BRANDS VS. GENERICS: SELF-REGULATION BY COMPETITORS

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In 1975, Congress embraced one of its most significant public mandates with its call for the creation of a national market system. The legislation variously empowered the SEC to pursue an agenda guided by five objectives to assure: (1) competition among market participants and the exchanges and other markets, (2) the efficient execution of securities transactions, (3) information to market participants regarding quotations for and transactions in securities, (4) the practicability of best execution of customer orders, and (5) the opportunity of customer orders being executed without the participation of a dealer and in a way consistent with the first four objectives.[2] Markets as we knew them in 1975, when Congress made its call for a national market system, do not reflect today's marketplace. Many more trading venues exist today than in 1975. The two most important securities markets, the NYSE and the NASDAQ, in response to the competitive threat they face from electronic communications networks ("ECNs") and other alternative trading systems, have announced their intent to demutualize. And the American Stock Exchange is now owned by the NASDAQ. Chairman Arthur Levitt's address sets a course to address these changes in our securities markets and guide the regulatory ship toward the objectives of the National Market System. The central features of his strategy are competition and transparency of quotations among the markets.

Chairman Levitt's strategy already appears to be yielding results consistent with the National Market System's objectives. The NYSE recently announced its new electronic limit order book that will provide the customers of members with

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2 *See* Securities Exchange Act of 1934 § 11A(1)(C), 15 U.S.C. ' 78k-1(a)(1)(C) (1994).

seamless execution for orders of 1,000 shares or less. The NYSE refers to this system as an ECN within the NYSE, and predicts that it will be possible to execute such orders in a few seconds instead of the current twenty-two seconds.[3] Because the system is Internet-linked, it allows limit orders to be displayed and published so that real-time information from this limit order book will be available worldwide. Moreover, the NYSE Board of Governors voted in December to abolish its controversial and anti-competitive Rule 390 that barred NYSE members from trading on another market securities that were listed on the NYSE before April 26, 1979.[4] The NASDAQ has also stepped toward the objectives of the National Market System by launching its OptiMark trading system. OptiMark is an electronic matching system for trading equities that matches trades across the various market makers for a security.[5] A complementary initiative is NASDAQ's new order display window for its Workstation II screens that not only display pre-trade data, quotes and orders to buy and sell NASDAQ securities (including those traded on ECNs), but also will provide automated trade executions.[6]

These recent developments reflect the competitive forces facing both the NYSE and NASDAQ. Each pursues a common course because they each face the same threat: the emergence of many ECNs that continue to erode their market dominance. No longer do the NYSE and NASDAQ concentrate their competitive strategies solely on winning listings from the other; the listing fees garnered in that contest are surpassed by the amounts given up in trading fees and

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[3] *See* Greg Ip & Randall Smith, *NYSE Sets Plans for Speedier Trade Execution*, WALL ST. J., Nov. 8, 1999, at C6.

[4] *See NYSE Board Agrees to Abolish Rule 390, Seeks Broad SEC Customer Protection Rule*, 31 SEC. REG. & L. REP. (BNA) 1570 (Dec. 3, 1999).

[5] *See NASDAQ Launches New Trading System with First Phase Including 10 Securities*, 31 SEC. REG. & L. REP. (BNA) 1356 (Oct. 15, 1999).

[6] *See NASDAQ Unveils New Order Display Window Aimed at Centralization, Price Transparency*, 31 SEC. REG. L. REP. 1327 (Oct. 8, 1999).

revenues related to the sale of market trading information, which can be siphoned off by the regional markets or ECNs who, through lower costs and/or payment for order flow, attract trading to their markets.[7] To preserve these revenues, both the NYSE and NASDAQ are addressing the sources of their operations that place them at a cost (including trading time) disadvantage, vis-a-vis their competitors.

It is of great importance whether the NYSE and NASDAQ can preserve a substantial portion of their market shares against the fierce competition they face. Studies confirm that price discovery occurs predominately on the NYSE and not on the regional exchanges.[8] Just how effective are seven or eight ECNs at providing this socially beneficial service?[9]

Of equal import is the link between the financial health of the NYSE and the regulation of securities markets. Financial success bodes well for a strong self-regulatory force in securities markets, because the more profitable the NYSE and NASD are, the greater the resources they can devote to self-regulatory efforts. Here we might consider the analogy of the conflicting positions of, on the one hand, the major drug companies whose coffers are filled by their patented drugs, and, on the other hand, the lesser known drug manufacturers who depend upon generic drugs for their revenues. The substantial profits garnered by the drug companies during the patent lives of their miracle drugs are a constant

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[7] According to NASDAQ's Chief Economist, Dean Furbush, an important reason NASDAQ market makers pay broker-dealers for order flow is that the execution results in proprietary market data that the market maker can then profitably sell. *See On the Heels of NYSE Move, SEC Launches Ground-Breaking Plans to Spur Competition*, 31 SEC. REG. & L. REP. (BNA) 1571 (Dec. 3, 1999).

[8] *See* Joel Hasbrouck, *One Security, Many Markets: Determining the Contribution to Price Discovery*, 50 J. FIN. 1175 (1995).

[9] The answer is a definitive "no" when the ECN is structured to merely match orders directed to it, so that it shows to the market only unmatched quotes that are then referred to the NYSE or NASDAQ. *See* Sarah Hewitt & Gerard R. Boyce, *Alternative Trading Systems: New Regulatory Framework*, 221 N.Y. L. J. 5 (Jan. 14, 1999) (discussing different operational structures of leading alternative trading systems).

source of public debate. The major drug companies champion longer patent lives, which they consider vital to engaging in costly research efforts.[10] By contrast, the manufacturers of generics naturally prefer shorter patent lives. The major drug companies complain that the manufacturers of generic drugs are free riding on the expensive and risky activities of the major drug companies. Though the debate heats up from time to time, the result is that the drug companies continue to be good stocks for any wise investor's portfolio. Their high profits also support substantial research that is socially beneficial.

We can view the ECNs and other alternative trading systems as today's securities markets' version of the generic drug manufacturers. Each provides a product at a lower cost to the consumer, but we have legitimate cause to wonder whether there are important externalities left in their wake. The most formidable concern here is what the growing number of alternative trading systems means for the reputational capital or brand of the NYSE and NASDAQ.[11] To have a brand, the NYSE and NASDAQ must offer *more* than efficient executions and liquidity, because ECNs can be expected to be equally competitive on these fronts. Perhaps they may even enjoy a competitive advantage if, as a result of not being burdened by a fair share of the costs for regulatory oversight, they have more funds to invest in technology to enhance their efficiency than the NYSE or NASDAQ. How then can NYSE and NASDAQ preserve their brands?

Professor John Coffee has recently written that the attraction of a U.S. listing to foreign issuers is that they

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[10] Some complain that too much of the profits are diverted to non-research efforts, such as marketing programs and tinkering with the formulation of the underlying drug to seek to extend the monopoly protection afforded by the grant of a new patent.

[11] In addition to providing reputational capital to listed firms, exchanges also provide liquidity when there are momentary imbalances in order flow, standardize contracts to reduce transaction costs, and monitor trading to assure fairness in the markets. *See generally* 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 CORNELL L. REV. 1007 (1990).

thereby become subject to mandatory disclosure requirements that provide greater protection to stockholders from opportunistic behavior by their managers or control persons.[12] If the NYSE and NASDAQ wish to preserve their brands, they can do so through self-regulatory efforts so that issuers who list their shares on the NYSE or NASDAQ further signal to the investment community their commitment to ensure transparency, fair treatment of shareholders, and efficient execution of securities trades. That is, the NYSE and NASDAQ can preserve their franchises through strong self-regulatory efforts that preserve, and even enhance, the reputational gains of their listed companies.

This effect raises the interesting question whether the NYSE and the NASDAQ should each have important self-regulatory activities with respect to their members, as they do today, or whether their self-regulatory efforts should be confined to their market functions, with the regulation of broker-dealers transferred to a super-self-regulatory body. Related to this issue is the fairness of permitting alternative trading systems to free ride on the costly self-regulatory efforts of the NYSE and NASDAQ. For example, monitoring efforts by the NYSE that have the effect of maintaining or raising investor confidence in the fairness of trading in NYSE-listed securities also redound to the benefit of the alternative trading system, which trades NYSE listed securities. Hence, a cross-subsidy to the alternative trading systems is made by the security's major market.

The current regulatory framework pursued by the SEC permits alternative trading systems that opt to be regulated as broker-dealers, as well as those that opt to be treated as exchanges, to delegate market oversight functions to a Self-Regulatory Organization ("SRO").[13] Such oversight raises legitimate concerns that the self-regulatory efforts will be

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[12] *See* John C. Coffee, Jr., *The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications*, 93 NW. U. L. REV. 641 (1999).

[13] *See* Regulation of Exchanges and Alternative Trading Systems, Exchange Act. Rel. No. 40,760 (Dec. 8, 1998).

adequately and fairly funded by all securities markets. Any breakdown in the financial health of the NYSE or NASDAQ will lead to a concomitant weakening in their commitment to brand themselves through strong self-regulatory efforts. Thus far, the SEC has not addressed the role of self-regulation for competitive, but electronically linked, markets.

Chairman Levitt has charted a course bounded by competition and electronic linkages. It remains to be seen just how this sea populated by increasing numbers of trading islands can sustain the rich history of U.S. securities markets in self-regulation. Certainly we must maintain a watchful eye for anti-competitive enforcement initiatives by the NYSE or NASDAQ as a result of their surveillance powers over alternative trading systems that trade their securities. The masking of anti-competitive steps in the cloth of self-regulation will only introduce friction in the path of further developments in alternative trading systems.[14] At the same time, there needs to be a solution to funding self-regulatory efforts, so that the alternative trading systems bear their fair share of the regulatory burdens. And, we should expect that ultimately the expansion in the number of trading venues will give rise to substantial augmentation in the budget of the SEC to address the prospect that the self-regulatory efforts will not cover all trading venues. Such a step appears to be a natural one to take; the electronic linkages among markets that exist, and which will develop further, can become the backbone for efficient electronic surveillance.[15] This efficient surveillance will, in turn, force the SEC to develop objective criteria for not only the meaning of best execution, but also to assure actions consistent with the objec-

[14] For a collection of studies on how the enforcement activities by self-regulatory organizations appear guided by anti-competitive influences so that larger, more established firms, are preferred over smaller, younger rivals, *see* JAMES D. COX ET AL., SECURITIES REGULATION 1092-93 (2d ed. 1997).

[15] *See* Jonathan R. Macey & Maureen O'Hara, *Regulating Exchanges And Alternative Trading Systems: A Law And Economics Perspective*, 28 J. LEGAL STUDIES 17 (1999).

tives of a national market system. Otherwise, market developments may continue to evolve, but without obeisance to a central regulatory objective.