26. Securities Markets

Congress should

- allow securities exchanges to compete to offer both products and mechanisms to ensure the safety and soundness of those products,
- instruct the Securities and Exchange Commission (SEC) to abandon plans to regulate price and order flows, and
- restrict the SEC to acting against cases of actual fraud.

As Dale A. Oesterle of the University of Colorado–Boulder says, "The core of capitalism is the accumulation and use of capital by private individuals. Securities markets are indispensable for a prosperous free-market economy." In those markets, or exchanges, companies raise the capital they need to run and expand their productive activities and individuals invest their savings. Over half of all Americans now own stocks, mostly through private retirement accounts like individual retirement accounts (IRAs) and 401(k) plans, and that portion is likely to grow in the future. Thus, the future of securities markets is more important than ever.

Exchanges, such as the New York Stock Exchange (NYSE), the country's largest, and the Chicago Board of Trade (CBT), have operated as exclusive, nonprofit organizations, similar to member-owned and member-operated country clubs. The members themselves trade shares of stock with one another on physical floors, with specialized trading pits for different kinds of securities. Because their brokers possess specialized knowledge and have access to financing, exchanges can guarantee that there will always be buyers and sellers for their listed securities. It is the exchange members themselves, not the exchanges as organizations, that make profits as the middlemen executing trades.

In order to attract and keep customers, exchanges have had incentives to ensure that stocks traded by their members were from legitimate businesses.

Thus, companies wishing to have their stock traded on an exchange are required to meet certain criteria.

In recent years, electronic exchanges have given traditional exchanges such strong competition that the latter now are considering relinquishing their member-owned, country club status, selling shares to the public to raise capital and establishing their own electronic trading systems. The Securities and Exchange Commission (SEC) now faces the problem of how to regulate the new exchanges as well as the evolving traditional exchanges. Unfortunately, the SEC is considering approaches that would restrict dynamic markets rather than free them.

Self-Regulatory Organizations

The Securities and Exchange Act of 1934 and subsequent legislation brought exchanges under federal control. Specifically, the act required exchanges to operate as self-regulatory organizations (SROs) with rules and self-policing. Initially, the idea was that SROs would have the exclusive right to make certain rules. The SEC, which was created by the act, would be allowed to alter or supplement only certain categories of exchange rules, upon the request of an interested party. Other proposed SRO rules would take effect automatically unless the SEC acted to make specific, limited alterations.

But over the years the SEC's authority has grown. Today, not only must most SRO rules be approved by the SEC, but the SEC also can impose rules on SROs. The SRO-SEC arrangement gives the illusion that the government is strictly monitoring exchange activities when, in fact, the exchanges are supposed to be policing themselves on a day-to-day basis. This illusion lulls exchange customers into a false sense of security and removes an incentive for exchanges to strictly police themselves to protect their reputations. On the other hand, when the occasional stock scandal does occur, the SEC steps in to micromanage, often without adequate consideration of potential adverse effects.

The Electronic Challenge

The securities market landscape has been altered fundamentally over the past decade by the emergence of electronic trading companies, also called electronic communications networks (ECNs). These privately owned companies allow brokers to subscribe by paying an access fee. The systems match buy and sell orders from subscribers electronically,

on the basis of a variety of criteria. There literally is no trading floor, computers take its place, and no floor brokers; specialized software does the job.

These electronic companies drastically reduce the overhead costs needed to maintain physical exchanges the size of airport hangers as well as armies of brokers and specialists. Such systems can better guarantee that orders will be executed in a timely manner. Furthermore, the new technology allows brokers more easily to spread out large orders anonymously so that their trades will not adversely affect their prices. In addition, ECNs have offered prices in smaller fractions than have been offered by traditional exchanges that until recently priced only to 1/8 of a dollar. On a multi-million-dollar trade, that spread meant more profit for exchange member-brokers and less for customers.

Currently, ECNs process some 30 percent of all NASDAQ-listed stocks and around 8 percent of all exchange-listed securities.

Regulating Electronic Exchanges

The emergence of ECNs has sparked new SEC regulations. Rules that became effective in April 1999 gave ECNs two options. They could either register as exchanges and fall under the same SRO regime as traditional exchanges, or they could declare themselves broker-dealers. The latter option would place them under the jurisdiction of the National Association of Securities Dealers Regulation Inc. (NASDR), the SRO operated by the National Association of Securities Dealers, which also operates NASDAQ. Neither of these options is good for the emerging ECNs or market competition.

If ECNs register as exchanges, as have several, they will be subject to regulations meant for flesh-and-blood brokers trading on a physical exchange floor. But ECNs have no floors or brokers. Computers match orders automatically. SEC regulatory requirements can add enormous monitoring and compliance costs for companies that have no brokers to monitor or discipline. And, unlike traditional exchanges, ECNs are not nonprofit organizations with member-owners but for-profit enterprises that charge fees for access. It is impossible for the SEC to fit ECNs into the SRO regime.

If ECNs register as brokers, they come under the jurisdiction of NASDR, the SRO of NASDAQ, one of their competitors. This situation creates a potential regulatory conflict. Also, the same regulatory problems that arise

when ECNs register as exchanges arise if they register as brokers subject to NASDR.

Even worse, traditional exchanges now promote certain SEC rule changes that would, in fact, limit competition. For example, the NYSE wants SRO rules to consolidate order flow on the NYSE as a means to prevent inefficient market fragmentation. However, such a measure would harm the NYSE's competitors.

Pressure to "Go Public"

The advent of electronic exchanges has compelled traditional exchanges to consider abandoning their nonprofit, member-owned status and "going public," that is, becoming for-profit, publicly owned companies. Consider an example that illustrates why there is pressure to make such a change. To compete with ECNs, the NYSE has developed its own electronic trading system, which it has operated with only limited success. The reason for this poor performance is that many NYSE members will lose business if such a system operates efficiently. The NYSE case illustrates why most traditional exchanges are planning to sell stock in their operations. Although some members might be harmed, others understand that, in the long run, if their exchanges do not modernize, the exchanges themselves and thus all of their members will suffer.

If traditional exchanges are publicly owned, the stockholders and the board of directors will insist that they operate efficient electronic trading systems, even if some exchange members, who will then be employees of the company, lose some economic power. Furthermore, when exchanges sell shares in their own operations, they will raise capital needed to establish electronic systems. In addition, exchange members no doubt will receive or purchase stock shares of the publicly owned company as an incentive to support "going public." Members of such exchanges thus will receive some of the profits from the privatized exchange.

The futures exchanges in London and Paris have already closed their physical trading floors in favor of electronic exchanges. Also, for the sake of competitiveness, the London and German stock exchanges had planned to merge. Although that merger did not take place, the attempt illustrates that exchanges worldwide see consolidation and connections with others as necessary for their future competitiveness. When American exchanges go electronic and "go public," the regulatory situation will be further complicated. First, the SEC will be applying an obsolete regulatory regime to the electronic systems of those exchanges as well as to the new ECNs.

Second, it will be even more difficult to apply the SRO regime, meant for nonprofit, member-owned exchanges, to publicly owned companies. And third, NASDAQ was considering a formal relationship with the merged London and German exchanges. Although that merger and thus that relationship did not come about, it is likely that, in the future, relationships will be formed between American and foreign exchanges. Such relationships will add international regulatory issues to the domestic mix. Which set of government bureaucrats will have jurisdiction over which activities in electronically connected global exchanges?

Unsound SEC Options

The SEC is now considering exactly how to regulate the dynamic securities markets. Its past record suggests that it will not promote, but rather interfere with, the development of efficient markets. For example, it already has meddled in ECN operations, setting rules concerning subscriber access, listing requirements, and execution fees.

The SEC is evaluating future regulations in light of the authority granted it by Congress in 1975 to regulate securities communications. In effect, the SEC is allowed to create a centralized system for collecting and disseminating market price information.

In a market system, prices are not only the result of buying and selling; they are also information that affects who buys and who sells, when, and at what price. If some monopolist company or entity could keep price information to itself, it might be able to purchase for less than an informed seller might accept or sell for more than an informed buyer might be willing to pay. A monopolist might also extract rents by selling price information.

The SEC has issued a Concept Release that reviews the various means by which it is considering regulating price information. Unfortunately, all of the approaches require it to force exchanges to funnel price information through some form of centralized system. In effect, the SEC wants to regulate a price information system like a public utility, mandating cost-based pricing of that information. This is ironic in light of the fact that for several decades governments have recognized the inefficiency of public utilities regulation and, as a consequence, have been deregulating and privatizing as a way to allow utilities to operate more efficiently or reduce prices. Those governments understand that competitive markets, not government regulators, produce efficiency.

The SEC's proposals also are pointless. After all, real-time price information now is readily available, and data prices for individual investors have fallen by as much as 90 percent since 1998.

Concern about price information flow is part and parcel of the SEC's concern about market fragmentation. But here, too, the SEC's proposed solution would be inferior to market alternatives.

For example, a proposed price-and-time priority rule would mandate a Consolidated Limit Order Book, which would require that an order placed on any exchange be forwarded to the first exchange offering the best price. On March 22, 2000, Matthew Andresen, the president of The Island ECN described the problem with this approach before the Senate Banking Committee's Subcommittee on Securities:

> Assume that ECN A is a market that provides its members with the fastest and most reliable trading system in the industry. In addition, assume that Traditional Market B utilizes obsolete technology that lacks adequate capacity. If, under a regime of price/time priority, Market B is the first to display the best offer of $100 in stock XYZ, any order to buy XYZ at $100 received by ECN A must be routed to Traditional Market B—despite its inferior technology. Thus, even if you as an investor intentionally sent your order to ECN A to take advantage of its superior speed of execution, ECN A would be required to route your order to Traditional Market B. Thus, ECN A would be completely dependent on a response back from Traditional Market B in order to fill your order.

It makes more sense to allow exchanges to compete by offering price, speed, security, and an entire package of services designed to fit the needs of customers than to allow the SEC to try to second-guess the market with its mandate.

Another SEC proposal would use the existing Intermarket Trading System, which, historically, has only connected national and regional exchanges. All exchanges would be required to be members of a system. Membership would subject them to changing rules and SEC mandates. The SEC would regulate the system in a manner similar to that in which public utilities historically have been regulated. A better model is found in the way that the travel market has emerged on the Internet. Various Web sites compare and offer customers choices of airline tickets, hotels, car rentals, and more from various suppliers, without government mandates and coordination.

A Market-Based Approach

The communications and information revolution is undermining traditional securities exchanges. The SEC is scrambling to find new ways to

regulate the emerging market with its competitive ECNs. But, as is the case with other government agencies, the SEC will not be able to create efficient market institutions. Rather, its heavy-handed efforts will retard the evolutionary process that already is transforming securities trading.

To ensure efficient securities markets in the future, Congress should allow securities exchanges to compete in offering both products and mechanisms to ensure the safety and soundness of those products. Furthermore, it should instruct the SEC to abandon its various plans to regulate price and order flows.

Part of the government's duty to protect property is to prosecute the kind of direct stock fraud that could occur on securities exchanges. Congress should restrict the SEC to acting against cases of actual fraud.

Suggested Readings

Andresen, Matthew. Statement before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs, March 22, 2000.

Brown-Hruska, Sharon, and Jerry Ellig. "Financial Markets as Information Monopolies?" *Regulation* 23, no. 3 (2000).

Oesterle, Dale A. "The SEC's Assault on Electronic Trading." *Regulation*. 21, no. 3 (1998).

_____. "Securities Markets Regulation: Time to Move to a Market-Based Approach." Cato Institute Policy Analysis no. 374, June 21, 2000.

Pirrong, Craig. "Electronic Exchanges Are Inevitable and Beneficial." *Regulation* 22, no. 4 (1999).

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