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The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation

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The NYSE Response to Specialist Misconduct:
An Example of the Failure of Self-Regulation

Nan S. Ellis†

Lisa M. Fairchild‡‡

Harold D. Fletcher‡‡‡

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INTRODUCTION

Capital markets are essential for businesses to raise capital for operations, expansion, job creation, product development and innovation. The functioning of such markets is, however, contingent upon public confidence. The New York Stock Exchange ("NYSE" or "the exchange") is known as one of the most important and prestigious stock exchanges in the world. Over 2,800 publicly-traded companies list their shares on the NYSE and a large percentage of all securities trading occurs on its floor. The NYSE acknowledges that "[b]efore committing their trust and savings to the market, investors must be guaranteed a fair and level playing field along with equal access to information and guidance they can trust." At least in part to achieve these objectives, the NYSE has been granted the powers of a self-regulatory organization (SRO). SROs in the securities industry operate under the oversight of the Securities and Exchange Commission (SEC) and must observe...
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statutorily specified procedures to promulgate rules, policies and procedures.\(^7\)
The wisdom of allowing the NYSE to continue as an SRO has, however, been questioned.\(^8\)

Unfortunately, a series of scandals has shaken consumer confidence in stock markets in general, and, specifically, the NYSE. In addition to the Enron, WorldCom, and mutual fund scandals, the current banking crisis threatens to undermine financial markets globally.\(^9\) Moreover, the NYSE itself was rocked by allegations of trading irregularities in the early 2000's.\(^10\) Specifically, seven specialist firms\(^11\) admitted to violating stock trading rules and to engaging in practices of inter-positioning,\(^12\) front-running,\(^13\) and freezing.\(^14\) Prodded by

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7. Ornig H. Dombalagian, Self and Self-Regulation: Resolving the SRO Identity Crisis, 1 BROOK J. CORP. FIN. & COM. L. 317 (2007). See also William I. Friedman, The Fourteenth Amendment's Public/Private Distinction Among Securities Regulators in the U.S. Marketplace-Revisited, 23 ANN. REV. BANKING & FIN. L. 727, 730 (2004) (characterizing SROs as “full-fledged quasi-governmental entities charged with enforcing federal securities laws under the Exchange Act.”). Friedman explains how Congress achieved an “historic compromise between the public and private powers of Washington and Wall Street ... by both endorsing the continued viability of the NYSE, which already possessed a well-established tradition of self-regulation in the U.S. marketplace, while at the same time transforming this once exclusively private club into a government supervised self-regulatory body.” Friedman, supra, at 738. Phyllis Flintch, Reed Keeps SRO Status, But Adds Independent Board, DOW JONES NEWSWIRES, Nov. 5, 2003 (discussing how the reforms impact SRO status). See also infra notes 291-317 and the accompanying text for a discussion about the debate surrounding continued self-regulation of the securities industry.

8. See infra notes 299-307 and the accompanying text.

9. See generally Eamonn K. Moran, Wall Street Meets Main Street: Understanding the Financial Crisis, 13 N.C. BANKING INST. 5, 10-11 (2009) where the author discusses the ripple effects of the global financial meltdown. (“Between July 2007, when the credit crisis began, and mid-October 2008, the country’s nine largest banks and financial institutions marked down their valuations on loans and other troubled assets by a combined $323 billion.”). Id. at 9

10. In addition, NYSE Chairman Richard Grasso was forced to resign over his $187.5 million compensation package. Vincent Boland, NYSE’s Reed fires back at reform critics: Corporate governance: Exchange ‘hurt’ by complaints of state treasurers, pension fund managers, FIN. TIMES, Nov. 28, 2003.

11. A specialist is a “dual trader” who either brokers orders for its clients (investors) or fills orders for these clients from its own inventory. Specialists are known by different names in different markets. They are often referred to as market makers. In 2001, there were eight specialist firms employing all the specialists at the NYSE. Five of these firms handled approximately 95% of the NYSE dollar volume. LARRY HARRIS, TRADING AND EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 494-95 (2003). Professor Harris describes the three roles performed by specialists as 1) dealers, when they trade for their own account; 2) brokers, when they broker trades for other brokers; and 3) exchange officials who play a role in assuring the maintenance of orderly markets. Id. at 496. The NYSE describes the “four vital roles” performed by specialists as 1) auctioneer, who “makes firm and continuous two-sided quotes that accurately reflect market conditions”; 2) catalyst, who “makes all reasonable efforts to bring together buyers and sellers to facilitate the public pricing of orders”; 3) agent, for “all orders routed electronically through the NYSE’s SuperDOT® System for orders left with him with special instructions from floor brokers”; and 4) principal, who buys and sells from its own account to maintain orderly markets, to assure liquidity and to reduce volatility. Inside the NYSE: The Specialist, NYSE MAGAZINE, Mar. 7, 2003. See infra notes 29-47 and the accompanying text where the specialist’s role in NYSE operation is discussed. See also infra notes 64-70 and the accompanying text where the specialist’s affirmative and negative obligations are discussed.

12. Inter-positioning refers to the practice of “penny-jumping” by “stepping in the way” of matching orders of buyers and sellers. See infra note 94 and accompanying text.

13. Front-running refers to the practice where specialists trade for their own account as principals before completing orders placed by public investors. See infra note 94 and accompanying text.
the threat of an investigation by the SEC, the NYSE investigated the allegations and concluded that there was specialist misconduct. In response, the NYSE fined five specialist firms a total of $150 million;\textsuperscript{15} in addition, a settlement was reached with the specialist firms agreeing to pay over $240 million.\textsuperscript{16} Following these disclosures, the NYSE itself was accused of being complicit in the trading schemes, of publishing misleading representations of regulatory oversight, and of failing to oversee the specialist system.\textsuperscript{17}

Largely in response to the public’s concerns about conflicts of interest between the NYSE’s market and regulatory functions, the NYSE overhauled its corporate governance, separating the regulatory function from the market function.\textsuperscript{18} Most importantly for the purposes of this paper, the NYSE reform left untouched the specialist system and the NYSE continues to operate as a

\begin{footnotesize}
\begin{enumerate}
\item[14.] Freezing occurs when the specialist freezes his book on a particular stock and makes trades for his own account prior to executing the public investor’s orders. \textit{See infra} note 95; \textit{see also infra} notes 82-95 and the accompanying text where specialist misconduct is discussed in more detail.
\item[15.] The $150 million fine is the largest in the exchange’s history. \textit{NYSE to fine specialists for improper trading, ATLANTA JOURNAL-CONSTITUTION, Oct. 16, 2003.}
\item[16.] The specialist firms of Bear Wagner Specialists LLC, Fleet Specialists, Inc., LaBranche & Co., LLC, Spear, Leeds & Kellogg Specialists LLC and Van de Molen Specialists USA, LCC reached a settlement with the SEC and the NYSE in which they agreed to pay a settlement totaling $241,823,257 in penalties and disgorgement. Moreover, they agreed to implement steps to improve their compliance systems. These fines stemmed from violations that occurred between 1999 and 2003. Press Release, SEC, Settlement Reached with Five Specialist Firms for Violating Federal Securities Laws and NYSE Regulations; Firms Will Pay More than $240 Million in Penalties and Disgorgement (March 30, 2004), http://www.sec.gov/news/press/2004-42.htm (last visited May 28, 2008). At the time of the settlement, Stephen M. Cutler, the SEC’s Director of Enforcement, said, “When an exchange specialist unlawfully takes advantage of its privileged position by seizing trading opportunities that it should leave for public customers, it fundamentally undermines the fair and orderly operation of the exchange auction system. As the sanctions imposed in this case indicate, the Commission will aggressively punish such behavior.” \textit{Id.}
\item[18.] \textit{See infra} notes 167-76 and the accompanying text where the NYSE reform is considered in detail. The NYSE instituted these reforms largely in response to public outcry surrounding the compensation package of NYSE Chairman and CEO Richard Grasso, rather than as a reaction to the specialist scandal. Jake Keaveny, \textit{In Defense of Market Self-Regulation: An Analysis of the History of Futures Regulation and the Trend Toward Demutualization, 70 BROOK. L. REV. 1419, 1440-1441 (2005). It is not unusual for market reforms to be implemented in response to scandals. In 1792, the NYSE was organized in response to a scandal in the government bond market. Congress and the SEC have imposed governance reforms numerous times from 1934 to the present in response to scandals. Roberta S. Karmel, \textit{Is the Financial Industry Regulatory Authority a Government Agency?} (Brook. Law Sch., Legal Studies Paper No. 86, 2007), available at http://ssrn.com/abstract=1018396.}
\end{enumerate}
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SRO. 19

Despite the importance of specialists in the operation of the NYSE, 20 surprisingly little scholarly attention has been paid to their role. 21 In this paper, we intend to question the continued viability of the specialist system. More importantly, we will argue that the failure of the NYSE to prevent or to adequately address these scandals is emblematic of the problems of SRO status. Therefore, we will question the continued viability of the SRO scheme of regulation of the NYSE.

To begin such an analysis, we will outline in Part I the specialist misconduct that came to light in 2003. We will explain first how the NYSE operated at the time the specialist misconduct occurred, including a detailed description of the role of the specialist. Further, we will outline the regulation of the NYSE, including the rules that governed specialist behavior. This Part will examine the failure of the regulatory scheme to prevent specialist misbehavior, including allegations of inadequate enforcement by the NYSE and the inadequacies of the SEC oversight. Part I will conclude by focusing on the recent CalPERS case, which effectively rendered the NYSE immune from civil actions by individual investors. 22

In Part II we will examine the NYSE response to the specialist misconduct. We will describe the separation between the regulatory and market functions of the NYSE and the new regulatory arm. We will outline the recent merger activity that has resulted in the new NYSE Euronext. Importantly, for the purposes of this paper, while moving toward increased electronic trading, the new NYSE retains the specialist system and maintains the self-regulatory scheme.

In Part III, we will argue that the specialist system should be abandoned.

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19. See infra notes 188-96 and the accompanying text.
20. At least one article minimizes the importance of specialists. James L. Cochrane, Senior Vice President for Research and Planning at the NYSE, asserts that "specialists account for, on average, only ten percent of the shares purchased and ten percent of the shares sold on the NYSE." James L. Cochrane, Brian McNamara, James E. Shapiro & Michael J. Simon, The Structure and Regulation of the New York Stock Exchange, 18 J. CORP. L. 57, 60 (1993). But see Arthur Oesterle, On the Business of Defending NYSE Specialists, 18 J. CORP. L. 79, 88 (rebuttering the Cochrane article).
The inherent conflict of interest posed by the specialist arrangement and its inefficiency when compared to electronic markets provide arguments for replacing the specialist system with a predominately electronic market. In this Part, we will examine the arguments in favor of specialists. We will demonstrate that the arguments in favor of retention of the specialists (e.g., liquidity and lack of volatility) are not supported by the finance literature. For example, we will note that the specialist system has failed entirely to prevent the volatility that has been commonplace during the current monetary crisis.

In Part IV we will note recent specialist misconduct, examine the continued failure of the NYSE to effectively regulate itself and conclude that self-regulation should be replaced with a more active role for the SEC in regulating the NYSE.  

I. AN ILLUSTRATION OF THE PROBLEM

A. NYSE Operations

1. The NYSE as an Auction Market

Traditionally, the NYSE has been a pure auction market. Auction markets are characterized by a centralized market; trading occurs in a single location with prices that are publicly announced. An auction market can have a physical location, like the NYSE, or it can operate electronically, like the London Stock Exchange. The location of the market is irrelevant because, in an auction market, all participants, including dealers, brokers, and investors, have knowledge of trading opportunities and access to those opportunities. At any given point in time, the prices posted represent the most favorable prices available from auction market participants. Because trades take place between market participants, the market does not need to maintain an inventory of


25. See infra note 244. In fact, most of the trading on the NYSE today is electronic. William G. Christie & Robert B. Thompson, Wall Street Scandals: The Curative Effects of Law and Finance, 84 WASH. U. L. REV. 1567, n.35 (2006) ("The NYSE has now shifted most of its trading to an electronic platform."); Colesanti, supra note 21, at 33 (describing the change in trading at the NYSE in the past two years from 80% human trading to 80% electronic trading).
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securities for liquidity purposes as is the case with dealer markets. Rather, liquidity is supplied by open limit orders. The lack of a need for inventory results in lower transaction costs in the auction market than in a dealer market. Additionally, investors can immediately execute orders to buy or sell securities if they are willing to accept the prevailing price in the market.

The act of an individual investor wishing to buy or sell a security on an auction market such as the NYSE immediately triggers the actions of a number of players. The buy or sell order of the investor goes from the brokerage firm, which owns a seat on the exchange, to its commission broker (or floor broker), who is on the floor of the exchange. The commission broker executes the order. However, the order is not necessarily handled by a floor broker. In some cases, an independent member of the exchange handles executions for commission brokers when these brokers have too many orders to handle.

2. The Role of the Specialist

Traditionally, the specialist has been central to the entire trading process of the NYSE. The specialist “makes” a market in several listed securities. The trading in a stock takes place at one specific location on the exchange floor, called the specialist’s post. There is a computer screen at this post, the so-called “Display Book,” which presents all the current offers from various traders to buy or sell shares at various prices, and the associated number of shares. The role of the specialist is to manage the trading in stocks at the particular post. The NYSE assigns the responsibility to make the market in each stock to a specific specialist firm; in other words, there is only one specialist per stock. However, each specialist firm is responsible for several

26. A limit order provides a price and quantity at which the investor is willing to buy or sell.
27. ANTHONY SANTOMERO & DAVID BABBEL, FINANCIAL MARKETS, INSTRUMENTS AND INSTITUTIONS 440 (2001).
28. We think it is important to describe the role of the specialist at this point to highlight the potential for trading abuses. It should be noted, however, that following the documented trading abuses of specialists, there have been calls for their elimination. As a result, the NYSE has initiated reforms which move more trades to electronic platforms and out of the specialists’ hands. The details of these reforms are provided in Part II of this article.
29. The specialist system for trading originated in 1875, when one of the NYSE brokers, named Boyd, broke his leg and decided to deal in one place. Because he was trading in Western Union stock, the “hot” stock of the day, those wishing to buy Western Union stock flocked to his side. When his leg was healed, he refused to move. CalPERS Complaint, supra note 17, at 1; Patricia Fisher, A Special Breed of Traders Neither Bulls Nor Bears, They Keep Markets Moving, NEWSDAY, Feb. 6, 1989. See generally, Jerry W. Markham & Daniel J. Harty, For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs, 33 J. CORP. L. 865, 867-71 (2008) (discussing creation of NYSE and the role of the specialist). This is also referred to as the “open outcry” trading model. See Colesanti, supra note 21, at 1.
30. In re NYSE Specialists Sec. Litig., 503 F.3d 89, 92 (2d Cir. 2007).
32. Id.
stocks. The specialist firm can also act as a dealer in a specific stock, trading for its own account.

The individual investor can place stock orders in several formats. The investor could place a market order, which simply orders a buy or sell order to be executed immediately at current market prices. For example, the investor can call her broker and request a stock purchase “at the market.” The broker then relays this request to the commission broker on the floor of the NYSE. The commission broker then moves to the specialist’s post and asks for sell offers from other brokers around the post or from the specialist if there are no sell offers available. The competing selling brokers will indicate to the commission broker the price at which they are willing to sell and the commission broker takes the lowest price. When a trade takes place, the specialist’s clerk files an order card that reports the time, price, and quantity of shares traded, and the transaction is then reported on the exchange’s ticker tape.

The investor can also place a limit order in which he specifies the price at which he is willing to buy or sell a security. A limit-buy order instructs the broker to execute the trade if the stock price falls below the specified limit. Conversely, a limit-sell order instructs the broker to sell as soon as the stock price goes above the specified limit. Similarly, the investor can place a stop-loss order, which instructs the broker to sell the stock if its price falls below the stipulated level, or a stop-buy order, which instructs the broker to buy the stock if its price rises above a given level. The specialist firm’s unique role in the execution of the stock trade warrants more detailed exploration. In “making the market” for a stock, the specialist could be required to act as either a broker or a dealer. As a broker, the specialist’s role is simply to execute the orders of other brokers. The specialist firm can also buy or sell shares from their own inventory when acting as a dealer. When no other broker wants to take the other side of a trade, the specialist firm does so even if it means that it must buy or sell from its own inventory. The NYSE commissioned specialist firms to perform these responsibilities and monitors their performance.

According to NYSE rules, the specialist is required to use the highest

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33. Id.
34. Id. at 230.
35. See supra note 11, at 13.
36. Christie & Thompson, supra note 25, at n.7.
37. See supra note 11, at 13.
38. See id.
39. See id.
40. A significant part of the specialist’s job as a broker is clerical. The specialist firm maintains a “book” (computer console) listing all outstanding unexecuted limit orders entered by brokers on behalf of investors. When limit orders can be executed at market prices, the specialist executes, or “crosses,” the trade.
41. See infra notes 68-70 and the accompanying text. This is part of the specialist’s affirmative obligation.
outstanding purchase price and lowest outstanding offered selling price when matching trades.\textsuperscript{42} Hence, the specialist system of the NYSE resulted in an auction market. In other words, all buy and sell orders come to one location and the best orders win the trades. The specialist firm acts as a facilitator in the auction process.

Another major function of the specialist firm was to maintain a “fair and orderly market” by acting as dealers in the stock.\textsuperscript{43} In exchange for the exclusive privilege to make the market in a specific stock on the NYSE, the specialist firm is responsible for maintaining an orderly market by buying and selling shares from the firm’s own inventory of securities.\textsuperscript{44} The specialist firms maintain their own inventories of stock and quoted bid and ask prices at which they are obligated to meet at least a limited volume of market orders at these quotes.\textsuperscript{45} The specialist firms earn income from commissions by acting as brokers for orders and from the spread between the bid and ask prices at which they buy and sell securities.

In summary, the specialists play three roles. They are dealers when they trade from their own account. They are brokers when they match orders and trade for other brokers. Last, they are exchange officials who are responsible for conducting orderly markets.\textsuperscript{46}

\textbf{B. The Regulatory Environment of the NYSE}

\textit{1. The Nature of the Regulatory Scheme}

The 1934 Securities and Exchange Act (Exchange Act) prohibits broker-dealers\textsuperscript{47} from engaging in a transaction on an exchange\textsuperscript{48} unless that exchange

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\footnote{42. See supra note 11, at 498.}
\footnote{43. Id.}
\footnote{44. Id. See also Oesterle, Winslow \& Anderson, supra note 21, at 234.}
\footnote{45. The specialist firm’s published price quotes are valid only for a given number of shares. If the buy or sell order is placed for more shares than the quote size, the specialist has the right to revise the quote.}
\footnote{46. HARRIS, supra note 11, at 486.}
\footnote{47. A “broker” is one who receives an order from a customer and forwards that order to a third party for execution but does not buy or sell the security for her own account. When one acts as a broker, she is acting in an agency capacity. 15 U.S.C.A. §3(a)(5); 15 U.S.C.A. § 78c(a)(4)(A). A “dealer” is one who buys or sells a security from his own account. When one acts as a dealer, he is acting in the capacity of a principal. Id. at § 3(a)(5); §78c(a)(5)(A). Specialists act as both brokers and dealers of the same securities. See notes 228-36 and the accompanying text where the inherent conflict of interest in assuming both principal and agent roles is discussed.}
\footnote{48. An “exchange” is defined in Section 3(a)(1) of the Exchange Act as “any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.” Securities and Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(1).}
\end{footnotesize}
is registered as a national securities exchange under Section 6 of the Act or is exempt from registration. The NYSE is an SRO sanctioned and overseen by the SEC.\(^\text{49}\) The NYSE drafts rules to govern the operation of the exchange which must be approved by the SEC. The NYSE is charged with enforcing its own rules as well as SEC rules.\(^\text{50}\) As a registered national stock exchange, the NYSE must enforce compliance with the Exchange Act, SEC rules and regulations, and NYSE rules.\(^\text{51}\) Moreover, it must have rules that are designed to prevent fraudulent and manipulative practices and to protect investors and the public interest.\(^\text{52}\) Last, the rules of the exchange must provide for appropriate disciplinary action for violations.\(^\text{53}\) If the NYSE fails to comply


The NYSE's status as an SRO has been in place from the beginning of the NYSE and was allowed to continue after passage of the Exchange Act. See Mark Borrelli, Market Making in the Electronic Age, 32 LOY. U. CHI. L. 815, 818 (2001). The SEC was given expanded authority to regulate the NYSE under the Securities Acts Amendments of 1975. Pub. L. No. 94-29, 89 Stat. 97 (1975). The Sarbanes-Oxley Act of 2002 gave the SEC increased authority over SROs. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in sections of 11, 15, 18, 28 and 29 U.S.C.). Euronext has relinquished most of its SRO function to governmental regulators. Questions have been raised about the extent to which the NYSE will continue to function as an SRO following the Euronext-NYSE merger. See Karmel, supra note 3, at 392 ("In a global market where exchanges are public companies, it is difficult for them to continue to operate as SROs to the extent they have done so in the past."). See infra notes 291-96 and the accompanying text where problems with self-regulation are discussed.

\(^{50}\) 15 U.S.C. §§ 78(b), 78o-3(b)(2). The regulations adopted by the NYSE have the force of federal law. See Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005). Dombalagian distinguishes between private ordering and mutual regulation. See Dombalagian, supra note 7, at 317. In the case of private ordering, organizations promulgate uniform rules, but have historically "lacked the wherewithal to monitor for compliance, as well as the legal ability or economic incentive to discipline non-compliant members." Id. The self-regulatory model of the NYSE is one of mutual regulation ("the regulation of transactions among members through rules"), reciprocal regulation ("the development of standards that govern relations between members and their public customers"), partitive (balancing the interests of one class against the conflicting interests of another) and gate-keeping. Id.

\(^{51}\) Section 6(b) of the Exchange Act provides that:

An exchange shall not be registered as a national securities exchange unless the Commission determines that (1) Such exchange is so organized and has the capacity to carry out the purposes of this title.... and to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations there under, and the rules of the exchange.


\(^{52}\) Section 6(b)(5) provides that:

An exchange shall not be registered as a national securities exchange unless the Commission determines that (5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade... to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest....


\(^{53}\) Section 6(b) provides:

An exchange shall not be registered as a national securities exchange unless the Commission
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with the Exchange Act, the SEC can impose sanctions, up to and including revocation of its registration as an SRO. 54

2. The Regulation of Specialist Behavior

Specialist behavior is governed by SEC and NYSE rules and regulations. Pursuant to Section 11(b) of the Exchange Act,55 which authorizes the SEC to regulate the conduct of specialists, the SEC promulgated Rule 11b-1. Rule 11b-1 sanctions specialist systems as long as the exchange: 1) establishes “adequate capital requirements” for specialists;56 2) imposes limits on their trading activity;57 and 3) creates a system of “effective and systemic surveillance of the activities of specialists.”58 NYSE rules address these mandates. NYSE rules set capital requirements for specialists,59 regulate specialist participation in openings,60 set reporting requirements,61 work to assure best execution,62 and regulate the misuse of information.63

Each specialist has “the primary responsibility for making the market and keeping it orderly.”64 Under NYSE and SEC rules, both negative and affirmative obligations are imposed on specialists.65 SEC rules impose a negative duty on specialist trading activities. Rule 11b-1 limits trades in which the specialist trades for his own account “as far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market.”66 In other words, specialists are unable to trade as principals unless their trades

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54. 15 U.S.C. § 78s (g)-(h). Friedman, supra note 7, at 743.
59. N.Y.S.E. Rule 104.10, 2 N.Y.S.E. Guide (CCH) ¶ 2104.10 (requiring that member firms created a “Chinese Wall” that separates a specialist from the “upstairs” activities).
60. N.Y.S.E. Rule 104.11, 2 N.Y.S.E. Guide at ¶ 2104.11.
63. N.Y.S.E. Rule 98, 2 N.Y.S.E. Guide at ¶ 2098 (requiring that member firms created a “Chinese Wall” that separates a specialist from the “upstairs” activities).
64. N.Y.S.E. Rule 104.10, 2 N.Y.S.E. Guide at ¶ 2104-10(3).
65. These two obligations are often referred to as the “dual roles” of the specialist. Colesanti, supra note 21, at 4.
are essential to provide market stabilization. 67

Furthermore, NYSE rules impose an affirmative obligation on specialists. 68 Under this affirmative obligation, specialists are required to trade when necessary to provide price continuity and when necessary to eliminate a gap between supply and demand. 69 In other words, NYSE rules impose an affirmative duty on the specialists to act against their own self-interest by requiring them to buy when investors are selling and to sell when investors are buying. This was designed to achieve market stability. 70

Rules and regulations are effective only if they are adequately monitored and enforced. In fact, an effective monitoring system is essential because of the inherent conflict of interest in the specialist’s dual role as agent and principal. 71 The NYSE does provide for oversight of specialist behavior. For example, Floor Officials are charged with the responsibility of approving transactions where the price deviates substantially from the previous price and for monitoring delayed openings and trading halts involving a significant imbalance of orders. 72 More importantly, for the purposes of this paper, the NYSE’s Market Surveillance division 73, a subset of the Regulatory Group, is charged with investigating abuses relating to insider trading, market manipulation, trading irregularities, 74 and violation of NYSE rules. 75 If the

67. Even in the early 1930’s critics pointed to alleged abuses by specialists of their position as both brokers and dealers (i.e. agents and principals). Congress responded by enacting §11, imposing the negative obligation. In 1937, the SEC released the Saperstein Interpretation which required that the specialists be able to provide a justification related to the obligation to maintain a fair and orderly market for each transaction where it traded for its own account. Oesterle, Winslow & Anderson, supra note 21, at 245-46. Nowak argues, however, that, “[t]his obligation adds nothing to the market; rather, it merely prevents the specialist from acting to harm the integrity of the market.” Nowak, supra note 3, at 500. This section provides that the SEC can restrict specialist trades “so far as practicable to those reasonably necessary . . . to maintain a fair and orderly market.” Securities Exchange Act of 1934, § 11(b) 15 U.S.C. § 78(b)(1988).

68. This affirmative obligation is imposed on specialists in exchange for the monopoly position afforded to specialists. See, e.g., Nowak, supra note 3, at 501-02 (“The specialist’s affirmative trading obligations are incurred in exchange for the privilege of being a specialist.... Specialists have an explicitly granted monopoly on making the market in a given security.”).

69. N.Y.S.E. Rule 104 provided: “In connection with the maintenance of a fair and orderly market, it is commonly desirable that a member acting as specialist engage to a reasonable degree under existing circumstances in dealings for his own account when lack of price continuity, lack of depth, or disparity between supply and demand exists or is reasonably to be anticipated.” N.Y.S.E. Rule 104.10(1), 2 N.Y.S.E. Guide at ¶ 2104.10(1).

70. Pursuant to N.Y.S.E. Rule 104, the “maintenance of a fair and orderly market implies the maintenance of price continuity with reasonable depth, and the minimizing of the effects of temporary disparity between supply and demand.” N.Y.S.E. Rule 104.10(2), 2 N.Y.S.E. Guide at ¶ 2104.10(2).

71. According to Professor Oesterle, “The specialist is expected to serve a public role as well as serve the private function of making a profit.” Oesterle, Winslow & Anderson, supra note 21, at 235.

72. Cochrane, McNamara, Shapiro & Simon, supra note 20, at 62.

73. NYSE surveillance gathers and analyzes trading data relating to “price continuity, market depth, and specialist trading activity including the extent of participation and degree to which such dealings are stabilizing.” See generally id. at 65-67.

74. Trading irregularities would include the violations described above such as front-running, inter-positioning and freezing.

75. Cochrane, McNamara, Shapiro & Simon, supra note 20, at 64.
review reveals a potential problem, the matter is referred to an investigator who then conducts a more detailed review. This review can culminate in disciplinary action by the NYSE.

The type of disciplinary action pursued depends on the severity of the violation. A minor violation is likely to result in a cautionary letter or a nominal fine. A significant violation is forwarded to the Exchange's Enforcement Division for a proceeding conducted by the Exchange's Hearing Panel. The Panel has the power to impose a wide range of sanctions, including ordering reallocation of stocks, imposing fines and barring Exchange membership or affiliation.

C. Specialist Misconduct

1. The Specialist Scandals of the Early 2000’s

Although the specialist system is not new, specialist behavior has come under increasing scrutiny and criticism. In March 2001, the Wall Street Journal declared that specialists were “increasingly exploiting their unique inside view of the markets to do highly profitable trading with their own money.” In fact, NYSE figures showed that the volume of trading in which specialists traded for their own account jumped from 18% in 1996 to 27% in 2000 and that specialists’ profits soared in conjunction with this change in trading patterns. As a precursor to the scandal that eventually became public in 2003, the Wall Street Journal reported in 2001 that specialists were engaging in penny-jumping and inter-positioning. Moreover, the article detailed increased sanctions imposed by the NYSE in response to specialist misconduct. In 2003, the SEC sent a team to New York to investigate the behavior of seven specialist firms. In a series of articles published that

76. Id. at 67.
77. Id.
78. Id.
79. Id.
80. Id.
81. Id.
82. Greg Ip, Floor Show: If Big Board Specialists are an Anachronism, They’re a Profitable One, WALL. ST. J., Mar. 12, 2001, at A1.
83. Id.
84. Id.
85. The Wall Street Journal reported 13 disciplinary actions in the 10 years between 1988 and 1998, and 14 actions from 2000 to 2001. Id. See supra notes 96-115 and 176-84 (discussing the inadequacy of NYSE’s response). See also Markham & Harty, supra note 29, at 901 (discussing flipping and 'trading for eighths' violations).
86. Apparently, the SEC investigation was initiated because the SEC was frustrated by the lack of action by the NYSE. CalPERS Complaint, supra note 17, para. 6.
spring, the details of the allegations became known. The Wall Street Journal reported that specialist firms had been violating NYSE rules and trading for their own benefit over an extended period of time. Specifically, the Wall Street Journal reported that the specialists were engaging in inter-positioning, front-running, and freezing of the specialist books.

Inter-positioning occurs when a specialist, instead of matching orders from buyers and sellers, interferes in the transaction for its own profit. To illustrate, assume that Buyer sends a purchase order to purchase 10,000 shares of Acme at $20.06 per share. Assume further that Seller sends an order to sell 10,000 shares of Acme at $20.00. If the specialist takes Buyer’s order, she can, using her own account, sell Buyer’s 10,000 shares at $20.05. Subsequently, she can buy 10,000 shares from Seller at $20.01. While ostensibly providing each customer with a $0.01 improvement in their bid price, the specialist is in reality getting in the way of the orders and profiting at investors’ expense. Inter-positioning violates the negative obligation imposed on specialists by NYSE rules because the specialist trades for her own account to profit from the trade rather than to maintain market stability.

Moreover, specialists were accused of front-running, which refers to the practice whereby specialists trade for their own account as principals before completing orders placed by public investors. By front-running, specialists take advantage of the confidential knowledge they possess in order to make a profit. Thus, when the specialist engages in front-running, he violates his negative obligation. Last, allegations were made that specialists engaged in


89. See CalPERS Complaint, supra note 17, at para. 7.

90. Id. “This is often referred to as “penny-jumping”. Christie & Thompson, supra note 25, at 1580.

91. See CalPERS Complaint, supra note 17, at 26, where a similar example is outlined. The same example is provided by Christie & Thompson, supra note 25, at 1580.

92. See supra notes 66-67 and accompanying text where the specialist’s negative obligation is more fully discussed.

93. CalPERS Complaint, supra note 17, at para. 3. See also Christie & Thompson, supra note 25, at 1581.

94. Front-running is also termed “trading ahead.” See Christie & Thompson, supra note 25, at 1581 (discussing how the specialist abuses his discretion for profit when trading ahead). It is estimated that front-running by one specialist firm, Fleet Specialist, Inc., cost customers potentially $26 million. Colesanti, supra note 21, at 12.
freezing the book. Freezing occurs when the specialist freezes her book on a particular stock and makes trades for her own account prior to executing the public investor's orders. This practice facilitates front-running and interpositioning.\textsuperscript{95}

Given the regulatory scheme, including SEC and NYSE rules, the question remains: why did this regulatory scheme neither prevent the described misconduct nor cause it to be discovered it earlier? The next section will consider why neither NYSE regulation, SEC oversight, nor the threat of a private cause of action by injured investors was able to prevent or adequately address specialist misbehavior.

2. \textit{Inadequacy of NYSE Regulation}

Although the rules outlined above appear to provide an adequate enforcement mechanism, the NYSE failed to adequately enforce these rules.\textsuperscript{96} The SEC, in its report of the trading irregularities of 2003\textsuperscript{97}, concluded that the NYSE had "no meaningful compliance programs for reviewing their specialists' compliance" with NYSE rules."\textsuperscript{98} There are several reasons for this. First, the rules themselves are often vague and, therefore, difficult to enforce.\textsuperscript{99} NYSE rules failed to specify maximum or minimum liquidity, depth or continuity requirements.\textsuperscript{100} Instead, the NYSE developed in-house tests for assessing specialist performance.\textsuperscript{101} These in-house tests monitored both depth and continuity in stocks traded by individual specialists as measures of

\textsuperscript{95} See CalPERS Complaint, \textit{supra} note 17.

\textsuperscript{96} Oesterle, Winslow & Anderson, \textit{supra} note 21, at 257 ("The effectiveness of these NYSE efforts at regulation, however, is questionable at best."). \textit{See also} Oesterle, \textit{supra} note 20, at 82 ("The regulations 'work' only because they are inherently unenforceable except in the most blatant of cases."). \textit{But see} David P. Doherty, Arthur S. Okun, Steven F. Korostoff, & James A. Nofi, \textit{The Enforcement Role of the New York Stock Exchange}, 85 Nw. U.L. Rev. 637, 639 (1991), where representatives from the NYSE assert that the Exchange has increased attention and resources devoted to enforcement efforts in recent years resulting in more effective enforcement ("Enforcement's increased resources have resulted in a significant increase in the number of enforcement actions instituted and in a number of noteworthy cases. Enforcement's stepped-up efforts have also resulted in more contested litigation.").


\textsuperscript{98} \textit{Id}.

\textsuperscript{99} The NYSE has been described as being "on the horns of a dilemma" because it is forced to enforce "general, hoary language" against "some of its more powerful members." Oesterle, Winslow & Anderson, \textit{supra} note 21, at 269.

\textsuperscript{100} \textit{Id}. The failure to specify such maximums or minimums is important because it is difficult to enforce rules which are open-ended and vague. \textit{Id}.

\textsuperscript{101} \textit{Id}. at 269 n.236 (citing Hans R. Stoll, \textit{The Stock Exchange Specialist System: An Economic Analysis}, MONOGRAPH SERIES IN FINANCE AND ECONOMICS 33 (Graduate School of Business Administration, New York University, Monograph No. 2, 1985) ("The NYSE has established a variety of tests of specialist performance that measure the degree of price continuity, the extent to which the specialist trades against the price trend, and the size of the bid-ask spreads.").
specialist performance; however, these tests arguably failed to provide any objective criteria. 102 Furthermore, these measures were arguably affected less by specialist performance than by the fundamental characteristics of the stocks traded by these specialists. For example, the NYSE used the much-criticized "tick test," which is at best an incomplete measure of specialist behavior. 103

Second, specialists were rarely punished for failure to "pass" these tests, and punishments were rarely sufficiently severe. Under Rule 103A, the NYSE's Market Performance Committee monitors specialist performance. One method of disciplining poor-performing specialists is through the use of the stock allocation system. 105 Reallocation proceedings were, however, infrequent. 106 The SEC's confidential 2003 report questioned the weakness of the NYSE's surveillance and investigative procedures, including its practice of ignoring repeat violations by specialist firms 107, and concluded that the NYSE was "either ill-equipped or too worried about increasing its workload to care"

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102. Professors Macey and Kanda argue that the NYSE’s tests provide no objective criteria against which to evaluate specialist conduct. Macey & Kanda, supra note 21, at 1027 ("Even this elaborate formulation is quite vague."). See also Oesterle, supra note 20, at 81-82 ("[T]he regulations make little sense. Some are unrelated to the quality of a specialists’ performance and others are close to impossible to obey."). Some argue that the depth and continuity guidelines are actually counter-productive. See, e.g., Oesterle, supra note 20, at 82 ("[T]he depth and continuity guidelines ... may actually harm the market.").

103. The tick test measures how often a specialist sells on up ticks and how often he buys on down ticks. Oesterle, Winslow & Anderson, supra note 21, at 271. This test is, in effect, a measure of how often the specialist "leans against the wind." The authors offer three criticisms of the tick test. First, they assert that leaning against the wind is not always desirable policy. If stock fundamentals dictate price changes, the specialist should not be expected to act as a matter of policy in a way that would ultimately lead to bankruptcy. Leaning against the wind is desirable only when specialists know "with some certainty that price trends are not reflections of stock fundamentals, but rather are the result of order timing." Id. at 273. They further assert that "[t]he cumulative effect of the front running restrictions plus the tick test (the “negative obligation”) place the specialist in a seemingly impossible position.... [A] specialist is supposed to trade for his own account in some gray area of information – information good enough to beat the market (otherwise he is bankrupt) and not so good that it is labeled “front-running.” It stretches credibility to assume that specialists can and do consistently operate in this narrow range of prescribed conduct." Id. at 274. Second, there are no objective criteria to which to apply the tick test. Third, specialists have managed to avoid the test’s enforcement by manipulating their trading practices in such a way as to conceal destabilizing behavior.

104. Oesterle, Winslow & Anderson, supra note 21, at 267. The NYSE vigorously disputes this assertion. See Cochrane, McNamara, Shapiro & Simon, supra note 20, at 65-68.

105. Stock allocation penalties can result in the removal of the offending specialist’s ability to trade in a particular stock. Oesterle, Winslow & Anderson, supra note 21, at 280. Professor Oesterle refers to this as the NYSE’s “primary, if not exclusive, mechanism for disciplining its specialists.” Id. The NYSE challenges this statement. See Cochrane, McNamara, Shapiro & Simon, supra note 20, at 67 ("The Hearing Panel is authorized to impose a wide range of sanctions including ordering the reallocation of stocks, the imposition of fines, and the imposition of temporary or permanent bars to Exchange membership or affiliation with an Exchange member").

106. Oesterle, Winslow & Anderson, supra note 21, at 280.

107. The Wall Street Journal reports that “One NYSE surveillance system issued 640 alerts in 2001 and 2002, but the SEC said a more comprehensive system would likely have triggered more than 8,000 alerts in that time.” Solomon & Craig, supra note 97. “Of the 640 alerts that were found, NYSE analysts concluded that 494 were violations. But in many cases, the SEC said, ‘analysts inappropriately concluded that a violation did not occur.’” Id.
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about rules violations. The SEC cited situations where the NYSE closed cases without adequately investigating, even when recidivist behavior was involved. When violations were discovered, "the exchange [did] little more than admonish the specialists in a letter or slap them on the wrist with a light fine." Multiple violations by the same firm were often aggregated into a single fine. The firms were typically not even required to return the profits they had made from engaging in trading irregularities. The SEC expressed concern "that the NYSE’s disciplinary program is viewed by specialists and specialist firms as a minor cost of doing business, and that it does not adequately discipline or deter violative conduct." 

Last, there is an inherent conflict of interest that makes enforcement and regulation difficult. It has, in fact, been argued that "[the] reason for the recurring problems with specialists is that their regulation is basically nonsensical. Those who regulate specialist behavior expect specialists to act against their self-interest and perform an increasingly impossible task, without clearly defined standards."

3. Inadequacy of SEC Oversight

The SEC is responsible for oversight of the NYSE’s regulation of specialists. In partial fulfillment of this obligation, the SEC conducts periodic on-site inspections and reviews the NYSE’s surveillance and enforcement. However, "from the beginning of federal securities regulation the SEC [had] allowed the exchanges to enjoy considerable autonomy . . . . Play[ing] an essentially passive role, [the SEC] ‘allow[ed] the securities industry to govern itself in its own wisdom.’ " The Exchange Act was

108. See id.
109. For example, the NYSE’s investigative division consolidated 16 referrals of trading-quote violations by Van der Moolen over a 20 month period and issued an admonition letter. The Wall Street Journal reports that "[t]he investigative division didn’t launch probes into the individual specialists that were responsible for the violation and didn’t investigate the 2,300 ‘alerts’ – indicating possible trading violations – that were generated but not reviewed. Solomon & Craig, supra note 97. Furthermore, the SEC said that when the NYSE uncovered additional alleged violations, the NYSE dismissed them as ‘cumulative’ and then stopped reviewing quote violations generated for Van der Moolen for a ‘grace period’ of three months. Id.
110. Solomon & Craig, supra note 97.
111. For example, Spear Leeds was cited for multiple violations in 2000 and 2001. Id. The Exchange investigative unit found several violations and sent a letter of admonishment and closed the case. Id.
112. Id.
113. Id.
114. See infra notes 228-36 and the accompanying text.
116. Cochrane, McNamara, Shapiro & Simon, supra note 20, at 63.
117. Id.
118. NORMAN S. POSER, BROKER-DEALER LAW & REGULATION, §13.01, n.33 (2d ed. 2001) (quoting Richard W. Jennings, Self-Regulation in the Securities Industry: The Role of the Securities and
amended in 1975 in part to broaden the oversight authority of the SEC.\textsuperscript{120} As the legislative history of the 1975 amendments makes clear, one justification for these amendments was Congress’s belief that the SEC was abrogating its enforcement responsibility.\textsuperscript{121} Calling the SEC a “tame watchdog,”\textsuperscript{122} Congress concluded that it had provided the SEC with sufficient power to protect investors, “but [that] no amount of legislative tinkering can build within the SEC the commitment and vitality to make full use of the tools Congress provides.”\textsuperscript{123} In fact, a congressional committee wrote that “the major regulatory problems in the securities industry have not by and large been the result of the SEC’s lack of authority but rather its apparent lack of the will to use the powers it already has.”\textsuperscript{124}

\textit{Exchange Commission, 29 LAW & CONTEMP. PROBS. 663, 665 (1964)).


120. The aim of the 1975 amendments was to “ensure that there is no gap between self-regulatory performance and regulatory need.” S. Rep. No. 94-75, at 2 (1975), reprinted in 1975 U.S.C.C.A.N. 179, 181, cited in Toni Anne Puz, Private Actions for Violations of Securities Exchange Rules: Liability for Nonenforcement and Noncompliance, 88 COLUM. L. REV. 610, 612. This aim was further clarified by the following statement from the United Stated Senate:

Although self-regulation has not always performed up to expectations, on the whole it has worked well, and the Committee believes it should be preserved and strengthened. [The 1975 Amendments] are designed to accomplish this, not only by clarifying regulatory responsibilities at all levels, but also by assuring that... the [SEC’s] oversight powers are ample and its responsibility to correct self-regulatory lapses is unmistakable. The intent of the [1975 amendments] is not to diminish the role of self-regulation but to strengthen the total regulatory fabric.

\textit{Id.} at 23, 1975 U.S.C.C.A.N. at 201-02. See also Friedman, supra note 7, at 742 (“The 1975 amendments have essentially served to strengthen the government’s role in the securities industry.”).

121. \textbf{SECURITIES INDUSTRY STUDY: REPORT OF THE SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, H.R. REP. NO. 92-1519, at 113 (1972) [hereinafter House Industry Study] (“W[e] have also noted... a tendency of the [SEC] to assert an unjustified lack of authority concerning matters which we believe are covered by the Acts which the agency administers.”)}; Puz, supra note 120, at 629 (quoting S. Rep. No 94-75, at 33 (1975), reprinted in 1975 U.S.C.C.A.N. at 211) (“The committee believes the SEC can do a great deal more than it has in the past to foster the development of a more rational self-regulatory framework.”). Similarly, concerns about the wisdom of self-regulation of securities exchanges had been raised following reports of stock market abuses as early as 1963. SEC, \textit{REPORT OF THE SPECIAL STUDY OF SECURITIES MARKET, H.R. DOC. NO. 88-95, Pt. 4, at 502 (1963) (calling for stronger self-regulation); Karmel, supra note 18, at 15-16}.

122. Puz, supra note 120, at 621 (quoting Richard W. Jennings, \textit{Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission}, 29 L. & CONTEMP. PROBS. 663, 664-65 (1964)). In 1940, William O. Douglas opined that the role of the SEC was to “keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it never have to be used.” Silver v. NYSE, 373 U.S. 341, 352 (1963) (\textit{quoted in Friedman, supra note 7, at 740}).

123. Puz, supra note 120, at 621 (\textit{quoting SECURITIES INDUSTRY STUDY: REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, S. DOC. NO. 93-13, at 180 (1973) [hereinafter House Securities Industry Study]}).

124. \textit{Id. (quoting House Securities Industry Study, at 108). The specialist scandal is not the first time that the SEC has been accused of failing to adequately oversee the NYSE’s compliance with its statutory obligations. In the 1990’s, the SEC was forced to take action when the NYSE failed to enforce regulations against floor brokers. Friedman, supra note 7, at 748-49. See generally, Walter Werner, The SEC as a Market Regulator, 70 VA. L. REV. 755, 755 (reviewing the regulatory action of the SEC since its inception). Werner asserts that the review “shows the historical unwillingness of the SEC to exercise market regulatory powers.” Id. at 756.}
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Hence, it can be argued that the reason SEC oversight of the NYSE was ineffective at preventing specialist misconduct is that the SEC, even after the 1975 amendments, was simply not vigilant. Along those lines, it is interesting to note that the SEC was curiously slow in responding to the complaints about specialist misconduct brought against the seven specialist firms involved in the 2003 scandal.125

4. Inadequacy of the Threat of a Private Cause of Action

Securities laws are typically enforced either by an administrative agency, through criminal prosecution by the government, or by private civil actions initiated by injured investors.126 As discussed above, when specialists violate

125. See supra notes 110-26 and accompanying text.

126. See generally, Puz, supra note 120.
securities laws by engaging in trading irregularities, they are potentially subject to administrative enforcement, either by the SEC or the NYSE; however, as this Part has demonstrated,127 neither NYSE regulation nor SEC supervision was successful in adequately monitoring or preventing specialist misconduct. Moreover, criminal prosecution of traders and specialist firms has proven to be problematic. Unfortunately, as this section will show, the last method of enforcement—the threat of private civil liability to injured investors—is also inadequate to enforce specialist compliance with the securities laws.

In 2007, the Second Circuit Court of Appeals held that private investors may not sue the NYSE for failure to enforce SEC regulations against SROs.128 In that case, the California Public Employees' Retirement System (CalPERS) brought suit against the NYSE.129 CalPERS, the largest public employee retirement system in the United States, allegedly purchased and sold almost three billion shares of NYSE-listed stock during the Class Period.130 CalPERS initiated a class action suit on behalf of public investors who had purchased or sold shares listed on the NYSE during the Class Period; defendants included the NYSE and the individual specialist firms who were responsible for maintaining the market.131 The complaint asserted violations of Section 10(b)
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of the Exchange Act and Rule 10b-5, 132 Section 20(a) 133 of the Exchange Act, and Section 6(b) 134 of the Exchange Act. 135 In addition, the complaint alleged that all defendants breached their fiduciary duties and/or aided and abetted in the breach of such duties. 136 The complaint included allegations against the specialist firms of inter-positioning, trading ahead, freezing the book, manipulating the tick, 137 and falsifying trade reports. 138 More importantly, for the purposes of this paper, the plaintiffs alleged that the NYSE “engage[d] in a scheme to defraud investors who traded on the NYSE,” by “working with the specialists to engage in improper trading activity and to evade the regulatory scrutiny that would have prevented such conduct.” 139 The plaintiffs alleged that the NYSE knew of the specialists’ violations, deliberately failed to enforce the rules, and tipped off the specialists prior to investigations so that they could more easily conceal their illegal activities; in fact, the plaintiffs alleged that the NYSE Division of Market Surveillance coached the specialists as to how to alter data in order to hide evidence of their wrongdoing. 140 Last, the complaint alleges that the NYSE made false and misleading statements concerning the oversight and operation of the exchange. 141 The NYSE’s actions were

132. Rule 10b-5 provides in pertinent part:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5.
133. Section 20(a) provides as follows:
Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable... to the same extent as such controlled person... unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
134. Section 6(b) of the Exchange Act provides, in pertinent part, that “[a]n exchange shall not be registered as a national securities exchange unless the Commission determines that—(6) its members and persons associated with its members shall be appropriately disciplined for violations of... the rules of the exchange.” 15 U.S.C. § 78f(b).
135. See id.
136. See id.
137. Manipulating the tick involves “asking or signaling a member in the crowd to purchase part of a public offer so that a specialist could then, under NYSE rules, engage in a proprietary trading.” In re NYSE Specialists District Court, 405 F. Supp. 2d at 292.
138. See id.
139. Id. at 298.
140. Id.
141. A January 2001 press release issued by the NYSE stated, “Our agency-auction model joins the greatest liquidity and transparency with the most efficient method of price discovery, leading to the lowest execution costs and best prices for customers.” In re NYSE Specialists Securities Litigation, 503. F.3d 89, 94 (2d Cir. 2007) [hereinafter In re NYSE Specialists Circuit Court]. Moreover, Exchange
motivated, according to the complaint, by the “direct financial interest of the NYSE and its top executives.”

While the claims against the specialists were allowed to go forward, the district court dismissed most claims against the NYSE based on the doctrine of absolute immunity. Absolute immunity is afforded to “public officials entrusted with sensitive tasks” to give them “a protected area of discretion within which to carry out their responsibilities.” Although the NYSE is not a governmental entity, as a national exchange under Section 6 of the Exchange Act, the NYSE is an SRO charged with the obligation of regulating its members and enforcing member compliance with the Exchange Act, SEC rules and regulations, and all NYSE rules. Therefore, the court held that the NYSE is afforded absolute immunity for all actions it commits pursuant to its quasi-governmental role.

executives, including Chairman Grasso, issued public statements during the Class Period that assured the public of the NYSE’s integrity and commitment to a fair and orderly market. Id.

142. Id.
143. Id. at 95.
144. The court dismissed the claims based upon Section 6(b), the fraudulent scheme claims based upon Section 10(b), and those based upon the fiduciary duty claims. In re NYSE Specialists District Court, 405 F. Supp. 2d at 304. The court let stand the claims based upon the fraudulent statement violations of Section 10(b). Id. The court found that the fraudulent promotional statements “would not appear to be protected by NYSE’s absolute immunity for quasi-governmental functions.” Id.
145. Barr v. Abrams, 810 F.2d 358, 361 (2d Cir. 1987) (quoted in In re NYSE Securities Circuit Court, 503 F.3d at 95).
146. See supra notes 49-51 and the accompanying text. The NYSE has been treated as a private sector business organization for some purposes and as a quasi-governmental entity for others. See generally Karmel, supra note 18. The quasi-governmental function of the SRO was recognized by the Second Circuit in In re NYSE Specialists Circuit Court, 503 F.3d at 91 (“We have previously noted that the SEC has delegated to the NYSE ‘substantial authority… to regulate [its] own conduct and that of [its] members.’”) (quoting MFS Secs. Corp. v. N.Y. Stock Exch., 277 F.3d 613, 615 (2d. Cir. 2002)). See generally Craig J. Springer, Weissman v. NASD: Piercing the Veil of Absolute Immunity of an SRO Under the Securities Act of 1934, 33 DEL. J. CORP. L. 451 (2008) (providing a history of the application of immunity to SROs). Courts have also recognized that there is a tension between granting immunity to protect SROs on the one hand, and denying a remedy to a plaintiff on the other hand. Id. at 455.
147. In so holding, the court relied on the case of D’Allesio v. New York Stock Exch., Inc., 258 F.3d 106 (2d Cir. 2001), in which the Second Circuit held that the NYSE, as an SRO, “stands in the shoes of the SEC in interpreting the securities laws for its members and in monitoring compliance with those laws . . . [and therefore,] [t]he NYSE should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC’s broad oversight authority.” Id. at 105. In Butz v. Economon, 438 U.S. 478, 510-13 (1978), the Supreme Court articulated the test for determining when a private entity can be afforded absolute immunity. See generally Friedman, supra note 7, at 763-67 (discussing the application of the Butz rule to securities industry’ SROs). Under the three-pronged Butz test, an SRO achieves immunity when 1) the functions of the SRO mirror the characteristics of the judicial system, 2) the actions of the SRO are likely to lead to recriminatory lawsuits by affected participants, and 3) there are sufficient safeguards within the statute to control unconstitutional conduct.

Courts that have considered this issue have granted absolute immunity to SROs using a number of different justifications. Some have afforded immunity when the SRO performs the same oversight functions as the SEC; some have afforded immunity because the SROs are described as acting pursuant to “delegated” governmental authority; and some have afforded immunity because the SRO’s functions are deemed to be “quasi-governmental.” Karmel, supra note 18, at 34. The court’s opinion in the CalPERS case seems to encompass all of these reasons.

There have emerged two inconsistent lines of cases in which courts have afforded SROs absolute
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On appeal, the Second Circuit clarified that, in determining whether an SRO's actions are entitled to absolute immunity, the proper focus is on "the nature of the function performed, not the identity of the actor who performed it."\(^{148}\) The test is whether the SRO activity "relates to the proper functioning of the regulatory system."\(^{149}\) Hence, the court found that absolute immunity attached to the NYSE because its "alleged misconduct [fell] within the scope of the quasi-governemental powers delegated to [it]."\(^{150}\) The plaintiffs argued that, because the NYSE had failed to act to enforce its rules and regulations, it had, in fact, "abandoned" its duty to regulate, and therefore was not entitled to immunity.\(^{151}\) The court, however, found that absolute immunity attached despite the fact that the allegations did not involve affirmative action on the part of the NYSE.\(^{152}\) The court held that the "power to exercise regulatory authority necessarily includes the power to take no affirmative action. . . . While absolute immunity by its very nature necessarily gives rise to a risk that reprehensible conduct — whether active or passive — will go unpunished, that risk is accepted so that SROs will not be excessively timid in their regulatory decisions, including their decisions not to act."\(^{153}\)

immunity in civil actions while at the same time have refused to allow persons under investigation by SROs to claim their privilege against self-incrimination. In the first line of cases, courts have treated SROs as governmental entities; in the second line of cases, courts have found SROs to be private bodies. Steven J. Cleveland, The NYSE as State Actor?: Rational Actors, Behavioral Insights and Joint Investigations, 55 AM. U.L. REV. 1 (2005) (discussing the evolution of the state action doctrine leading courts to construe that the actions of the NYSE, the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD) should not be attributed to the government for purposes of Fourth and Fifth Amendment issues). See also Badway & Busch, supra note 6, at 1357-58 ("Thus, SROs are immune from suits brought by private parties because courts have construed SROs to be quasi-governmental for their actions relating to the disciplinary function. On the other hand, SROs are private parties when members or associated persons seek to enforce their constitutional rights in disciplinary actions."); Friedman, supra note 7, at 731 ("[I]n essence the judicial branch has backed both sides of the public/private debate, by sweeping aside the concept of a completely non-governmental private entity by labeling them quasi-governmental entities, while in the next breath strengthening the agency argument by characterizing the government as something akin to either a regulatory partner or control person of the SROs and upholding the constitutionality of the SRO's impregnation with government immunity."); John F.X. Pelosi & Ben A. Indek, A Question of Fairness, 225 N.Y.L.J. 3 (2001).

Professor Karmel finds it impossible to reconcile these cases theoretically, but believes the distinctions can be justified on public policy grounds: arguably, in both cases courts defer to the SRO to better enable the SRO to perform its regulatory function. Karmel, supra note 18, at 31 ("The courts have given deference to SRO conduct and arguments so as not to interfere with their regulatory responsibilities in apparent disregard of the serious discrepancies in judicial precedents. Perhaps the public/private distinctions involving SROs are neither necessary nor helpful, but rather, inquiry should be made of whether under the circumstances, there are adequate protections for affected persons"). See also Mark Hamblett, Bid to Crack Nasdaq's Immunity Shield Fails, 231 N.Y.L.J 1 (2005).

148. In re NYSE Specialists Circuit Court, 503 F.3d at 96 (quoting Forrester v. White, 484 U.S. 219, 229 (1988)).
149. Id. at 96.
150. Id.
151. Id. at 97.
152. Id.
153. The court asserted that the "purposes of absolute immunity" mandate the application of immunity to passive actions. Id. The court declared that "the purpose of immunity is to give
Moreover, the court rejected the plaintiffs’ argument that absolute immunity should attach only when an SRO was acting in its capacity as an SRO.\textsuperscript{154} The plaintiffs argued that, because the NYSE’s alleged conduct was inconsistent with the SEC’s regulatory goals, the NYSE was not acting in its capacity as an SRO when it committed the alleged misconduct. Therefore, the plaintiffs argued that the NYSE was not entitled to immunity.\textsuperscript{155} While admitting that the argument had “superficial appeal,” the court rejected the argument,\textsuperscript{156} stating that the determinative question was not whether the alleged action was consistent with the regulations to be enforced, but whether the SRO’s “specific acts and forbearances were incident to the exercise of regulatory power.”\textsuperscript{157} While the court had no difficulty in concluding that the NYSE’s conduct with respect to working with the specialists to engage in trading irregularities fell within the scope of the immunity,\textsuperscript{158} the court struggled with the question of whether the NYSE’s alleged conduct with respect to aiding the specialists in concealing wrongdoing and alerting them as to pending investigations fell within the scope of its quasi-governmental functions.\textsuperscript{159} The court answered that question in the affirmative, reasoning that while “none of these actions appear[ed] to fall within the ambit of the powers delegated to the Exchange [,] [t]he gravamen of the Lead Plaintiffs’s claims, however, center[ed] on the functions performed by the NYSE in its supervisory and regulatory role. . . .”\textsuperscript{160}

Finally, although the court agreed that the NYSE’s alleged behavior was egregious, the court rejected the plaintiffs’ request that the court carve out a “fraud exception” to the rule of absolute immunity.\textsuperscript{161} The court feared that applying a fraud exception in that case would “open a Pandora’s box that

governmental officials – or those acting with the express delegation of the government, as with SROs – breathing room to exercise their powers without fear that their discretionary decisions may engender endless litigation. It makes little logical sense to cabin that needed breathing room by according immunity only to the decision to act.” \textit{id.} (citations omitted).

\textsuperscript{154} \textit{id.} at 97-98.
\textsuperscript{155} \textit{id.}
\textsuperscript{156} \textit{id.}
\textsuperscript{157} \textit{id.} at 98. \textit{See also id.} (“The central question our SRO immunity cases ask is not whether the SRO is acting (or not acting) ‘consistent with’ the laws it is supposed to apply but rather whether the plaintiff’s allegations concern the exercise of powers within the bounds of the government functions delegated to it.”).
\textsuperscript{158} \textit{id.} at 99-100.
\textsuperscript{159} \textit{id.} at 100.
\textsuperscript{160} \textit{id.} In other words, the court held that the alleged acts were “central to effectuating the NYSE’s regulatory decision-making” and that such acts were an essential part of the exercise of the regulatory function. The court declared that the NYSE’s actions were related to its “core regulatory functions” without explaining how alerting the specialists of investigations and instructing the specialist firms in how to submit doctored and altered regulatory reports could be considered “core” regulatory functions.
\textsuperscript{161} \textit{id.} at 101 (“[W]e . . . conclude that a fraud exception should not apply here – even a one-time ‘most unusual circumstances’ exception.”).
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would undermine the entire purpose behind the immunity doctrine.162

The CalPERS decision shields the NYSE from civil liability under the doctrine of absolute immunity for any actions which may be attributed to its quasi-governmental function, however incidental, or even contradictory, these actions may seem.163 Thus, the (non-existent) threat of a private cause of action by injured investors does not and cannot provide an effective method of deterring the NYSE from failing to adequately monitor and punish specialist misconduct.164

D. The Free Ride

As we have demonstrated in this Part, there are inadequate deterrents in place to prevent specialist misconduct. We have seen that the NYSE has significant economic incentives to engage in misconduct. For example, interpositioning by as little as a penny ("penny-jumping") can result in significant economic windfalls. We have seen, unfortunately, that the NYSE failed to enforce its rules to prevent such misconduct, and the SEC’s oversight was not sufficiently vigilant. Moreover, we have seen that the threat of private enforcement is ineffective to force adequate regulatory oversight and has been nearly eliminated by the grant of absolute immunity in the CalPERS case. Thus, specialists have been afforded a ‘free ride,’ where they can reap huge financial benefits constrained only by ineffective regulation and without the fear of civil suit.

As the public realized the extent of the problem and the inability of all responsible bodies to effectively deal with it, there were calls for reform.165

162. Id. The court emphasized that SEC oversight is an effective alternative that will achieve the same public policy objectives as allowing civil action. The court pointed out that the SEC has the power to suspend or revoke the SRO’s registration. As evidence of the effectiveness of SEC oversight, the court pointed to the SEC investigation and settlement. By contrast, see supra notes 118-24 and the accompanying text where the ineffectiveness of SEC oversight is discussed.

163. The Supreme Court denied a writ of certiorari in the CalPERS case, which means that this decision is binding precedent in the Second Circuit, in which the NYSE is located, unless and until it is overturned by a judicial decision or by Congress.

164. It is possible, however, that the NYSE’s conversion to a for-profit institution limits its absolute immunity. See supra note 164; see, e.g., Weissman v. NASD, Inc., 500 F.3d 1293, 1297 (11th Cir. 2007), where the court denied absolute immunity to NASDAQ. In Weissman, the court held that in order to determine whether or not the conduct was entitled to immunity, it needed to examine the “objective nature and function of the activity for which the SRO seeks to claim immunity.” Weissman v. NASD, 500 F.3d at 1297. Moreover, the court created a fraud exception by “making a distinction between NASDAQ’s private actions and its regulatory functions.” Springer, supra note 146, at 453. See supra notes 292, 304-07 and accompanying text where the effect of the NYSE’s conversion to for-profit status on SRO feasibility is discussed.

165. See Badway & Busch, supra note 6, at 1363-64 (discussing media attention to the trading abuses of 2003). The size of then-Chairman and CEO of the NYSE Richard Grasso’s compensation package was severely criticized. Karmel, supra note 3, at 386-87. He was forced to resign on September 17, 2003. Id. Arguably, the firestorm around his compensation package detracted from criticism of specialist misconduct. Id. Moreover, other scandals (e.g., market timing, late-trading and hedge fund management scandals) only added fuel to the fire, especially because these scandals were
Most importantly, for the purposes of this paper, questions began to be raised about whether or not the NYSE should continue as a SRO.\textsuperscript{166}

II. NYSE REFORM

A. Governance Issues

By 2003, the NYSE’s reputation was significantly tarnished by revelations of then-NYSE Chair Richard Grasso’s compensation between 1995 and 2001\textsuperscript{167} and of the specialists’ misconduct. Alarmingly, the NYSE’s Board of Directors indicated that they had no knowledge of Grasso’s exorbitant compensation and, as we have seen, their reaction to the specialist misbehavior was superficial.\textsuperscript{168} As a result of these revelations, there were calls for the SEC to directly regulate the NYSE and end the NYSE’s ability to self-regulate.\textsuperscript{169}

The NYSE’s reaction was immediate. First, Richard Grasso was forced to resign as Chair in 2003 and was replaced by former Citigroup Chair John Reed.\textsuperscript{170} As the NYSE’s new Chair, Reed moved quickly to reform the NYSE and rebuild its reputation. In an effort to avoid government regulation, Reed took steps to reorganize the NYSE’s self-regulatory process.\textsuperscript{171} Because the NYSE’s failure to regulate adequately was in part influenced by the conflict between NYSE market operations and regulation, NYSE reform separated the NYSE’s regulatory arm from its market operations.\textsuperscript{172}

The NYSE was reorganized as one firm with two separate and independent entities: NYSE Regulation, Inc. and the New York Stock Exchange, LLC.\textsuperscript{173} NYSE Regulation was formed as a not-for-profit subsidiary responsible for regulating the New York Stock Exchange, LLC and its subsidiaries.\textsuperscript{174} The Chief Executive Officer (CEO) of NYSE Regulation was given primary responsibility for the regulatory oversight of the exchange and its subsidiaries


\textsuperscript{167.} Reportedly, Richard Grasso’s compensation increased from $2 million in 1995 to $30 million in 2001. Also, his estimated retirement benefits were valued at approximately $140 million. See Seligman, supra note 49.

\textsuperscript{168.} Id.

\textsuperscript{169.} Id.

\textsuperscript{170.} Id.

\textsuperscript{171.} Id.

\textsuperscript{172.} Id.

\textsuperscript{173.} See NYSE website for the regulatory structure, available at http://www.nyse.com/about/nysecviewpoint/1097788616359.

\textsuperscript{174.} Id.
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and reported solely to the Board of Directors for NYSE Regulation.\(^{175}\)

As part of the reorganization of the NYSE, the Board of Directors for NYSE Regulation was streamlined to try to ensure that there were no conflicts of interest between NYSE Regulation’s board members and the exchange operations.\(^{176}\) Specifically, NYSE Regulation’s board was comprised of six directors having no affiliation with the NYSE Board or any company listed on the exchange or any member firm of the NYSE.\(^{177}\) Three of the NYSE Regulation directors also sit on the Board of Directors for the New York Stock Exchange, LLC.\(^{178}\) One of the NYSE Regulation directors was designated as a “management director” with that seat automatically filled by the CEO of NYSE Regulation.\(^{179}\)

The objective of the new organizational structure was to ensure that the conflicts of interest inherent in the previous self-regulatory structure were eliminated.\(^{180}\) By eliminating the conflicts of interest that had led to the scandals surrounding the NYSE in 2003, the NYSE hoped to improve its reputation, alleviate investor concerns, and preserve its self-regulatory ability.\(^{181}\)

B. Retention of the Specialist System

Most importantly, for the purposes of this paper, the specialist system was retained despite the revelations of trading abuses by the specialists and the failure of the NYSE to properly regulate specialist conduct. The NYSE, however, faced pressure, especially from the SEC, to move toward more electronic trading processes.\(^{182}\) In fact, the SEC changed its rules in 2004 to allow the NYSE’s competitors to bypass the NYSE completely (even if the prices quoted by the NYSE were better) unless the NYSE allowed more automatic execution of trades by electronic means.\(^{183}\) The NYSE’s move toward automation was intended to reduce investors’ trading costs, prevent large institutional investors from trading via electronic competitors, and reduce the ability of opportunistic specialists and floor brokers from profiting at the expense of investors.\(^{184}\) After NYSE reform, the specialists existed alongside

\(^{175}\) Id.

\(^{176}\) Recall that one of the allegations in the CalPERS case was that the NYSE failed to adequately enforce its regulations because of its profit motivation. See supra note 141 and accompanying text.

\(^{177}\) Id.

\(^{178}\) Id.

\(^{179}\) Id.

\(^{180}\) Id.

\(^{181}\) Id.

\(^{182}\) See supra note 128.

\(^{183}\) Id.

\(^{184}\) See Paula Dwyer, Amy Borus & Gary Weiss, Big Bang at the Big Board, BUSINESSWEEK, Feb. 16, 2004, at 66. Large institutional investors such as mutual funds and pension funds are expected
increased trading by electronic means, creating a hybrid market operation.

C. The Current NYSE Structure

Since the scandals of 2003 and subsequent reforms, the NYSE has undergone two mergers. The first merger occurred between the NYSE and Archipelago Holdings in 2006 and resulted in the formation of NYSE Group, Inc.185 NYSE Group became a for-profit corporation with publicly-traded stock.186 The motivation for the NYSE-Archipelago merger was to expand the types of securities traded by the exchange and to acquire the electronic trading operations of Archipelago.187

Shortly after the NYSE-Archipelago merger, NASDAQ attempted to acquire the London Stock Exchange.188 NYSE Group’s management recognized that this merger would result in a formidable global competitor and, as a result, the NYSE Group offered $10.2 billion to buy Euronext, a combination of European exchanges that primarily trade electronically.189 The resulting firm became NYSE Euronext and the combination formed the first global stock market.190 The merger between NYSE and Euronext became official in April 2007.191

In 2007, NYSE Regulation merged with NASD Regulation to create the Financial Industry Regulatory Authority, Inc. (FINRA), a single self-regulator.192 The creation of NYSE Euronext gives the NYSE additional...
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capacity for electronic trading even though the specialist system is still retained.193

D. Inadequacy of Reform

The NYSE response to the scandals of the early 2000’s addressed the compensation issue that was in the forefront of the public attention, but it failed to address the specialist misconduct. By failing to adequately respond to the specialist scandal, and by leaving the specialist system intact, the NYSE has called the entire SRO model into question, and has allowed for continued debate about retention of the specialist system.

III. THE ROLE OF THE SPECIALIST

The debate surrounding the use of specialists and the advisability of converting to automated markets, such as electronic communication networks (ECNs)194 is not new.195 By the same token, arguments have been advanced in favor of a national markets system linked by computer networks. Congress and the SEC advocated conversion to a national market system in 1975.196 Although progress has been made with respect to a national market system, and it is possible for an investor to place an order without specifying the market for the transaction to take place, to date, such conversion has not yet taken place.197

A number of public policy objectives are furthered by an appropriate market structure. In 2000, the New York Stock Exchange conducted a study of its market structure.198

It stated that “public interest requires a market structure that is fair and stable, that attracts maximum liquidity (for truest price discovery), and that operates in an efficient and cost-effective manner. In sum, the NYSE’s market structure must be

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194. An electronic communication network (ECN) is an electronic system that matches buy and sell orders for securities. ECNs act as agents and proprietary ECNs charge an access fee for this service. Instinct was one of the first ECNs. Borrelli, supra note 49, at 826.
195. Nowak, supra note 3, at 485 (“This note proposes the elimination of the least efficient link in the communication process between buyers and sellers of stock and derivative financial instruments – the physical exchanges – in favor of a completely automated communication and exchange process.”); Oesterle, Winslow & Anderson, supra note 21, at 267 (“criticism of individual specialists and calls for some form of discipline have grown increasingly louder”).
197. The effort has been termed an “exercise in futility.” Markham & Harty, supra note 29, at 879.
capable of delivering the best possible order execution."\(^{199}\)

Moreover, the NYSE study identified six core principles that it believes are best met by the current system: best execution, fairness, stability, liquidity, efficiency and reliability.\(^{200}\) This section will discuss the extent to which the specialist system works to achieve these objectives. It will be contrasted with a system that abandons the specialist system and adopts electronic markets. We will examine the arguments in favor of retaining the specialists and those opposed to the specialist system.

A. Arguments in Favor of Retaining Specialists

According to proponents, the specialist plays a crucial role in achieving a number of objectives. Recall that the NYSE is an auction market\(^{201}\) in which specialist activity assumes a secondary, supplemental role.\(^{202}\) In that role, the specialist serves as an auctioneer, catalyst, agent and principal.\(^{203}\) As an auctioneer, the specialist has a fiduciary obligation to set the opening price of a stock in a manner that accurately reflects the supply and demand in the marketplace.\(^{204}\)

1. The Need for Human Judgment

Proponents of the specialist system argue that one benefit of specialists is that they are human. Alan Greenspan has suggested that specialists, as human beings, are capable of exercising human judgment in a way that computers cannot.\(^{205}\) Under this argument, one benefit of the specialist system is that it allows for negotiation to the ultimate benefit of investors. In other words, the face-to-face negotiation that occurs on the exchange floor results in a better price for both parties.\(^{206}\) It is argued that human judgment is essential to the

\(^{199}\) Id. at 12.

\(^{200}\) Id. at 12-17.

\(^{201}\) See supra note 24 and accompanying text. See also Cochrane, McNamara, Shapiro & Simon, supra note 20, at 58 (discussing the fact that the "specialist supplements, rather than displaces, the direct interaction of public orders").

\(^{202}\) Mr. Cochrane, Senior Vice President of Research & Planning at the NYSE, writing in response to the Professor Oesterle et al., contends that "there are substantial limitations on specialists' ability to act as dealers and capture dealer insider trading." Id. at 59-60. Presumably, he is referring to the negative and affirmative obligations discussed supra in notes 65-70 and accompanying text.

\(^{203}\) See supra note 11.

\(^{204}\) Supra note 11, at 496.

\(^{205}\) Nowak, supra note 3, at 497. Federal Reserve Chairman Alan Greenspan asserted in 2007 that "the open outcry system of trading is still the 'optimum model' because, while computers are useful, human beings always prefer personal interactions." Markham & Harty, supra note 29, at 896. Nowak counters this argument by pointing out that the "key to the market is information. While the computer may provide less tactile, emotional information, it and the other technologies which may accompany it eventually will provide the trader with infinitely more information." Nowak, supra note 3, at 495.

\(^{206}\) The NYSE asserts that 38 percent of all trades are executed "between the quotes," because of the face to face negotiation that occurs on the exchange floor. Nowak, supra note 3, at 495.
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specialist’s ability to establish a fair and accurate opening price. Moreover, proponents of the system argue that human element is necessary to maintain fair and orderly markets.

2. Maintenance of Fair and Orderly Markets

Specialists have a duty to maintain fair and orderly markets. In fact, Macey and Kanda claim that the duty to maintain fair and orderly markets is the justification for the specialist’s existence and importance. This obligation is particularly important in times of high market volatility. For example, many argue that during the October crash of 1987 the NYSE was the most meaningful source of market liquidity and they credit specialist performance for that liquidity. Specifically, by some accounts, specialists purchased almost 20 percent of the stock sold on October 19th, 1987. Moreover, as part of the specialist’s role as auctioneer, he establishes the opening prices for his issues. Because of the importance of the price continuity for fair and orderly markets, a fair opening price is crucial.

3. Reduced Volatility

Specialists are credited with reducing volatility in the stocks that they manage. The primary measures of market quality are continuity and depth. In markets with continuity, the prices do not vary substantially from one transaction to another. Under rules established by the NYSE Market Surveillance Committee, stocks are flagged for investigation when the price movement exceeds certain established guidelines. A market has depth when price movements relate reasonably to the amount of shares traded. In other

207. Id. at 500-01. Nowak argues, however, that “there appears to be no significant reasons why this judgment cannot be made in an automated environment.” Id. at 501. In addition, he notes that during October 1987, errors in setting the opening prices contributed to creating uncertainty in the market.


209. Macey & Kanda, supra note 21, at 1026.


211. Cochrane, McNamara, Shapiro & Simon, supra note 20, at 71 (“One finding is that specialists on the NYSE behaved exactly as they are supposed to during these periods of stress. They purchased heavily on downswings and sold heavily on upswings.”). According to a report by the SEC’s Division of Market Regulation, one in four specialist firms obeyed their affirmative duty at the expense of their profits. Colesanti, supra note 21, at 9.

212. Cochrane, McNamara, Shapiro & Simon, supra note 20, at 68 (“performance of the specialist system as a whole was viewed as significantly superior to the performance of over-the-counter market makers”).

213. Specifically, ‘price continuity’ refers to minimizing successive price changes. Price continuity is listed as one of a specialist’s obligations in the NYSE Fact Book.

214. Oesterle, Winslow & Anderson, supra note 21, at 270.

215. Id.
words, changes in stock prices as trades occur should be relatively small and continuous. Under NYSE practice, depth is measured by a “count of the number of price change ticks per thousand shares.”\textsuperscript{216} For example, a large number of ticks between trades is a sign of a relatively thin market. A specialist should assure that there are a small number of price changes between the previous and the current trade. The NYSE’s Market Surveillance Committee has established “Depth Guidelines” which flag stocks that exhibit excessive price movements. There is some empirical evidence that specialists are effective at achieving reduced volatility; studies have shown that NYSE quotes tend to be evenly distributed among ticks and that the quoted inside spreads are lower in the NYSE than in dealer markets.\textsuperscript{217}

4. Enhanced Liquidity

Only a fraction of the trading by specialists is in conjunction with their role as dealers. The majority of transactions involving specialists entail providing liquidity by bringing together buyers and sellers of securities, especially in the context of limit orders.\textsuperscript{218} Specifically, the specialist has the responsibility of maintaining liquidity for a given stock on the NYSE.\textsuperscript{219} Liquidity is a characteristic that assures investors that they can promptly purchase or sell their stock at a price closely related to the market’s best estimate of the value of the stock.\textsuperscript{220} As such, it has three elements. First, liquidity relates to the speed with which a stock can be purchased or sold. Second, the price at which the stock is sold should be close to the market’s estimate of the firm’s future earnings. Third, the information related to stock prices must be available at a low cost.\textsuperscript{221} Liquidity means that investors should be able “to dispose of or purchase securities at a price reasonably related to the preceding price.”\textsuperscript{222} Liquidity is important because a liquid market keeps both transaction costs and

\textsuperscript{216} Id. at 271.

\textsuperscript{217} See Christie & Thompson, supra note 25, at 1579 (“NYSE quotes tended to be evenly distributed among all ticks and the quoted inside spreads tended to be lower than traditional dealer markets) (citing Hendrick Bessembinder, Trade Execution Costs and the Market Quality after Decimation, 38 J. Fin. & Quant. Analysis 747 (2003); Hendrick Bessembinder, Trade Execution Costs on Nasdaq and the NYSE: A Post-Reform Comparison, 34 J. Fin. & Quant. Analysis 387 (1999)).

\textsuperscript{218} See Oesterle, Winslow & Anderson, supra note 21, at 233 n.50 in which they cite a 1985 monograph by Hans R. Stoll. Professor Stoll reports that the specialist “acts as dealer on one side or the other in 24 percent of the shares traded.” Hans R. Stoll, The Stock Market Exchange Specialist System: An Economic Analysis 13 (Monograph Series in Finance and Economics, Graduate School of Business Administration, New York University, Monograph No. 2, 1985).

\textsuperscript{219} Macey & Kanda, supra note 21, at 1026.

\textsuperscript{220} Ahdieh, supra note 23, at 285 (“liquidity measures immediacy, that is, the ability to timely execute a buy or sell order, and price resiliency, investors’ ability to trade without moving the price of a security against themselves”).

\textsuperscript{221} Macey & Kanda, supra note 21, at 1012.

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information costs are kept low.223

There is empirical evidence supporting the claim that specialists enhance liquidity. One study found that fully automated options markets are less liquid than markets with a physical trading floor and human intervention (i.e., specialists) to conduct trades. While fully automated markets have lower costs of execution of trades, such markets do not enhance liquidity.224

5. Increased Efficiency

Many argue that specialists increase the efficiency of the market. Specialists aid efficiency by holding limit orders and executing trades when the market prices reach the order price.225 The use of specialists permits other brokers to carry on their business instead of having to stay at the trading post. Moreover, it is argued that efficiency and liquidity go hand in hand. In other words, the same things that make a market efficient also cause it to be liquid; specifically, purchasing and selling by investors causes market prices to adjust to a level at which the stock is liquid and transmits information about future prospects to the market.226

B. Arguments Against Retaining Specialists

Despite the arguments in favor of retaining the specialist system, critics of the floor-based specialist system have advanced a number of arguments against the system and in favor of a more automated market. They question whether the advantages of the model outweigh problems created by the informational asymmetries inherent in the specialist system.227

1. Conflict of Interest

Opponents of the specialist system argue that allowing specialists to operate as both agents and principals creates an inherent conflict of interest that violates the fiduciary obligation of agents. In other words, opponents have questioned whether or not the negative and affirmative obligations described above228 can indeed be fulfilled. Oesterle, Winslow, and Anderson argue that "[t]he specialist’s obligation to act as dealer for the sake of the market generates a

223. Ahdieh, supra note 23, at 285; Macey & Kanda, supra note 21, at 1012.
226. Macey & Kanda, supra note 21, at 1014.
227. Colesanti, supra note 21, at 1 ("regulators and others have publicly questioned whether the liquidity and continuous trading afforded by the model outweigh its apparent informational asymmetries").
228. See supra note 65-70 and accompanying text.
mass of conflicts of interest and inconsistent motivations because it requires the specialist, on select occasions, to ignore personal gain for the benefit of the market.\textsuperscript{229}

For example, the specialist has free access to information on current and pending transactions. Some argue that this access to information gives the specialist an advantage over other trades. The specialist can, for example, observe the pattern of limit orders and make a reasonable conclusion about the direction of the stock price.\textsuperscript{230} This is not problematic for the specialist in his role as an agent, but creates massive problems when one considers that the specialist is also permitted to trade for his own account, as a principal. The specialist "is uniquely positioned at the center of the trading activity in any given stock it controls the trading in and has intimate knowledge of that stock's trading pattern and the supply and demand for that stock."\textsuperscript{231}

The conflict of interest arguably leads to excessive profits by the specialists and the specialist firms that employ them.\textsuperscript{232} A study of the profitability of specialist firms revealed that such specialist firms were more profitable than other firms in the securities industry and more profitable than all publicly-traded firms.\textsuperscript{233} Moreover, the fact that specialists earn a small positive profit in the short-term and in the intermediate term, led one commentator to conclude that specialists are "constrained, profit maximizing informed investors instead of zero profit traders."\textsuperscript{234} By contrast, automated markets are

\textsuperscript{229} Oesterle, Winslow & Anderson, supra note 21, at 235.

\textsuperscript{230} Id. at 231-32. It should be noted that with the advent of computer generated trading strategies, the limit book has lessened in importance. Id. at 232. For example, program trading significantly reduces the extent to which the limit book can predict market trends.

\textsuperscript{231} CalPERS complaint, supra note 17.

\textsuperscript{232} Greg Ip & Susanne Craig, NYSE's 'Specialist' Probe Puts Precious Asset at Risk: Trust, WALL. ST. J., Apr. 18, 2003. According to Ip and Craig, "[s]pecialists remain among the most profitable businesses on Wall Street." Id. Moreover, the reputed profitability of specialists drives the price of seats on the exchange. According to James Selway "[a]nyone familiar with the year-in, year-out profitability of specialist firms know the answer to this riddle [why NYSE seats cost $2 million]: [t]he floor is a very profitable place to be." James Selway, Five Myths About Listed Trading, INSTITUTIONAL INVESTOR, 76-80 (2002), available at www.institutionalinvestor.com/iochannel/institutionattrading/TP_SP_02_Selway.pdf.

\textsuperscript{233} Professor Becker analyzed the 2002 pre-tax profitability of five of the seven specialist firms operating on the NYSE. He reported that the pre-tax profitability of the specialist firms relative to their revenues ranged from 35 to 60 percent. On average, pre-tax profit to revenues was 47.5 percent. To emphasize how profitable specialist firms are relative to other firms in the securities industry, Becker compared the profitability of the specialist firms to that of securities brokers, dealers, and flotation companies as well as investment advisory firms. The pre-tax profit relative to revenues was 9.7 percent for securities brokers, dealers and flotation companies while the same ratio was 14.5 percent for investment advisory firms. Moreover, for all publicly-traded firms across all industries, the pre-tax profit to revenue ratio ranged from 2.4 percent to 19.9 percent. In addition, Becker finds that specialists on the NYSE earn more revenue per traded share than their dealer counterparts on the NASDAQ. Brian C. Becker, Profitability Analysis of NYSE Trading Specialists (Precision Economics, LLC, Working Paper, 2003).

\textsuperscript{234} Sigridur Benediktsdottir, An Empirical Analysis of Specialist Trading Behavior at the New York Stock Exchange 17 (Int. Fin. Discussion Papers No. 876, 2006). In addition, it should be noted that trades involving the participation of specialists result in a larger impact on stock prices than trades that
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less profitable for exchanges and specialist firms from an economic standpoint than non-automated markets. 235 Numerous rules, such as customer priority rules, linkage rules, trade-through, order handling, display rules, and firm quote rules, have been imposed upon exchanges and the specialists, which create time and place advantages for specialists due to the inefficient mechanics of trading within the specialist system.

Finally, this conflict of interest is problematic when monitoring is considered. The specialist plays a role in monitoring exchange transactions and thus, in effect, plays a role in monitoring himself. The conflict of interest impairs the specialist's ability to serve as an effective monitor. 236

2. Inefficient Relative to Electronic Networks

Opponents of the specialist system argue that the use of specialists is inefficient when compared to electronic networks. Prior to the advent of computers, there were seventeen human contacts involved in one exchange on the floor of the NYSE. 237 By some reports, the error was so great that it was undermining consumer confidence in the market. 238 One study, however, examined the moves toward automation by the NYSE and the Toronto Stock Exchange and concluded that automated markets are as efficient as non-automated markets. 239 It found that the level of information efficiency was unchanged before and after implementation of automation for these two exchanges although there seemed to be a slight decline in efficiency for the NYSE immediately after the implementation of automated trading. Moreover, long term effects of information efficiency of the Toronto Stock Exchange were improved as a result of automation. 240

Other exchanges, both domestically and internationally, use electronic communication systems to a larger extent than the NYSE. 241 However, the

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236. Macey & Kanda, supra note 21, at 1035.

237. Nowak, supra note 3, at 490. Nowak describes the so-called “back office crisis” that occurred from 1967 to 1970 as caused by the inefficiency of a totally manually operated system during a time when volume exploded on the NYSE. He reports that during that time “[s]tock certificates and related documents were piled ‘halfway to the ceiling’ in some offices.” Id.

238. Id. at 490-91 (“Even as late as July 1989, one of every 8.4 transactions resulted in a failure to deliver the proper securities on the official settlement day.”).

239. Supra note 240.

240. William Freund & Michael Pagano, Market Efficiency in Specialist Markets Before and After Automation, 35 FIN. REV. 79, 99 (2000). However, Freund and Pagano find that there was a slight decline in information efficiency at the NYSE following the implementation of automated trading.

241. From a global perspective, the structure of security markets varies considerably from one
NYSE does use its electronic routing system, SuperDot to handle at least 70 percent of its trading volume.\textsuperscript{242} Numerous alternatives have been proposed which preserve the basic nature of the floor exchange,\textsuperscript{243} including the Universal Message Switch (UMS)\textsuperscript{244} and the Combined Limit Order Book (CLOB).\textsuperscript{245} Both of these proposals would not only automate the NYSE, but also link it with other exchanges, creating efficiency advantages.\textsuperscript{246}

Moreover, even if one accepts the argument that specialists increase the efficiency of the market, such efficiency may come at the expense of other regulatory goals. For example, this model may sacrifice fairness, erode consumer confidence and add to increased volatility. Some question whether the cost of efficiency is too high.\textsuperscript{247}

3. \textit{Liquidity}

Recall that one of the arguments in favor of the specialist system is that specialists provide needed liquidity and therefore improve market quality.\textsuperscript{248}
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Unfortunately, the finance literature is at best ambivalent in supporting these claims. Some studies find that factors exogenous to the firm, such as characteristics of the market or exchange on which the firm’s stock is traded, have little to do with the liquidity of a firm’s shares. For example, some argue that the more volatile the price fluctuations of a stock, the more liquid the market for those shares and the larger the number of shares outstanding, the greater the liquidity. Stock exchanges themselves can enhance liquidity in the secondary market by serving as producers and disseminators of information. Exchanges disseminate information quickly and at low cost. Macey and Kanda have argued that exchanges enhance liquidity irrespective of the rules or particulars of the exchange. Under this line of reasoning, many of the benefits of an exchange stem from the nature of a centralized location for trading and that computer linkages can provide the same advantages. For example, Macey and Kanda note that NASDAQ, as an “exchange-like system,” provides “virtually the same benefits as an organized exchange.” Moreover, further studies provide evidence that liquidity of the NASDAQ market increased due to increased trading via ECNs.

Contrary to those who allege that specialists facilitate liquidity, opponents of the specialist system argue that specialists are not needed to facilitate liquidity. A common way to measure liquidity is by looking at the bid-ask spreads. If the spreads are abnormally high, the specialist is actually damaging the liquidity of the market. In fact, studies have demonstrated that the quoted bid-ask spread and depth varies across NYSE specialist firms. This empirical evidence, at best, only weakly supports the claim that specialists

249. See, e.g., Macey & Kanda, supra note 21, at 1014 (“Exogenous factors such as the particular secondary trading market on which a firm’s stock is listed will have little, if anything to do with whether a firm’s shares enjoy liquidity.”).
250. Id. at 1019.
251. Id. (“[T]he simple fact that exchanges provide a single centralized forum where securities trading can occur enhances secondary market liquidity.”). Macey and Kanda have three explanations for this effect: first, by forcing all trading to a centralized location, exchanges facilitate the market’s ability to produce information; second, exchanges lower the costs of disseminating information; and third, the fixed location of the exchange lowers the transaction costs involved in making a trade. Id. at 1020. Macey and Kanda make clear, however, that technology can easily perform these same functions: “[a]s technology has advanced … computer linkages can perform the same function as a fixed geographic location.” Id.
252. Id. (supra note 256, at 721-22).
253. Professor Oesterle suggests that a distinction must be made between quoted and realized spreads and between spreads reported and spreads actually paid. Oesterle, Winslow & Anderson, supra note 21, at 277.
enhance liquidity. For example, a comparison of transactions from competitive electronic order books with the limit order book of the specialist reveals that the specialists provide good liquidity.\textsuperscript{257} However, if there is limited asymmetric information, the spreads are wider and investor welfare is lower when the specialist is involved versus the purely competitive limit order book within an automated market.\textsuperscript{258}

Additional evidence suggests that the form of organization of the specialist firm has a bearing on liquidity.\textsuperscript{259} Specifically, studies demonstrate that closely-held specialist firms are more beneficial for liquidity provision than other organizational forms.\textsuperscript{260}

Moreover, it has been argued that specialists might actually impede liquidity. There are five ways in which specialists may impede liquidity: 1) specialists misjudge the opening price this may impede liquidity in volatile markets; 2) specialists create unrealistic expectations by holding themselves out as providers of liquidity; 3) specialists have the power to order trading halts which reduce liquidity by postponing inevitable price changes; 4) the decimalization of stock prices has reduced spreads and made it difficult for specialists to fulfill their responsibilities without interfering with the execution of trades; and 5) there is a conflict between the NYSE monitoring activities and the specialist duties.\textsuperscript{261}

In addition, the size of the investor affects the ability of the specialist to provide liquidity. Even if specialists are able to provide liquidity to small investors, studies demonstrate that they are less capable of providing liquidity to institutional investors.\textsuperscript{262} In a typical transaction of large blocks of stock, the institutional investors will themselves contact other dealers and institutions to broker the deal. Hence, the specialist "actually serves as a market maker only for the residual small blocks and odd lots of stock."\textsuperscript{263} Thus, Macey and Kanda argue that "[t]he rise of institutional investors and the emergence of dynamic hedging strategies such as portfolio insurance have rendered specialist obsolete as liquidity providers."\textsuperscript{264} More specifically, they assert that "investment bankers, and not the exchange specialists, are the real providers of liquidity for the block trading that has become the dominant form of trading in

\textsuperscript{258} Id.
\textsuperscript{259} Jay Coughenour & Daniel Deli, \textit{Liquidity Provision and the Organizational Form of NYSE Specialist Firms}, 57 J. FIN. 841, 864 (2002).
\textsuperscript{260} Id. at 1028.
\textsuperscript{261} Id. at 1028.
\textsuperscript{262} Id. at 1033-34.
\textsuperscript{263} Id. at 1031.
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modern securities markets. Moreover, arguments against imposing regulations that force specialists to maintain market liquidity have been termed a “self-defeating process.”

4. Fair and Orderly Markets

Specialists have a responsibility to maintain fair and orderly markets. This has, however, been referred to as the “stabilization myth” because specialists are not always able or willing to fulfill this responsibility. Notably, specialists have been unwilling or unable to effectively perform this stabilizing role during periods of market crisis. The SEC has asserted that “specialists frequently fail to provide sufficient depth, in other words, purchase or sell enough securities for their own account, to maintain an orderly market.” For example, specialists were unable to provide either liquidity or depth to the market during the 1987 Market Crash. They did not perform much better during the 1989 Market Disturbance. By some accounts, eight-two percent of specialists were net sellers during October 1987. Moreover, during the current crisis, specialists have been unable to maintain fair and orderly markets. One official of the SEC observed that during such crises it is unreasonable “to expect specialists to engage in ‘kamikaze’ trading strategies.” Oesterle, Winslow, and Anderson have argued that the increased market volume and changes in the size of the average trade has reduced the ability of the specialist

265. Id.

266. Macey and Kanda recognize that specialists must be compensated for fulfilling their affirmative duties. The bid-ask spreads represent this compensation. On the other hand, wider spreads represent increased transaction costs and work against creating liquidity. Id. at 1032.

267. See Oesterle, Winslow & Anderson, supra note 21, at 241-51 (providing a historical treatment of specialist regulation). They assert that by the 1940’s “the stabilization myth (or exaggeration) of specialists, which began as a justification for the specialists’ dealer status, had become a ‘bedrock belief’ of the Exchange.” Id. at 247.

268. Id. at 250 (describing how during the 1950’s the specialists were unable to insulate the market from market imbalances). See also id. at 261-62 (“The regulated monopoly status of specialists is the price that is supposedly paid for the stabilization of markets. Those claims are made despite the ample historical evidence that the stabilization function was a myth or exaggeration from the beginning and in more recent decades was undercut by evidence of specialist failures in times of crisis.”).

269. Nowak, supra note 3, at 502 (citing SEC, INSTITUTIONAL INVESTOR STUDY (1971)).

270. After the crash of 1987, the President commissioned a Presidential Task Force on Market Mechanisms to study the crash. In the so-called Brady Report, many specialists were praised for their attempts to stabilize the market by “leaning against the wind.” Many were, however, criticized for being net sellers during this period and for setting unrealistically high opening prices when trading resumes. Oesterle, Winslow & Anderson, supra note 21, at 264. The Brady Report caused the NYSE to reexamine the specialist system. Unfortunately, “the NYSE attempted to resuscitate the dying specialist system but refused to reconsider its basic assumptions.” Id.

271. Id. at 266. Professor Oesterle concludes that “[t]he SEC and others are not happy with the system’s performance but are reluctant to scrap it, choosing to blame individual specialists rather than the system for recent market calamities.” Id.

272. Macey & Kanda, supra note 21, at 1031.

273. Id. (quoting U.S. GEN. ACCOUNTING OFFICE, PRELIMINARY OBSERVATIONS ON THE OCTOBER 1987 CRASH 57 (January 1988)).
to mitigate market trends or even to be able to monitor market activity because the number of transactions is too large to monitor and profitably exploit. The evidence of financial economists suggests that small investors increasingly use institutional investors, such as mutual funds, to make trading decisions for them. Therefore, when modern trading practices and hedging strategies are considered "the notion of obligating an exchange specialist to maintain a fair and orderly market become simply ludicrous."  

5. Increased Volatility

Those favoring an unrestricted market have argued that specialists might actually increase price volatility by acting contrary to market forces or by interjecting nonmarket influences into the auction process. According to this way of thinking, specialists actually retard the ability of the market to establish an accurate price. Professors Oesterle, Winslow, and Anderson conducted a study of price volatility in the market by comparing the volatility of share prices on the NYSE and the London Stock Exchange (LSE) before and after the LSE converted from a specialist to a computerized system (the time of conversion is referred to as Big Bang). This study revealed that before Big Bang, the two markets had similar volatility. If specialists are effective in reducing market volatility, one would expect that after Big Bang the LSE would be more volatile than the NYSE. However, the study found that after Big Bang the LSE was significantly less volatile than the NYSE. In other words, the market without specialists provided similar or better degrees of liquidity and lack of volatility.

275. Macey & Kanda, supra note 21, at 1027.
276. Id.
278. This study has been severely criticized. See Cochrane, McNamara, Shapiro & Simon, supra note 20, at 70-71 (“While changes in volatility, spreads, and anything else in London following Big Bang are interesting subjects, they have no relevance to the issues raised in this Article. Furthermore, the Authors' attempt to say anything about the effects of Big Bang based on a few weeks of data immediately following the event – as opposed to a more long term approach – is misguided.”).
279. Oesterle, Winslow & Anderson, supra note 21, at 282-95. Professor Oesterle concludes: “The common position is that specialists stabilize prices over short, typically daily, time periods. Our findings suggest that in either stable or declining markets specialists induce price volatility” rather than minimizing it. Id. at 295.
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IV. FURTHER REFORMS ARE NEEDED TO ENHANCE TRADING IN SECURITIES MARKETS

A. An End to the Specialist System

We have discussed two separate, but related, issues. First, as we have discussed, there is debate about the benefits of the specialist system. While the specialist system is set forth as a way to maintain fair and orderly markets, we have seen that specialists enjoy information advantages with respect to knowledge of trading positions and have an incentive to exploit these advantages in a way that is unfair to market participants.280 Also, there have been numerous times when specialists have failed to fulfill their obligations to maintain fair and orderly markets.281 While the specialist system is offered as a way to reduce volatility, enhance liquidity and increase efficiency, finance literature reveals mixed evidence with respect to these purported advantages of the specialist system. Moreover, we have discussed the benefits of electronic trading as opposed to the open outcry auction model of trading. The specialist model is becoming unique to the NYSE as NASDAQ and foreign exchanges adopt other models.282

Even if one accepts that the specialist system provides benefits in terms of liquidity and efficiency, the benefits do not outweigh the disadvantages of the system.283 Most importantly, the inherent conflict of interest between the

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280. See Part I of this article.
281. See Part I of this article.
282. NASDAQ is a national and international stock market consisting of communications networks for the trading of thousands of stocks. This market is a wholly owned subsidiary of the National Association of Security Dealers (NASD), a self-regulating body of brokers and dealers that oversees over-the-counter practices, much as the NYSE does for its members. In contrast to the NYSE, trades on the over-the-counter market or NASDAQ stock markets are negotiated directly through dealers. No specialists are involved. Each securities dealer maintains an inventory of selected securities and buys and sells from its portfolio at bid and ask prices. Because the NASDAQ system does not require a specialist, trades do not require a centralized trading floor as do NYSE-listed stocks. The investor who desires to purchase or sell a security engages a broker who tries to locate the dealer offering the best deal on the security over a computer network. This is in contrast to NYSE trading in which buy and sell orders are negotiated through the specialist, who arranges for the best bids to get the trade. Ellis, Michaela and Ohara studied the NASDAQ market and found that one dealer tends to dominate the trading in a particular stock. However, the same dealer is not necessarily the same dominant dealer each day. They also found that the NASDAQ dealer market for small stocks is more competitive than the specialist market. See Katrina Ellis, Roni Michaela & Maureen O'Hara, The Making of a Dealer Market: From Entry to Equilibrium in the Trading of NASDAQ Stocks, 57 J. OF FIN. 2289, 2315 (2002). In the NASDAQ market, brokers must search the offers of dealers directly to find the best deal. Thus, the NASDAQ is primarily a price quotation system. The bid and ask prices are obtained from the NASDAQ computer network and the actual trade must be directly negotiated between the investor's broker and the dealer. ARTHUR LEVITT & PAULA DWYER, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 179 (2002).

In contrast, European exchanges are fully automated. See, e.g., Poser, supra note 4, at 501 ("The European exchanges... have eliminated their trading floors in favor of electronic trading.").

283. Recall that specialists serve functions as both brokers and dealers. Both broker and dealers are held to fiduciary standards. See Cheryl Goss Weiss, A Review of the Historic Foundations of Broker-
specialist as a maker of the market and as a principal is fatal. Unfortunately,
Specialists are in business for themselves, and they often buy and sell shares for
their own accounts. Unlike other types of auctioneers, the specialist is allowed to
bid for shares while conducting the auction. If you think a specialist’s ability to see
incoming orders gives him a built-in advantage when trading for himself, you’re
right. It’s like being in a card game in which only one of the players gets to see
everyone else’s hand, exploit that advantage, too: in late 2001, they were
accounting for about 32 percent of all the shares traded.284

Recent technological advances in market operation have actually
exacerbated the potential for improper specialist behavior. For example, the
recent move to decimal pricing has significantly reduced specialists’ profits.
Therefore, to remain profitable, the specialist firms are driven to exploit their
other advantages.

The appearance of propriety and objectivity is also essential for investor
confidence in the market. If investors believe that the specialists are acting in
their own best interests rather than in the interests of the investors, they will not
invest. Specialists have been characterized as having an unfair advantage that
gives them an “insurmountable lead in the tilt.” 285 The scandals in recent years
have made that readily apparent to the investing public.

In addition, response to the scandals has been disappointing. Civil
litigation against the NYSE has proven to be impossible, as the CalPERS court
imposed the protection of absolute immunity.286 The NYSE itself has imposed
governance reform, but left the specialist system unchanged and failed to
address the specifics of specialist misconduct. Arguably, the SEC
has concluded that the “conflicted roles” of the specialists are “necessary
evils”287 and left monitoring to the NYSE, which has proven to be ineffective
at such policing.

Therefore, abolishing the specialist system is essential. While some might
argue that the specialist system is outdated and will die a natural death,288

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284. ARTHUR LEVITT & PAULA DWYER, TAKE ON THE STREET: WHAT WALL STREET AND
CORPORATE AMERICA DON’T WANT YOU TO KNOW 179 (2002) (statement by former SEC Chairman).
285. Colesanti, supra note 21, at 11.
286. It is possible that courts would refuse to grant immunity now that the NYSE has converted to a
for-profit entity. See, e.g., Springer, supra note 146, at 451 (discussing the issue of “when SROs forfeit
their [immunity] by participating in actions that are solely for their own private interests.”). Given the
Weissman decision, however, it seems likely that even after the demutualization of the NYSE that they
would be afforded immunity for the failure to regulate specialist behavior. It is likely that a post-
Weissman court would distinguish between the misrepresentation claim and the failure to regulate
claims because the misrepresentation alleged was part of advertisements designed to attract business. In
looking at similar representations, the Weissman court found that the “advertisements were in the
service of [Nasdaq’s] own business, not the government’s” and found them unprotected by the shield of
immunity. Weissman, 468 F.3d at 1312. This is consistent with the CalPERS decision.
287. Colesanti, supra note 21, at 29.
288. During the last two years, trading on the NYSE has moved toward electronic trading. In fact,
inaction rather than action is not good public policy. Following the merger between the NYSE and Euronext, the issue of continued viability of the specialist model has again gained attention. Duncan Niederaur, CEO of the NYSE, supports changing the NYSE rules so that there is more open access to the order books and more access to electronic trading, and is in favor of shifting the compensation of the intermediaries, including specialists, from being information-based to cost-based. Based on these initiatives, in late 2007, the NYSE was also considering eliminating the specialists and converting their positions into "designated market makers." Such a move would result in a more competitive market making system and remove some of the conflicts of interest currently found within the specialist system.

B. The Continued Viability of the Self-Regulatory Model

Second, we have demonstrated that the existing system of self-regulation has been ineffective to prevent or adequately address the specialist misconduct that occurred. In fact, given the inherent conflict of interest in the specialist system, such misconduct is inevitable. Moreover, there is a conflict of interest between NYSE enforcement and NYSE profits that cannot be easily resolved. While separating the market and regulatory arms of the NYSE and the creation of FINRA addressed these concerns, these reforms were inadequate to deter future misconduct.

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290. Id.
291. Unfortunately there are also conflicts of interest inherent in the SRO system and, arguably, conflicts are not the only weaknesses. Badway & Busch, supra note 6, at 1366 (arguing that lack of transparency is a problem with the current SRO system).
292. See, e.g., Cervantes, supra note 192, at 831 (arguing that creation of FINRA was essential as the "conflicts of interest that in recent years have resulted in both organizations focus[ing] on profit generation instead of on their obligations as supervisory organizations."). See also Fleckner, supra note 185, at 2543-44 ("Wearing two different hats, those of player and referee, as stock exchanges do, creates tensions ... Even if we assume that stock exchanges will not deliberately favor their own interests over others', we should nevertheless be concerned with the unconscious influences that tend to arise from conflicts of interest.").
293. See Badway & Busch, supra note 6, at 1370 ("[S]eparating the market and regulatory functions of SROs will only resolve some inherent self-regulation system tensions. The reform movement must now eliminate the ability of SROs to police and discipline themselves, the greatest of all conflicts."); Karmel, supra note 3, at 391-92 ("It is worth noting that these conflicts have existed for..."
One of the goals of regulation of the securities markets is to assure a fair playing field and to instill public confidence in the market. To some extent, federal regulation of security markets was intended to re-establish public confidence in the markets following the Stock market Crash of 1929. Therefore, it is imperative that we question the continued viability of self-regulation at the present time. We are not the first scholars to question the present system of self-regulation. In fact, the wisdom of self-regulation in the securities industry has been the subject of extensive debate. Nor are we the first to question the system of self-regulation in response to specialist misconduct.

Commentators offer several perceived benefits of self-regulation. First, self-regulation may avoid the slowness of bureaucracies. Second, SROs may understand the securities industry better than governmental regulators.

many years ... What has changed is the context of self-regulation.

See, e.g., Ahdich, supra note 23, at 281 for a discussion of the role of regulation in the creation and design of securities markets ("[L]aw's essential function is to coordinate expectations across an array of securities market participants, from market sponsors to market professionals, and from issuers to investors.").

See generally Badway & Busch, supra note 6, at 1352 ("After the 1929 stock market crash, political sentiment shifted and forced the federal government to discuss public regulation of the capital markets, in an effort to re-establish market confidence.").

On the one hand, many commentators argue for an elimination of the self-regulatory model. See generally Badway & Busch, supra note 6, at 1358 ("Recent events indicate that the system of self-regulation may no longer fit the mold of our modern securities market."); Jordan & Hughes, supra note 1, at 208 ("The prevalent self-regulatory model of exchange governance in the United States has been susceptible to abuses and scandals for decades."); Robert Kuttner, The Big Board: Crying Out for Regulation, BUS. Wk., Oct. 13, 2003, at 26 (quoting former Chairman Donaldson: "In the SOA era, the question has become: how much longer can we reasonably function under the current system of self-regulation? Is it becoming obvious that SROs are not capable of policing anything more than the occasional 'small-time' larceny?"). See also Karmel, supra note 3, at 392 ("Whether it is more efficient and effective for such regulators to be SROs rather than government agencies remains to be seen.").

On the other hand, benefits of self-regulation have been recognized. See generally Badway & Busch, supra note 6, at 1662-63 (discussing the arguments in favor of self-regulation); Dombalagian, supra note 7, at 317 ("With all its shortcomings, however, self-regulation is inherently at sound – and perhaps somewhat underutilized – means of regulating securities market conduct."); Doherty et al., supra note 96, at 651 ("An effective and aggressive enforcement program of a self-regulatory organization deters violative activity, induces compliance, and enhances investor confidence in the integrity of the market. Enforcement pursues these objectives by bringing disciplinary proceedings and sends the message to the member firm community that it is serious in its enforcement efforts."); Keaveny, supra note 18, at 1450 ("It seems unlikely that the government could operate more efficiently as a sole regulator.").


MICHAEL CROZIER, THE BUREAUCRATIC PHENOMENON 3 (1964) (the danger of rigid rules); Steven M.H. Wallman, Competition, Innovation, and Regulation in the Securities Markets, 53 BUS. LAW. 341, 356 (1998). But see Dombalagian, supra note 7, at 323 (discussing the fact that SROs are becoming increasingly bureaucratic).

Dombalagian, supra note 7, at 317 ("SROs are also best positioned to debate and promulgate ethical norms that govern the industry."); Charles H. Kock, Jr., Control and Governance of Transmission Organizations in the Restructured Electricity Industry, 27 FLA. ST. U.L. REV. 569, 602 (2000); Paul G. Mahoney, The Exchange as Regulator, 83 V. L. REV. 1453, 1455 (1997) (E)xchanges should be the primary writers and enforcers of rule relating to disclosure by listed companies, standards
Similarly, some have asserted that SROs technical expertise allows them to better respond to some regulatory problems. 300 Third, self-regulation avoids the governmental costs of SEC oversight. 301 Last, some argue that exchanges have competitive pressures to promulgate and enforce rules to protect investors. 302 Such commentators dispute the "race to the bottom" thesis that argues just the opposite (i.e., that competition among exchanges encourages adoption of pro-management rules). 303

However, several criticisms of self-regulation have been advanced. Most importantly, it has been asserted that SROs have an inherent self interest that makes it difficult, if not impossible, for them to effectively regulate their members. 304 These criticisms of self-regulation will likely intensify now that the NYSE has converted from a not-for-profit organization into a for-profit entity. 305 Conflicts between the goals of self-regulation and the profit motive have been noted. 306 Some have asserted that after demutualization, the SROs "are in the throes of an identify crisis... advocating no interest more keenly than their own survival." 307 Therefore, self-regulation by the NYSE, even as monitored by the SEC, is unlikely to uncover and adequately enforce regulations designed to ensure a fair and orderly market. 308

The SEC has itself sought comment on several potential models of regulation. 309 However, the system of self-regulation has remained firmly in

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of conduct for member broker-dealers, and market structure."). Professor Mahoney argues that government regulators "start from a substantial disadvantage in information, experience, and incentives compared to an exchange." Id. at 1462.

300. Keaveny, supra note 18, at 1451 ("The SRO system is preferable to a pure government regulatory scheme because it defrays much of the costs onto the market users, and makes efficient use of the expertise at the exchange."); Jonathan R. Macey, Options for Future Regulation of Financial Planners, Part II, 15 J. FIN. PLAN. 90 (2002); Sam S. Miller, Self-Regulation of the Securities Markets: A Critical Examination, 42 WASH. & LEE. L. REV. 853, 855 (1985); Wallman, supra note 298, at 368-69.

301. Dombalagian, supra note 7, at 317 ([T]here are many SROs that provide the critical infrastructure needed to ensure fair and efficient markets while sparing the SEC and the public the cost of securities oversight.").

302. See, e.g., Keaveny, supra note 18; Werner, supra note 124.


304. See generally Dombalagian, supra note 7 (discussing this conflict).

305. See supra notes 185-93 and the accompanying text where this change is discussed.


308. See, e.g., Markham & Harty, supra note 29, at 924-30.

309. See Badway & Busch, supra note 6, at 1367-68 where various regulatory models are discussed. Potential models include the Market Corporate Subsidiaries Model (creating independent subsidiaries for regulatory and market operations), the Hybrid Model (under which the SEC would designate a single SRO to regulate all SRO members with each SRO still operating its own market), the Competing Hybrid Model (multiple competing SROs), the Universal Industry Self-Regulator alternative (creation of one SRO to regulate all market and member rules), Universal Non-Industry Regulator
place. 310 This differs dramatically from the rest of the world. For example, both the United Kingdom and Hong Kong have moved away from self-regulation. 311 Self-regulation was never the prevailing model in Europe. 312 It is time for a new regulatory model to be adopted in the U.S. 313 The NYSE was sanctioned by the government because of the belief that exchanges are intended to serve the public interest; public interest also serves as a justification for regulation. 314 While the model of self-regulation was adopted as the first-line defense against illegal and unethical securities practices, 315 it is no longer effective to meet those public policy goals. 316 Moreover, the important role that the stock exchanges, particularly the NYSE, play in shaping the health of our economy demands that we be particularly vigilant. 317

(create one regulator but this regulator would be outside the industry). The last proposal, SEC regulation, would abolish SROs in favor of SEC regulation. See generally, SEC INDUS. ASSOC., REINVENTING SELF-REGULATION, WHITE PAPER FOR THE SECURITIES INDUSTRY ASSOC. 8-9 (2000, Updated 2003), available at http://www.sifma.org/regulatory/reinventingselfreg.html (evaluating the six potential models for self-regulation).

310. Professor Dombalagian asserts that the system of self-regulation remains in effect “because lawmakers have generally regarded self-regulation to be a practical and efficient way to outsource the burdens of regulation to the private sector.” Dombalagian, supra note 7, at 320. He asserts that the concept of self-regulation continues to garner support despite “periodic scandals of exchange governance and member misconduct.” (citing Joel Seligman, CAUTIOUS EVOLUTION OR PERENNIAL IRRESOLUTION: STOCK MARKET SELF-REGULATION DURING THE FIRST SEVENTY YEARS OF THE SECURITIES AND EXCHANGE COMMISSION, 59 BUS. LAW. 1347, 1347-49 (2004)).

311. Id.

312. See generally Jordan & Hughes, supra note 1, at 223 (comparing regulatory models. The model in the United States is described as one of “overlapping oversight and shared responsibilities.”).

313. Theoretically, there are several competing paradigms of securities regulation. Commentators have discussed “principle-based” regulation, “rules-based” regulation and “institution-based” financial regulation. The distinction between the principle-based approach and the rules-based approach can best be understood as a continuum. At one end of the spectrum is the principle-based approach where the regulatory articulates principles and allows the firm to determine how best to meet the outcome required by the principle. At the other end of the spectrum, under the rules-based approach, the regulator sets forth specific rules dictating how the outcome sought should be achieved. The principle-based approach is the common approach adopted internationally. Cervantes, supra note 192, at 857. This approach sets standards as to the types of behaviors expected by firms, rather than by adopted rules. See generally, Cristie L. Ford, NEW GOVERNANCE, COMPLIANCE, AND PRINCIPLE-BASED SECURITIES REGULATION, 45 AM. BUS. L.J. 1 (2008); James J. Park, THE COMPETING PARADIGMS OF SECURITIES REGULATION, 57 DUKE L.J. 625 (2007). See also John H. Walsh, INSTITUTION-BASED FINANCIAL REGULATION: A THIRD PARADIGM, 49 HARV. INT’L L. J. 381, 382 (2008) (where the author rejects both the principle-based and rules-based approaches and argues for a strategy, which he terms institution-based). Under this approach, the government or SRO requires entities to create internal institutions.

314. Jordan & Hughes, supra note 1, at 214.

315. Friedman, supra note 7, at 739.

316. See, e.g., Jordan & Hughes, supra note 1, at 213 where they conclude that “in light of the new realities of today’s evolving exchanges, these justifications for self-regulatory powers ring somewhat hollow” and that “self-regulation is on the wane.”

317. See Fleckner, supra note 185, at 2544 where she recognizes that self-regulated exchanges are not immune from “governance missteps.” She points out that, however, “missteps by stock exchanges tend not to be limited to certain areas, but... shake the economy as a whole.” Id.
The NYSE Response to Specialist Misconduct

V. CONCLUSION

The financial services industry is certainly facing challenging times. Investor confidence in the financial markets has been shaken by questionable lending practices in the mortgage market, the demise of traditional investment banks such as Lehman Brothers, and the failure of large commercial banks such as IndyMac and Washington Mutual. As part of the wide-sweeping reform that is likely to result from the current financial crises, we support reform of NYSE operations and regulation. Reform of the NYSE would enhance investor confidence in the financial markets. One commentator has already opined that “now is precisely the time to consolidate and streamline the regulatory system.”

As Congress begins the inevitable regulatory overhaul, the issues raised in this article should be part of the discussion. First, the specialist system should be abolished. Just ten years ago, this would have been a very drastic recommendation. Today, when more than 80 percent of trading on the NYSE is accomplished through electronic means, a decision to abolish the specialist system is almost a decision to hurry the inevitable.

Second, the concept of the NYSE as a self-regulatory organization should end. The existence of the specialist system is emblematic of the problems associated with the NYSE being a self-regulatory organization. The documented misconduct of the specialists is a good example of how the NYSE has proven to be ineffective at self-regulation; it is a for-profit entity that should be denied the benefits of self-regulation. Moreover, the reform and reorganization of the NYSE has not prevented the reoccurrence of specialist misconduct. We recommend that Congress consider replacing NYSE self-regulation with SEC regulation. We are not the first to suggest that the SEC should assume full responsibility for NYSE regulation. While the SEC has often proven to be a toothless regulator, it must be charged with the responsibility, and given adequate resources, to oversee NYSE regulation.

318. Cervantes, supra note 192, at 831.
319. Badway & Busch, supra note 6, at 1370; Dombalagian, supra note 7, at 317 (“Industry leaders and associations have even entertained the possibility of dismantling the current self-regulatory system entirely in favor of Securities and Exchange Commission (SEC) regulation.”).