Disorderly Conduct: Day Traders and the Ideology of “Fair and Orderly Markets”

Caroline Bradley

I. INTRODUCTION

This Article uses the day trading phenomenon as the focal point for an exploration of the relationship between ideas of fairness and orderliness in the regulation of the securities markets. Although day traders have historically been professional traders, the term “day trader” now often refers to nonprofessional securities traders whose patterns of securities trading are different from those of ordinary investors.

Day traders may be characterized in one of two contrasting ways. On the one hand, they are investors who are empowered by technological developments to take charge of their own financial affairs; on the other they are vulnerable gamblers who are easy prey for unscrupulous broker-dealers. They are an example of the American Dream at work, or they are a terrible threat to the institution of American capitalism. In both stories they operate to some extent outside the established framework of the securities markets. Day traders do not fit our usual model of what a securities market professional looks like, nor

* Professor of Law, University of Miami School of Law. An earlier version of this article was presented at the Law and Society Conference in Chicago in May 1999. I would like to acknowledge the University of Miami School of Law’s support for the writing of this article, and to thank the participants in a Colloquium at the University of Washington School of Law, and in a Legal Theory Workshop at the University of Miami School of Law, for their helpful comments. Thanks, as always, to Michael Froomkin. Thanks also to Angie Padin for research assistance. © Caroline Bradley 2000. All rights reserved.


2. The New York Stock Exchange (NYSE) has suggested that the term “day trading” should be understood to refer to “the purchase and sale of the same security in the same day in a margin account.” See Press Release, NYSE, NYSE and NASD Propose Higher Level of Margin Requirements for Day Trading (December 10, 1999), at http://www.nyse.com/press/press.html.
do they fit our idea of what a typical investor looks like. They challenge our ideas of what securities regulation should look like.³

The rhetoric of securities regulation is of "fair and orderly markets."⁴ Politicians and regulators use this rhetoric to justify and legitimate their actions, invoking a discourse of the maintenance of public confidence in the markets and of investor protection.⁵ For over sixty years, United States securities regulators have told us that if they can ensure that the markets operate in a fair and orderly manner, investors will have the confidence to invest in securities issued by businesses which need to raise capital.⁶ The rhetoric is not confined to the United States, nor to securities regulators. Regulators of commodity and futures markets have also used this rhetoric,⁷ as have regulators in other jurisdictions⁸ and policy makers in international organizations.⁹

3. "We can all agree that a market structure tilted toward the needs of hedge fund managers should not be our goal. At the same time, we should not foster a system bent toward day traders. Our future markets must serve the diversity of America's investors." Chairman Arthur Levitt, Securities and Exchange Commission, Visible Prices, Accessible Markets, Order Interaction, Address at Northwestern University School of Law, (March 16, 2000), http://www.sec.gov/news/speeches/spch355.htm.

4. E.g., DIV. OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 14-15 (1994) ("The Division also believes that it would be difficult to provide different tiers of regulation for retail and institutional participants and still maintain fair and orderly equity markets."); see also infra note 71 and accompanying text (citing statutory sources of this language).


[S]elective disclosure has an adverse impact on market integrity that is similar to the adverse impact from illegal insider trading: Investors lose confidence in the fairness of the markets when they know that other participants may exploit "unerodable informational advantages" derived not from hard work or insights, but from their access to corporate insiders. Selective Disclosure and Insider Trading, Exchange Act Release No. 34,43154, 65 Fed. Reg. 51,716 (Aug. 24, 2000) (to be codified 17 C.F.R. pts. 240, 243, and 249); see also REGULATORY REFORM TEAM, HM TREASURY, FINANCIAL SERVICES AND MARKETS BILL: DRAFT RECOGNITION REQUIREMENTS FOR INVESTMENT EXCHANGES AND CLEARING HOUSES 7 (Feb. 1999) (a "consultation document" proposing regulation requirements for investment exchanges including a requirement that business be conducted "in an orderly manner and so as to afford proper protection to investors," available at http://www.hm-treasury.gov.uk/pub/html/reg/fsmb.pdf.

6. This idea was an important reason for the adoption of the federal securities laws. See, e.g., House Comm. on Interstate and Foreign Commerce, H.R. Doc. No. 73-9323, at 5 (1934) (stating the need for law to promote investor confidence).


Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.
There is empirical evidence that financial markets are neither fair\textsuperscript{10} nor orderly.\textsuperscript{11} Despite this, regulators, politicians, and commentators continue to claim that markets are fair and orderly, or at least that they may be made so by regulation. This Article first looks at some of the ways in which technological developments have introduced new stresses into our systems of financial regulation, in particular, by facilitating day trading by nonprofessional participants in the securities markets.\textsuperscript{12} The Article then analyzes the terms of the rhetoric of fair and orderly markets, and examines the ways in which regulators claim that rules do and should promote the fair and orderly markets objective.\textsuperscript{13} This Article argues that the rhetoric of fair and orderly markets is incoherent as a justification for regulation.

This incoherence is a basic and structural problem of financial (and particularly securities) regulation. It is not a new problem, but technological developments and the dominance of economic analysis in the development of regulatory policy,\textsuperscript{14} make it

particulars to be published for the admission of securities to official stock-exchange listing, with regard to the obligation to publish listing particulars") (referring to its recitals to "proper operation of the markets").


11. The 1987 stock market crash emphasized that the markets do not always operate in an orderly way. See, e.g., PRESIDENTIAL TASK FORCE ON Mkt. MECHANISMS, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988); DIV. OF MKT. REGULATION, SEC. & EXCH. COMM., THE OCTOBER 1987 MARKET BREAK, FED. SEC. L. REP. (CCCH) reprinted in Special Reports (Feb. 1988) (debating the extent to which the securities markets are efficient); see also Andrei Shleifer & Lawrence H. Summers, The Noise Trader Approach to Finance, J. ECON. PERSP., Spring 1990, at 19 (continuing the debate about the extent to which the securities markets are efficient).

12. See infra Part II.

13. See infra Part III.

14. Views of how the federal securities laws should be interpreted have changed over time. The dominant view now is that the statutes should be interpreted primarily as setting up a system of disclosure. See, e.g., Joel Seligman, The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation, 93 MICH. L. REV. 649, 649 (1995) (stating that "the primary policy of the federal securities laws involves the remediation of information asymmetries" (footnote omitted)). "Securities law, then, should be understood as a law of property rights in information. The central function of regulators should be to assure that those property rights are clearly delineated, understood, and enforced." Paul G. Mahoney, Technology, Property Rights in Information, and Securities Regulation, 75 WASH. U. L.Q. 815, 817 (1997) (footnote omitted). Others assert that Congress intended a rather different role for the statutes. See Steve Thel, Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934, 1988 COLUM. BUS. L. REV. 359, 361-64 (arguing that Congress intended that the SEC should be able to act to prevent speculation interfering with the proper operation of the securities markets).
harder to ignore it, as regulators struggle with fitting current practice into a defective paradigm.15

II. FINANCIAL MARKETS AND TECHNOLOGY

Technological developments tend to challenge the law and legal systems.16 At times of dramatic change, laws and institutions struggle to catch up with reality. In the 1980s, technology linked financial markets across the world,17 created new markets, and

15. Of course, there are those, particularly those with vested interests, who continue to argue that the old paradigm is still meaningful:

Despite changes in the way the securities business is done, however, the fundamental goals of the securities laws—which include transparency, access, and fairness, as well as competition, efficiency, and, of course, investor protection—remain the same. By and large, technology has made achieving these goals easier. It has also raised our expectations about what is possible. Therefore, our challenge—and the securities industry’s challenge—is to meet these expectations. We need to focus on how regulation can promote deep and liquid markets as well as foster investors’ interests.


The laws regulating our markets are a product of the New Deal era. To me, their concepts are as indelible as the Constitution. They have weathered challenge after challenge, decade after decade, and are every bit as relevant and effective today as they were the day they were written. Companies offering their shares—whether off a website or through a paper prospectus—still have to disclose what they are selling and why. Brokers—whether traditional or on-line—still have the same obligations to their customers. And fraud—whether perpetrated over the Internet, on the phone, or in-person—is still fraud.


allowed institutions to manage their portfolios of financial assets with computer programs.18

By the end of the 1980s, regulators were concerned about trading strategies and new financial instruments which might destabilize the financial markets.19 New technology eroded the competitive advantage of exchanges, allowing non-exchanges to compete with exchanges for trades in securities and other financial instruments. Institutional investors could carry out securities trades outside organized markets in ways which risked undermining pricing efficiency in exchange markets such as the New York Stock Exchange (NYSE).20 Securities dematerialized, and financial firms became increasingly dependent upon technology.

In the 1990s, the Internet brought financial markets into ordinary people’s homes. Now anyone with a computer and a modem can conduct her relationships with providers of banking,21 insurance, and investment services from home, on her own schedule. Investors can even make bets on the market online.22 Online financial relationships are more flexible for consumers and for financial firms. Individual investors have access to significant amounts of current market information through numerous websites.23 They

18. On program trading, see, for example, Richard A. Booth, The Uncertain Case for Regulating Program Trading, 1994 COLUM. Bus. L. REV. 1.


23. See, e.g., G. Philip Rutledge, The Internet and U.S. Financial Markets, 16 DICK. J. INT’L L. 563, 564 (1998) (stating that “[i]ndividual investors now are able to review market and research data on the Web that heretofore was unavailable to them because it was proprietary or was available only to private brokerage clients or those willing to pay a fee”).
can invest in initial public offerings (IPOs)\textsuperscript{24} and carry out securities trades online through online brokers.\textsuperscript{25}

Traditional exchanges are facing increased competition from other firms.\textsuperscript{26} When investors trade in securities, they may trade through exchange markets, or through an over-the-counter (OTC) market such as the NASDAQ National Market.\textsuperscript{27} Issuers may set up their own systems for trading in their securities.\textsuperscript{28} Wealthier investors may trade securities generally through various newer forms of off-exchange market systems, including electronic bulletin boards\textsuperscript{29} and "proprietary" systems developed by intermediaries. These proprietary systems are closed access systems, which only allow

\begin{itemize}
  \item[26.] "Governments are also realizing that they cannot afford to protect institutions that no longer bring value to their economies. Thus, traditional stock exchanges must change or quite simply, they will be gone. This, of course, provokes competition, and competition is growing between securities exchanges and other market participants." Nasdaq Chairman Frank G. Zarb, Building the Global Digital Stock Market, Remarks at the National Press Club (June 13, 2000), http://www.nasdaqnews.com/views/zarb_npc.pdf.
  \item[29.] Cf. John C. Coffee, Jr., Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation, 52 BUS. LAW. 1195, 1216 (1997) (suggesting that existing bulletin board trading systems are unlikely to be an "important evolutionary advance in market structure" because they lack liquidity).
\end{itemize}
investors who meet certain standards (such as credit standards) to use their facilities, and
they are regulated as Electronic Communications Networks (ECNs).\textsuperscript{30}

Investors with more limited means have access to online trading firms,\textsuperscript{31} regulated
as broker-dealers, but not to ECNs.\textsuperscript{32} Trading through an online brokerage is slower than
trading through an ECN,\textsuperscript{33} and pricing is less favorable to the investor.\textsuperscript{34} Investors with
relatively limited resources do not benefit as much as wealthier investors from some of
these developments, but technological change has some potential to democratize the
securities markets.\textsuperscript{35} It remains to be seen whether this potential will be realized. There
are signs that retail investors may be able to derive greater benefits from these
technological changes in the future: Instinet\textsuperscript{36} has announced that it plans to allow retail
investors to use its facilities\textsuperscript{37} and acquired a large stake in Tradepoint, a British
electronic stock market.\textsuperscript{38} Other developments, such as the extension of trading hours,
are more controversial.\textsuperscript{39}

\textsuperscript{30} Electronic Communications Networks are regulated by the SEC under Rule 17a-23. See
Recordkeeping and Reporting Requirements for Trading Systems Operated by Brokers and Dealers, Exchange
electronically. For examples of ECNs, see Instinet, at http://www.institnet.com (last visited Nov. 19, 2000)
(Instinet is owned by Reuters); Island, at http://www.isid.com (last visited Nov. 19, 2000) (Island is owned by
Datek). On the implications of technology for financial markets, see, for example, Ian Grigg, \textit{Digital Trading}
(Sept. 16, 1997) (describing four waves of development, from information through Internet brokerage, and

Investors also have access to a range of nonsecurities markets on the Internet, such as currency markets. See,
e.g., Opulent Trading, at http://www.opulent-fx.com/ (last visited Nov. 19, 2000).

\textsuperscript{31} Online brokerages typically require their customers to deposit about $2000 with them in order to
Nov. 19, 2000).

\textsuperscript{32} Cf. CyberCorp.com, an intelligent order routing system, and a subsidiary of the Charles Schwab
Corporation, which routes orders to an exchange, NASDAQ, or an ECN (including Island, Archipelago, and
Brut). Cybercorp requires a minimum of $10,000 to open an account, an income of $35,000 per year, and a
liquid net worth of $65,000 (exclusive of farm and home). See Cybercorp, Minimum Account Requirements, at
19, 2000).

\textsuperscript{33} Cf. the Keynote Web Broker Trading Index, which “shows the average response times and success
rates for creating a standard stock-order transaction on selected brokerage Web sites.” Keynote, Keynote Web

\textsuperscript{34} See, e.g., DIV. OF MKT. REG., SEC, SPECIAL STUDY: ELECTRONIC COMMUNICATION NETWORKS AND

\textsuperscript{35} See, e.g., Zarb, supra note 26 (identifying four major developments in the securities markets:
globalization, privatization, consolidation, and democratization).

\textsuperscript{36} Instinet is an ECN. For more information about Instinet and other ECNs, see supra note 30 and
accompanying text.

\textsuperscript{37} See Diana B. Henriques, \textit{Facing Growing Competition, Instinet Scrabbles for Position}, N.Y. TIMES,
May 8, 1999, at B3. Other ECNs already encourage day traders to use their facilities. See, e.g., All-tech's
Attain, at http://www.attain.com (last visited Nov. 19, 2000); Spear, Leeds & Kellogg, Redi Products, at

\textsuperscript{38} Tradepoint benefits from a small volume exemption from registration with the SEC as an exchange.
See Order Granting Limited Volume Exemption From Registration as an Exchange Under Section 5 of the
(CCH) ¶ 86,128, at 81,954 (Mar. 22, 1999); see also, Elizabeth M. McCarron, \textit{Regulation of Electronic
Communications Networks: An Examination of Tradepoint Financial Network's SEC Approval to Become the
Day trading firms usually provide day traders with direct access to securities markets so that these traders have better access to the markets than do most online brokerage customers. The SEC has estimated that there are about "one hundred day trading firms organized as retail brokerage firms." In such an arrangement, the day trader is a customer of the firm. However, day traders may also be characterized as employees or as principals in day trading firms. A recent SEC study found that in a sample of 224 day traders, more than half claimed to earn more than $100,000 each year, and seventy-eight percent of the sample stated that they had a net worth of over $200,000. Other studies suggest that day traders face serious risks of losing money and that day trading is, therefore, not for those of limited resources. Technology, therefore, seems to allow individual investors more autonomy in managing their financial affairs. It expands access to information and enhances investors’ access to the markets themselves. Rather than entering into a relationship with a broker-dealer firm, which is the investor’s major source of information about financial markets and products, the investor can use many different, easily accessible information resources. Widely available information about broker-dealers’ fees and services enables investors to shop around and increases competition between broker-dealer firms. Of course, wealthier investors benefit more

(arguing the low volume exemption will help Tradepoint, but may constrain growth); Press Release, Tradepoint, SEC Approves Tradepoint to Enter U.S., First Foreign Stock Exchange Cleared to Operate in U.S. (Mar. 23, 1999) (announcing that Tradepoint will operate in the United States), http://www.tradepoint.co.uk.

39. See, e.g., DIV. OF MKT. REG., supra note 34.

40. See OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, supra note 1, ¶ III.B. The charges for such access range from $50 to $675 per month. See id. ¶ IV.A.

41. Id. ¶ IV.A.

42. For instance, Heartland bought Datek Online Brokerage’s day trading unit in April 1998 and now markets itself as a firm with professional day traders. See Heartland Securities Corp., at http://www.hrld.com/ (last visited Nov. 19, 2000). Heartland’s homepage states the following:

Heartland Securities is a financial services firm specializing in equity day trading in the electronic marketplace. The firm serves both institutional and high net worth clients on a discretionary basis. Utilizing state-of-the-art hardware and software technology, its staff of over 200 professionals executes thousands of transactions on the NASDAQ Stock Market each day.


43. See OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, supra note 1, ¶ IV.A.

44. Id. ¶ IV.C.


Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.
than those with more limited resources, and regulators worry about whether online investors, in practice, obtain the level of market access they expect. 49 However, individual investors are experiencing greater levels of access to financial markets than was previously the case.

This expansion of access to the markets is only the latest technology-related issue for regulators in the financial markets. For a number of years, financial regulators have been concerned that increasing internationalization of financial markets and increasing use of derivative securities generally pose new threats to order in the financial markets. 50 Domestic financial markets are affected by events in other domestic financial markets. This creates incentives for financial regulators to work together.

At the same time, regulators have been focusing more directly on technology-related issues 51 such as non-exchange trading systems, 52 day trading, 53 the “Year 2000” (or


49. See, e.g., Online Brokerage, supra note 25 (analyzing issues surrounding online brokerage).


And we certainly cannot yet model the impact which the Internet will have on the delivery of financial services. There are those who think the Internet is simply another delivery mechanism, and others who think the Internet will change everything. A regulator should never be at one extreme on any spectrum, but I am closer to the “change everything” pole. I think we have not yet begun to see the way in which the Internet will alter the competitive dynamics of the financial sector.


53. For web sites that cater to day traders, see, for example, Day Traders Network, Institutional Quality Executions, Services, and Professionalism For the Active Home Trader, at http://www.daytrades.com/tradebetween.html (last visited Nov. 19, 2000); Direct Trade, Inc., Welcome to Direct Trade, at http://www.d-trade.com (last visited Nov. 19, 2000).
"Y2K") problem, concerns about systems security, increased risks of fraud through the Internet, and the needs for improved consumer education and to level the playing field for individual investors. Regulators are also concerned more generally about speculation in the markets and about investors' perceptions of risk.

In a speech in May of 1999, Arthur Levitt suggested that day traders are involved in "gambling" rather than speculation. In doing so, he invoked some powerful rhetoric: federal securities legislation requires the SEC to promote "fair and orderly" securities markets. Activities which can be characterized as "gambling" are activities which may jeopardize the fairness and orderliness of the markets, and are therefore a legitimate target for regulatory concern. The following sections of this Article discuss the meaning of the concept of fair and orderly securities markets and how the concept is used rhetorically in the context of day trading.


58. Levitt, Plain Talk, supra note 16.


60. Speculation in the securities markets was one of the reasons for the federal securities laws of the 1930s. See, e.g., Allen Boyer, The Great Gatsby, the Black Sox, High Finance, and American Law, 88 MICH. L. REV. 328, 340 (1989) ("The Liberty Bond boom of the early 1920s touched off the stockmarket speculation which characterized the rest of the decade. This helped cause the Great Depression, and led, in turn, to the securities legislation of 1933 and 1934.").

Paul Mahoney suggests that dislike of speculation may have a discreditable basis:

Speculation, because of its individualistic and impersonal nature, is a ready means for those who face barriers elsewhere to make a living—a feature that undoubtedly contributes to its unpopularity. Thus attacks on speculation (and, of course, on the related evil of usury) have often had an anti-semitic tinge.

III. THE IDEOLOGY OF "FAIR AND ORDERLY MARKETS?"

The ideology of "fair and orderly markets," often associated with ideas of "market integrity," is everywhere. In 1997, Arthur Levitt, the Chairman of the SEC, stated, "While technology has changed, the principal goals of regulation remain the same—to protect investors and to ensure our markets are fair and orderly." Financial markets use this rhetoric. For example, in describing a settlement the NYSE had reached with the SEC, Richard Grasso, the Chairman of the NYSE, emphasized the exchange's commitment "to assure fairness and honesty in the market." Officials of NASDAQ-Amex also employ ideas of fair and orderly markets. The use of this rhetoric is inescapable. It is at the same time a reflection of the legal obligations imposed on the regulators and markets, and an attempt to make investors feel comfortable about interacting with the markets.

We tend not to question the rhetoric because it is everywhere. But even if securities regulators, politicians, and commentators, in the United States and elsewhere, agree that a major objective of financial regulation is the achievement and maintenance of fair and orderly markets, this does not tell us what it means to say that a market is fair or orderly. These terms are capable of different meanings depending on the perspective adopted. An issuer of securities might have different views about what would make a securities market fair and orderly from the perspective of an operator of the market, or a broker-dealer who trades through the market, or an institutional investor. Different individual investors might have different views about what constitutes an acceptable level of

61. See, e.g., Sir Andrew Large, Chairman of the Securities and Investments Board, The Legal Foundations of Regulation in a Converging World, Address to the ALI-ABA Course of Study—Broker-Dealer Regulation (Jan. 9, 1997) ("[W]e supervisors have made real progress. Our legislative underpinnings may be different, but we share basic common goals. We know the importance of there being satisfactory levels of investor protection, of market integrity and of systemic security."). http://www.sib.co.uk/speeches/090197.htm.

[The strength of U.S. capital markets also can be undoubtedly traced to the significant amount of confidence investors have in the efficiency and fairness of those markets. Capital markets will not flourish if investors think that their orders to purchase and sell securities will not be executed quickly and fairly.]

Id. at 18.
fairness or orderliness. As a practical matter, the implementation of the rhetoric is driven by the views of market participants, rather than by those of ordinary investors. 66

The details of this rhetoric of fair and orderly markets for financial products are not always clearly articulated. Regulators often give the impression that they know unfairness and disorder when they see them and need to stamp them out, rather than expressing a coherent idea of the necessary conditions for fair and orderly markets. Indeed, the rhetoric is clearly problematic. Markets are not necessarily orderly, 67 and rules designed to make them more so are likely to undermine fairness. 68 The idea that we can seriously describe markets as “fair” is strange. 69 “Fair or orderly” in the context of securities regulation clearly do not have the same meaning they have in everyday speech. 70

The rhetoric of fair and orderly markets is embedded in the law, 71 and it is politically powerful, but there is a difficulty in characterizing markets as fair. 72 It is

---

66. See, e.g., Richard A. Booth, Discounts and Other Mysteries of Corporate Finance, 79 CAL. L. REV. 1055, 1116 (1991) (stating that “[b]y arguing that fixed-price offerings are necessary to provide equal access to small investors, or to allow smaller regional brokerage houses to participate in offerings, the securities industry has prevailed on the regulators to enforce what amounts to a price-fixing scheme and has captured a monopoly-like license for itself”).

67. Many commentators have argued that there is much irrational behavior in the financial markets. See, e.g., Thomas Lee Hazen, Rational Investments, Speculation, or Gambling—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets, 86 NW. U. L. REV. 987, 988 (1992) (arguing that “current regulatory philosophy is over reliant on the premise of market rationality”).

68. For a suggestion that trading suspensions may raise concerns about fairness, see, e.g., Caroline Bradley, Suspension and Disbelief (or, How Managed Should a Market Be?), 26 SETON HALL L. REV. 597 (1996).

69. See generally In re Merrill Lynch Sec. Litig., 911 F. Supp. 754, 758 (D.N.J. 1995) (describing what constitutes fairness in financial markets). The Merrill Court stated:

The function of a stock exchange is to provide an environment in which the transfer of capital between enterprises can be accomplished at fair prices for minimal cost. One measure of the success of an exchange in fulfilling that role, known as liquidity, is the rapidity and ease with which such transfers can be effectuated. A marketplace with good liquidity affords buyers and sellers the opportunity to locate counterparts willing to trade a wide range of issues at acceptable prices as quickly and efficiently as possible.

Id. at 758.

70. For example, when I say to David, my seven year old son, “It is not fair to take all of the cookies. Other people might want some,” or when he says to me, “Benjamin took that toy. I was playing with it. That’s not fair,” these examples illustrate a distinction between distributional fairness and the protection of vested rights. Karl Polanyi pointed out the following: “The true criticism of market society is not that it was based on economics—in a sense, every and any society must be based on it—but that its economy was based on self-interest.” KARL POLANYI, THE GREAT TRANSFORMATION 249 (1944); cf. David M. Schizer, Benign Restraint: The SEC’s Regulation of Execution Systems, 101 YALE L.J. 1551, 1552 n.4 (1992) (“[S]ecurities market’s raison d’etre is to create wealth, not to serve as the ultimate level playing field or the fairest of casinos. Redistributive or fairness goals are better pursued by other means.”).

71. Section 2 of the 1934 Act refers to the need to “insure the maintenance of fair and honest markets.” 15 U.S.C. § 78b (1994). The 1934 Act also refers to the need to “promote just and equitable principles of trade” and “fair dealing.” Id. § 78f(b)(5), § 78f(b)(2). Section 11 of the Act refers to “fair and orderly markets.” Id. § 78k. The 1975 amendments to the 1934 Act instructed the SEC to work towards achieving a national market system that has regard toward the public interest, to the protection of investors, and to the maintenance of fair and orderly markets. See Securities Acts Amendments of 1975, Pub. L. No. 94-29, §7, 89 Stat. 97, 111-12 (1975) (adding section 78k-1 to the Act).

72. “There never was a presumption that markets yielded an optimal societal or generational distribution of income and now there does not seem to be any basis for the presumption that markets yield efficient
probably for this reason that the term "market integrity" is now being used to describe what financial regulation is trying to ensure. 73 This is a term which can at the same time be presented as practically synonymous with fairness and orderliness of the markets and as more consistent with the policy makers' preoccupation with ideas of market efficiency.

We tend to think that markets which are not "fixed" are fair. However, financial markets, like markets for many types of services, including professional services, are fixed by regulation. 74 Exchange markets are privileged by regulation in many ways. The NYSE, as operator of a market, has access to information about prices, and it charges others for access to this market information. 75 Only select people or firms who prove their eligibility are allowed to perform various functions in regulated securities markets. 76 Regulators do sometimes recognize that there is a tension between fairness and regulations that control how the market operates. 77 In addition to practical barriers to entry into markets, such as the need for resources to invest in computer systems, regulation itself imposes barriers, thus restricting competition. 78

In addition to the substance of the rules on access, the application of the rules may also raise fairness issues. In the same way that some jurisdictions regulate a person's ability to hold herself out as a plumber or a lawyer, many jurisdictions regulate a person's ability to hold herself out as a securities broker or a securities exchange member. 79 The

---

73. For an example of the use of the term "market integrity," see, e.g., Div. of Mkt. Reg., Sec. and Exch. Comm'n, Special Study: Elec. Communication Networks & After-Hours Trading, Pt. III.II.D (2000), available at http://www.sec.gov/news/studies/ecnafter.htm (stating that "[w]hen the SRO extended-hours pilots were initiated in October 1999, both the SROs and the Commission determined that essential investor protection and market integrity rules should apply to the after-hours market.").


76. For an example of sensitivity on this issue, see IOSCO, supra note 51, § 7.3 ("As a condition to authorization, the legislation or the regulator should require an SRO to . . . avoid using the oversight role to allow any market participant unfairly to gain advantage in the market.").

77. Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,123 (1998) (proposed May 12,1998) (to be codified at 17 C.F.R. pts. 34-35) ("There is an inherent tension between the desire to promote open and competitive markets by allowing access and the desire to maintain financial integrity by imposing admission standards.").

78. There are some limits on the ability of regulation to restrict access to functions related to the financial markets. See, e.g., Lowe v. SEC, 472 U.S. 181 (1985) (holding that including publishers of impersonal investment advice in the definition of "investment adviser" in the Investment Advisers Act of 1940 would violate the First Amendment); but, cf. Commodity Futures Trading Comm'n v. Vartuli, 228 F.3d 94, 103, 111-12 (2d Cir. 2000) (holding that giving investment advice through electronic media, for profit, including advice provided through software for futures day trading, required registration as a commodities trading advisor under the Commodity Exchange Act and that the software did not produce constitutionally protected speech).

organizations which make these determinations are often self-regulatory organizations (SROs), formed by those who carry out the functions in question.

Rules of the exchange market regulate how a person may become a member of the exchange. Prospective members are required to pass examinations in order to prove their eligibility. Traditionally, exchanges have been required to be membership organizations, rather than proprietary organizations, and exchange membership has been rather like membership in an exclusive, or not-so-exclusive, club. Members of the club must comply with required standards of conduct.

In the United States, securities brokers who are not members of an exchange join the National Association of Securities Dealers (NASD), which has a regulatory arm (NASD Regulation) that decides how people may establish their eligibility to become securities brokers. The NASD's rules provide that an applicant may apply for the National Adjudicatory Council to review a membership decision. NASD Rule 1019 provides that an applicant may apply to the SEC for review of a final decision of the NASD under section 19(d)(2) of the Securities and Exchange Act of 1934.

80. In 1938, Congress enacted the Maloney Act, 15 U.S.C. § 78o-3 (1994), mandating industry self-regulation through registered national securities associations. S. REP. NO. 75-1455, at 3-4 (1938); H.R. REP. NO. 75-2307, at 4-5 (1938). Congress did this because existing regulatory mechanisms were inadequate "to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry," S. REP. NO. 75-1455, at 3 (1938), and inadequate "to cope with those methods of doing business, which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market," H.R. REP. NO. 75-2307, at 4 (1938).

81. See Constitution of the New York Stock Exchange art. 2, 2 NYSE GUIDE (CCH) ¶¶ 1051-64, at 1053-59 (1994). A person can only become a member of the NYSE with the approval of the Board of the NYSE. Id. ¶ 1053, at 1054. Members of the Exchange may transfer or lease their memberships to others under certain conditions. See NYSE Rule 301, 2 NYSE GUIDE (CCH) ¶ 2301, at 3025-35 (1993).


83. See NYSE Rule 308, 2 NYSE GUIDE (CCH) ¶ 2308, at 3042-43 (1993-94) (describing the NYSE's "Acceptability Proceedings"). Decisions are made by an Acceptability Committee, subject to the possibility of review by the Board of Directors. Id.

84. See NYSE Rule 401, 2 NYSE GUIDE (CCH) ¶ 2401, at 3695 (1994) ("Every member ... shall at all times adhere to the principles of good business practice. . . .").

85. Members of an exchange are regulated by the exchange. Cf. Feins v. Am. Stock Exch., Inc., 81 F.3d 1215, 1219 (2d Cir. 1996) (holding that there is no private cause of action for damages under Sections 19(d), 19(f) and 19(g) of the Securities Exchange Act of 1934, where exchange improperly refuses membership); but cf. id. at 1218 (noting that "the amended Exchange Act requires that the exercise of [the] self-regulatory powers conform to the standards of due process").

86. Section 15(b)(8) of the 1934 Act requires registered brokers or dealers who effect transactions in securities to be a member of a securities association registered under §15A of the Act, or to be a member of the securities exchange through which they affect transactions. The only securities association registered under this section is the NASD. For more information on membership of the NASD, see NASD Membership and Registration Rules 1000-140, NASD MANUAL (CCH) 3111-411 (1996-99) (giving membership, registration and qualification requirements for the NASD).


Regulation also makes determinations about when people should have their status as a registered broker-dealer suspended or terminated.

The NASD has a measure of discretion in making decisions about membership, in the same way that the NYSE does. Some of the criteria are objective, such as whether an applicant has passed the examinations required of NASD members. Other criteria are more subjective, and involve a greater scope for the exercise of discretion by the NASD. For example, the NASD's criteria include whether "[t]he Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and the Rules of the Association, including observing high standards of commercial honor and just and equitable principles of trade." The criteria also require an applicant to have proper arrangements in place for its business plan, together with adequate capital, and financial controls, compliance, internal control, and supervisory systems. Although these criteria are not particularly specific, they are more specific than the NYSE's criteria for acceptability.

However transparent the criteria for membership in an exchange or in the NASD, the securities markets are, like all aspects of life, affected by biases and unfairness. Although women have increased their representation among employees of financial firms in recent years, other groups have not fared so well. Some financial firms have reacted


90. People who wish to challenge NASD's exercise of its regulatory functions have limited rights to do so. See, e.g., Desiderio v. NASD, 191 F.3d 198, 207-08 (2d Cir. 1999) (holding plaintiff did not have a private right of action against the NASD under the 1934 Act and dismissing state law claims brought against the NASD); Sparta Surgical Corp. v. NASD, 159 F.3d 1209, 1213 (9th Cir. 1998) (holding that "a party has no private right of action against an exchange for violating its own rules").

91. See NASD Membership and Registration Rule 1014, NASD Manual (CCH) 3118 (1998) (setting out the NASD's standards for admission).

92. Id.; NASD Membership and Registration Rule 1070, NASD Manual (CCH) 3291 (1997) ("Qualification Examinations and Waiver of Requirements").


95. C.f. NYSE Rule 308, supra note 83.

96. "Service industries," like insurance and banking, have a "female intensive workforce." FEDERAL GLASS CEILING COMM'N, GOOD FOR BUSINESS: MAKING FULL USE OF THE NATION'S CAPITAL 17 (1995). However, women may be less well represented in managerial positions. The Federal Glass Ceiling Commission study cites figures of 58.6% female employment in finance, insurance, and real estate, but 49.93% were executives, administrators, and managers. Id. at 221. African Americans represented 8% of employed persons in finance, insurance, and real estate, whereas Hispanic Americans represented 5.5% of employed persons. Id. at 220.
to suggestions that they are not as inclusive as they should be by publicizing their strategies for diversity.97

As well as fixing the financial markets by restricting access, regulators also fix the way in which business is carried out on those markets. There are questions about whether these rules promote fairness. A person who establishes her eligibility to call herself a securities broker as a member of NASD is bound by that organization’s rules, which include a rule prohibiting conduct inconsistent with “high standards of commercial honor and just and equitable principles of trade.”98 Similarly, the NYSE insists on “the principles of good business practice.”99 One could argue that these rules involve uncertainty, and therefore a risk of unfairness, but the potential unfairness to the regulated person should be balanced against the need to protect his customer. Achieving an appropriate balance may be difficult, and some of the NYSE’s rules have been criticized as inconsistent with the objective of fair treatment.100 The SEC has approved the NYSE’s decision to abandon a rule which many argued restricted competition by restricting the ability of exchange members to execute trades off the exchange.101

Securities markets employ other rules to ensure fairness, including disclosure requirements and restrictions on insider trading102 and manipulative practices.103 One might argue that the federal securities laws dramatically improve the rights of investors in securities, beyond the rights investors had at common law and beyond the rights people have in the context of nonsecurities transactions. But there are weaknesses in the rules. The Bespeaks Caution Doctrine allows issuers of securities to make forward looking


98. NASD Rule 2110 provides, “A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.” NASD Conduct Rule 2210, NASD MANUAL (CCH) 4111 (1998). The NASD also describes the standards of fair dealing with customers in more detail and prohibits activities such as churning. See NASD Conduct Rule IM-2310-2, NASD MANUAL (CCH) 4261 (1997). NASD describes fair dealing as requiring that “sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.” Id. For example, it is inconsistent with Rule 2110 to forge signatures to checks and convert the proceeds. See In re Eliezer Gurfel, Securities Exchange Act of 1934, Release. No. 41229 (March 30, 1999), http://www.sec.gov/enforce/opinions/3441229.txt.

99. See supra note 84.


103. See Rule 78, 2 NYSE GUIDE (CCH) ¶ 2078, at 2656 (1998).
statements provided that such statements are accompanied by cautionary language.\textsuperscript{104} The statute requires specific cautionary language, but cautionary statements are, in fact, sometimes quite general. There are other ways in which the rules are limited in their assurance of fairness. For example, rules distinguish between "acceptable" and "unacceptable" market manipulation:\textsuperscript{105} stabilization of the price of securities issued in an IPO is allowed, but other activities designed to alter the price at which securities trade are not.\textsuperscript{106} Stock exchange specialists have an obligation to intervene in their markets in certain circumstances, and their actions affect the prices of the securities in those markets.\textsuperscript{107} A person is only prohibited from trading on the basis of information others do not have if her use of the information to trade would violate a duty she owes to another person or entity.\textsuperscript{108} The rules adopt selective views of what fairness involves, and they tend to favor market professionals over nonprofessionals.\textsuperscript{109}

Rules which securities markets implement to ensure the orderly operation of the markets require particular procedures for entering into, clearing, and settling


Statements made in this press release that state "we will," "we expect," or otherwise state the companies' predictions for the future are forward-looking statements. Actual results might differ materially from those projected in the forward-looking statements. Additional information concerning factors that could cause actual results to materially differ from those in the forward-looking statements is contained in each Company's annual report on Form 10K-A for the year ended December 31, 1998 filed with the U.S. Securities and Exchange Commission.


\textsuperscript{106} Cf. Lynn Stout, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 MICH. L. REV. 613, 664 (1988) (stating that stabilization as an artificial propping up of market price is inconsistent with the idea that the encouragement of efficiency is the priority of securities regulation).

\textsuperscript{107} See, e.g., Daniel R. Fischel, Organized Exchanges and the Regulation of Dual Class Common Stock, 54 U. CHI. L. REV. 119, 126 (1987) (stating that "[t]he specialist is charged with the responsibility of maintaining an 'orderly' market, in addition to acting as a transactional intermediary. In practice this means he attempts to moderate price changes by buying or selling for his own account").


\textsuperscript{109} See, Richard A. Booth, The Uncertain Case for Regulating Program Trading, 1994 COLUM. BUS. L. REV. 1, 5-7 (suggesting that the NYSE's opposition to program trading might be based on a desire to protect specialists); cf. Morris Mendelson & Junius W. Peake, Market 2000: Intermediaries' or Investors': Whose Market is it Anyway?, 19 J. CORP. L. 443, 447 (1994) ("Unfortunately, in their attempt to execute the directives of the 1975 Act and to set new standards and develop the system, the SEC turned for guidance and expertise to the very group of market center managers who were dead set against designing themselves out of business.").
transactions. They seek to limit price volatility in the market, for example, by limiting trading during periods of significant market decline. Securities markets also exercise the power to suspend trading in specific securities. However, an issuer which feels its interests have been prejudiced by a suspension of trading in its securities has no right to damages for any loss incurred as a result.

For some time, economists have debated the relative efficiency of different mechanisms for fixing prices in securities markets—investigating the relative advantages and disadvantages of different market structures. Regulators debate the extent to which market structures should be determined by market forces or by regulation. Financial markets are like markets for nonfinancial services, but different from markets for goods. A market for a particular consumer good would generally be regarded as fair if prices were not fixed, but were settled by a process which reconciled supply and demand in order to find a price at which the market would clear, which would be a market that was not dominated by a monopoly supplier or customer. In a fair market for this product, there would be no cartels operating and no barriers to entry into the market. In this market, information about the product would be freely available, so that customers could compare products to make decisions about substitution of one product for another, in order to maintain price competition. In financial markets the assumption of perfect

---

110. See, e.g., Other NASDAQ and NASD Markets Rule 5109, NASD Manual (CCH) 6217-18 (1999). Rule 5109 states:

Clearance and Settlement of International Transactions: (a) Association members and approved affiliates that effect international transactions must clear and settle all such transactions through a clearing agency registered with the Commission that uses a continuous net settlement system. This requirement may be satisfied through direct participation in a suitable clearing agency or through a clearing arrangement with another party.

Id.


113. See Sparta Surgical Corp. v. NASD, 159 F.3d 1209, 1212 (9th Cir. 1998) (noting that “15 U.S.C. § 78aa... vests exclusive jurisdiction over claims concerning duties created by exchange rules in the federal courts.”). The Sparta Court also found:

The results of any immunity rule may be harsh. If we take Sparta’s complaint at face value, which we must, defendants acted in a capricious, even tartuffian manner which caused Sparta enormous damage. Nonetheless, when Congress elected “cooperative regulation” as the primary means of regulating the over-the-counter market, the consequence was that self-regulatory organizations had to enjoy freedom from civil liability when they acted in their regulatory capacity.

Id. at 1215.

114. In many markets, there may be many prices for the same goods, which reflect factors other than the preferences of the parties involved. For example, retail stores in poor neighborhoods may charge higher prices for the same goods than stores charge for the same goods in wealthier neighborhoods. Cf. Ian Ayres, Fair Driving: Gender and Race Discrimination in Retail Car Negotiations, 104 HARV. L. REV. 817 (1991) (finding different prices for cars were offered to prospective purchasers depending on race and gender differences); Ian Ayres, Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause, 94 MICH. L.
information does not apply, and much regulation is geared toward ensuring the production and verification of information for market participants.115

Whereas consumers of soaps can distinguish between different types of soap according to personal preferences for certain scents or types of soap, and consumers of washing machines can consult Consumer Reports, consumers of financial products often lack the expertise to understand differences between different products or services available to them.116 This lack of expertise may even extend to an inability to understand the information required to be provided to consumers under the securities laws. It is this difficulty of the consumer's which is generally used to justify restrictions on the supply of professional services. The regulation of a market cannot compensate for unfairness which derives from a lack of expertise. Where such lack of expertise is combined with a lack of resources to buy in expertise, unfairness truly exists.117

Technology can itself promote the fairness of markets: as current information becomes more accessible to anyone with access to a computer hooked up to the Internet, asymmetries of information should be reduced. On the other hand, this information is only really useful to those who can use it to profit from their interactions with the market. Information on its own is of no use to an investor without the skills to interpret it. Increasingly, investors can obtain online and offline training in understanding financial markets and data.118 However, some web sites may be designed to lead investors into investing in ways which suit the interests of the operators of those web sites.119

---


*Car purchase*: I have bought my last two cars through a buying agent, who charges me a flat fee of three hundred dollars over dealer's invoice. I use this service mostly because I am too busy to negotiate with car dealers. But there is another reason: I worry that I may receive worse offers than a similarly situated White male. By using the buying agent, I skirt the aggravation of wondering, "Am I being discriminated against?"

*Id.*


The standard theories of the efficiency of competitive markets are based on the premise that there is perfect information. Thus the fundamental theorems of welfare economics, which assert that every competitive equilibrium is Pareto efficient, provide no guidance with respect to the question of whether financial markets, which are essentially concerned with the production, processing, dissemination, and utilization of information, are efficient.

*Id.*


118. See, e.g., Auditrack, *Auditrack Simulated Brokerage*, at http://auditrack.com/ (last visited Nov. 19, 2000) (providing a simulated brokerage operation created to offer customers all the benefits of trading live markets without the capital risk); Capscape, "Power for the People, Capitalism for the masses," at
In an orderly securities market people who desire to buy and sell securities should be able to do so in a timely and continuous manner, and without needing to worry whether the transactions they agree to will be effected. Many would argue that excessive volatility in a securities market is undesirable. In financial markets, intermediaries usually act as facilitators for the markets to work. Regulators seek to promote the orderliness of the markets by controlling the way in which securities trades are handled and cleared and adopting rules which attempt to limit the volatility of securities prices in the markets.

In practice, it is clear that there are many occasions of regulatory failure in the securities markets. Market participants manipulate the markets, and they collude to fix prices, broker-dealers pass worthless securities along to their customers, and insiders engage in insider trading. Vast resources are dedicated to tracking down and attempting to prevent these abuses. Nonetheless, some level of market abuse is inevitable, and thus, some unfairness is inevitable.

Some investors would argue that the rules which exist do not go far enough to protect their interests. The antitrust rules do not apply to securities market activities in the same way as they apply to other markets. The rules which regulate broker-dealer and


119. Web sites that merely offer advice may be immune from regulation by the SEC and other regulatory agencies on the basis that what they offer is not commercial speech and therefore benefit from First Amendment protection. See Commodity Trend Serv., Inc. v. Commodity Futures Trading Comm’n, 149 F.3d 679, 685-86 (7th Cir. 1998) (“The publications advertised in the exhibits submitted by the CFTC do not appear to propose commercial transactions between CTS and any customers. Rather, they appear to provide information on commodity trading in general and leave any actual trading to other parties.”).

120. See, e.g., Tammar Frankel, supra note 111, Permanent Subcomm. on Investigations, supra note 45, at 4-5 (stating that “market volatility is generally considered to be detrimental to investors because stock prices fluctuate for reasons unrelated to the business prospects of the company or the fair value of its shares”). For a suggestion that not all types of volatility in investment markets are harmful, see Lawrence Harris, The Dangers of Regulatory Overreaction to the October 1987 Crash, 74 CORNELL L. REV. 927, 928 (1989).

121. See United States v. Oakford, 79 F. Supp. 2d 357, 358 (S.D.N.Y 1999) (“Federal law delegates to the New York Stock Exchange ... substantial authority, and responsibility, to police itself and its members ... The legal problems posed by the instant case ... largely derive from the apparent failure of the Exchange to fulfill that responsibility adequately in its supervision of independent floor brokers.”).


126. See, e.g., Gordon v. N.Y. Stock Exch., Inc., 422 U.S. 659, 688-91 (1975) (holding that the antitrust laws are deemed repealed to the extent necessary to permit the securities laws to function as intended by Congress); but see Roskind v. Morgan Stanley Dean Witter & Co., 80 Cal. App. 4th 345, 352 (2000) (holding
markets allow some market participants to benefit at the expense of others.127 Some commentators argue that the SEC has not been nearly as aggressive as it should have been in dealing with the anti-competitive behavior of self-regulatory organizations.128 In addition, those who are affected by the rules laid down by exchanges and the NASD, or by their application of those rules, have a limited ability to obtain a remedy for any loss.129

Other phenomena challenge our ability to accept this rhetoric of fair and orderly markets. We are generally concerned about different types of risk.130 In the context of financial markets we see problems in the evaluation of the riskiness of investments, in particular, complex investments such as derivatives. We are preoccupied with the increasing complexity of our lives. Disorder and unfairness are everywhere.

IV. REGULATING TO ACHIEVE "FAIR AND ORDERLY MARKETS"

Politicians and regulators claim that regulation of financial market activity enhances confidence in those markets, promoting investment and the health of the markets as sources of capital for real production.131 In order to promote this confidence, we regulate markets, transactions on those markets, and market participants.132 Because politicians believe that it is crucial to promote investor confidence in the financial markets, they are

that federal securities laws did not preempt California’s unfair competition law), cert. denied 148 L. Ed. 2d 781 (2001).

127. See, e.g., Dale Arthur Oesterle et al., The New York Stock Exchange and its Out Moded Specialist System: Can the Exchange Innovate to Survive? 17 J. CORP. L 223, 236 (1992) (arguing that the NYSE does not effectively monitor specialists behavior so that “specialists get the better part of the deal: they make a substantial profit and their return obligation to the Exchange is largely a public relations ploy”).


129. See, e.g., Barbara v. N.Y. Stock Exch., Inc., 99 F.3d 49, 59 (2d Cir. 1996). The Barbara court found:

Absolute immunity is particularly appropriate in the unique context of the self-regulation of the national securities exchanges. Under the Exchange Act, the Exchange performs a variety of regulatory functions that would, in other circumstances, be performed by a government agency. Yet government agencies, including the SEC, would be entitled to sovereign immunity for all suits for money damages. As a private corporation, the Exchange does not share in the SEC’s sovereign immunity, but its special status and connection to the SEC influences our decision to recognize an absolute immunity from suits for money damages with respect to the Exchange’s conduct of disciplinary proceedings.

Id. (internal citations omitted).


131. See, e.g., Testimony of Chairman Alan Greenspan Before the Senate Comm. on Banking, Housing, and Urban Affairs, 105th Cong (June 17, 1998), http://www.bog.frb.fed.us/boarddocs/testimony/19980617.htm (“We believe that it is important for Congress to set the rules for this industry, which is so important to our nation’s health and prosperity. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.”).

132. See Larry Soderquist, The Role of the SEC in a Changing Market, 2000 COLUM. BUS. L. REV. 45, 45 (noting that “because of investors and the general public’s great risks from under-regulated markets, substantial regulation is necessary” (footnote omitted)).
extremely nervous about public perception that the markets are corrupt. A hint of scandal may result in a raft of new rules. New rules are often introduced rapidly in reaction to perceived abuses in the market. Thus, the rules are not always as carefully thought-out as they might be.

On the other hand, professional participants in the financial markets may be powerful lobbyists for their own interests. This lobbying by professional participants may result in rules which do not give sufficient protection to investors. The rhetoric of fair and orderly markets feeds into this, as market participants can use the rhetoric to legitimate rules that may allow them to increase their market power.

Financial markets are complex businesses, involved in providing information, opportunities for market participants to trade, and for businesses to raise capital. Some of those who trade through the market have a special relationship with the market, which gives them special privileges and special obligations. Thus, the markets have to deal with a wide range of interests which are likely to conflict. Some financial markets are recognized by the jurisdictions in which they are located as having an explicit regulatory role, while others claim to exercise self-regulation as a means of legitimating themselves. Either way, there may be a conflict between the market’s regulatory role and its role as a commercial enterprise.

Financial markets have in recent years been part of how nations compete with each other. Politicians act as though they are important to New York and to the United States, and that the NYSE is the world’s largest stock exchange by market capitalization and by trading volume. Until recently, financial markets based in different European countries

133. See Paul G. Mahoney, supra note 60, at 1374 ("The New Deal, then, was only one iteration of a long standing cycle of political reaction to securities trading.").
134. Consider, for example, the debates about the NASDAQ Supermontage proposal (proposing a new quotation management system), in which NASDAQ, critics, and the SEC invoked ideas of fair and orderly markets. See, e.g., Self Regulatory Organizations; Order Approving Proposed Changes by the National Association of Securities Dealers, Inc., Exchange Act Release No. 34-43863, 66 Fed. Reg. 8020, 8024 (Jan. 26, 2001) ("The Commission therefore finds that the requirement that registered market makers in Nasdaq accept automatic executions against their published quotes is not a new feature of the SuperMontage and that it remains an appropriate feature of a system designed to provide economically efficient executions to investors within a fair and orderly market.").
135. The New York Stock Exchange was a self-regulatory body at its inception. See, e.g., Stuart Banner, The Origin of the New York Stock Exchange, 1791-1860, 27 J. LEG. STUD. 113, 132 (1998) ("From its inception, the New York Stock and Exchange Board operated a miniature legal system, with its own rules governing securities trading and its own mechanism for resolving trade-related disputes."). Currently, self-regulation is used to different extents in different markets. See, e.g., Technical Comm., IOSCO, Supervisory Framework for Markets 11 (May, 1999), available at www.iоссо.org/docs-public/1999-supervisory_for_markets.html ("In most jurisdictions, the model has shifted from the pure self-regulatory model, so that both the market authority and the regulator perform regulatory responsibilities. However, the extent to which self-regulation is used varies.").
136. "[T]he Treasury fully supports the governance principles... that a recognized investment exchange should avoid any conflict between its regulatory role and the pursuit of its commercial interests, and that an exchange should be run in the interests of the full range of its users and members." SELECT COMMITTEE ON TREASURY SECOND SPECIAL REPORT, THE GOVERNMENT'S RESPONSE TO THE TREASURY COMMITTEE'S FIFTH REPORT FROM THE COMMITTEE IN SESSION 1996-97: THE PROSPECTS FOR THE LONDON STOCK EXCHANGE, Appendix at ¶ 12 (1997) (footnote omitted), http://www.parliament.the-stationery-office.co.uk/pa/cm199798/cmsgtcm/198s2/tss202.htm.
137. Note Ralph Nader’s comments:
also competed against each other. Currently these markets seem to have decided that they must combine with other markets in order to ensure their future success.

The internationalization of financial markets means that regulation in one market may have an impact on other markets. If one state adopts rules to protect its markets in the event of a crisis, such as the United States’ rules on circuit breakers, those rules may have an impact on other markets in other states. Regulators from different jurisdictions work together to agree on standards for regulation of the securities markets, as they do on standards for regulation of international banking. The IOSCO 1998 Report, Objectives and Principles of Securities Regulation, identifies three objectives of securities regulation: (1) investor protection; (2) fairness, efficiency, and transparency of markets; and (3) the reduction of systemic risk. IOSCO’s document states that fairness involves regulatory approval of the operators of securities trading systems, that it is “linked” to investor protection, and regulation should prevent market manipulation and other unfair

Take the $900 million package for the New York Stock Exchange, a naked subsidy to the high temple of free markets ostensibly designed to keep it from moving to New Jersey. This deal, which provides for about $200,000 in subsidies for each “retained” job, isn’t the only corporate-welfare arrangement the Mayor has struck with a financial exchange. He has bestowed similar gifts on the American Exchange, the Mercantile Exchange and the Coffee, Sugar and Cocoa Exchange.


Despite the volatility, trading, clearing and settlement systems, in general, worked well and many systems handled extremely large volumes without disruption. In some markets, the use of circuit breakers, margins and other measures appears to have enabled markets to absorb information and to respond to the volatility. However, issues such as the impact of the early closure of the U.S. markets on markets elsewhere, and the coordination of suspension of and trading in cross-listed securities, warrant further consideration.

Id.

141. See generally IOSCO, supra note 51.

142. Id. at 1, 6-8. Note also section 10.2 which states: “Regulation of issuers should ensure both investor protection and a fair, orderly and efficient market.” Id. at 24. Cf. Andrea M. Corcoran, The Uses of New Capital Markets: Electronic Commerce and the Rules of the Game in an International Marketplace, 49 AM. U. L. REV. 581, 608 (2000) (arguing, with some caveats, that “markets potentially can harmonize requirements across borders where Legislators have failed (or have yet) to do so”).
trading practices. Fair markets would not favor some users over others, and investors would have "fair access to market facilities and market or price information." The markets would also "ensure fair treatment of orders" and a "reliable" price formation process. As with many products of international harmonization activities, it is not clear how beneficial these statements are. They are not precise. For example, they do not specify what constitutes "fair access," or what "unfair trading practices" should be prohibited. As with domestic systems, there is a wide gap between the general rhetoric of "fair and orderly markets" and the specific rules that regulate the securities markets.

Change challenges regulators to bridge this gap.

From the perspective of a securities regulator, the development of new securities markets and new techniques for trading securities is a challenge. One can argue that these new markets and techniques develop because there is a market for them. On the other hand, the innovations do not fit neatly within existing regulatory structures (sometimes by design), and therefore threaten to destabilize the regulated markets. They threaten the orderliness, which the regulators are bound to protect.

As the securities markets change, so do the participants in those markets. Increasingly, active traders in the securities markets are nonprofessionals. They may trade through broker-dealers who provide facilities for day traders, or they may be owners of a broker-dealer. The advent of the nonprofessional "day trader" has worried regulators. Regulators have expressed concern that such day traders might not have an adequate perception of the risks involved in their activities. The NASD has acted on

---

143. IOSCO, supra note 51, at 7-8.
144. Id.
145. The SEC has stated:

Securities markets have become increasingly interdependent. The use of technology permits market participants to link products, implement complex hedging strategies across markets and across products, and trade on multiple markets simultaneously. While these opportunities benefit many investors, they may also create misallocations of capital, widespread inefficiency, and trading fragmentation if markets are not coordinated.


146. "When I started in this business, it was really a business of rich men selling stocks to each other. That is obviously no longer the case. Now Mr. and Mrs. America are in the stock market. Soon, it will be Mr. and Mrs. World." Zarb, supra note 26.

147. See, e.g., Gilligan v. Director, 11 N.J. Tax 414 (1991) (holding that for the purposes of the New Jersey gross income tax scheme, the distinction between a person who operates a securities business and a personal investor is the intention of the taxpayer as evidenced by the facts surrounding the taxpayer's activity).

148. Some day traders are members of limited liability companies (LLCs) registered as broker-dealers with the SEC, but exempt from any requirement to become members of NASD because they are exchange members and do not hold customer accounts. For the relevant exemption, see Rule 15b9-1 under the 1934 Act, Registration of Brokers and Dealers, 17 C.F.R. § 240.15b9-1 (2000). See Testimony of Arthur Levitt, Concerning Day Trading, Chairman of the SEC Before the Senate Permanent Subcomm. on Investigations of the Comm. on Governmental Affairs (Sept. 16, 1999), http://www.sec.gov/news/testimony/tsy/2199.htm.

149. "Professional" day traders may lose their clients' money. See In re Rea, 245 B.R. 77 (Bankr. N.D. Tex. 2000) (holding debts to investors resulting from day trading were nondischargeable in debtor's bankruptcy).

150. Chairman Levitt testified:
this concern by introducing rules requiring member firms which promote day trading to screen their customers who wish to become day traders.151

The day trading phenomenon is an interesting one. The archetypal day trader is a person without the traditional qualifications of a professional market participant. He needs financial resources to participate in the market as a day trader, but does not need to prove to a regulator that he is eligible to trade. He is an American entrepreneur, seizing opportunity where he finds it. The firms which help him to do so are facilitating the democratization of the markets. The counter-story is that these firms which provide facilities for day-traders are taking advantage of vulnerable people who are enticed by an unrealistic idea of easy profits into spending their lives hooked up to computer screens, where they gamble away what financial resources they have.152

The story that Arthur Levitt has started to tell about day traders is a story which invokes the rhetoric of fairness (irresponsible people are taking advantage of the vulnerable) and orderliness (gambling threatens the securities markets).153 Day traders therefore raise two, somewhat separate, areas of concern: how regulators should protect vulnerable investors (fairness), and how we can minimize the impact of gambling by day traders on the financial markets (order). The following section of this Article identifies some of the ways in which regulators and legislators are responding to the day trading phenomenon. Day trading is one aspect of a larger issue, which is the regulatory response to the development of online relationships between broker-dealers and their customers. But day traders raise some of these issues in a particularly stark way.

All online investors want to ensure their access to a wide range of information about issuers of securities and about current market prices. The Internet has dramatically increased the amount of information that is available to investors generally, reducing the disparity between information available to market professionals and nonprofessionals. Many of the regulatory issues currently perceived to surround online trading in securities are, unsurprisingly, issues about what rules should control the provision of information to investors online.154 In particular, there is an issue about whether current pricing arrangements for market data are fair and reasonable and do not discriminate unreasonably between professional and nonprofessional users of market data.155

---


153. See Levitt, Plain Talk, supra note 16.

154. See, e.g., Online Brokerage, supra note 25, at 82,742-82,745 (November 22, 1999).

V. DAY TRADERS AND REGULATION

The term "day trader" is usually applied to people who engage in day trading strategies and who are not traditional securities market professionals. However, although the day trader is not a market professional, he is not an ordinary investor either, because his approach to money management is seen as being different from that of an ordinary investor. Broker-dealers can clearly make significant profits from their associations with clients who engage in active trading, and some day traders are seen as insufficiently attuned to the risks involved in their activities, perhaps because they are naturally feckless, or perhaps because they have been misled by unscrupulous broker-dealers into developing an inaccurate view of the risks involved in day trading. This picture of the day trader suggests that the regulatory response should be to educate the day trader in the risks associated with his trading strategies, and to require the broker-dealer firm with which he is associated to take seriously its obligations to its prospective day trading clients.

In 2000, the SEC approved a new NASD rule requiring firms that promote day trading strategies to provide a detailed risk disclosure statement to such clients and then only allow the clients to engage in day trading if the firm has reasonable grounds for believing that such a strategy is suitable for the investor. The broker-dealer should evaluate the issue of suitability by exercising "reasonable diligence to ascertain the essential facts relative to the customer, including his or her financial situation, tax status, prior investment and trading experience, and investment objectives." This rule looks like a rule which fits very clearly within our ideas of securities regulation: Securities regulation should protect people in their dealings with broker-dealers, and rules which require broker-dealers to recommend suitable investments to their clients are part of this protection. In focusing on broker-dealer firms that promote day trading strategies, the NASD's rule requires risk disclosure and a suitability assessment to counterbalance the

156. See, e.g., Permanent Comm. on Investigations, supra note 45, at 22 (noting that "a growing number of people are giving up their existing careers or withdrawing their savings to become full-time professional day traders. The Subcommittee's investigation suggests that day trading closely resembles gambling for novice, undercapitalized traders.").

157. Online Brokerage, supra note 25, ¶ 86,222, at 82,727-82,728 (noting the existence of competition among online brokerages for the business of active traders).

158. The SEC has noted that risk disclosures by day trading firms have improved, apparently in response to the SEC's focus on this issue. See OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, supra note 1, § IV.


impact of the firm's "promotion" of day trading strategies. But the rule does not require risk disclosure and suitability assessment where a client has read all of the latest books on day trading, and then opens an account with a broker-dealer firm which does not promote day trading. The rule disciplines broker-dealers rather than protecting vulnerable investors. The rule seems designed more to discipline broker-dealer firms who adopt outlier business strategies, rather than to protect people from engaging in unsuitable investment strategies per se. A prospective day trader can avoid the suitability assessment by carrying out her trading through a firm which does not promote day trading strategies in order to avoid a discussion of suitability.

This insistence on suitability is clearly limited. As well as limiting its application to firms that promote day trading strategies, the rule applies only to day trading rather than to risky investment strategies more generally. The rule will not, therefore, dissuade investors from engaging in other risky investment strategies. This result is inherent in the statute. The Securities Exchange Act of 1934 allows the SEC to regulate broker-dealers, but not to tell investors what investment strategies they should or should not adopt.

Another tool for protecting investors from risky investments is education. Securities regulators are generally attempting to sensitize online investors to the risks of trading securities online using the same medium broker-dealer firms use to attract their interest. The Washington State Department of Financial Institutions has set up an Online Investor Resource Center which includes a list of "8 Things Every Online Investor Should

161. There are many books about day trading. See, e.g., BOB BAIRD & CRAIG MCBURNEY, ELECTRONIC DAY TRADING TO WIN xiii (1999) (advocating electronic direct access trading rather than trading through a broker-dealer); GREGORY J. MILLMAN, THE DAY TRADERS: THE UNTOLD STORY OF THE EXTREME INVESTORS AND HOW THEY CHANGED WALL STREET FOREVER (1999).


163. See Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Opening of Day-Trading Accounts, 64 Fed. Reg. at 51,169. Note that technological developments may be producing more rules which focus on advising investors of the risks of specific investment strategies. For example, the SEC has approved an NASD Notice to its members advising them of the need to inform clients of the risks of after-hours trading in securities. See Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to a Notice to Members on Extended Hours Trading, Exchange Act Release No. 34-42363 (Jan. 28, 2000), 65 Fed. Reg. 5715 (Feb. 4, 2000).

Know." The SEC’s web site includes some advice to prospective day traders under the headline “Day Trading: Your Dollars at Risk.” The SEC’s advice is organized under the following headings: (1) “Be prepared to suffer severe financial losses;” (2) “Day traders do not ‘invest;’” (3) “Day trading is an extremely stressful and expensive full-time job;” (4) “Day traders depend heavily on borrowing money or buying stocks on margin;” (5) “Don’t believe claims of easy profits;” (6) “Watch out for ‘hot tips’ and ‘expert advice’ from newsletters and web sites catering to day traders;” (7) “Remember that ‘educational’ seminars, classes, and books about day trading may not be objective;” and (8) “Check out day trading firms with your state securities regulator.” The contrast between this advice and the explanations available on many web sites and in bookstores of successful day trading strategies is striking. The SEC wants investors to recognize their powerlessness; day trading firms want to attract clients who are interested in investing for themselves.

The day trader seems to live in the space between the categories of professional and nonprofessional market participants. In recent years, regulators in different jurisdictions have invoked distinctions between the rules that apply in the context of wholesale market transactions and those that apply in the context of retail market transactions, or between persons and firms who can be relied upon to look after their own interests and those who cannot. Other rules distinguish between the conditions under which professionals and nonprofessionals can participate in the markets. The day trader invites us to reconsider the bases for these distinctions.

Capital adequacy requirements and margin requirements both aim to control the risks associated with securities transactions and to require those who invest in securities to have an equity interest in the securities they acquire. Broker-dealer firms are subject to capital adequacy requirements which are designed to be prudential rules.
encouraging broker-dealer firms to consider the risks associated with positions they take in securities, and providing a cushion against adverse changes in the values of the securities the firms hold for the protection of their clients. In addition, broker-dealers have responsibilities to comply with margin requirements that limit broker-dealers’ ability to lend money to clients so that the clients can invest in securities.173

In the United States, margin regulation requires an investor to pay for fifty percent of the current market value of the securities held in a margin account.174 The rules limit the extent to which an investor may purchase securities on credit.175 The rules also limit the amount of money broker-dealer firms may lend to their clients.176 Margin requirements may be seen as having the following three objectives: protecting investors who purchase securities on margin, preventing the excessive use of credit for the purchase of securities and the consequent diversion of resources from productive enterprise, and preventing excessive market fluctuations.177

Both margin requirements and capital adequacy requirements are arguably designed to encourage those subject to the rules to be prudent, but they operate in different ways. Day trading operations have been structured to take advantage of differences between these two different sets of rules. For example, day trading firms have been formed as limited liability companies (LLCs) whose members engage in day trading. Such firms avoided the need to join the NASD by becoming members of a stock exchange. As a stock exchange member firm, the day trading firm must comply with capital adequacy requirements.178 However, the traders who were the members of the day trading firm did

---


175. Id. § 220.4.

176. Id.

177. See, e.g., LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3225 (3d ed. 1991). On margin requirements generally, see id. at 3221-306.

178. In amending the rules of the Exchange, the SEC stated that: "According to the Exchange these off-floor traders generally become members of an LLC to avail themselves of good faith margin provided through the LLC’s Joint Back Office agreement with its clearing agent." Order Granting Approval to Proposed Change and Amendment Nos. 1 and 2 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change Requiring Off-Floor Traders for Which the Phx is the Designated Examining Authority to Successfully Complete the General Securities Representative Examination Series 7, Exchange Act Release No. 34-41776, 64 Fed. Reg. 47,214, 47,217 (Aug. 30, 1999) (footnotes omitted). For the meaning of "good faith margin," see Credit By Brokers and Dealers, Regulation T, 12 C.F.R. § 220.2 (2000). On joint back office arrangements, see Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval of Amendment to the Proposed Rule Changes that Adopt Capital and
not need to comply with the margin requirements which apply to customers of a broker-dealer.\textsuperscript{179} They were owners of the business, rather than its customers. The day trading firm would lend them money to enable them to trade.\textsuperscript{180}

One could argue that the avoidance of margin requirements by day traders is not of great concern if the firms they trade through are subject to capital adequacy requirements. However, margin requirements are designed in part to limit speculation generally, whereas capital adequacy requirements are designed to protect clients of a broker-dealer firm. A broker-dealer firm with no clients is not subject to the same level of capital requirement as a broker-dealer firm with clients. Where day traders decide to borrow significant amounts of money to help them to purchase securities, we may worry about whether they fully understand the risks they are exposed to,\textsuperscript{181} and further, whether their trading will divert resources from enterprise and increase the volatility of the markets.

The first of these concerns is the only concern that is unique to the day trader, as professional market participants may be allowed to speculate, provided that the interests of their clients are protected.\textsuperscript{182} Nonprofessionals are not supposed to speculate.\textsuperscript{183} However, there are some general systemic concerns about excessive speculation in the

---


\textsuperscript{182} See, Levitt, Plain Talk, supra note 16 (noting that day trading has historically been an activity in which professionals engage).

securities markets.\textsuperscript{184} Highly leveraged hedge funds raise some of the same issues as day traders.\textsuperscript{185}

In the 1930s, excessive speculation was regarded as one of the causes of the 1929 market crash.\textsuperscript{186} Over the last few years, a number of commentators have compared what was happening in the securities markets in the years leading up to 1929 with more current events and have predicted a new market crash.\textsuperscript{187} But it is now harder to disapprove of speculation as such,\textsuperscript{188} because we have normalized speculation.\textsuperscript{189} Now, if we want to identify an activity we disapprove of, we have to describe it as "gambling," an entirely different matter:

On the other end of that spectrum are so-called "day traders" whose time horizon for moving in and out of stock positions is measured by minutes, if not seconds. Some argue day trading is really nothing more than speculation. And, speculation is not new to our markets. Personally, I don't think day traders are speculating because traditional speculation requires some market knowledge. They are instead gambling, which doesn't. Historically, short-term trading has been an activity filled by a relatively small number of professional traders.\textsuperscript{190}

More recently, the SEC has described day trading as "frequent, fast and risky trading."\textsuperscript{191} But risky trading is what professionals do all the time, and we tend to accept


More prudent practices by regulated firms that are universally applied across sectors and appropriately encouraged by diligent supervisors should have a significant effect on reducing some elements of systemic risk raised by the activities of HLI's...the best efforts of individual regulated firms and the incentives provided by regulators to encourage prudent risk management practices will not be sufficient to reduce the systemic risks of concern. Therefore, additional measures beyond enhanced risk management at regulated firms should be considered.

\textit{Id.}

\textsuperscript{186} See, e.g., FERDINAND PECORA, WALL STREET UNDER OATH ix (1939) (stating that "[u]nder the surface of the governmental regulation of the securities market, the same forces that produced the speculative excesses of the 'wild bull market' of 1929 still give evidence of their existence and influence").

\textsuperscript{187} See Hu, supra note 164, at 781-91 (reciting comments about current overvaluation of the stock market).

\textsuperscript{188} For a description of the distinction between investment and speculation, see Louis Lowenstein, \textit{WHAT'S WRONG WITH WALL STREET} 13-30 (1988).

\textsuperscript{189} Commentators argue that the activities of speculative investors enhance liquidity in the markets. Day traders have added liquidity, see, e.g., Permanent Subcomm. on Investigations, supra note 45, at 33 (stating that "there is strong evidence that day trading has expanded liquidity").


\textsuperscript{191} OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, supra note 1, at § II.
that they do so.\textsuperscript{192} Moreover, the investment strategies used by nonprofessional day traders are not unique to them. It will be interesting to see whether attitudes toward day trading change as respectable participants in the financial markets acquire ownership of day trading firms.\textsuperscript{193}

The distinction between speculation and gambling is problematic. Those who have wished to draw distinctions between investment and speculation have linked investment with ideas of fundamental values. They have suggested that those who speculate are making their decisions about what securities to buy on the basis of an assessment of what others in the market might be interested in acquiring at some later date.\textsuperscript{194} But any speculator may make a mistake. Nonprofessional day traders may have less knowledge about the views and the likely behavior of other investors in the securities markets than do professional speculators, but the activities of professional speculators are also an issue of more general concern. The Center for Economic Policy Research has recently been working on a proposal for a tax on securities transactions (a "Tobin tax") to discourage speculation.\textsuperscript{195}

We could argue that day traders are engaging in less risky investment strategies than many other traders. Typically, a day trader will not hold a security for any length of time and will close out his positions overnight.\textsuperscript{196} Such an approach to trading reduces the major risk of investment—that the market price of the investment will decline while the investor is not paying attention. An attentive day trader will limit this downside risk. Perhaps the concern about day traders is not so much that they subject themselves to risks, but that they have not proved their eligibility to use a day trading strategy. If the concern is about the personal position of the day traders and leads to regulation of day trading, then such traders may well decide to gamble on securities rather than purchasing securities. If the concern is about the impact on the securities markets of traders who are not trading on the basis of fundamental analysis, then the nonprofessional day traders are not the only ones to watch.

Day traders raise issues of fairness and of orderliness. Some broker-dealer firms may unfairly be taking advantage of vulnerable people in introducing them to day trading. Other arrangements look more like the provision of trading facilities to people who can look after themselves.

\textsuperscript{192} It may well be that it is rational for day traders to hope for large (but uncertain) profits: "[C]onsumers desire large amounts of sudden wealth, and lotteries offer a unique opportunity to satisfy such desires." Edward J. McCaffery, \textit{Why People Play Lotteries and Why It Matters}, 1994 Wis. L. Rev. 71, 74.

\textsuperscript{193} For example, the Charles Schwab Corporation is now in the day trading business through its ownership of Cybercorp. See Cybercorp, \textit{About Cybercorp}, http://www.cybercorp.com/faq/about.asp (last visited Jan. 23, 2001).

\textsuperscript{194} A number of commentators have argued that the securities markets are speculatively, rather than allocatively efficient, and that securities regulation is geared to enhancing the speculative, rather than the allocative efficiency of the markets. \textit{See}, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, \textit{Efficient Markets, Costly Information and Securities Research}, 60 N.Y.U. L. Rev. 761 (1985); \textit{Stout}, supra note 106.

\textsuperscript{195} \textit{See}, e.g., Center for Economic and Policy Research, \textit{The Tobin Tax: Shifting the Tax Burden From Wages to Wagers}, at http://www.cepr.net/speculation/ (last visited Nov. 19, 2000); \textit{cf.} Lowenstein, \textit{ supra} note 188, at 86-87 (advocating taxation of gains from sale of stocks or derived securities held for less than a year at 100%).

\textsuperscript{196} \textit{See}, e.g., Office of Compliance Inspections and Examinations, \textit{ supra} note 1, at § IIc ("Day traders generally acknowledge they are not investors due to the short time they hold positions. Many day traders hold stocks for seconds or hours, seldom overnight, closing out positions for small profits.").
Regulators are trying to deal with both parts of this picture. Rules which emphasize the need for broker-dealers to make disclosure about the risks associated with day-trading as an investment strategy clearly relate to the first part of the picture. In December 1999, the NYSE and the NASD announced that they had decided to establish special margin requirements for day traders to confront the risks of day trading. 197 The proposed changes to the margin requirements would apply special requirements to customers who engage in a pattern of day trading. 198 Such traders would be required to maintain a minimum equity balance of $25,000 in their accounts, in contrast to the $2000 usually required of customers of broker-dealers. 199

Another regulatory approach to day trading is to recognize that some day traders are like market professionals in many ways, and should therefore be subject to similar regulatory requirements to those imposed on professionals. A person who trades as an associated person of a member of a securities exchange may be required to pass examinations. 200 The requirement is designed to ensure that associated persons are in a position to comply with securities laws and regulations. 201 But it makes little sense to require day traders to pass examinations just because they are principals in a stock exchange member firm, regardless of whether their actions within the firm have any more impact on the markets or other investors than if they were carrying on the same activity as customers of a broker-dealer.

As to orderliness, we can question whether Levitt’s distinction between the (acceptable) speculation engaged in by professionals and the (unacceptable) gambling engaged in by non-professional day traders is a principled distinction. Any attempt to regulate on the basis of this distinction would risk the appearance of unfairness.

VI. CONCLUSION

Securities regulators often justify changes in the rules they administer by reference to the need to make the markets fairer or more orderly. This Article has argued that the concept of fairness invoked by these regulators is a limited concept: it does not account for unfairness constituted by limited access to financial resources, and educational and

198. This term is intended to cover a person who engages in four or more day trades within five business days in an account. Id. Proposed rule 431(f)(8)(B)(i) would define a pattern day trader as “any customer who executes four (4) or more day trades within five (5) business days. However, if the number of day trades is 6% or less of total trades for the five (5) business day period, the customer will no longer be considered a pattern day trader and the special requirements under paragraph (f)(8)(B)(v) of this Rule will not apply.” Id.
199. Id. at 4007.
200. See Order Granting Approval to Proposed Change and Amendment Nos. 1 and 2 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 to the Proposed Rule Change Requiring Off-Floor Traders for Which the Phlx is the Designated Examining Authority to Successfully Complete the General Securities Representative Examination Series 7, Exchange Act Release No. 34-41776, 64 Fed. Reg. 47,214, 47,217 (Aug. 30, 1999) (“The proper education of securities industry personnel is but one component of a carefully considered statutory and regulatory framework designed to promote the integrity of securities markets and protect investors.”).
201. Id.
other resources. Technology promises to increase access of ordinary people to information about financial products and to cheaper transactions in those products. Increasingly, the potentially democratizing impact of the Internet challenges our ideas about the appropriateness of existing regulatory classifications. The wide availability of information about issuers of securities and the markets through the Internet raises numerous issues. The Internet has truly democratizing potential in all sorts of ways, including the potential to democratize access to the securities markets, but there are risks that this potential will not be achieved.

We should worry about two sets of risks which are likely to interfere with the process of democratization of the securities markets. First, some members of society have greater access to technology and to the resources necessary to exploit this technology than others. Limits on access to technology and on access to resources are likely to impede democratic access to the markets. Second, regulation does restrict the terms on which many people can have access to the markets and is likely to continue to do so. Regulators work on dealing with some of the very real dangers this increased access brings with it: they focus on the risks of fraud through the Internet, and think about how to educate investors to look after their own interests. But the regulators bring to their role preconceptions of the proper distinctions between professional and nonprofessional, between sophisticated and unsophisticated, and between appropriate and inappropriate investment strategies for ordinary investors. Regulatory responses to day trading so far seem to be directed to maintaining, rather than questioning, these distinctions.

In addition, regulators are preoccupied with preventing threats to the orderliness of the markets, and the activities of day traders are regarded with suspicion because they threaten the orderliness of the markets, contributing to volatility. It is easy to characterize the activities of day traders as gambling and, therefore, dangerous, but we need to go further. We need to satisfy ourselves that regulatory distinctions are principled distinctions rather than distinctions based on our preconceptions.

---


203. Levitt, supra note 16 ("The democratization of our markets is a desirable development which regulators should not frustrate").

204. See Commerce Dept. et al., supra note 56.

205. Joseph Stiglitz includes a wider range of fairness issues among the legitimate functions of capital market regulation, focusing on "promoting investment by certain 'underserved' groups and sectors, like minorities, small businesses, low-income housing, or rural areas." Stiglitz, supra note 115.
Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business

J. William Callison*

I. INTRODUCTION ................................................................................................................... 98

II. THE RISE OF THE LIMITED LIABILITY COMPANY FORM AND THE NEUTRALIZATION OF TAX AND LIABILITY DISTINCTIONS AMONG BUSINESS ORGANIZATIONS ........................................................................................................... 102

III. GOVERNANCE ISSUES AND THE LACK OF ROLE DIFFERENTIATION IN LIMITED LIABILITY COMPANIES ........................................................................................................................... 104
   A. Introduction .............................................................................................................. 104
   B. Forms of LLC Management ................................................................................. 106
   C. Raising Equity Capital in Member-Managed LLCs—The Problem of a Failure to Separate Ownership and Control ..................................................................................... 108
   D. Raising Equity Capital in Manager-Managed LLCs—The Problem of a Failure to Separate Decision Management from Decision Control .............................................. 111

IV. POSSIBLE ADVANTAGES TO THE LLC FORM .................................................................. 114
   A. Broad Freedom of Contract ................................................................................ 114
   B. Dissenters’ Rights ................................................................................................. 115
   C. Flexibility With Respect to Organizational Formalities .................................. 115
   D. Fiduciary Duties ..................................................................................................... 115

V. REPLICATING CORPORATE GOVERNANCE SYSTEMS IN LIMITED LIABILITY COMPANY FORM .............................................................................................................................. 116
   A. Contracting for Corporate Governance Structures ........................................... 116
   B. State LLC Statutes Providing for Board Monitoring ........................................... 116
   C. Modifications to ULLCA and State LLC Statutes to Embrace a Board-Directed Management Structure ......................................................................................... 118
   1. Foreign Law Equivalents ..................................................................................... 119
      a. German Gesellschaft mit beschränkter Haftung ............................................ 119
      b. French Société à Responsabilité Limitée ..................................................... 120
      c. Brazilian Limitadas ....................................................................................... 121
      d. Summary ......................................................................................................... 122

* Partner, Faegre & Benson LLP; A.B. Oberlin College, 1977; J.D., University of Colorado, 1982; LL.M. Yale University, 2000. I would like to thank Deborah DeMott, Dennis Hynes, Bob Keatinge, Dan Kleinberger, Andrzej Rapaczynski, Maureen Sullivan, Allan Vestal, and the participants in the Yale Law School Graduate Seminar for their helpful thoughts and comments.