as "kickbacks,"<sup>109</sup> another camp has argued that POF merely signifies the competition between market centers rather than broker-dealers<sup>110</sup> and that POF is a natural outgrowth of this competition.<sup>111</sup> An additional member of this camp has noted that a primary market in a security would also offer POF were it efficient for the primary market to do so.<sup>112</sup>

Aside from the criticism that POF may represent a breach of fiduciary duty by a broker-dealer to its clients, it is clearly problematic in terms of efficiency.<sup>113</sup> Professor Ferrell has correctly observed that the NYSE is systematically unable to offer POF; therefore, it is disadvantaged by non-price competition.<sup>114</sup> Consequently, he argues that dealers will avoid routing orders to auction markets, notwithstanding the opportunity to obtain better price execution for a client. Even if all markets could offer POF, moreover, market distortion in order routing would still exist due to the inability of markets to quickly adjust the size of their POF payments to reflect relative market efficiencies.

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<sup>103</sup> See Blume and Goldstein, *supra* note 39.

<sup>104</sup> See Kenneth L. Garbade & William L. Silber, *A Study of Dually-Traded Securities*, 61 REV. ECON. & STAT, 455 (1970); Joel Hasbrouck, *One Security, Many Markets: Determining the Contribution to Price Discovery*, 50 J. FIN. 1175, 1197 (1995).

<sup>105</sup> See McInish, Thomas H., and Robert A. Wood, *Competition, Fragmentation and Market Quality*, in THE INDUSTRIAL ORGANIZATION AND REGULATION OF THE SECURITIES INDUSTRY 63 (Andrew W. Lo, ed., 1996).

<sup>106</sup> See Lee, *supra* note 102, at 1012.

<sup>107</sup> Inefficient Market Competition, *supra* note 27, at 1; See generally Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV 1675-92 (1994).

<sup>108</sup> See Inefficient Market Competition, *supra* note 27, at 1.

<sup>109</sup> *Id.*

<sup>110</sup> See Survey, *supra* note 24, at 30 (citing Lightfoot, Lois, Peter Martin, Market Peterson, and Eric Sirri, *Preferencing and Market Quality on U.S. Equity Exchanges*, Paper presented at NBER Conference, July 17, 1997).

<sup>111</sup> See Survey, *supra* note 24, at 31 (citing INDUCEMENTS FOR ORDER FLOW, A REPORT TO THE BOARD OF GOVERNORS, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. 25 (1991)).

<sup>112</sup> See Stoll, *supra* note 99, at 515.

<sup>113</sup> See Inefficient Market Competition, *supra* note 27, at 6-9.

<sup>114</sup> See *id* at 29-36.

Finally, he argues that the inferior execution resulting from POF discriminatorily effects small, unsophisticated investors.<sup>115</sup>

As with the consolidation/fragmentation debate, empirical studies on POF produce divergent conclusions. One study found that POF tended to divert the orders of uniformed investors from the NYSE to a regional exchange or the OTC market.<sup>116</sup> In contrast, another study of trading data found that the conclusion that ancillary markets divert information constrained orders away from the NYSE to be “premature.”<sup>117</sup>

### *Transparency*

The issue of transparency within the NMS has been a subject of ongoing study.<sup>118</sup> Researchers have focused on the dissemination of information to market participants concerning the size, type, and source of orders and trades. One set of analyses has focused on the degree to which asymmetric information increases bid-ask spreads within the NMS using theoretical and empirical methodologies.<sup>119</sup> Other studies of transparency compare order and dealer markets within the NMS.<sup>120</sup> Another researcher has studied the effects of transparency on the efficiency, bid-ask spreads, volatility, and liquidity of a market.<sup>121</sup> Notwithstanding the substantial research on the issue, no unequivocal conclusion has been reached concerning the transparency benefits of the NMS. The reason for the nebulous results is the infinite variety of independent variables inherent in the concept of transparency. The author of the Survey asserted:

In conclusion, the foregoing survey of the literature on market transparency reveals that transparency is a much more complex issue than is generally assumed by market regulators and commentators. The net welfare effects of greater transparency are ambiguous. As the literature reveals, transparency has

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<sup>115</sup> See *id.* at 35-36 (collecting sources); see also Survey, *supra* note 24, at 33-34 (collecting sources); John C. Coffee, Commenting on McInish, Thomas H., and Robert A. Wood, *Competition, Fragmentation and Market Quality*, in THE INDUSTRIAL ORGANIZATION AND REGULATION OF THE SECURITIES INDUSTRY 63 (Andrew W. Lo, ed., 1996).

<sup>116</sup> See David Easley, Nicholas M. Keiba, and Maureen O'Hara, *Cream-Skimming or profit-sharing? The Curious Role of Purchased Order Flow*, 51 J. FIN. 811 (1996) (concluding that there exist significant differences in information content in orders executed on NYSE and Cincinnati stock exchanges that are consistent with “cream skimming”).

<sup>117</sup> See Robert H. Battlio, *Third Market Broker-Dealers: Cost Competitors or Cream Skimmers?* 52 J. FIN. 341, 344 (1997).

<sup>118</sup> See Survey, *supra* note 24, at 38-49 (collecting sources).

<sup>119</sup> See, e.g., Thomas E. Copeland and Dan Galia, *Information Effects on the Bid-Ask Spread*, 38 J. OF FIN. 1457 (1983); Lawrence R. Glosten, *Components of the Bid-Ask Spread and the Statistical Properties of Transaction Prices*, 42 J. FIN. 1293 (1987); Hans R. Stoll, *Inferring the Components of the Bid-Ask Spread: Theory and Empirical Evidence*, 44 J. FIN. 115, 132 (1989).

<sup>120</sup> See Marco Pagano and Ailsa Roell, *Transparency and Liquidity: A Comparison of Auction and Dealer Markets with Informed Trading*, 51 J. FIN. 579 (1996); Ananth Madhavan, *Security Prices and Market Transparency*, 5 J. FIN. INTERMED. 255 (1996).

<sup>121</sup> Ananth Madhavan, *Security Prices and Market Transparency*, *supra* note 120.

different effects depending on the particular investor, market, and security at issue. Therefore, a one-size-fits-all approach to transparency regulation is undesirable.<sup>122</sup>

*Conclusion*

The result of this review is that the NMS has created cumbersome regulations that have neither been proven or discredited as to their optimality. As a result of the recent Releases responding to new technologies, the SEC has made the NMS system of regulation even more complicated and by creating fine distinctions among participants: broker-dealers, access providers, SIPs, ATSS, and exchanges. However, these Releases do not address issues connected with fragmentation, POF and transparency when domestic issues trade on foreign exchanges.

*B. Market Background: A Global Securities Marketplace*

This Section describes the extent that securities markets have become “globalized” during the last decade. A review of this phenomenon is important, because it contrasts sharply with the Targeting Approach. Moreover, the extraordinary developments in global securities markets contrast sharply with the SEC’s incremental modifications to the NMS. These developments are the increase in transnational equity trading and listing, the consolidation of physical markets and the proliferation of ATSS.

*1. Globalization of Equity Markets*

In 1998, the U.S. capital markets accounted for approximately one-half of global market capitalization of domestic companies. According to the International Federation of Stock Exchanges [hereinafter, “FIBV”], the ten largest exchanges by market capitalization for common and preferred shares of domestic companies were:

**Table 1**

**The 10 largest stock markets in the world by market capitalization of domestic companies in 1998**  
(US\$ billion)

|                         |                     |
|-------------------------|---------------------|
| <b>NYSE</b>             | <b>10,271,899.8</b> |
| <b>NASDAQ</b>           | <b>2,527,970.0</b>  |
| <b>Tokyo</b>            | <b>2,439,548.8</b>  |
| <b>London</b>           | <b>2,372,738.1</b>  |
| <b>Germany</b>          | <b>1,093,961.9</b>  |
| <b>Paris</b>            | <b>991,483.8</b>    |
| <b>Switzerland</b>      | <b>689,199.1</b>    |
| <b>Amsterdam</b>        | <b>603,182.2</b>    |
| <b>Italy</b>            | <b>569,731.8</b>    |
| <b>Canada (Toronto)</b> | <b>543,394.0</b>    |
| <b>Global Total</b>     | <b>25,683,171.1</b> |

Source: FIBV<sup>123</sup>

<sup>122</sup> Survey, *supra* note 24, at 49.

<sup>123</sup> See <<http://fibv.com/statistics.asp>> (site visited Mar. 23, 2000). (excluding closed-end funds, rights, warrants, and convertibles).

The following table provides valuable perspective on the international character of the U.S. equity markets. Although the percentage of foreign listings on the U.S. markets is small relative to the percentage on certain other markets, the large size of the U.S. equity markets relative to the rest of the world make them very international in character.

Table 2

**The 10 largest stock markets in the world  
by average daily turnover: foreign  
company trading and listing**

(US\$ million for average daily turnover)

|             | 1997<br>Average<br>Daily<br>Turnover | Foreign<br>Turnover<br>As % Of | 1986 | Number of<br>Foreign<br>Companies |       | 1997<br>Foreign<br>Listings<br>as % of<br>Total |
|-------------|--------------------------------------|--------------------------------|------|-----------------------------------|-------|---|
|             |                                      | Average<br>Daily<br>Turnover   |      | 1990                              | 1997  |   |
| NYSE        | 15,829                               | 8.4%                           | 59   | 96                                | 355   | 13.5%   |
| NASDAQ      | 12,279                               | 13.7%                          | 244  | 256                               | 454   | 8.3%  |
| London      | 5,451                                | 58.1%                          | 584  | 613                               | 467   | 18.6%   |
| Paris       | 5,010                                | 2.2%                           | 195  | 226                               | 184   | 20.0%   |
| Taiwan      | 3,585                                | 0.0%                           | 0    | 0                                 | 0     | 0.0%  |
| Germany     | 2,925                                | 4.5%                           | 181  | 234                               | 1,996 | 74.0%   |
| Toyko       | 2,455                                | 0.2%                           | 52   | 125                               | 60    | 3.2%  |
| Switzerland | 1,559                                | 5.0%                           | 194  | 240                               | 212   | 49.5%   |
| Toronto     | 836                                  | 0.2%                           | 51   | 66                                | 58    | 4.1%  |
| Italy       | 557                                  | 0.1%                           | 0    | 0                                 | 4     | 1.7%  |

Source: FIBV<sup>124</sup>

2. *Increase of Cross-Border Securities Offerings and Transactions*

As illustrated by the Tables 3 and 4, the international equity offerings and the market for cross-border equities became significant in the mid-1980s, continues to grow at a dramatic rate.<sup>125</sup>

Table 3

**International  
Equity Offerings:**

**1987-1994**

(USD billion)

|                                      | 1987 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|--------------------------------------|------|------|------|------|------|------|------|
| International<br>Equity<br>Offerings | 20.4 | -    | -    | -    | 25.3 | 36.6 | 58.1 |
| Of which, Dep.<br>Receipts           | 4.6  | -    | -    | -    | 5.3  | 9.5  | 11.0 |

Source: OECD and IMF.<sup>126</sup>

<sup>124</sup> Reprinted in Hal S. Scott and Phillip H. Wellons, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION, 2-17, 7<sup>th</sup> Edition (forthcoming) [hereinafter, "INTERNATIONAL FINANCE"]. Stock market size determined by 1994 Turnover. Average Daily Turnover determined by total turnover divided by 365.

<sup>125</sup> See *id.* at 20.

<sup>126</sup> Organization for Economic Co-operation and Development, Table F.T.-0.a, "International Capital Markets Statistics" (1996), OECD Financial Market Trends (November 1997), and International Monetary

Table 4

**Cross-Border  
Equity Trading:  
1987-1994**  
(USD billion)

|                                      | 1987    | 1989    | 1990    | 1991    | 1992    | 1993    | 1994    |
|--------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| <b>Gross Equity Flows</b>            | 1,377.8 | 1,562.6 | 1,390.9 | 1,322.5 | 1,404.9 | 2,266.1 | 2,550.0 |
| <b>Cross-exchange Trading</b>        | 508.6   | 582.9   | 873.9   | 779.1   | 968.7   | 1,547.5 | 2,000.0 |
| <b>Net Equity Flows</b>              | 16.4    | 86.6    | 3.2     | 100.6   | 53.7    | 196.3   | 119.6   |
| <b>Cross-border M&amp;A Activity</b> | 70.9    | 117.5   | 128.4   | 83.7    | 91.0    | 95.1    | 156.2   |

Source: IMF<sup>127</sup>

To provide a further perspective on the internationalization of the U.S. markets, foreign issuers and investors are attracted to the NYSE in substantial numbers, as indicated by the facts the NYSE has released.<sup>128</sup> Between 1980 and 1995, the total activity by U.S. persons in foreign securities grew from \$53.1 billion to \$2,573.6 billion, representing over a 4700% increase.<sup>129</sup>

### 3. Consolidation of Physical Securities Markets/Proliferation of Electronic Trading Systems

Physical securities markets are consolidating. In the U.S., this has been a long-term trend. There were 34 stock exchanges in the U.S. at the passage of the Exchange Act,<sup>130</sup> compared to seven market centers at present. In Europe, this consolidation began in the late 1990's and is ongoing. This recent trend is caused by European investors and market participants demanding market consolidation to reduce the costs of trading, clearance and settlement in an environment of Euro-denominated, cross-border trading

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Fund, International Capital Markets: Developments, Prospects, and Policy Issues 189 (Aug. 1995) reprinted in part in INTERNATIONAL FINANCE, *supra* note 124, at 18. "Depository Receipts" include ADRs, GDRs and Rule 144A stock.

<sup>127</sup> International Monetary Fund, International Capital Markets: Developments, Prospects, and Policy Issues 189 (Aug. 1995) reprinted in INTERNATIONAL FINANCE, *supra* note 124, at 21. Data for 1994 are estimates. "Gross Equity Flows" are the sum of all purchases and sales in a foreign security. "Net Equity Flows" indicate new money inflows, the difference between the purchases and the sales of foreign equity. *See id.*

<sup>128</sup> In 1998, 43 non-U.S. companies listed on the NYSE. This brought the total to number of companies to 379—more than three times the number of such companies listed 5 years ago. *See* <<http://www.nyse.com/international/internationalco.htm>>(site visited March 22, 2000). Companies from 48 countries are listed on the NYSE. *See* <<http://www.nyse.com/content/faqs>>(site visited Mar. 22, 2000). The global market capitalization of the non-U.S. companies is US\$4.5 trillion. *See id.*

<sup>129</sup> *See* Securities Industry Association, 1996 Securities Industry Fact Book 67 (June 1997).

<sup>130</sup> *See* STOCK EXCHANGE PRACTICES, REPORT OF SENATE COMM. ON BANKING AND CURRENCY 5, S. REP. NO. 73-1455 (1934).

activity.<sup>131</sup> This consolidation is a rapid and sometimes frenetic process. In February 2000, for example, the London Stock Exchange and Brussels Exchange announced its interest in merging with another European bourse.<sup>132</sup> By March 2000, the plan had changed. Paris Bourse S.A., the Amsterdam Exchange and Brussels Exchange announced their intent to merge into a company called Euronext N.V.<sup>133</sup> As Table 5 illustrates, there presently exist a number of proposed cross-border alliances<sup>134</sup> Finally, as described in the Introduction to this essay, the EASDAQ is operating as a pan-European exchange.<sup>135</sup>

In contrast to physical exchanges, the number of electronic trading markets are proliferating. As noted *supra* electronic exchanges handle 4% of orders in NYSE-listed securities and 20% of all order flow in the OTC market. In its recent request for comment, the Commission noted that in the market for NASDAQ equities trading interest is divided among various market centers.<sup>136</sup> Several ATSs operate electronic limit order books for the trading of NASDAQ equities. In September 1999, nine of these ATSs collectively accounted for 28.0% of trades in NASDAQ issues.<sup>137</sup>

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<sup>131</sup> See *London Exchange Signals Its Interest In European Merger*, WALL ST. J., Feb. 3, 2000, at C22; see generally INTERNATIONAL FINANCE, *supra* note 124, at 14-47 – 14-53.

<sup>132</sup> See *id.*; see also *Belgian Exchange's 15.2% Drop This Year Fuels Worries Over Small Bourses in Europe*, WALL ST. J., Feb. 16, 2000, at C14. Earlier this year, an alliance of eight European bourses was announced, but the merger has not been completed. See *id.*

<sup>133</sup> See *French, Dutch and Belgian Bourses Set Plans to Join Forces as New Company*, WALL ST. J., Mar. 20, 2000, at B14. Under this plan, equities would be traded in Paris, derivatives would be traded in Amsterdam, and clearing and settlement would occur in Brussels.

<sup>134</sup> See Financial Times, July 8, 1998, reprinted in SECURITIES LAW & THE INTERNET at 17. But see WALL ST. J., Mar. 20, 2000, at B14 (describing mergers illustrated in Table 5 as being “considered dead in all but name”). For further detail on the evolving alliances among Europe’s trading centers, see INTERNATIONAL FINANCE, *supra* note 124, at 14-49 – 14-53 (collecting sources); see also *Link to NASDAQ Possible in Merger of European Bourses*, WALL ST. J., Apr. 24, 2000, at A22 (reporting that a possible merger between the London Stock Exchange and Deutsche Börse could include a linkage to the NASDAQ).

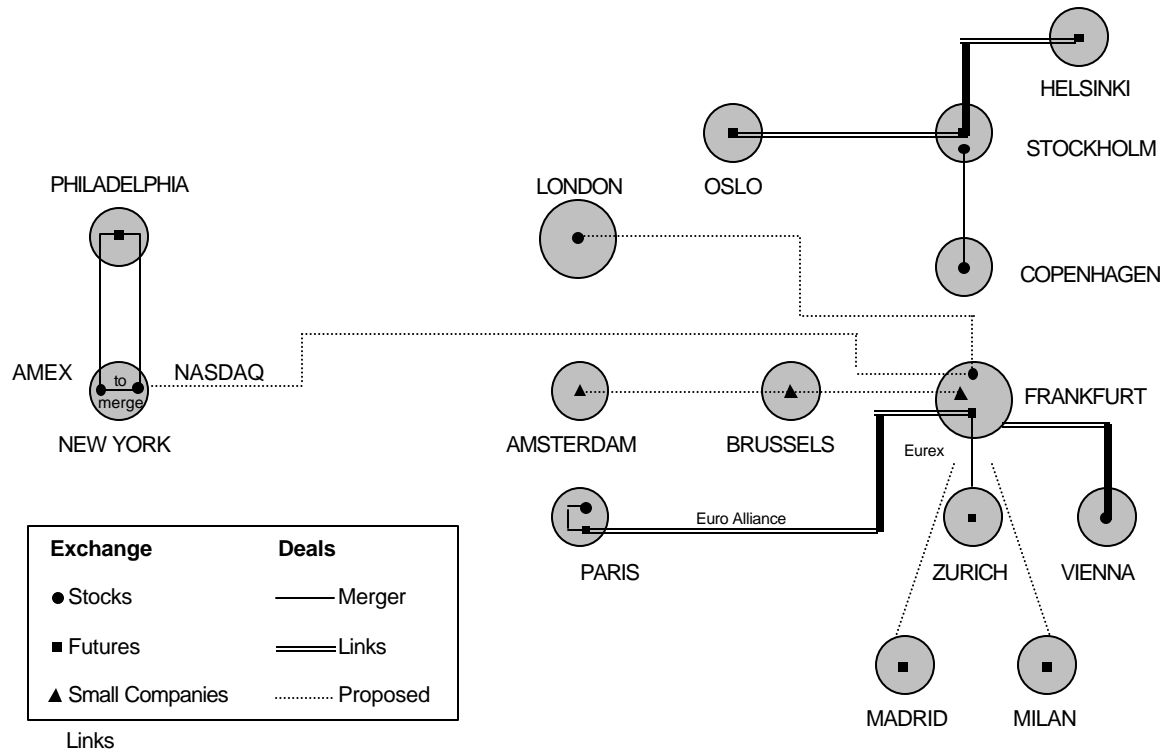
<sup>135</sup> See *supra* note 1.

<sup>136</sup> See SEC, Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Rescind Exchange Rule 390; Commission Request for Comment on Issues Relating to Market Fragmentation, Release No. 34-42450 (February 23, 2000) at 7. [Hereinafter, “Fragmentation Release”].

<sup>137</sup> See *id.* Nevertheless, the Commission believes that the U.S. markets for listed equities currently reflect a fairly low degree of fragmentation. As evidence, the Commission cites that in September 1999, 74.4% of the trades and 83.9% of the share volume in NYSE-listed equities were executed on the NYSE, and that approximately 68.7% of the trades and 70.5% of the share volume in Amex-listed securities were executed on the Amex. See *id.* at 7. The Commission correctly observed that “these percentages could change after the rescission of off-board trading restrictions such as NYSE Rule 390.” *Id.*

Table 5

**Europe's  
Emerging  
Exchange:  
1998**



Source: Financial Times, July 8, 1998  
reprinted in SECURITIES LAW &  
THE INTERNET 17.