SPECIAL SECTION: SECURITIES

FOREWORD AND IMPACT OF MARKET 2000 STUDY

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This issue of the Pacific Basin Law Journal contains three articles dealing separately with securities regulation in Taiwan[1], Singapore,[2] and China[3]. These articles are being published shortly after the January 27, 1994 release by the Division of Market Regulation of the United States Securities and Exchange Commission of its report on the U.S. equity markets: *Market 2000: An Examination of Current Equity Market Developments.*[4]

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1. Jeffrey H. Chen & Jack J.T. Huang, *Taiwan's Evolving Stock Market Policy and Regulatory Trends*, 12 UCLA PAC. BASIN L.J. 34 (1993).

2. Michael S. Bennett, *Securities Regulation in Singapore: The City-State As An International Financial Center*, 12 UCLA PAC. BASIN L.J. 1 (1993).

3. Andrew Xuefeng Qian, *Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China*, 12 UCLA PAC. BASIN L.J. 62 (1993).

4. DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCH. COMM'N, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (1994) [hereinafter MARKET 2000 STUDY]. The Securities and Exchange Commission's published its last comprehensive study of the equity markets in 1971. INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCH. COMM'N, H.R. Doc. No. 64, 92nd Cong., 1st Sess. 1 (1971). In response to that study and to Congressional hearings, in 1975 Congress enacted Section 11A of the Securities Exchange Act of 1934. 15 U.S.C. § 78k-1 (1992). Section 11A(a)(1) sets forth certain "findings" of Congress to the following effects:

(1) the securities markets are an important national asset,
(2) new technological developments create the opportunity for more efficient and effective market operations,
(3) the linking of markets will contribute to the best execution of orders, and
(4) it is in the public interest to assure economically efficient execution of securities transactions, fair competition among brokers, the availability of information with respect to quotations in securities, the execution of investors' orders at the best market price, and where appropriate, the execution of investors' orders without participation of a dealer.

The U.S. equity markets are the most "efficient and liquid in the world."[5] Questions have arisen, however, concerning the "fairness, competitiveness, and efficiency" of these markets.[6] The rapid advances in technology, the development of new financial products, and the accelerating pace of global economic expansion have led Congress, investors, and the markets to raise "concerns about possible market fragmentation, inadequate disclosure of market information, and uneven regulation among competitors."[7] The purpose of the *Market 2000 Study* is to "address these issues to "ensure that U.S. equity markets remain vibrant and efficient."[8]

As the United States seeks to make necessary adjustments in its own equity markets, the *Market 2000 Study* should provide helpful guidance to Taiwan, Singapore, and China, as well as other countries, in developing appropriate approaches to securities regulations. For that reason, this Foreword briefly discusses some of the more significant points raised in the *Study* that could have a bearing on the problems addressed in the articles contained in this issue.

In addressing these regulatory issues it is important to remember that the purpose of equity markets is to "raise capital, provide investment opportunities, and promote entrepreneurship."[9] As pointed out in the Statement by the U.S. Securities and Exchange Commission that accompanies the *Market 2000 Study*, the promotion of these goals can be facilitated by maintaining a "fair field of competition" and by pursuing the following three broad themes:

> First, that arrangements between customers and broker-dealers should be as clear as possible. Second, that markets should have as much information about supply and demand as is consistent with customer interests. Third, that competition and

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Section 11A(a)(2) directs the Commission to "facilitate the establishment of a national market system for securities ... in accordance with the [above stated] findings and to carry out the [above stated] objectives..." Although Congress did not define the term "national market system," in Section 11A(a)(3), Congress authorized the Commission in furtherance of the directive to establish a national market system to (1) create advisory committees, (2) require self regulatory organizations (SROs), such as the exchanges and the NASD, to act jointly, and (3) conduct studies and make recommendations to Congress. The *Market 2000 Study* is the latest study promulgated pursuant to the Commission's authority under Section 11A(a)(3).

5. MARKET 2000 STUDY, *supra* note 4, at 1.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

innovation in the provision of trading services should be encouraged.[10]

These three broad themes are addressed in four separate sections of the *Market 2000 Study* dealing with (1) the fair treatment of investors, (2) the timely and comprehensive disclosure of market information (*i.e.*, transparency), (3) fair competition among markets and market participants, and (4) the expansion of open access.[11] The recommendations contained in each of these sections will be considered below.

Before reviewing the specific recommendations of the *Market 2000 Study*, however, two comments should be made. First, conclusions reached in the *Study* are based on a detailed analysis of the U.S. equity markets pursuant to the directives and authority set forth in Section 11A. While these conclusions may be of assistance in designing regulatory schemes in other countries, there is, of course, no substitute for a directed study of each country's securities markets. Indeed, it would be prudent for other countries to follow the lead of the United States in giving their securities regulators directives and authority to develop the equivalent of the national market system now employed in the United States.

Second, the *Market 2000 Study* reaches the conclusion that the "Commission best fulfills its statutory mandate when it concentrates on protecting investors, facilitating fair competition and promoting full disclosure" and that the "equity markets are too dynamic to conclude that the government could once and for all establish the 'ideal' way to trade equity securities."[12] Effectively the study calls for principled supervision rather than rigid regulatory control, an observation which may prove invaluable to evolving equities markets forced to contend with diverse issues such as the ratio of institutional investors in the market[13] and the wisdom of stock option trading.[14]

Fair Treatment of Investors

One of the "cornerstones" of U.S. "market integrity" is the requirement under the securities laws that a broker-dealer seek to obtain the best execution for the orders of its customers.[15] Automated systems have increased the speed involved in han-

10. Statement by the Securities and Exchange Commission, Upon Release of the Market 2000 Report, Jan. 27, 1994.
11. MARKET 2000 STUDY, *supra* note 4, at 2.
12. *Id.* at 15.
13. *See, e.g.*, Chen & Huang, *supra* note 1, at parts II, III.
14. Bennett, *supra* note 2, at 215.
15. *Id.* at 21. The "best execution" principal requires that the customer be provided with the best price available in the market.

dling individual orders and automated routing of small orders can facilitate best execution, but there are possible defects in such systems. Consequently, the *Market 2000 Study* recommends that broker-dealers regularly monitor such systems to ensure that order flow is directed to markets that provide best execution.[16] The *Study* additionally recommends that automated systems for listed stocks be modified to offer "some possibility of price improvement" by adoption of order exposure principles similar to those that apply in auction markets.[17]

In addition to monitoring of automated systems, the *Market 2000 Study* calls for greater disclosure with respect to a variety of payment practices engaged in by brokers, dealers, specialists, and investment advisors. This emphasis on fiduciary disclosure, could potentially interfere with the customers right to best execution, but is illustrative of the importance of both the sanctity of the best execution concept and benefits that are expected to flow from full disclosure. In less well developed markets, it may be appropriate to simply prohibit practices that could interfere with best execution rather than relying on disclosure. However, it is important for governments to promote full disclosure and the free-flow of financial information. This principle may not yet have taken root in the Asian equity markets as evidenced by the Singapore government's reluctance to "place[ ] a high value on the free flow of information."[18]

The best execution principle may also be adversely effected by the practice of market makers "trading ahead" of customer orders. This involves a market maker trading for its own account at prices better than a customer's limit order price without first executing the customer's order.[19] The *Market 2000 Study* concludes that this practice should be flatly prohibited.[20] Prohibitions on "trading ahead" have apparently not been adopted uniformly in the Asian equity markets as indicated by the Chinese practice of allowing persons with inside connections with the issuing company or stock exchanges to have their orders executed before those of the general public.[21]

16. *Id.* at 24.
17. *Id.*
18. Bennett, *supra* note 2, at 223.
19. MARKET 2000 STUDY, *supra* note 4, at 24.
20. *Id.* at 25.
21. *Qian*, *supra* note 3, at 72.

Transparency

The *Market 2000 Study* explains that transparency is the "real-time dissemination of information about prices, volume and trades."[22] The *Study* further explains:

> [T]ransparency plays a fundamental role in the fairness and efficiency of the secondary markets. Transparency ensures that stock prices fully reflect information and lowers trading costs by improving investors' ability to assess overall supply and demand. It also contributes to the fairness of the markets by offering all investors timely access to market information.[23]

Transparency in the U.S. markets has been facilitated by the creation of a consolidated stock reporting tape and last sale reporting of NASD securities.[24]

In an effort to further promote both fair competition between markets and an efficient price discovery mechanism, the *Market 2000 Study* makes the following five recommendations for enhancing market transparency. These recommendations are clearly specific to the U.S. equity exchanges but may provide a useful framework for reform of Asian equity markets which are engaged in their own struggle for transparency.[25]

First, the *Study* recommends that the SROs consider requiring the display of customer limit orders in certain cases.[26]

Second, the *Study* recommends that the current pricing system, which is based on a minimum variation for bids and offers of one-eighth (12.5 cents), be modified to possibly adopt a decimal pricing system in which prices are set in pennies.[27] This type of change could eliminate the artificially wide spreads that can occur under the present system and also promote quote competition.[28]

Third, the *Study* recommends that the NASDAQ's SelectNet trading system be modified to eliminate the selective display of orders.[29] Such orders should be displayed on an equal basis without differentiation among market makers.[30] In addition to enhancing transparency, this proposal should also increase competition.

Fourth, to promote the full and accurate reporting of trades, the *Study* recommends that the SROs develop systems for the

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22. MARKET 2000 STUDY, *supra* note 4, at 17.
23. *Id.*
24. *Id.*
25. *See, e.g.*, Qian, *supra* note 3, at 72.
26. MARKET 2000 STUDY, *supra* note 4, at 17.
27. *Id.* at 18.
28. *Id.*
29. *Id.* at 19.
30. *Id.*

reporting of trades in U.S. securities occurring after regular trading hours in the U.S. (after-hour trading) and on foreign markets (off-shore trading).[31]

Fifth, the *Study* recommends that the SROs consider the adoption of an order exposure rule. Such a rule would require a "market maker to stop (*i.e.*, guarantee execution of) a customer order at the proposed price and, through the Consolidated Quotation System, to publicly bid or offer the order at a better price before executing the order as principal."[32] The *Study* acknowledges, however, that adoption of such a rule may cause market makers, who generally make their income on the spread, to begin to charge commissions.

Fair Market Competition

The *Market 2000 Study* recommends four changes needed to promote fair competition among the markets. These recommendations will be reviewed below although their application to the Asian equity markets is somewhat premature as most of these markets have not diversified to include over-the-counter trading.

First, the *Study* recommends that the NASD promulgate rules to provide maximum oversight of the "third market" (i.e., OTC trading of exchange listed stocks) and to set forth trading principles for such a market.[33] The *Study* explains that there has been a great debate over whether an auction or dealer system best promotes liquidity, stability and fairness. The Commission's view is that each system has "specific advantages and disadvantages, and it would be contrary to the Commission's mission to impose a particular design."[34] Although this conclusion seems sound for the U.S. market, it might not be appropriate for a country with less well developed markets.

Second, although the *Market 2000 Study* rejects the argument of the exchanges that proprietary trading systems (PTSs) should be regulated as exchanges rather than broker-dealers, the *Study* recommends enhanced record-keeping and reporting requirements for broker-dealers operating automated systems, much as PTSs.[35]

Third, the *Study* recommends that the transaction fees currently imposed on listed stocks be expanded to apply also to OTC stocks.[36] The *Study* explains: "Given the intense competi-

31. *Id.* at 20.
32. *Id.* at 21.
33. MARKET 2000 STUDY, *supra* note 4, at 26.
34. *Id.*
35. *Id.* at 27.
36. *Id.* at 27.

tion for listing among the OTC and exchange markets, disparate application of such fees provides the OTC market with an unintended competitive advantage that is not justifiable."[37]

Fourth, the *Study* rejects the arguments of the equity exchanges that filing requirements unique to the equity markets place them at a competitive disadvantage with PTSs and third market dealers.[38] The *Study* argues that PTSs do not perform the same functions as exchanges and, therefore, do not need the same level of regulation.[39] The *Study* does recommend, however, that the Commission accelerate its review of proposed rule changes.[40]

Open Market Access

The *Market 2000 Study* explains that "[p]ast experience has shown that competitive interests can cause an SRO to take actions to disadvantage competitors, while cloaking these activities with regulatory purpose."[41] Consequently, the Commission must be certain that market participants do not "impose restriction on where the users of the markets can conduct transactions, and [that] the restrictions on professionals are consistent with notions of fair competition."[42] In furtherance of these objectives, the *Market 2000 Study* makes three recommendations.

First, the *Study* recommends that NYSE remove restrictions on off-board trading occurring after-hours.[43] These restrictions have the effect of forcing NYSE members who desire to engage in after-hour trading to do so overseas. The *Study* explains:

> [T]he anti-competitive effect of the after-hours restriction within the United States is absolute. NYSE Member firms simply have no choice: they must trade overseas or be forced to use the NYSE's [after-hours] crossing sessions, which are limited in time and scope.[44]

Second, the *Study* recommends that the procedures for delisting stocks on the NYSE and the AMEX be modified. NYSE Rule 500 requires a 66.6% vote of outstanding shares for delisting. AMEX Rule 18 gives the Exchange the authority to determine whether a board's proposal for delisting is granted with or without shareholder notification. On the other hand, the NASD rules permit certain issuers to delist upon written notice to the

37. *Id.* at 27-28.
38. *Id.* at 28.
39. *Id.*
40. *Id.*
41. *Id.* at 29.
42. *Id.*
43. *Id.* at 29-30.
44. *Id.* at 30.

NASD.[45] The *Study* concludes that the NYSE delisting rule is too onerous and the AMEX rule is too vague.[46] Consequently, the *Study* recommends that these rules be modified to grant to the board of directors and independent directors the power to make such a decision.[47]

Third, the *Study* recommends that intermarket trading in exchange listed securities, which allows a broker-dealer in one market for a security to send orders to another market for the same security, be enhanced to further promote intermarket access.[48] This additional access should facilitate the best execution principle.

Conclusion

While the *Market 2000 Study* purports to provide a detailed study of the U.S. equity markets, many of its recommendations reach far beyond the boundaries of the United States. The study concludes by noting four dominant trends in the U.S. equity markets. It is worth considering these trends as they are likely to be reflected in evolving equity markets world-wide. First, the growth and dominance of institutional trading requiring regulators to accommodate the needs of both institutional and retail customers.[49] Second, a growth in global trading forcing competition with foreign markets offering a variety of regulatory standards.[50] Third, the development of derivative markets, which permit users to "re-create" synthetically virtually any asset or trading strategy," thus "challeng[ing] the Commission to control risk and promote fair competition among markets."[51] Finally, persistent technological advances making it possible for public investors to obtain direct access to the markets.[52]

These trends inform the *Market 2000 Study's* recommendation of fair treatment of investors, transparency, fair market competition, and market access, and provide sound guidance for securities regulators in Taiwan, Singapore, China, and the rest of the world.

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45. *Id.*
46. *Id.* at 31.
47. *Id.*
48. *Id.* at 31.
49. *Id.* at 32.
50. *Id.*
51. *Id.*
52. *Id.*