

## **Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets"**

Caroline Bradley\*

I. INTRODUCTION .....	63
II. FINANCIAL MARKETS AND TECHNOLOGY .....	66
III. THE IDEOLOGY OF FAIR AND ORDERLY MARKETS? .....	73
IV. REGULATING TO ACHIEVE FAIR AND ORDERLY MARKETS.....	83
V. DAY TRADERS AND REGULATION .....	88
VI. CONCLUSION .....	95

### 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,<sup>1</sup> the term "day trader" now often refers to nonprofessional securities traders whose patterns of securities trading are different from those of ordinary investors.<sup>2</sup>

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.

1. See, e.g., OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, SEC, REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS, § III.A (2000), available at <http://www.sec.gov/news/studies/daytrp.htm> (commenting that "day trading as a strategy employed by retail investors is a fairly recent phenomenon").

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.<sup>3</sup>

The rhetoric of securities regulation is of "fair and orderly markets."<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> The rhetoric is not confined to the United States, nor to securities regulators. Regulators of commodity and futures markets have also used this rhetoric,<sup>7</sup> as have regulators in other jurisdictions<sup>8</sup> and policy makers in international organizations.<sup>9</sup>

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).

5. "[I]nvestors commit capital because they have a basic confidence in the quality and integrity of America's markets." Chairman Arthur Levitt, Securities and Exchange Commission, Renewing the Covenant with Investors, Speech at New York University, Center for Law and Business (May 10, 2000), <http://www.sec.gov/news/speeches/spch370.htm>.

[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. 34,431,54, 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).

7. *See* Over-the-Counter Derivatives, Concept Release, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,282, at 46,243 (May 12, 1998) ("[T]he Commission believes it is appropriate at this time to consider whether any modifications to the scope or the terms and conditions of the swap and hybrid instrument exemptions are needed to enhance the fairness, financial integrity, and efficiency of this market."). *But see* Concept Release Concerning Over-the-Counter Derivatives, 64 Fed. Reg. 65,669 (Nov. 23, 1999) (to be codified at 17 C.F.R. pts. 34-35) (withdrawing the 1998 concept release). The 1998 release provoked the Securities and Exchange Commission (SEC) and reinvigorated the dispute between the Commodity Futures Trading Commission (CFTC) and the SEC about who should regulate the swaps market. *Cf.* Exemption for Bilateral Transactions, 65 Fed. Reg. 39,033 (proposed June 22, 2000) (to be codified at 17 C.F.R. pt. 35) (proposing clarification and expansion of the CFTC's exemption for swaps transactions).

8. *See, e.g.*, Council and Parliament Directive 94/18/EC, art. 54, 1994 O.J. (L 135) 1-4 ("amending Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing

There is empirical evidence that financial markets are neither fair<sup>10</sup> nor orderly.<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup> 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,<sup>14</sup> 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 in its recitals to "proper operation of the markets").

9. "[P]rotecting consumers is not only good social policy, it also builds confidence that there is a 'level playing field' in economic markets. Without such confidence those markets will remain thin and ineffective." Joseph Stiglitz, *More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus*, 1998 WIDER Annual Lecture, Helsinki, Finland 13 (Jan. 7, 1998), at <http://www.worldbank.org/html/extdr/extme/js-010798/wider.pdf>; see also BANK FOR INT'L SETTLEMENTS (BIS), SUMMARY OF REPORTS ON THE INTERNATIONAL FINANCIAL ARCHITECTURE (1998) (setting forth the report of the Working Group on (1) "Enhancing Transparency and Accountability," 2) "Strengthening Financial Systems," and (3) "Managing International Financial Crises"), at <http://www.bis.org/publ/othp01.htm>.

10. Insider trading, market manipulation, and other activities which harm investors occur even in highly regulated markets such as those in the United States. See, e.g., *United States v. O'Hagan*, 521 U.S. 642 (1997) (applying misappropriation theory of insider trading liability); *United States v. Falcone*, 97 F. Supp. 2d 297, 301 (E.D.N.Y. 2000) (applying misappropriation theory); *United States v. Oakford Corp.*, 79 F. Supp. 2d 357, 358 (S.D.N.Y. 1999) (discussing appropriate sentencing for unlawful discretionary trades by floor-brokers at the NYSE). For a discussion of what fairness in financial markets might mean, see *infra* Part III.

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. (CCH) 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.<sup>15</sup>

## II. FINANCIAL MARKETS AND TECHNOLOGY

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

*Concerning the Effect of Technology on the Capital Markets: Hearing Before the House Subcomm. on Capital Markets, Sec., and Gov't Sponsored Enterprises of the House Comm. on Banking and Fin. Services*, 106th Cong. 1-2 (1999) (written statement of Laura S. Unger, Commissioner, SEC), available at <http://www.sec.gov/news/testimony/tsty0799.txt>; cf. Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997) (arguing that crashes, rather than technology, cause changes in securities regulation).

16. See, e.g., Therese H. Maynard, *What is an "Exchange?"—Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange*, 49 WASH. & LEE L. REV. 833 (1992) (analyzing the definition of an "exchange" under the Securities Exchange Act of 1934 and its application to proprietary trading systems); Lewis D. Solomon & Louise Corso, *The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation*, 24 J. MARSHALL L. REV. 299 (1991) (examining the ways in which technology has changed securities trading). Compare Remarks of SEC Chairman Arthur Levitt:

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.

Chairman Arthur Levitt, Plain Talk About On-line Investing, Speech at the National Press Club (May 4, 1999), <http://www.sec.gov/news/speeches/spch274.htm> [hereinafter "Plain Talk"].

17. On issues associated with the internationalization of securities markets, see, for example, Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855 (1997) (arguing that the internationalization of securities markets has a positive impact on the efficiency of the markets); James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 Nw. J. INT'L L. & BUS. 119 (1996) (arguing that corporate governance should be understood as cultural product); Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241 (arguing for harmonization of securities disclosure rules); Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563 (1998) (arguing that multiple listings of securities in different jurisdictions allows regulatory regimes to undermine each other); Bevis Longstreth, *A Look at the SEC's Adaptation to Global Market Pressures*, 33 COLUM. J. TRANSNAT'L L. 319 (1995) (describing the ways in which the SEC has adjusted its regulations to a global environment).

allowed institutions to manage their portfolios of financial assets with computer programs.<sup>18</sup>

By the end of the 1980s, regulators were concerned about trading strategies and new financial instruments which might destabilize the financial markets.<sup>19</sup> 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).<sup>20</sup> 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,<sup>21</sup> insurance, and investment services from home, on her own schedule. Investors can even make bets on the market online.<sup>22</sup> 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.<sup>23</sup> They

---

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

19. See, e.g., COMM. ON PAYMENT AND SETTLEMENT SYS. AND EURO-CURRENCY STANDING COMM., BANK FOR INT'L SETTLEMENT, OTC DERIVATIVES: SETTLEMENT PROCEDURES AND COUNTERPARTY RISK MANAGEMENT (1998), <http://www.bis.org/publ/cps27.htm> (analyzing the risk management practices of participants in the over-the-counter markets in derivatives and identifying weaknesses in those practices); COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT'L SETTLEMENTS, THE MEASUREMENT OF AGGREGATE MARKET RISK (1997), <http://www.bis.org/publ/ecsc07.htm> (analyzing "market risk, market dynamics, [and] market liquidity").

20. See, e.g., RUBEN LEE, WHAT IS AN EXCHANGE? 257 (1998) (describing the possible impact of "opaque" trading markets on transparent markets as follows: "if one market sanctioned opacity, other markets might not be able to assess the overall supply and demand for securities, and thus the determination of the optimal price for the securities could be inaccurate"). In 1998, the SEC introduced new rules for "alternative trading systems." See Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844 (Dec. 22, 1998) (codified at 17 C.F.R. pts. 202, 240, 242, 249) (providing that securities markets could choose to be regulated as exchanges, or as broker-dealers subject to alternative trading system rules, including new rules to promote price transparency), corrected by 64 Fed. Reg. 13,065 (Mar. 17, 1999); 64 Fed. Reg. 19,450 (Apr. 21, 1999) (making technical amendments to final rule). Since the introduction of the new rules on alternative trading systems, "Island," an Electronics Communications Network (ECN), has announced plans to register with the SEC as an exchange. See Press Release, The Island ECN, Inc., Island Takes First Steps Toward Becoming Registered Stock Exchange (April 30, 1999), at <http://www.isld.com/pressroom/releases/043099.htm>.

21. See, e.g., Wells Fargo Homepage, at <http://wellsfargo.com/home/> (last visited Nov. 19, 2000); Bank America, *Build Your Own Bank*, at <http://www.BankAmerica.com/byob/byob.html> (last visited Nov. 19, 2000); WingSpanBank.com Homepage, at <http://home.wingspanbank.com/> (last visited Nov. 19, 2000); see also Karen Furst, et al., *Special Studies on Technology and Banking, Who Offers Internet Banking?*, Q. J., June 2000, at 36, available at <http://www.occ.treas.gov/qj/qj19-2.pdf>.

22. E.g., WallStreetBets, *Sportsbook, Casino and Financial Wagering*, at <http://www.wallstreetbets.com/> (last visited Nov. 19, 2000).

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)<sup>24</sup> and carry out securities trades online through online brokers.<sup>25</sup>

Traditional exchanges are facing increased competition from other firms.<sup>26</sup> 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.<sup>27</sup> Issuers may set up their own systems for trading in their securities.<sup>28</sup> Wealthier investors may trade securities generally through various newer forms of off-exchange market systems, including electronic bulletin boards<sup>29</sup> and "proprietary" systems developed by intermediaries. These proprietary systems are closed access systems, which only allow

24. See, e.g., Wit Capital Group, Inc., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,577, at 78,906 (July 14, 1999); Press Release, Wit Capital Secures SEC Accord for New Online IPO Process (July 14, 1999), at <http://www.witsoundview.com/about/pr.jsp?pr=19990714> (announcing the SEC no-action ruling as a "landmark" that will make it "substantially more convenient" for individuals to take part in online IPOs); Direct Stock Market, *The Private Equity Market Place*, at <http://www.dsm.com/> (last visited Nov. 19, 2000) (making investment opportunities available to accredited investors over the Internet). On the development of Wit Capital, see Andrew D. Klein, WALLSTREET.COM: FAT CAT INVESTING AT THE CLICK OF A MOUSE (1998). Andrew Klein, founder of Wit Capital, made financial history when he launched the first IPO over the Internet, raising \$1.6 million for an up-start microbrewery. See *id.* at 89-91.

25. See, e.g., INVESTOR PROT. & SEC. BUREAU & INTERNET BUREAU, OFFICE OF NEW YORK STATE ATTORNEY ELIOT SPITZER, FROM WALL STREET TO WEB STREET: A REPORT ON THE PROBLEMS AND PROMISE OF THE ONLINE BROKERAGE INDUSTRY (1999), [http://www.oag.state.ny.us/investors/1999\\_online\\_brokers/full.pdf](http://www.oag.state.ny.us/investors/1999_online_brokers/full.pdf); Online Brokerage: Keeping Apace of Cyberspace, Executive Summary [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,222, at 82,705 (November 22, 1999) [hereinafter Online Brokerage] (addressing how online brokerage has affected the securities marketplace), available at <http://www.sec.gov/pdf/cybrtrnd.pdf>. For examples of web sites which offer online trading facilities, see Datek Online, at <http://www.datek.com/> (last visited Nov. 19, 2000); E\*trade, at <http://www.etrade.com/> (last visited Nov. 19, 2000); Charles Schwab, at <http://www.schwab.com/> (last visited Nov. 19, 2000); Ameritrade, at <http://www.ameritrade.com/fhtml/advantages6.fhtml> (last visited Nov. 19, 2000); DLJ direct, at <http://www.dljdirect.com/> (last visited Nov. 19, 2000).

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](http://www.nasdaqnews.com/views/zarb_npc.pdf).

27. NASDAQ is an over-the-counter (OTC) market registered as a securities information processor under Section 11A of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §78k-1 (1994). See, e.g., Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,852 (Dec. 22, 1998) (codified at 17 C.F.R. pts. 202, 240, 242, 249). NASDAQ is operated by the National Association of Securities Dealers (NASD), which is registered as a national securities association under section 15A of the 1934 Act, 15 U.S.C. §78o-3 (1994). See, e.g., *id.* at 70,586; NASD v. SEC, 801 F.2d 1415, 1416 (D.C. Cir. 1986). NASD delegates its responsibilities for market surveillance to NASD Regulation. See NASD Regulation, at <http://www.nasdr.com> (last visited Nov. 19, 2000).

28. See, e.g., Real Goods Trading Corp., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,134 (July 24, 1996) (formalizing conditions for online bulletin boards). For the Real Goods "Off-the-Grid" Trading System, see <http://www.realgoods.com/renew/stock/trade.cfm> (last visited Nov. 19, 2000). See also Net Stock Direct, at <http://www.netstockdirect.com> (last visited Nov. 19, 2000) (offering direct investment and free membership with access to over 1600 companies).

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).

investors who meet certain standards (such as credit standards) to use their facilities, and they are regulated as Electronic Communications Networks (ECNs).<sup>30</sup>

Investors with more limited means have access to online trading firms,<sup>31</sup> regulated as broker-dealers, but not to ECNs.<sup>32</sup> Trading through an online brokerage is slower than trading through an ECN,<sup>33</sup> and pricing is less favorable to the investor.<sup>34</sup> 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.<sup>35</sup> 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<sup>36</sup> has announced that it plans to allow retail investors to use its facilities<sup>37</sup> and acquired a large stake in Tradepoint, a British electronic stock market.<sup>38</sup> Other developments, such as the extension of trading hours, are more controversial.<sup>39</sup>

---

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 Act Release No. 33605, 59 Fed. Reg. 8368 (Feb. 9, 1994). These systems match buy and sell orders electronically. For examples of ECNs, see Instinet, at <http://www.instinet.com> (last visited Nov. 19, 2000) (Instinet is owned by Reuters); Island, at <http://www.isld.com> (last visited Nov. 19, 2000) (Island is owned by Datek). On the implications of technology for financial markets, see, for example, Ian Grigg, *Digital Trading* (Sept. 16, 1997) (describing four waves of development, from information through Internet brokerage, and Internet exchange to Internet instruments), at [http://www.systemics.com/docs/papers/digital\\_trading.html](http://www.systemics.com/docs/papers/digital_trading.html). 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).

31. Online brokerages typically require their customers to deposit about \$2000 with them in order to maintain an account. See, e.g., Ameritrade, at <http://www.ameritrade.com/fhtml/advantages6.fhtml> (last visited Nov. 19, 2000).

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 <http://www.cybercorp.com/cyberweb/CyBerWeb.ASP?WCI=AccountRequirements&WCU> (last visited Nov. 19, 2000).

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 Broker Trading Index, at <http://www.keynote.com/measures/brokers/> (last visited Nov. 19, 2000).

34. See, e.g., DIV. OF MKT. REG., SEC, SPECIAL STUDY: ELECTRONIC COMMUNICATION NETWORKS AND AFTER-HOURS TRADING § II.A (2000), <http://www.sec.gov/news/studies/ecnafter.htm>.

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

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

37. See Diana B. Henriques, *Facing Growing Competition, Instinet Scrambles 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 <http://www.redi.com> (last visited Nov. 19, 2000) (advertising "Tools built by traders for traders").

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 Securities Exchange Act, Exchange Act Release No. 34-41199, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,128, at 81,954 (Mar. 22, 1999); see also, Elizabeth M. McCarroll, *Regulation of Electronic Communications Networks: An Examination of Tradepoint Financial Network's SEC Approval to Become the First Non-American Exchange to Operate in the United States*, 33 CORNELL INT'L L.J. 211, 216 (2000)

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.<sup>40</sup> The SEC has estimated that there are about "one hundred day trading firms organized as retail brokerage firms."<sup>41</sup> In such an arrangement, the day trader is a customer of the firm. However, day traders may also be characterized as employees<sup>42</sup> or as principals in day trading firms.<sup>43</sup> 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.<sup>44</sup> Other studies suggest that day traders face serious risks of losing money and that day trading is, therefore, not for those of limited resources.<sup>45</sup> 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.<sup>46</sup> Widely available information about broker-dealers' fees and services<sup>47</sup> enables investors to shop around and increases competition between broker-dealer firms.<sup>48</sup> 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.hrlid.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.

*Id.*; cf. Heartland Secs. Corp v. Gerstenblatt, No. 99 Civ. 3694, 2000 U.S. Dist. LEXIS 3496 (S.D.N.Y. Mar. 22, 2000) (granting motion to dismiss plaintiff employer's claims for training costs and to enforce restrictive covenant when day traders left Datek to become self-employed within four years of beginning employment).

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

44. *Id.* § IV.C.

45. See PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON GOVERNMENTAL AFFAIRS, DAY TRADING: CASE STUDIES AND CONCLUSIONS, S. REP. NO. 106-364, pt. 2, at 27-28 (2000).

46. Examples of the resources available (or soon to be available) are portfolio management tools. See, e.g., FinPortfolio, at <http://www.finportfolio.com> (last visited Nov. 19, 2000) (planning to offer "Institutional-quality Portfolio Management Tools for the Individual Investor"); SmartLeaf Advisor, at <http://www.smartleaf.com/> (last visited Nov. 19, 2000) (offering Quick Tools).

47. See, e.g., Gomez.com, at [http://www.scorecard.com/scorecards/index.asp?topcat\\_id=3&subsect=finance](http://www.scorecard.com/scorecards/index.asp?topcat_id=3&subsect=finance) (last visited Nov. 19, 2000); Don Johnson, *OnLine Investment Services*, at <http://www.sonic.net/donaldj/> (last visited Nov. 19, 2000); Keynote, *Web Broker Trading Index*, at <http://www.keynote.com/measures/brokers/> (last visited Nov. 19, 2000); Xolia.com, *Online Broker Decision Center*, at <http://www.xolia.com/broker/default.asp> (last visited Nov. 19, 2000); but cf. Geoffrey Smith, *Wanted: A Better Scorecard for Online Brokers*, BUSINESSWEEK ONLINE, May 1, 2000 (describing difficulties of comparison shopping for brokers), at <http://www.businessweek.com/ebiz/perspect/perspectark.htm>.



than those with more limited resources, and regulators worry about whether online investors, in practice, obtain the level of market access they expect.<sup>49</sup> 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.<sup>50</sup> 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<sup>51</sup> such as non-exchange trading systems,<sup>52</sup> day trading,<sup>53</sup> the "Year 2000" (or

---

48. See, e.g., Margaret Popper, *Schwab's Swift Shift to a Full-Service Strategy*, BUSINESS WEEK ONLINE April 3, 2000, at <http://www.businessweek.com/bwdaily/dnflash/apr2000/sw00403.htm> (describing competition between broker-dealers).

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

50. See, e.g., Fed. Res. Bd. Chairman Alan Greenspan, Financial Derivatives, Remarks Before the Futures Industry Association, Boca Raton, FL (March 19, 1999), <http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm>.

51. See, e.g., INT'L ORG. OF SEC. COMM'NS (IOSCO), OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 2 (1998) ("Regulators should be prepared to address the significant challenges posed by the increasing importance of technology and particularly developments in the area of electronic commerce."), <http://www.iosco.org/download/pdf/1998-objectives-eng.pdf>; Howard Davies, Chairman of the Financial Services Authority, The Single Financial Market in Five Years Time: How Will Regulation Work?, Address Before the European Commission (March 20, 2000), <http://www.fsa.gov.uk/pubs/speeches/sp43.html>. Mr. Davies stated:

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.

*Id.*; see generally, SEC, THE IMPACT OF RECENT TECHNOLOGICAL ADVANCES ON THE SECURITIES MARKETS (1997) (Report to Congress pursuant to Section 510(a) of the National Securities Markets Improvements Act of 1996), <http://www.sec.gov/news/studies/techrp97.htm> (reporting on the impact of technological change on the securities markets); Coffee, *supra* note 29 (discussing implications of the Internet for securities regulations).

52. See, e.g., Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844 (Dec. 22, 1998); Regulation of Exchanges, Exchange Act Release No. 34-38672, 62 Fed. Reg. 30,485, 30,489 (June 4, 1997); see EUROPEAN COMM'N, IMPLEMENTING THE FRAMEWORK FOR FINANCIAL MARKETS: ACTION PLAN 6 (1999) (indicating the intent to work on definitions of markets and exchanges, and on the authorization and supervision of alternative trading systems), [http://www.europa.eu.int/comm/internal\\_market/en/finances/general/actionen.pdf](http://www.europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf); cf. Fédération Internationale des Bourses de Valeurs, Focus Newsletter, May 1999 (copy on file with author) (making reference to a "'Monster,' an acronym for 'Market Oriented New System for Terrifying Exchange Regulators' or in other words Proprietary Trading System (PTS)"). The term "monster" was introduced by Ruben Lee. See Lee, *supra* note 20, at 1.

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,<sup>54</sup> concerns about systems security, increased risks of fraud through the Internet,<sup>55</sup> and the needs for improved consumer education and to level the playing field for individual investors.<sup>56</sup> Regulators are also concerned more generally about speculation in the markets<sup>57</sup> 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.<sup>58</sup> In doing so, he invoked some powerful rhetoric: federal securities legislation requires the SEC to promote "fair and orderly" securities markets.<sup>59</sup> 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.<sup>60</sup> 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.

54. *E.g.*, SEC, READINESS OF THE UNITED STATES SECURITIES INDUSTRY AND PUBLIC COMPANIES TO MEET THE INFORMATION PROCESSING CHALLENGES OF THE YEAR 2000 (1997) (Report to Congress prepared in response to a request from Congressman John Dingell), <http://www.sec.gov/news/studies/yr2000.htm>.

55. *See, e.g.*, TECHNICAL COMM., INT'L ORG. OF SEC. COMM'NS (IOSCO), REPORT ON ENFORCEMENT ISSUES RAISED BY THE INCREASING USE OF ELECTRONIC NETWORKS IN THE SECURITIES AND FUTURES FIELD (1997), [http://www.iosco.org/docs-public/1997-report\\_on\\_enforcement\\_issues.html](http://www.iosco.org/docs-public/1997-report_on_enforcement_issues.html); G. Philip Rutledge, *The Internet and U.S. Financial Markets*, 16 DICK. J. INT'L L. 563, 564-65 (1998) (suggesting that the Web has encouraged legitimate capital formation and investment frauds).

56. *See, e.g.*, S.E.C. Commissioner Laura S. Unger, Empowering Investors in an Electronic Age, Remarks to the IOSCO Annual Conference, Sydney, Australia (May 17, 2000) (discussing investor protection in the electronic environment), <http://www.sec.gov/news/speeches/spch380.htm>. On the digital divide, *see, e.g.*, COMMERCE DEPT. ET AL., FALLING THROUGH THE NET: TOWARD DIGITAL INCLUSION, A REPORT ON AMERICANS' ACCESS TO TECHNOLOGY TOOLS (2000), <http://www.ntia.doc.gov/ntiahome/ftn00/falling.htm>.

57. *See, e.g.*, S.E.C. Chairman Arthur Levitt, Remarks at the Finance Conference 2000: "The New Economy," Address at Boston College (March 6, 2000) (expressing concern about the securities markets' valuation of high technology stocks), <http://www.sec.gov/news/speeches/spch352.htm> [hereinafter Levitt, Address at Boston College]; *cf.* Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 780 (2000) ("The SEC and the Federal Reserve have helped establish a stock-based investor religion and thereby distorted market demand for stocks. Ironically, government has directly contributed to the very ascent in stock prices that it is worried about and paralyzed by.").

58. Levitt, Plain Talk, *supra* note 16.

59. *See, e.g.*, 15 U.S.C. § 78(k) (referring to fair and fair and orderly markets).

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.

Paul G. Mahoney, *The Pernicious Art of Securities Regulation*, 66 U. CHI. L. REV. 1373, 1392 (1999) (reviewing STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860* (1998)).

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

The ideology of "fair and orderly markets," often associated with ideas of "market integrity," is everywhere.<sup>61</sup> 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."<sup>62</sup> 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."<sup>63</sup> Officials of NASDAQ-Amex also employ ideas of fair and orderly markets.<sup>64</sup> 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.<sup>65</sup>

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>.

62. S.E.C. Chairman Arthur Levitt, *Concept Release on Exchange Regulation and Foreign Market Access to the United States*, Opening Statement at the Open Meeting of the SEC (May 23, 1997), <http://www.sec.gov/news/speeches/spch161.txt>.

63. Press Release, NYSE, *Media Statement: NYSE-SEC Settlement* (June 29, 1999), <http://www.nyse.com/press/NT0000A74E.html>; cf. American Stock Exchange, *Mission Statement*, at <http://www.amex.com/about/mission.stm> (last visited Nov. 19, 2000) ("To facilitate capital formation in the public and private sector by developing, operating and regulating the most liquid, efficient and fair securities market for the ultimate benefit and protection of the investor.").

64. "Without size limitations or geographical boundaries, or a central trading floor, NASDAQ's market structure allows an unlimited number of market participants to trade in a company's stock. Together, these participants help ensure transparency and liquidity while maintaining a fair and orderly market." *Going Public—The End of the Rainbow for a Small Business? Hearing Before the Subcomm. on Gov't Programs and Oversight of the House Comm. on Small Bus.*, 106th Cong. (1999) (testimony of John T. Wall, President & C.O.O., NASDAQ-AMEX International), <http://www.house.gov/smbiz/hearings/106th/1999/991014/wall.htm>.

65. See Jonathan R. Macey & Maureen O'Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 18 (1999). Professors Macey and O'Hara state:

[T]he 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.<sup>66</sup>

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,<sup>67</sup> and rules designed to make them more so are likely to undermine fairness.<sup>68</sup> The idea that we can seriously describe markets as "fair" is strange.<sup>69</sup> "Fair or orderly" in the context of securities regulation clearly do not have the same meaning they have in everyday speech.<sup>70</sup>

The rhetoric of fair and orderly markets is embedded in the law,<sup>71</sup> and it is politically powerful, but there is a difficulty in characterizing markets as fair.<sup>72</sup> 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'être* 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), § 78l(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.<sup>73</sup> 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.<sup>74</sup> 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.<sup>75</sup> Only select people or firms who prove their eligibility are allowed to perform various functions in regulated securities markets.<sup>76</sup> Regulators do sometimes recognize that there is a tension between fairness and regulations that control how the market operates.<sup>77</sup> 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.<sup>78</sup>

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.<sup>79</sup> The

---

outcomes." Joseph Stiglitz, *Redefining the Role of the State: What should it do? How Should it do it? And How should these decisions be made?*, Presented on the Tenth anniversary of MITI Research Institute, Tokyo, Japan 5-6 (March 17, 1998), <http://www.worldbank.org/html/extdr/extme/redefine.pdf>.

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").

74. Some rules imposed by self-regulatory organizations which regulate markets may merely establish standard terms of contracts in the market or common understandings of market practice. See, e.g., NASD Uniform Practice Code Rules 11000-900, NASD MANUAL (CCH), at 7711-989 (1996-2000).

75. Cf. Regulation of Market Information Fees and Revenues, Exchange Act Release No. 34-42208, 64 Fed. Reg. 70,613 (1999) (proposed Dec. 17, 1999) (to be codified at 17 C.F.R. pt. 240).

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).

79. Member States of the European Union are required by the Investment Services Directive to regulate those in the business of providing investment services. Council Directive 93/22, art. 3., 1993 O.J. (L141) 27. See, e.g., Manning Gilbert Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181 (1994).

organizations which make these determinations are often self-regulatory organizations (SROs),<sup>80</sup> 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.<sup>81</sup> Prospective members are required to pass examinations in order to prove their eligibility.<sup>82</sup> 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.<sup>83</sup> Members of the club must comply with required standards of conduct.<sup>84</sup>

In the United States, securities brokers who are not members of an exchange<sup>85</sup> 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.<sup>86</sup> The NASD's rules provide that an applicant may apply for the National Adjudicatory Council to review a membership decision.<sup>87</sup> 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.<sup>88</sup> NASD

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).

82. NYSE Rule 304A, 2 NYSE GUIDE (CCH) ¶ 2304A, at 3040-41 (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).

87. See NASD Membership and Registration Rule 1015, NASD Manual (CCH) 3141 (1998). A decision of the NASD Regulation National Adjudicatory Council is the final action of the NASD, subject to review at the discretion of the NASD Board. NASD Membership and Registration Rule 1016, NASD Manual (CCH) 3143-44 (1998).

88. NASD Membership and Registration Rule 1019, NASD Manual (CCH) 3148 (1998).

Regulation also makes determinations about when people should have their status as a registered broker-dealer suspended<sup>89</sup> or terminated.<sup>90</sup>

The NASD has a measure of discretion in making decisions about membership,<sup>91</sup> 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.<sup>92</sup> 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."<sup>93</sup> 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.<sup>94</sup> Although these criteria are not particularly specific, they are more specific than the NYSE's criteria for acceptability.<sup>95</sup>

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.<sup>96</sup> Some financial firms have reacted

---

89. See, e.g., NASD Complaints, Investigations, and Sanctions Rule 8220, NASD MANUAL (CCH) 7244 (1999) ("Suspension for Failure to Provide Requested Information"); NASD Complaints, Investigations and Sanctions Rule 8310, NASD MANUAL (CCH) 7271 (1999) ("Sanctions for Violation of the Rules"); see also NASD Code of Procedure Rules 9100-790, NASD MANUAL (CCH) 7301-482 (1998-99) (setting out a Code of Procedure); NASD Code of Arbitration Procedure Rules 10000-406, NASD MANUAL (CCH) 7501-632 (1999-2000) (setting out the Code of Arbitration Procedure). Note that Rule IM-10100 states that "it may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to" fail to cooperate with an arbitration, including failing to submit a dispute for arbitration under the NASD Code of Arbitration Procedure as required by the Code. NASD Code of Arbitration Rule IM-10100, NASD MANUAL (CCH) 7511 (1999).

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").

93. NASD Membership and Registration Rule 1014(a)(3), NASD MANUAL (CCH) 3118 (1998).

94. NASD Membership and Registration Rule 1014(a)(6)-(7), NASD MANUAL (CCH) 3118-19 (1998).

95. *Cf.* 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.<sup>97</sup>

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."<sup>98</sup> Similarly, the NYSE insists on "the principles of good business practice."<sup>99</sup> 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.<sup>100</sup> 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.<sup>101</sup>

Securities markets employ other rules to ensure fairness, including disclosure requirements and restrictions on insider trading<sup>102</sup> and manipulative practices.<sup>103</sup> 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

97. See MERRILL LYNCH, CAMPAIGN FOR WOMEN'S ACHIEVEMENT REPORT (1999) (copy on file with author); see also Merrill Lynch, *Respect for the Individual: Diversity at Work*, at [http://www.ml.com/diversity/womens\\_achiev.html](http://www.ml.com/diversity/womens_achiev.html) (last visited Nov. 19, 2000).

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.

100. See, e.g., Arthur Levitt, *The Future of Our Markets: Dynamic Markets, Timeless Principles*, 2000 COLUM. BUS. L. REV. 1, 10 (stating that "Rule 390 should not be part of our future").

101. The NYSE's Rule 390 was known as the "market responsibility rule," and restricted the ability of exchange members to trade in listed securities in the OTC market. See Order Approving Proposed Change To Rescind Exchange Rule 390, Exchange Act Release No. 34-42758, 65 Fed. Reg. 30175 (May 10, 2000). Cf. Commission Request for Comment on Issues Relating to Market Fragmentation, Exchange Act Release No. 34-42450, 65 Fed. Reg. 10,577 (February 28, 2000) (requesting comments on the proposal to rescind Rule 390 and on market fragmentation generally).

102. See, e.g., COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE ACCOMPANYING SECURITIES EXCHANGE BILL OF 1934, H.R. REP. NO. 73-1383, at 10 (1934). (concluding that manipulative practices should be banned to insure fair and honest markets); see also *United States v. O'Hagan*, 521 U.S. 642 (1997) (applying misappropriation theory of insider trading liability).

103. See Rule 78, 2 NYSE GUIDE (CCH) ¶ 2078, at 2656 (1998).



statements provided that such statements are accompanied by cautionary language.<sup>104</sup> 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.<sup>105</sup> 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.<sup>106</sup> 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.<sup>107</sup> 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.<sup>108</sup> The rules adopt selective views of what fairness involves, and they tend to favor market professionals over nonprofessionals.<sup>109</sup>

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

---

104. See 15 U.S.C.A. § 78u-5 (West Supp. 2000); see, e.g., Press Release, American Home Products, American Home Products and Warner-Lambert Outline Powerful Growth Story for AmericanWarner (November 8, 1999), [http://www.ahp.com/releases/ahp\\_110899.htm](http://www.ahp.com/releases/ahp_110899.htm).

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. . . .

*Id.*

105. See *Stabilizing and Other Activities in Connection with an Offering*, Regulation M, 17 C.F.R. § 242.104 (2000); cf. F. H. Buckley, *When the Medium is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493, 544 n.191 (1990) (criticizing this distinction); Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 507-10 (1991) (arguing for the abandonment of the conception of manipulation). For criticisms of the Supreme Court's restrictive approach to the definition of manipulation under the 1934 Act, 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.

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).

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").

108. See, e.g., *United States v. O'Hagan*, 521 U.S. 642 (1997) (recognizing the misappropriation theory of insider trading liability); cf. Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading after United States v. O'Hagan*, 84 VA. L. REV. 153 (1998) (arguing that courts should define the parameters of the misappropriation theory more clearly).

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.<sup>110</sup> They seek to limit price volatility in the market, for example, by limiting trading during periods of significant market decline.<sup>111</sup> Securities markets also exercise the power to suspend trading in specific securities.<sup>112</sup> 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.<sup>113</sup>

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.<sup>114</sup> 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.*

111. See, e.g., Rule 80A, 2 NYSE GUIDE (CCH) ¶ 2080A, at 2659-60 (1999); cf. Tamar Frankel, *What Can Be Done About Stock Market Volatility?*, 69 B.U. L. REV. 991 (1989) (arguing for new controls on market volatility).

112. See, e.g., Press Release, NYSE, NYSE to Suspend and Apply to Delist Common Stock American National Can Group, Inc. (July 24, 2000), <http://www.nyse.com/press/press.html>; Press Release, NYSE, NYSE to Suspend, Apply to Delist, Shoney's, Inc. (July 6, 2000), <http://www.nyse.com/press/press.html>.

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.<sup>115</sup>

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.<sup>116</sup> 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.<sup>117</sup>

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.<sup>118</sup> 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.<sup>119</sup>

---

REV. 109 (1995) (same); Jerry Kang, *Cyber-Race*, 113 HARV. L. REV. 1131, 1133 (2000) (footnote omitted). Kang writes:

*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.*

115. Joseph Stiglitz, Building Robust Financial Systems, Keynote Lecture at Private Capital Inflows: What Have We Learned, Bogotá, Colombia (October 1, 1997), <http://www.worldbank.org/html/extdr/extme/jssp100197.htm>. Stiglitz states:

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.*

116. See Levitt, *supra* note 16 (noting that "selling securities is not like selling soap"). Some regulators have begun to focus more directly on the need to educate consumers of financial products and services. See JANE VASS, FIN. SERV. AUTH., A GUIDE TO THE PROVISION OF FINANCIAL SERVICES EDUCATION FOR CONSUMERS (1998); Press Release, SEC, Unprecedented Campaign to Combat America's Financial Literacy "Crisis"; 65 Million American Households Could Fall Short of Major Financial Goals (February 24, 1998), <http://www.sec.gov/news/press/98-20.txt>.

117. On investor education, see James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105 (1998).

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.<sup>120</sup> 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.<sup>121</sup> Market participants manipulate the markets,<sup>122</sup> and they collude to fix prices;<sup>123</sup> broker-dealers pass worthless securities along to their customers,<sup>124</sup> and insiders engage in insider trading.<sup>125</sup> 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.<sup>126</sup> The rules which regulate broker-dealer and

<http://www.capscape.com> (last visited Nov. 19, 2000) (advertising software with advice on how to invest) (last visited Nov. 19, 2000); Financial Engines, *Your Personal Online Investment Advisor*, at <http://www.financialengines.com> (last visited Nov. 19, 2000); Informed Investor, at <http://www.informedinvestor.com> (last visited Nov. 19, 2000); The Motley Fool, at <http://www.fool.com> (last visited Nov. 19, 2000); Women's Wire, at <http://www.womenswire.com/basics/ebanking.html> (last visited Nov. 19, 2000).

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 benefits 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., Tamar 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.").

122. See, e.g., *United States v. Russo*, 74 F.3d 1383, 1386-88 (2d Cir. 1996), *cert. denied* 519 U.S. 927 (1996) (describing scheme for manipulation of the market in penny stocks).

123. See, e.g., *In re NASDAQ Market-Makers Antitrust Litigation*, 187 F.R.D. 465, 482 (S.D.N.Y. 1998) (approving settlement in respect of claims by investors alleging violations of the Sherman Act, 15 U.S.C. § 1, arising out of price fixing of spreads and stocks traded on NASDAQ); cf. *United States v. Alex. Brown & Sons, Inc.*, 963 F. Supp. 235 (S.D.N.Y. 1997), *aff'd*, 153 F.3d 16 (2d Cir. 1998) (approving consent decree where complaint alleged market workers in NASDAQ stocks had manipulated the prices of the stocks).

124. See, *Hudak v. Econ. Research Analysts, Inc.*, 499 F.2d 996 (5th Cir. 1974), *cert. denied*, 419 U.S. 1122 (1975).

125. See, e.g., *United States v. O'Hagan*, 521 U.S. 642 (1997).

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.<sup>127</sup> 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.<sup>128</sup> 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.<sup>129</sup>

Other phenomena challenge our ability to accept this rhetoric of fair and orderly markets. We are generally concerned about different types of risk.<sup>130</sup> 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.<sup>131</sup> In order to promote this confidence, we regulate markets, transactions on those markets, and market participants.<sup>132</sup> 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").

128. See, e.g., Dale A. Oesterle, *Comments on the SEC's Market 2000 Report: On, Among Other Things, Deference to SROs, the Mirage of Price Improvement, the Arrogation of Property Rights in Order Flow, and SEC Incrementalism*, 19 J. CORP. L. 483, 485-86 (1994).

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).

130. See generally ULRICH BECK, *RISK SOCIETY: TOWARDS A NEW MODERNITY* (Mark Ritter trans., Sage 1992) (1986) (analyzing post-modern society as a "risk society"); INTERDEPARTMENTAL LIAISON GROUP ON RISK ASSESSMENT, *RISK ASSESSMENT AND RISK MANAGEMENT: IMPROVING POLICY AND PRACTICE WITHIN GOVERNMENT DEPARTMENTS* (1998), <http://www.hse.gov.uk/dst/ilgra/minrpt2.htm>.

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.<sup>133</sup> 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.<sup>134</sup>

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.<sup>135</sup> Either way, there may be a conflict between the market's regulatory role and its role as a commercial enterprise.<sup>136</sup>

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.<sup>137</sup> 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.iosco.org/docs-public/1999-supervisory\\_for\\_markets.html](http://www.iosco.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/cmselect/cmtreasy/198s2/tss202.htm>.

137. Note Ralph Nader's comments:

also competed against each other.<sup>138</sup> Currently these markets seem to have decided that they must combine with other markets in order to ensure their future success.<sup>139</sup>

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.<sup>140</sup> 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,<sup>141</sup> identifies three objectives of securities regulation: (1) investor protection; (2) fairness, efficiency, and transparency of markets; and (3) the reduction of systemic risk.<sup>142</sup> 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.

Ralph Nader, *Socialism for the Rich*, N.Y. TIMES, May 15, 1999, at A17.

138. See Caroline Bradley, *The Market for Markets: Competition Between Investment Exchanges, in THE INTERNATIONALIZATION OF CAPITAL MARKETS AND THE REGULATORY RESPONSE* 183-196 (John Fingleton ed., 1992).

139. The Paris, Amsterdam, and Brussels stock exchanges announced in March 2000 that they intended to merge to form a European market to be called Euronext. See, e.g., *Stock Exchanges of Brussels. Paris and Amsterdam to Merge*, N.Y. TIMES, Mar. 20, 2000, at A6. Euronext documentation carries the legend "first european bourse." Euronext, *First European Bourse, What's Next?* (July 2000), at [http://www.matif.fr/E\\_euronext\\_2.pdf](http://www.matif.fr/E_euronext_2.pdf). A proposed merger between the Frankfurt and London Stock Exchanges was called off in September 2000 after a Swedish company, OM Gruppen, made a hostile take-over offer for the London Stock Exchange. Press Release, London Stock Exchange, LSE to Focus on Defeating OM Bid - IX Merger Proposal Withdrawn (Sept. 12, 2000), <http://www.londonstockexchange.com/press/releases/12-09-00.asp>. The OM bid failed. Press Release, London Stock Exchange, Response to OM Bid Lapse (Nov. 10, 2000), <http://www.londonstockexchange.com/press/releases/10-11-00.asp>.

140. See Press Communiqué, IOSCO, The 1997 Annual Conference of the International Organization of Securities Commissioners (Nov. 1997), at <http://www.iosco.org/press/presscomm971110.html>. IOSCO found that:

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 i, 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."<sup>143</sup> The markets would also "ensure fair treatment of orders" and a "reliable" price formation process.<sup>144</sup> As with many products of international harmonization activities, it is not clear how meaningful 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.<sup>145</sup> They threaten the orderliness, which the regulators are bound to protect.

As the securities markets change, so do the participants in those markets.<sup>146</sup> Increasingly, active traders in the securities markets are nonprofessionals.<sup>147</sup> They may trade through broker-dealers who provide facilities for day traders, or they may be owners of a broker-dealer.<sup>148</sup> The advent of the nonprofessional "day trader" has worried regulators.<sup>149</sup> Regulators have expressed concern that such day traders might not have an adequate perception of the risks involved in their activities.<sup>150</sup> 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.

Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,858 (December 22, 1998).

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/tsty2199.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.<sup>151</sup>

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.<sup>152</sup>

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).<sup>153</sup> 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.<sup>154</sup> 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.<sup>155</sup>

---

I am concerned that more and more people may be undertaking day trading strategies without a full appreciation of the risk and difficulty involved. No one should have any illusions of what he is getting involved in. I know of one state that recently found that 67 out of 68 day traders at a firm had in fact lost money.

Levitt, Plain Talk, *supra* note 16.

151. See Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, Exchange Act Release No. 34-43021, 65 Fed. Reg. 44,082, 44,085 (July 17, 2000).

152. Cf. Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996) (arguing that even sophisticated customers of broker-dealers need meaningful risk disclosure statements).

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).

155. See *id.* at 82,731-82,737; cf. Regulation of Market Information Fees and Revenues, Exchange Act Release No. 34-42208, 64 Fed. Reg. 70,613 (Dec. 17, 1999) (to be codified at 17 C.F.R. pt. 240) (soliciting comments on arrangements for dissemination of market information).

## 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.<sup>156</sup> 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,<sup>157</sup> 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.<sup>158</sup>

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.<sup>159</sup> 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."<sup>160</sup> 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.

159. See Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, Exchange Act Release No. 34-43021, 65 Fed. Reg. 44,082, 44,083 (July 17, 2000); see also Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Opening of Day-Trading Accounts, Exchange Act Release No. 34-41875, 64 Fed. Reg. 51,165, 51,166 (Sept. 20, 1999). Rule 2360(e) defines a day trading strategy as "an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities." *Id.*

160. 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 51,166 (proposing NASD Rule 2360(b)); see also Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, 65 Fed. Reg. at 44,083.

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,<sup>161</sup> has visited some web sites which provide information about day trading,<sup>162</sup> 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.<sup>163</sup> 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.<sup>164</sup>

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).

162. Some day trading web sites are clearly operated by broker-dealers seeking to attract new clients. See, e.g., Andover Brokerage LLC, at <http://andovertrading.com/> (last visited Nov. 19, 2000); Momentum Securities, Inc., at <http://www.soes.com/> (last visited Nov. 19, 2000). Others focus on the provision of information or training about day trading strategies; Career Day Trader, at <http://www.careerdaytrader.com/> (last visited Nov. 19, 2000); Day Trading Online, at <http://www.daytradingonline.com/> (last visited Nov. 19, 2000); Sceptre Trading, at <http://www.sceptretrading.com/> (last visited Nov. 19, 2000). The SEC has pointed out that NASD regulated firms would be caught by the day trader suitability rule if they promoted day trading strategies through third parties. See Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, 65 Fed. Reg. at 44,083.

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).

164. Henry Hu points out that the SEC "has no brief to encourage one investor religion over another," either as a matter of "general American economic norms" or as a matter of the philosophy which formed the basis for the SEC. Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 837-38 (2000). Cf. Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (arguing that securities regulation should focus on the protection of investors rather than on the regulation of issuers of securities).

Know.”<sup>165</sup> The SEC’s web site includes some advice to prospective day traders under the headline “Day Trading: Your Dollars at Risk.”<sup>166</sup> 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.”<sup>167</sup> The contrast between this advice and the explanations available on many web sites and in bookstores of successful day trading strategies is striking.<sup>168</sup> 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.<sup>169</sup> 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.<sup>170</sup>

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.<sup>171</sup> Broker-dealer firms are subject to capital adequacy requirements<sup>172</sup> which are designed to be prudential rules,

---

165. Investing Online, *8 Things You Need to Know*, at [http://www.investingonline.org/lvl2\\_8things.html](http://www.investingonline.org/lvl2_8things.html) (last visited Nov. 19, 2000). The eight headings are: (1) “Start Small;” (2) “Stay Diversified;” (3) “Don’t Bail out on Mutual Funds;” (4) “Costs May Not Always Be Obvious;” (5) “Limit Orders Are a Must;” (6) “Mind Those Market Orders;” (7) “Problems Are Inevitable;” and (8) “Information Is Power.”

166. SEC, *Day Trading Your Dollars at Risk*, at <http://www.sec.gov/consumer/daytips.htm> (last visited Nov. 19, 2000).

167. *Id.*

168. *See, e.g.*, Permanent Subcomm. on Investigations, *supra* note 45, at 17 n.119 (noting that the subcommittee counted nearly 50 day trading titles as of January 2000). Securities regulators in many jurisdictions worry about how to communicate to investors about risk. For the novel approach of the Australian Securities Commission to this issue, see Dimity Kingsford Smith, *Reluctant Majesty: Images of Financial Regulation* (unpublished manuscript, on file with author) (describing the ways in which ASC has used fictitious investment advertisements to educate investors about the risks of investing).

169. *See, e.g.*, Helen A. Garten, *The Consumerization of Financial Regulation*, 77 WASH. U. L. Q. 287, 318 (1999) (arguing that the bifurcation between regulation of retail and wholesale markets may be unsustainable in the long run).

170. *See, e.g.*, Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, Exchange Act Release No. 34-43021, 65 Fed. Reg. 44,082, 44,083 (July 17, 2000) (“[A] firm generally would be subject to the proposed rule if its advertisements address the benefits of day trading, rapid-fire trading, or momentum trading, or encourage persons to trade or profit like a professional trader.”).

171. *See* text at note 174, *infra*.

172. Securities Exchange Act § 15(c)(3), 15 U.S.C. § 780 (1994); Rules Relating to Over-the-Counter Markets, 17 C.F.R. § 240.15c3-1 (2000). Section 15(c)(3) of the 1934 Act gives the SEC quite general powers

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.<sup>173</sup>

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.<sup>174</sup> The rules limit the extent to which an investor may purchase securities on credit.<sup>175</sup> The rules also limit the amount of money broker-dealer firms may lend to their clients.<sup>176</sup> 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.<sup>177</sup>

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.<sup>178</sup> However, the traders who were the members of the day trading firm did

---

to make necessary and appropriate rules to regulate broker-dealers in the public interest and for the protection of investors. The statute does refer to "safeguards with respect to the financial responsibility" of broker-dealers, but does not suggest anything specific about the content of such rules. See Securities and Exchange Act § 15(c)(3), 15 U.S.C. § 780 (1994). Since the adoption of the net capital rule in 1975, the question of what capital adequacy rules should apply to securities firms has been discussed in the United States, in Europe, and at the international level. See, e.g., Net Capital Rule, Exchange Act Release No. 34-39456, 62 Fed. Reg. 68,011 (Dec. 30, 1997); IOSCO, REPORT OF THE TECHNICAL COMMITTEE, RECOGNIZING A FIRM'S INTERNAL MARKET RISK MODEL FOR THE PURPOSES OF CALCULATING REQUIRED REGULATORY CAPITAL: GUIDANCE TO SUPERVISORS (1999), [http://www.iosco.org/docs-public/1999-market\\_risk\\_model.html](http://www.iosco.org/docs-public/1999-market_risk_model.html).

173. See, e.g., Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78g (1994); Credit Brokers and Dealers, Regulation T, 12 C.F.R. § 220 (2000); Credit by Banks and Person Other than Brokers and Dealers, Regulation U, 12 C.F.R. § 221 (2000); Borrowers of Securities Credit, Regulation X, 12 C.F.R. § 224 (2000); NYSE Rule 431, 2 NYSE GUIDE (CCH) ¶ 2431, at 3751 to 3773-5 (2000).

174. Credit by Brokers and Dealers, Regulation T, 12 C.F.R. § 220.12 (2000).

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 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) (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.<sup>179</sup> They were owners of the business, rather than its customers. The day trading firm would lend them money to enable them to trade.<sup>180</sup>

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,<sup>181</sup> 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.<sup>182</sup> Nonprofessionals are not supposed to speculate.<sup>183</sup> However, there are some general systemic concerns about excessive speculation in the

---

Equity Requirements for Joint Back Office Arrangements, Exchange Act Release No. 34-42453, 65 Fed. Reg. 11,620 (Mar. 3, 2000).

179. See Levitt, *supra* note 148. Such firms tended to be members of the Philadelphia Stock Exchange. *Id.* The Philadelphia Stock Exchange, <http://www.phlx.com/index.stm> (last visited Nov. 19, 2000).

180. Note that as of February 25, 2000, the Rules of the Philadelphia Stock Exchange require each day trader who is a limited partner in a member firm to pass the General Securities Representative Examination Series 7. 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, 64 Fed. Reg. 47,214, at 47,215 (Aug. 30, 1999). Similar rules have been approved for the Pacific Exchange and for the Chicago Stock Exchange. See Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 to the Proposed Rule Change Requiring Qualified Off-Floor Traders for Which PCX is the Designated Examining Authority to Successfully Complete the General Securities Registered Representative Examination, Test Series 7, Exchange Act Release No. 34-41881, 64 Fed. Reg. 51,822 (Sept. 24, 1999) (Pacific Exchange); Order Approving Proposed Rule Change by the Chicago Stock Exchange, Inc. Relating to Examination Requirements for Securities Traders, Exchange Act Release No. 34-39874, 63 Fed. Reg. 19,990 (Apr. 22, 1998) (Chicago Stock Exchange).

181. The application of margin requirements by broker dealers can result in customers' securities being sold in a declining market to meet margin calls. See, e.g., NASD Regulation, Purchasing on Margin, Risks Involved With Trading in a Margin Account, at <http://www.nasdr.com/2535.htm> (last visited Feb 12, 2001). The NASD has recently focused on a program of informing investors about the application of margin requirements. See Press Release, NASD, NASD Board of Governors Approves Disclosure Statement for Margin Accounts (July 27, 2000), [http://www.nasdaqnews.com/news/pr2000/ne\\_section00\\_173.html](http://www.nasdaqnews.com/news/pr2000/ne_section00_173.html); see also Sec. and Exch. Comm. Notice on Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Delivery Requirement of a Margin Disclosure Statement to Non-Institutional Customers, Exchange Act Release 34-43441, 65 Fed. Reg. 63,275 (Oct. 23, 2000); NASD Regulation, *Margin Information*, at <http://www.nasdr.com/5700.htm> (last visited Nov. 19, 2000).

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

183. See, e.g., Chairman Arthur Levitt, Securities and Exchange Commission, Investing With Your Eyes Open, Speech at The Washington Post Investors Town Meeting, Washington, D.C. (Sept. 16, 2000) (suggesting that investors should invest, rather than trade, in securities).

securities markets.<sup>184</sup> Highly leveraged hedge funds raise some of the same issues as day traders.<sup>185</sup>

In the 1930s, excessive speculation was regarded as one of the causes of the 1929 market crash.<sup>186</sup> 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.<sup>187</sup> But it is now harder to disapprove of speculation as such,<sup>188</sup> because we have normalized speculation.<sup>189</sup> 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.<sup>190</sup>

More recently, the SEC has described day trading as "frequent, fast and risky trading."<sup>191</sup> But risky trading is what professionals do all the time, and we tend to accept

---

184. Cf. Lynn Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791, 792 (1997) ("[R]educing the transactions costs associated with speculative stock trading may not significantly benefit investors.").

185. See IOSCO, REPORT OF THE TECHNICAL COMMITTEE, HEDGE FUNDS AND OTHER HIGHLY LEVERAGED INSTITUTIONS 125-26 (1999), [http://www.iosco.org/docs-public/1999-hedge\\_funds.html](http://www.iosco.org/docs-public/1999-hedge_funds.html). The report states:

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.

*Id.*

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").

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

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

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").

190. Levitt, *supra* note 16. On gambling generally, see NATIONAL GAMBLING IMPACT STUDY COMMISSION, FINAL REPORT (1999), <http://www.ngisc.gov/reports/finrpt.html>; NATIONAL OPINION RESEARCH CENTER, REPORT TO THE NATIONAL GAMBLING IMPACT STUDY COMMISSION, GAMBLING IMPACT AND BEHAVIOR STUDY (1999), <http://norc.uchicago.edu/new/gamble.htm>.

191. OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, *supra* note 1, at § II.

that they do so.<sup>192</sup> 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.<sup>193</sup>

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.<sup>194</sup> 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.<sup>195</sup>

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.<sup>196</sup> 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.

---

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, *Why People Play Lotteries and Why It Matters*, 1994 WIS. L. REV. 71, 74.

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

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. See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Stout, *supra* note 106.

195. See, e.g., Center for Economic and Policy Research, *The Tobin Tax: Shifting the Tax Burden From Wages to Wagers*, at <http://www.cepr.net/speculation/> (last visited Nov. 19, 2000); cf. Lowenstein, *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%).

196. See, e.g., Office of Compliance Inspections and Examinations, *supra* note 1, at § IIIc ("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.<sup>197</sup> The proposed changes to the margin requirements would apply special requirements to customers who engage in a pattern of day trading.<sup>198</sup> 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.<sup>199</sup>

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.<sup>200</sup> The requirement is designed to ensure that associated persons are in a position to comply with securities laws and regulations.<sup>201</sup> 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

---

197. Notice of Filing of Proposed Rule Change by the New York Stock Exchange, Inc. to Amend NYSE Rule 431 ("Margin Requirements"), Exchange Act Release No. 34-42343, 65 Fed. Reg. 4005 (Jan. 25, 2000).

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)(ii) 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)(iv) 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.<sup>202</sup> 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,<sup>203</sup> 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.<sup>204</sup> Limits on access to technology and on access to resources are likely to impede democratic access to the markets.<sup>205</sup> 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.

---

202. Cf. Cheryl R. Lee, *Cyberbanking: A New Frontier for Discrimination?*, 26 RUTGERS COMPUTER AND TECH. L.J. 277 (2000) (arguing that cyberbanking raises issues "such as lack of access to credit opportunities, discriminatory lending practices, and security risks").

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. <i>Introduction</i> .....	104
B. <i>Forms of LLC Management</i> .....	106
C. <i>Raising Equity Capital in Member-Managed LLCs—The Problem of a Failure to Separate Ownership and Control</i> .....	108
D. <i>Raising Equity Capital in Manager-Managed LLCs—The Problem of a Failure to Separate Decision Management from Decision Control</i> .....	111
IV. POSSIBLE ADVANTAGES TO THE LLC FORM.....	114
A. <i>Broad Freedom of Contract</i> .....	114
B. <i>Dissenters' Rights</i> .....	115
C. <i>Flexibility With Respect to Organizational Formalities</i> .....	115
D. <i>Fiduciary Duties</i> .....	115
V. REPLICATING CORPORATE GOVERNANCE SYSTEMS IN LIMITED LIABILITY COMPANY FORM.....	116
A. <i>Contracting for Corporate Governance Structures</i> .....	116
B. <i>State LLC Statutes Providing for Board Monitoring</i> .....	116
C. <i>Modifications to ULLCA and State LLC Statutes to Embrace a Board- Directed Management Structure</i> .....	118
1. <i>Foreign Law Equivalents</i> .....	119
a. <i>German Gesellschaft mit beschränkter Haftung</i> .....	119
b. <i>French Société à Responsabilité Limité</i> .....	120
c. <i>Brazilian Limitadas</i> .....	121
d. <i>Summary</i> .....	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.