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Easing the Regulation of a Pan-European Securities Market: Applying the Recommendations of the Rudman Report to EASDAQ

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Maria A. Volarich

Abstract

This Note argues that the EASD should implement suggestions offered in the Rudman Report for Nasdaq because the success of EASDAQ depends on maintaining the trust of all its constituencies in the fair operation of the market. Part I discusses the development of the current regulatory structures of the US and EU securities markets. Part II examines the Rudman Report and the arguments of those who criticize and praise it. Part III argues that the Rudman Report's recommendations should be adopted by EASDAQ, because EASDAQ models itself on Nasdaq, and therefore will encounter the same criticisms of self-dealing and conflicts of interest that surround the NASD, EASDAQ should preempt such complaints by acknowledging the findings in the Rudman Report. This Note concludes that the self-regulatory structure of the EASD and EASDAQ, combined with adoption of the Rudman Report's recommendations, will enable EASDAQ to implement fairness and efficiency considerations essential to a successful market.

EASING THE REGULATION OF A PAN-EUROPEAN
SECURITIES MARKET: APPLYING THE
RECOMMENDATIONS OF THE RUDMAN
REPORT TO EASDAQ

*Maria A. Volarich**

[T]he need to safeguard the integrity of the securities markets is closely linked with the need to protect investors. It is a fair assumption that if the law does not guarantee satisfactory investor protection, investors will lose confidence in the financial markets The concern to protect investors and to safeguard the integrity of the financial markets may justify the imposition of restrictions on the freedom to provide services.¹

INTRODUCTION

A regulated securities² market³ protects investors by encour-

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1. Opinion of Advocate General Jacobs, *Alpine Investments* by v. Minister van Financiën, Case 384/93, [1995] E.C.R. __, __, [1995] 2 C.E.C. (CCH) 149, 163, 166. The freedom to provide services is one of the four freedoms deemed necessary for the creation of an internal market. Treaty Establishing the European Community, Feb. 7, 1992, [1992] 1 C.M.L.R. 573 [hereinafter EC Treaty], *incorporating changes made by Treaty on European Union*, Feb. 7, 1992, O.J. C 224/1 (1992), [1992] 1 C.M.L.R. 719, 31 I.L.M. 247 [hereinafter TEU]. The TEU, *supra*, amended the Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11, 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II) [hereinafter EEC Treaty], *as amended by Single European Act*, O.J. L 169/1 (1987), [1987] 2 C.M.L.R. 741 [hereinafter SEA], in TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES (EC Off'l Pub. Off. 1987). The EC Treaty includes among the activities of the Community "an internal market characterised by the abolition, as between Member-States, of obstacles to the free movement of goods, persons, services and capital." EC Treaty, *supra*, art. 3, [1992] 1 C.M.L.R. at 588. See Commission of the European Communities, *Completing the Internal Market: White Paper from the Commission to the European Council*, COM (85) 310 Final (June 1985) [hereinafter White Paper] (detailing program and timetable for achieving internal market); see also Walter Van Gerven & Jan Wouters, *Free Movement of Financial Services and the European Contracts Convention*, in EC FINANCIAL MARKET REGULATION AND COMPANY LAW 43, 61 (Mads Andenas & Stephen Kenyon-Slade eds., 1993) (discussing White Paper's approach to including financial services under EC Treaty).

2. See U.S. Securities and Exchange Act of 1934, 15 U.S.C. § 78c (1994) [hereinafter 1934 Act]. "Security" includes any note, stock, treasury stock, bond, debenture, investment contract, certificate of deposit, and any put, call, or option on any security. *Id.*

3. JOHN DOWNES & JORDAN E. GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 245 (3d ed. 1991) [hereinafter *DICTIONARY OF FINANCE*]. A market is a "public place where products or services are bought and sold, directly or through intermediaries." *Id.* In Europe, many national markets, excluding the United Kingdom, have minimal regulation. Andreas J. Roquette, *New Developments Relating to the Interna-*

aging the free flow of information, which ensures market efficiency.⁴ Moreover, a securities market accessible to small, entrepreneurial enterprises⁵ promotes job creation and industry competitiveness by encouraging growth and technological advances.⁶ In pursuit of these ideals, and in response to criticisms that they are not being met,⁷ the United States⁸ is considering

tionalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany, 14 U. PA. J. INT'L BUS. L. 565, 596 (1994). What regulation there is of the European stock exchanges, however, is established under self-regulatory organizations ("SROs"). *Id.* A SRO is an industry group, rather than a government agency, responsible for "the enforcement of fair, ethical, and efficient practices in the securities" market that it governs. DICTIONARY OF FINANCE, *supra*, at 404-05.

4. Council Directive No. 93/22/EEC, O.J. L 141/27, at 30 (1993) ("with the twofold aim of protecting investors and ensuring the smooth operation of the markets in transferable securities"). See Opinion of Advocate General Jacobs, *Alpine Investments*, [1995] E.C.R. at ___, [1995] 2 C.E.C. (CCH) at 163. Advocate General Jacobs states that financial services directives "recognise that ensuring investor confidence in the securities markets will promote the smooth operation of those markets. By providing a regulatory framework they will encourage investment, and so enable the securities markets to perform their economic function, namely the efficient allocation of resources." *Id.*

5. DICTIONARY OF FINANCE, *supra* note 3, at 125. An entrepreneur takes on the risks of starting a new business. *Id.* Early stage financing, in addition to those funds accessible to the entrepreneur, may be provided by venture capital sources, which share in the risk of the new enterprise for a share of the potential profits. *Id.* at 125, 503. Once the business is established, shares may be sold to the public through, for example, an initial public offering. *Id.* at 125. An initial public offering is an opportunity for the owners of the corporation to realize profits from their enterprise, because their shares will be given a market value reflecting expectations for the corporation's future growth. *Id.* at 200.

6. Commission Communication, COM (95) 498 Final at 3, ¶¶ 3, 6 (Oct. 1995) [hereinafter European Capital Market] (communicating to Member States on feasibility of creation of European Capital Market for smaller entrepreneurially managed growing companies). Small, entrepreneurial enterprises, referred to as "small and medium-sized enterprises" ("SMEs") within the European Union, account for 70% of total employment and are responsible for up to 40% of all new employment in manufacturing. Commission Communication, COM (93) 528 Final at 7, ¶ 7 (Nov. 1993) [hereinafter Financial Problems] (communicating to Member States on the financial problems experienced by small and medium-sized companies).

7. Scot J. Paltrow, *Inside Nasdaq. Questions About America's Busiest Stock Market. First in a Series*, L.A. TIMES, Oct. 20, 1994, at 1 [hereinafter *Inside Nasdaq, Part 1*]; Scot J. Paltrow, *Inside Nasdaq. Questions About America's Busiest Stock Market. Second in a Series*, L.A. TIMES, Oct. 21, 1994, at 1 [hereinafter *Inside Nasdaq, Part 2*]; Scot J. Paltrow, *Inside Nasdaq. Questions About America's Busiest Stock Market. Third in a Series*, L.A. TIMES, Oct. 22, 1994, at 1 [hereinafter *Inside Nasdaq, Part 3*]; Scot J. Paltrow, *Inside Nasdaq. Questions About America's Busiest Stock Market. Fourth in a Series*, L.A. TIMES, Oct. 23, 1994, at 1 [hereinafter *Inside Nasdaq, Part 4*]; Scot J. Paltrow, *Inside Nasdaq. Questions About America's Busiest Stock Market. Fifth in a Series*, L.A. TIMES, Oct. 24, 1994, at 1 [hereinafter *Inside Nasdaq, Part 5*]; Jerry Knight, *Who's Being Helped? Regulators Probe Whether NASD Can Own — and Oversee — Nasdaq*, WASH. POST, Sept. 3, 1995, at H1; Michael Schroeder, *Who Watches the Watchdog at Nasdaq? Critics From All Sides - Even From Within - Say the*

methods to improve the regulation of the National Association of Securities Dealers Automated Quotation⁹ ("Nasdaq") market, the securities market on which small capitalization¹⁰ issues primarily trade.¹¹ Similarly, the European Union¹² ("EU") seeks to create a regulatory environment for the implementation of a pan-European market¹³ for small growth companies.¹⁴

Market Can No Longer Police Itself, Bus. Wk., May 15, 1995, at 102. Recent criticism suggests that when the National Association of Securities Dealers ("NASD") fines or suspends members, the fines often go unpaid, and the individual may continue to work in the industry. Floyd Norris, *When a Fine Can Mean Nothing*, N.Y. TIMES, Mar. 31, 1996, § 3(1). During the past seven years, for example, the NASD imposed fines of US\$201 million, but collected less than 19% of that amount. *Id.*

8. 15 U.S.C. § 78a (1994). The 1934 Act created the Securities and Exchange Commission ("SEC"), the regulatory agency responsible for governing the U.S. securities markets. ZVI BODIE ET AL., INVESTMENTS 90-91 (1989); NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., SECURITIES REGULATION IN THE UNITED STATES 8 (2d ed. 1994) [hereinafter SECURITIES REGULATION]. The Maloney Act of 1938 amended the 1934 Act to authorize the registration with the Securities and Exchange Commission of national securities associations of broker-dealers. SECURITIES REGULATION, *supra*, at 9; Maloney Act of 1938, Pub. L. No. 719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o (1994)). Through the Maloney Act of 1938 the SEC gained responsibility for the actions of the broker-dealers, including trading in the over-the-counter markets. SECURITIES REGULATION, *supra*, at 9.

9. J. FRED WESTON & THOMAS E. COPELAND, MANAGERIAL FINANCE 36 (8th ed. 1989). Nasdaq is a computerized quotation system through which brokers and dealers in the over-the-counter securities market communicate. *Id.* "Nasdaq" was previously designated "NASDAQ." NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., REPORT OF THE NASD SELECT COMMITTEE ON STRUCTURE AND GOVERNANCE TO THE NASD BOARD OF GOVERNORS II-26 (1995) [hereinafter RUDMAN REPORT]. This Note adopts the convention used by the Rudman Report and consistently uses the "Nasdaq" designation.

10. DICTIONARY OF FINANCE, *supra* note 3, at 246. Market capitalization represents the value of a corporation, determined by multiplying the number of outstanding shares by the current market price of a share. *Id.*

11. European Capital Market, *supra* note 6, COM (95) 498 Final at 20, ¶ 1. Standard & Poor's defines issues eligible for inclusion in its small-cap stock index uses as those falling within the 50th-83rd percentile of the entire market's value. STANDARD & POOR'S, S&P SMALL CAP 600, 1995 DIRECTORY 5 (1995). For 1993, this represented a capitalization range of between US\$600 million and US\$80 million. *Id.* The European Association of Securities Dealers ("EASD") has not defined the ideal size of firms that would be appropriately listed on the EASDAQ. EUROPEAN ASSOCIATION OF SECURITIES DEALERS AUTOMATED QUOTATION, DESCRIPTION OF THE EASDAQ PROJECT (1995) [hereinafter EASDAQ]. This may be in recognition of the fact that many small corporations that listed on Nasdaq have grown much larger, yet have chosen to remain listed on Nasdaq. Knight, *supra* note 7, at H1. Examples of these firms include Microsoft and Intel. *Id.*

12. EC Treaty, *supra* note 1, art. A, [1992] 1 C.M.L.R. at 726-27.

13. European Capital Market, *supra* note 6, COM (95) 498 Final at 7, ¶ 15. A pan-European securities market represents a single market for the European Union, as opposed to national markets maintained in individual Member States. *Id.* at 6-7, ¶ 13.

14. *Id.* at 15, ¶ 49.

The National Association of Securities Dealers¹⁵ ("NASD") owns Nasdaq and acts as the self-regulatory organization¹⁶ ("SRO") governing it.¹⁷ Recent public criticism¹⁸ has alleged that the NASD is not fulfilling its obligations as a market regulator.¹⁹ In response, the NASD appointed a Select Committee on Structure and Governance²⁰ ("Select Committee") to evaluate

15. NASD Manual (CCH) 109 (July 1994). The NASD's Certificate of Incorporation indicates its purposes as:

- (1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws;
- (2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;
- (3) To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;
- (4) To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members;
- (5) To establish, and to register with the [SEC] as, a national securities association

Id. ¶ 1003. See WESTON & COPELAND, *supra* note 9, at 36 ("[NASD] is the self-regulatory organization of the OTC markets").

16. DICTIONARY OF FINANCE, *supra* note 3, at 404-05. The 1934 Act provided for the governance of the securities industry by SROs, with oversight by the SEC. 15 U.S.C. § 78o(3) (1994). The SEC delegates to SROs the day-to-day oversight of the securities markets. BODIE, *supra* note 8, at 91. In addition to the NASD, SROs include the New York Stock Exchange, the American Stock Exchange, and a number of regional stock exchanges. SECURITIES REGULATION, *supra* note 8, at 9. While these are registered exchanges, the NASD is the only national securities association registered under the amended 1934 Act. *Id.*; 15 U.S.C. § 78o(3)(a) (1994).

17. NASD Manual, *supra* note 15, at 109.

18. *Inside Nasdaq, Part 1*, *supra* note 7, at 1; see *supra* note 7 and accompanying text (describing criticisms of NASD's regulation of Nasdaq). Critics include small market maker firms, academics, and investors. *Inside Nasdaq, Part 1*, *supra* note 7, at 1.

19. Knight, *supra* note 7, at H1; see *supra* note 7 and accompanying text (discussing criticisms of NASD's governance of Nasdaq). As a securities market regulator, the NASD's responsibilities include overseeing Nasdaq, as well as NASD members' activities. SECURITIES REGULATION, *supra* note 8, at 10. The NASD sets listing requirements for corporations seeking to have their stock traded on Nasdaq and monitors companies' maintenance of these standards. *Id.* at 12. The NASD also monitors market activity for the purpose of detecting unusual or illegal trading activity. *Id.* In addition, the NASD conducts formal investigations and may refer cases to the SEC for action beyond the jurisdiction of the NASD. *Id.* at 14-15.

20. RUDMAN REPORT, *supra* note 9, at I-3. Former U.S. Senator Warren B. Rudman chaired the Select Committee. *Id.* Other members of the committee included: Jean W. Gleason (former Associate Director, SEC Division of Investment Management), Stephen L. Hammerman (Vice Chairman, Merrill, Lynch & Co.; former Chairman, NASD

the existing governance structure and recommend improvements.²¹ The Select Committee issued its report²² ("Rudman Report") in September 1995, suggesting changes in the structure and operation of the NASD.²³

In contrast to the United States, the European Union does not have a pan-European market for small and medium-sized enterprises ("SMEs").²⁴ With the adoption of the Investment Services Directive²⁵ ("ISD"), however, the European Union provided a vehicle for the establishment of a pan-European securities market.²⁶ The European Association of Securities Dealers²⁷ ("EASD") proposed the creation of the EASD Automated Quotation²⁸ ("EASDAQ") market.²⁹ EASDAQ promotes itself as the European Nasdaq.³⁰

This Note argues that the EASD should implement suggestions offered in the Rudman Report for Nasdaq because the success of EASDAQ depends on maintaining the trust of all its con-

Board of Governors), Peter S. Lynch (Vice Chairman, Fidelity Research and Management), Robert H. Mundheim (former Vice Chairman, NASD Board of Governors), Irving M. Pollack (former SEC Commissioner and former Director, SEC Division of Trading and Markets and SEC Division of Enforcement), and A.A. Sommer, Jr. (Vice Chairman, NASD Board of Governors and former SEC Commissioner). *Id.* at C-28.

21. *Id.* at I-4.

22. *Id.* at C-28.

23. *Id.* at R-1-R-32.

24. European Capital Market, *supra* note 6, COM (95) 498 Final at 3, ¶¶ 3, 6; *see supra* note 6 and accompanying text (defining SMEs).

25. Council Directive No. 93/22 EEC, *supra* note 4, O.J. L 141/27 (1993). Prior to the issuance of the ISD, the European Union compiled a list of legislation necessary for the completion of the internal market, including the field of investment services. White Paper, *supra* note 1, COM (85) 310 Final at Annex 29. The effect of a directive is to require the national governments of each Member State to enact legislation in compliance with the directive prior to the implementation date stipulated in the directive. Debevoise & Plimpton, *The European Economic Community and European Economic Area*, in *INTERNATIONAL SURVEY OF INVESTMENT ADVISER REGULATION* 119-20 (Marcia L. MacHarg & Roberta R.W. Kameda eds., 1994) [hereinafter *INTERNATIONAL SURVEY*].

26. EASDAQ, *supra* note 11, at 16.

27. *Id.* at 4. The EASD's primary responsibility will be to act as the SRO for EASDAQ. European Capital Market, *supra* note 6, COM (95) 498 Final at 9, ¶ 24.

28. EASDAQ, *supra* note 11, at 1 (describing "a pan-European regulated stock market which is liquid, efficient and fair, where fast growing companies with international aspirations can raise capital from interested investors").

29. *Id.* at 4-5.

30. *Id.* at 9. David Tweed, *New European Market Takes After Nasdaq*, WALL ST. J. EUR., Feb. 22, 1996, at 10; Amelia Torres, *Euro Nasdaq-Type Exchange to Start with 50 Firms*, REUTER EUR. COMMUNITY REP., June 23, 1995, available in LEXIS, Europe Library, CURNWS File.

stituencies in the fair operation of the market. Part I discusses the development of the current regulatory structures of the U.S. and EU securities markets. Part II examines the Rudman Report and the arguments of those who criticize and praise it. Part III argues that the Rudman Report's recommendations should be adopted by EASDAQ, because EASDAQ models itself on Nasdaq, and therefore will encounter the same criticisms of self-dealing and conflicts of interest that surround the NASD, EASDAQ should preempt such complaints by acknowledging the findings in the Rudman Report. This Note concludes that the self-regulatory structure of the EASD and EASDAQ, combined with adoption of the Rudman Report's recommendations, will enable EASDAQ to implement fairness and efficiency considerations essential to a successful market.

I. HISTORY AND CURRENT FORM OF U.S. AND EU SECURITIES MARKETS FOR SMALL COMPANIES

Corporations³¹ may raise capital by issuing debt³² or stock,³³ both of which are classified as securities for the purpose of the Securities Act of 1933³⁴ ("1933 Act") and the Securities and Exchange Act of 1934 ("1934 Act").³⁵ The 1933 Act governs the issuance of securities by corporations,³⁶ while the 1934 Act regulates the securities markets, including the market for over-the-counter³⁷ ("OTC") securities.³⁸ The NASD, overseen by the Se-

31. WESTON & COPELAND, *supra* note 9, at 55. In the United States, corporations are legal entities created by a governmental unit. *Id.* The governmental unit is usually a state, although certain corporations, such as banks, are also chartered by the federal government. *Id.* A corporation is a separate entity from its owners and managers. *Id.* This separateness leads to the four major advantages of the corporate structure: perpetual life, limited liability, division of risk among the owners into many units thereby limiting the risk exposure and facilitating diversification, and transferability of ownership interest. *Id.*

32. *Id.* at 34. Debt reflects a promise to pay a creditor a specified amount, plus interest, at a future date. *Id.*

33. *Id.* Stock generally refers to common stock, which represents ownership of a corporation. *Id.*

34. Securities Act of 1933, 15 U.S.C. § 77a (1994) [hereinafter 1933 Act].

35. 15 U.S.C. § 78a (1994). When introducing the bill that would become the 1934 Act, Senator King stated his belief that if provisions of the 1933 Act and 1934 Act had been enacted previously "they would have prevented the debacle of 1929 so far as the stock exchange, stock sales, and so forth, are concerned." 78 CONG. REC. 1991 (1934) (statement of Sen. King).

36. 15 U.S.C. § 77f (1994).

37. DICTIONARY OF FINANCE, *supra* note 3, at 306. On the over-the-counter

curities and Exchange Commission³⁹ ("SEC"), regulates Nasdaq, a quotation system that facilitates trading on the OTC market,⁴⁰ as well as the broker-dealer profession.⁴¹ Recent public criticism⁴² of the NASD and its governance of Nasdaq led to the creation of the Select Committee, which issued recommendations for changing the NASD's governance structure.⁴³

A. *General Corporate Finance Background*

Corporations raise capital for a variety of reasons, including working capital⁴⁴ and financing research and development.⁴⁵ A corporation seeking to finance its expansion, for example, may choose to raise capital by issuing debt or issuing stock.⁴⁶ By issuing stock, a corporation can raise necessary capital while diluting the investment of the current shareholders,⁴⁷ making the issu-

("OTC") market, dealers conduct trades over the telephone and computer networks, rather than on an exchange. *Id.*

38. 15 U.S.C. §§ 78f, 78k (1994).

39. 15 U.S.C. § 78d (1994). The SEC states that its "mission is to administer the federal securities laws that seek to provide protection for investors. The purposes of these laws are to ensure that the securities markets are fair and honest and to provide the means to enforce the securities laws through sanctions where necessary." U.S. SEC. AND EXCH. COMM'N, 1993 ANNUAL REPORT ii (1994). The 1934 Act, as amended by the Maloney Act of 1938, dictates that the SRO for the OTC market is subject to SEC supervision. 1934 Act, 15 U.S.C. §§ 78o, 78q(d) (1994); SECURITIES REGULATION, *supra* note 8, at 9.

40. C. DAVID CHASE, CHASE INVESTMENT PERFORMANCE DIGEST 78 (1994).

41. DICTIONARY OF FINANCE, *supra* note 3, at 99. "Broker-dealer" is a term used to refer to brokerage firms, which often act as both brokers buying and selling securities on behalf of investors and dealers buying and selling securities for their own account. *Id.*

42. *Inside Nasdaq, Part 1*, *supra* note 7, at 1; *see supra* note 7 and accompanying text (discussing criticisms of NASD's governance of Nasdaq).

43. RUDMAN REPORT, *supra* note 9, at C-2-C-3.

44. DICTIONARY OF FINANCE, *supra* note 3, at 515. Working capital finances the processing of raw materials into finished goods that can be sold and converted into cash. *Id.*

45. *Id.* at 369. Research and development represents the scientific and marketing evolution of a new product or service. *Id.* Research and development financing, in particular in the technology and biotechnology industries, is extensive because of high rates of obsolescence and competition. *Id.*

46. WESTON & COPELAND, *supra* note 9, at 751, 781.

47. *Id.* at 755. Corporations often give existing shareholders the opportunity to buy additional shares to avoid the dilution of their ownership in the corporation. *See id.* (explaining preemptive rights). In a small, entrepreneurial enterprise, however, the issuance of stock, and the resulting dilution of ownership, allows the existing shareholders to quantify the value of their investment in the corporation through the appreciation of the share price that accompanies initial public offerings and secondary offering.

ance of stock particularly attractive to entrepreneurs who have the bulk of their assets invested in the corporation.⁴⁸

Securities are initially⁴⁹ issued on a primary market and subsequently traded on a secondary market.⁵⁰ Securities trade on securities markets, which may be either exchange-based⁵¹ or screen-based.⁵² Exchanges are physical locations where a specialist⁵³ buys and sells the stock of a particular listed⁵⁴ corporation.⁵⁵ In contrast, screen-based markets are computer systems through which market makers⁵⁶ quote⁵⁷ the prices at which they

DICTIONARY OF FINANCE, *supra* note 3, at 200; *see supra* note 5 and accompanying text (explaining initial public offerings and their benefits for owners). In addition, shareholders may liquidate all or part of their investment through the sale of their stock and, therefore, realize the appreciation from their initial investment. *See* DICTIONARY OF FINANCE, *supra* note 3, at 356 (defining realized profit).

48. *Id.* at 125; *see supra* note 5 and accompanying text (explaining entrepreneurs' investment strategies).

49. DICTIONARY OF FINANCE, *supra* note 3, at 200; *see supra* note 5 and accompanying text (discussing initial public offerings). An initial public offering is a corporation's first issuance of stock to the public. DICTIONARY OF FINANCE, *supra* note 3, at 200.

50. WESTON & COPELAND, *supra* note 9, at 35. In primary markets, investment banking firms sell newly issued securities acquired from the issuing corporation through an underwriting syndicate or group. *Id.* After issuance, securities trade on secondary markets. *Id.* These transactions take place on organized exchanges and in less formal markets, such as the OTC market. *Id.*

51. *Id.* Organized securities exchanges are tangible physical entities. *Id.* Members may purchase seats on the exchange, representing the right to buy and sell securities on the exchange. *Id.*

52. EASDAQ, *supra* note 11, at 4 (characterizing Nasdaq as screen-based market); *see supra* note 37 and accompanying text (describing OTC market as market where trades are conducted over telephone lines and computers).

53. WESTON & COPELAND, *supra* note 9, at 36. A specialist is a firm that matches the buy and sell orders that come in, almost simultaneously, on an exchange. *Id.* A specialist is also responsible "for maintaining an orderly market in its particular security." *Id.*

54. DICTIONARY OF FINANCE, *supra* note 3, at 234. A listed security is a stock or bond accepted for trading by one of the securities exchanges registered with the SEC. *Id.* Unlisted securities trade in the OTC market. *Id.*

55. WESTON & COPELAND, *supra* note 9, at 36.

56. *Id.* at 36. Market makers refers to brokers and dealers on the OTC market "who stand ready to buy and sell securities." *Id.* The market makers function much like wholesale suppliers of goods or merchandise. *Id.* Where a stock trades infrequently, perhaps because it is a new or small corporation, the matching of buy and sell orders by a specialist may take an extended period of time. *Id.* To avoid this problem, market makers maintain an inventory of securities. *Id.* "At one time, these securities were held in a safe, and when they were traded, they were literally passed over-the-counter." *Id.*

57. DICTIONARY OF FINANCE, *supra* note 3, at 351. Market makers quote the highest bid and the lowest asked price currently available. *Id.* The bid price is the highest price the market maker is willing to pay for the quoted security, while the asked price is the lowest price at which he is willing to sell that security. *Id.* The difference between the

are willing to buy and sell stocks.⁵⁸

The OTC market refers to all securities trading activity that does not occur on an exchange.⁵⁹ The OTC market handles the stock of various U.S. corporations, some foreign stock issues, most bonds of U.S. corporations and federal, state, and local governments, and the stocks of most banks and insurance companies.⁶⁰ In addition, the OTC market handles new issues of securities and most secondary distributions of large blocks of stock, regardless of whether the issues are listed on an exchange.⁶¹ The OTC market, therefore, represents both a primary and a secondary market.⁶²

B. *The United States Securities Markets*

No federal securities laws existed in the United States prior to the 1929 stock market crash.⁶³ In response to the stock market crash of 1929, however, Congress passed the 1933 Act and the 1934 Act.⁶⁴ The 1934 Act requires the registration of securities exchanges and national securities associations.⁶⁵ Trading on the secondary market takes place on these registered exchanges and the OTC market.⁶⁶

bid and asked price is the spread. *Id.* at 427-28. The spread represents the market makers' profit margin. Scot J. Paltrow, *Nasdaq Spreads Have Narrowed, Study Shows Investing: A Computer Analysis of the Top-Selling Issues Shows a Significant Change in the Trading Margin for 49 of 50*, L.A. TIMES, Jan. 5, 1995, at 1 [hereinafter *Nasdaq Spreads*].

58. EASDAQ, *supra* note 11, at 4; *see supra* note 52 and accompanying text (defining screen-based market).

59. WESTON & COPELAND, *supra* note 9, at 36.

60. *Id.*

61. *Id.*

62. *Id.* at 35-36.

63. RUDMAN REPORT, *supra* note 9, at II-5. State laws prohibiting fraud in the sale of securities, known as "blue sky laws, because they attempt to prevent the false promotion and sale of securities representing nothing more than blue sky," did exist prior to 1929. BODIE, *supra* note 8, at 91.

64. Sen. Francis Maloney, Radio Address (Feb. 25, 1938), in 83 APP. TO THE CONG. REC. 789, 790 (1938). "After the crash in 1929 when hundreds of thousands of American investors saw their savings swept away, . . . Congress gave immediate attention to the subject [of abuses in the investment field]." *Id.* at 790; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 1-13 (rev. ed. 1995); RUDMAN REPORT, *supra* note 9, at II-5.

65. 15 U.S.C. § 78o-3 (1994).

66. WESTON & COPELAND, *supra* note 9, at 36; *see supra* notes 50-62 and accompanying text (defining secondary market and OTC market).

1. The 1933 Act and the 1934 Act

Congress established the 1933 Act to prevent frauds in the sale of securities.⁶⁷ The 1933 Act sets out requirements for the issuance of securities⁶⁸ and their registration with the appropriate government agency,⁶⁹ and attaches civil liability for a corporation's failure to comply with the requirements.⁷⁰ In contrast, the 1934 Act provides for the regulation of securities markets and the OTC market.⁷¹ In 1938, Congress amended the 1934 Act⁷² by requiring the registration of any national securities association seeking to supervise the OTC market.⁷³

67. 15 U.S.C. § 77a (1994). The preamble of the 1933 Act sets out that the purpose of the "Act [is] to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a (1994)) (quoting preamble). In recommending passage of the 1933 Act, President Franklin Roosevelt wrote to Congress that:

[T]he Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

77 CONG. REC. 937 (1933) (letter from President Franklin D. Roosevelt).

68. 15 U.S.C. § 77e (1994). These requirements include filing a registration statement with the SEC and issuing a prospectus for use by prospective investors. *Id.*

69. 15 U.S.C. § 77b(5) (1994). Congress originally designated the Federal Trade Commission ("FTC") as the agency with which securities issues would register. Securities Act of 1933, § 2(5), 48 Stat. at 75. With the creation of the SEC by the 1934 Act, however, the SEC became the regulatory agency of the securities markets. 15 U.S.C. § 78d (1994); *see supra* note 8 and accompanying text (describing SEC's creation).

70. 15 U.S.C. §§ 77k-1 (1994).

71. 15 U.S.C. § 78a (1994). The preamble of the 1934 Act states its purpose as "provid[ing] for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes." Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. 78a (1994)) (quoting preamble).

72. Maloney Act of 1938, 15 U.S.C. § 78o (1994). Senator Francis T. Maloney introduced the bill drafted by the predecessor of the NASD, the Investment Bankers Conference, Inc. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., NASD MANUAL 109 (Sept. 1991) [hereinafter NASD]. The preamble of the Maloney Act states that the purpose of the Act is "to provide for the establishment of a mechanism of regulation among over-the-counter brokers and dealers . . . to prevent acts and practices inconsistent with just and equitable principles of trade." *Id.*; *see supra* note 8 and accompanying text (explaining Maloney Act's purpose).

73. 15 U.S.C. § 78o (1994). Section 15A of the Securities Exchange Act of 1934 provided that:

2. Trading on the U.S. Secondary Market

Securities trading within the secondary market occurs on exchanges and in the OTC market.⁷⁴ The New York Stock Exchange⁷⁵ ("NYSE") is the oldest stock exchange in the United States and is the largest in terms of the capitalization⁷⁶ of the issues traded on it.⁷⁷ The American Stock Exchange⁷⁸ ("Amex") represents the second largest exchange in the United States.⁷⁹ Six additional securities exchanges are registered with the SEC.⁸⁰

As a screen-based market, Nasdaq⁸¹ operates differently from the securities exchanges.⁸² On Nasdaq, market makers⁸³ compete in the marketplace on the basis of their spreads,⁸⁴ while on an exchange a single specialist trades in a particular issue.⁸⁵

Any association of brokers or dealers may be registered with the [SEC] as a national securities association . . . by filing with the [SEC] a registration statement . . . setting forth the information, and accompanied by the documents, below specified:

(1) Such data as to its organization membership, and rules of procedure, and such other information as the [SEC] may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors; and (2) Copies of its constitution, charter, or articles of incorporation or association, with all amendments thereto, and of its existing bylaws, and of any rules or instruments corresponding to the foregoing, whatever the name, hereinafter in this title collectively referred to as the 'rules of the association.'

Id.

74. WESTON & COPELAND, *supra* note 9, at 35-36; *see supra* notes 50-62 and accompanying text (defining secondary markets and OTC market).

75. DICTIONARY OF FINANCE, *supra* note 3, at 279. The New York Stock Exchange ("NYSE") is also known as the "Big Board." *Id.*

76. *Id.* at 246; *see supra* note 10 and accompanying text (defining capitalization).

77. *Inside Nasdaq, Part 1, supra* note 7, at 1. In mid-1994, while the NYSE had only about half the listed corporations that Nasdaq had, the total capitalization of its listings exceeded US\$4 trillion, while the total capitalization of Nasdaq's quoted companies was less than US\$1 trillion. *See id.* (comparing NYSE and Nasdaq statistics).

78. DICTIONARY OF FINANCE, *supra* note 3, at 16.

79. *Id.*

80. U.S. SEC. AND EXCH. COMM'N, 1993 ANNUAL REPORT 31 (1994).

81. WESTON & COPELAND, *supra* note 9, at 36; *see supra* note 9 and accompanying text (defining Nasdaq).

82. EASDAQ, *supra* note 11, at 4; *see supra* notes 51-58 and accompanying text (describing differences between exchange-based and screen-based trading).

83. WESTON & COPELAND, *supra* note 9, at 36; *see supra* notes 56-57 and accompanying text (describing role of market makers).

84. CHASE, *supra* note 40, at 78; *see supra* note 57 (defining spread). "On the NYSE, spreads for most stocks are a mere eighth of a point [12.5 cents]." *Inside Nasdaq, Part 1, supra* note 7, at 1.

85. WESTON & COPELAND, *supra* note 9, at 36; *see supra* note 53 and accompanying text (defining specialist). *See also* CHASE, *supra* note 40, at 78-79 ("On the NYSE the

Many corporations prefer Nasdaq because its quoting requirements are less stringent than the listing requirements of exchanges.⁸⁶ The number of issues quoted on Nasdaq exceeds that listed on the NYSE.⁸⁷

3. U.S. Market for Small Capitalization Corporations

The NASD registered with the SEC as a national securities association in 1939.⁸⁸ As a national securities association, the NASD's responsibility is to regulate the business of its members, including trading in the OTC market.⁸⁹ Since 1971, the NASD also has overseen Nasdaq, a system for the dissemination of quotations on OTC securities.⁹⁰

a. NASD

On August 7, 1939, the Securities and Exchange Commission⁹¹ ("SEC") approved the NASD's initial registration statement as a national securities association.⁹² The NASD represented the efforts of some members within the securities industry to regulate itself.⁹³ The SEC continues to oversee the SROs, including the NASD.⁹⁴

average number of common stocks per specialist is approximately 25 On the Nasdaq the average number of marketmakers per security is 11.5.").

86. CHASE, *supra* note 40, at 78.

87. *Inside Nasdaq, Part 1*, *supra* note 7, at 1 (noting that in mid-1994 Nasdaq had 4849 quoted companies, while NYSE had 2499 listed companies).

88. 15 U.S.C. § 78o-3 (1994). The 1934 Act provides that "[a]n association of brokers and dealers may be registered as a national securities association . . . by filing with the [SEC] an application for registration." *Id.*

89. SECURITIES REGULATION, *supra* note 8, at 9.

90. NASD, *supra* note 72, at 112.

91. See 15 U.S.C. § 78d (1994) (establishing SEC).

92. NASD, *supra* note 72, at 110.

93. *Id.* The Securities Act of 1934 states that:

The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, *to protect investors and the public interest*; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers . . . or to regulate by virtue of any authority conferred by this chapter matters not related to the purpose of this chapter or the administration of the association.

1934 Act, 15 U.S.C. § 78o-3(b)(6) (1994).

94. 15 U.S.C. § 78s (1994); SECURITIES REGULATION, *supra* note 8, at 10. The SEC

The NASD is organized into a Board of Governors⁹⁵ ("NASD Board"), headed by a Chairman of the Board, and eleven District Committees.⁹⁶ The NASD Board determines national policy with respect to regulatory and market operation activities of the NASD.⁹⁷ The NASD membership is divided into eleven Districts, with one Governor from each district elected by member firms to serve on the NASD Board.⁹⁸ Each District has a District Committee responsible for enforcing NASD policy.⁹⁹ The Chairman of the Board appoints standing¹⁰⁰ and special¹⁰¹ committees to study specific areas of NASD activity and to advise the NASD Board.¹⁰² The NASD Board selects the NASD President, who reports to the NASD Board and is responsible for ensuring that NASD Board policies are executed properly.¹⁰³ The

maintains responsibility for the performance of the NASD, including its ability to regulate. *Id.* All SRO rules and regulations, for example, must be approved by the SEC prior to taking effect. *Id.*

95. NASD Manual, *supra* note 15, at 109.

96. *Id.* In 1990, in response to the recommendations of a Special Committee, the NASD decreased the proportion of district governors on the NASD Board, "increased the number of at-large industry governors," and assigned three seats to representatives of the public and three seats to issuers. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., FINAL REPORT OF THE SPECIAL COMMITTEE ON NASD STRUCTURE AND GOVERNANCE 9 (Jan. 1990). District governors, however, retained an absolute majority of the redesigned NASD Board. RUDMAN REPORT, *supra* note 9, at II-23.

97. NASD Manual, *supra* note 15, at 109. As of 1995, the Board consisted of the President of the NASD, 13-15 Governors elected by NASD members in the various Districts, and 11-13 Governors elected by the Board ("At-Large Governors"). NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., EXHIBITS TO THE REPORT OF THE NASD SELECT COMM. ON STRUCTURE AND GOVERNANCE TO THE NASD Bd. OF GOVERNORS E (1995) [hereinafter RUDMAN EXHIBITS]. In total, the NASD Board consisted of 21 industry members and 5 public members. *Id.* at A.

98. NASD Manual, *supra* note 15, at 109. The NASD selects At-Large Governors from among investors, Nasdaq-quoted companies, the securities industry generally, and related professions, such as accounting, business, education, and the law. *Id.*

99. *Id.* at 110.

100. *Id.* Committees, comprised of volunteers from the securities industry and the public sector, advise the NASD Board and make recommendations regarding specific areas of NASD activity. *Id.* Standing committees include: Arbitration, Institutional Investors, International Investment Companies, Issuer Affairs, Market Operations Review, Market Surveillance, Marketing, Membership, Nasdaq Listing Qualifications, Nasdaq Hearing Review, National Business Conduct, Operations, State Liason, and Trading. *Id.* The Issuer Affairs Committee consists of chief financial officers ("CFOs") of Nasdaq-quoted companies. John S. DeMott, *CFO Input to NASD*, CFO, Feb. 1996, at 12.

101. NASD, *supra* note 72, at 111. Special committees are selected to study a particular issue and do not serve on an ongoing basis. *Id.* The Select Committee is an example of a special committee. RUDMAN REPORT, *supra* note 9, at I-3.

102. NASD, *supra* note 72, at 111.

103. *Id.* at 112.

NASD President and his staff serve a primarily administrative function.¹⁰⁴

The NASD's three principal functions¹⁰⁵ include rulemaking,¹⁰⁶ regulation,¹⁰⁷ and the dissemination of quotations¹⁰⁸ on OTC securities.¹⁰⁹ The NASD promulgated the NASD Rules of Fair Practice¹¹⁰ which, together with the NASD By-Laws,¹¹¹ constitute the rules of the NASD.¹¹² The NASD carries out its regulatory responsibilities through member education, on-site reviews of member firms to determine their compliance with federal securities laws and NASD regulations, continuous automated surveillance of Nasdaq, and registration and testing of securities professionals.¹¹³ The NASD also provides services, such as arbitration, that enable investors and members to resolve disputes.¹¹⁴ NASD membership entitles an investment firm to

104. *Id.*

105. RUDMAN REPORT, *supra* note 9, at III-2.

106. NASD Manual, *supra* note 15, ¶ 2001 (containing NASD Rules of Fair Practice).

107. RUDMAN REPORT, *supra* note 9, at III-2. The NASD brings disciplinary proceedings against member firms and "registered representatives" regarding alleged violations of NASD rules, SEC regulations, or securities laws. *Id.* The NASD also monitors trading on Nasdaq and investigates suspected violations of the rules governing the use of Nasdaq, SEC regulations, and securities laws. *Id.*

108. DICTIONARY OF FINANCE, *supra* note 3, at 351; *see supra* note 57 and accompanying text (discussing quotations as prices at which market makers will buy or sell securities).

109. NASD, *supra* note 72, at 112. In addition to these core activities, the NASD performs additional services, including the review and approval of underwriting agreements entered into by member firms, the arbitration of disputes between member firms and their customers and employees, the administration of licensing examinations, the review of all member advertising and periodic financial reporting, and the maintenance of a database containing the employment and disciplinary histories of approximately 500,000 licensed or registered employees of NASD member firms. RUDMAN REPORT, *supra* note 9, at III-3.

110. NASD Manual, *supra* note 15, ¶ 2005 (stating in preamble that "[t]hese Rules of Fair Practice shall apply to all members and persons associated with a member").

111. *Id.* ¶ 1101.

112. *Id.* ¶ 2101 (defining NASD Rules as Rules of Fair Practice and By-laws).

113. *Id.* at 109.

114. *Id.* NASD disciplinary procedures, however, are not designed to recover damages or to obtain relief for any party. *Id.* at 110. Instead, disciplinary procedures are "intended to promote membership compliance with high standards of commercial honor and just and equitable principles of trade." *Id.* District committees have primary responsibility for conducting disciplinary procedures. *Id.* Sanctions imposed may take the form of censure, fine, suspension, expulsion of a firm from the NASD, or suspension or prohibition of an individual's association with a member firm. *Id.* at 111. In effect, the sanction may be prohibition of conducting business as a broker-dealer, be-

participate in the OTC securities business, to distribute new issues underwritten by NASD members, and to distribute shares of investment companies sponsored by NASD members.¹¹⁵ Since 1971, the NASD has used Nasdaq as a system for gathering and disseminating quotations.¹¹⁶ Since the NASD's purchase of Nasdaq in 1976, it has both owned and regulated Nasdaq.¹¹⁷

b. Nasdaq

Nasdaq is a computerized system¹¹⁸ that collects and stores quotations from a nationwide network¹¹⁹ of OTC dealers.¹²⁰ These dealers make markets¹²¹ in stocks that have met Nasdaq's inclusion requirements.¹²² Through Nasdaq, up-to-the-sec-

cause a broker-dealer must be a NASD member unless it conducts business only on a national exchange of which it is a member. *SECURITIES REGULATION*, *supra* note 8, at 9.

115. NASD, *supra* note 72, at 110.

116. RUDMAN REPORT, *supra* note 9, at C-7. Nasdaq was established in 1971 as a relatively simple automated quotation system. *Id.* In 1964, Congress amended the 1934 Act to require national securities associations to establish "provisions governing the form and content of quotations relating to securities sold otherwise than on a[n] . . . exchange." 15 U.S.C. § 78o-3(b)(11) (1994). In response, in 1968, the NASD entered into a contract with a vendor to design what would become Nasdaq. RUDMAN REPORT, *supra* note 9, at II-26. "Under the contract, the vendor owned the system, subject to NASD supervision and an option to purchase. The NASD owned the information on the system, controlled the listing of securities, set user fees, and established the system's rules." *Id.*

117. *Id.* at II-27.

118. NASD Manual, *supra* note 15, at 113. "Using advanced computer and telecommunications technologies, Nasdaq enables securities firms to execute transactions for investors and for themselves from anywhere they are located within an environment of real-time trade reporting and automated market surveillance." *Id.*

119. CHASE, *supra* note 40, at 79-80. The Securities Acts Amendments of 1975 mandated the creation of the Nasdaq National Market System ("NMS") to increase competition and efficiency in the securities markets. 15 U.S.C. § 78k-1 (1994); SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, *SECURITIES ACTS AMENDMENTS OF 1975*, S. REP. NO. 75, 94th Cong., 1st Sess. 43 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179; CHASE, *supra* note 40, at 79.

120. NASD, *supra* note 72, at 112. Dealers are in the business of buying and selling securities for their own account. 15 U.S.C. § 78c (1994). Dealers are called market makers in the OTC market and specialists on the exchanges. *DICTIONARY OF FINANCE*, *supra* note 3, at 239; *see supra* notes 53, 56 and accompanying text (defining market maker and specialist).

121. NASD Manual, *supra* note 15, ¶ 1802. Schedule D of the NASD By-Laws defines "Nasdaq Market Maker" as "a dealer that, with respect to a security, holds itself out (by entering quotations in the Nasdaq System) as being willing to buy and sell such security for its own account on a regular and continuous basis and that is registered as such." *Id.*

122. *Id.* "Inclusion requirements" are the OTC equivalent of listing requirements on exchanges. *DICTIONARY OF FINANCE*, *supra* note 3, at 234; *see supra* note 54 (defining

ond¹²³ quotations are transmitted electronically to brokerage firms throughout the United States.¹²⁴ Nasdaq, therefore, represents a computer-based market, without the specific location or trading floor of an exchange.¹²⁵

The NASD owns and operates Nasdaq through a wholly-owned subsidiary, The Nasdaq Stock Market, Inc.¹²⁶ ("Nasdaq, Inc."), a for-profit Delaware corporation.¹²⁷ A Board of Directors¹²⁸ ("Nasdaq Board") manages Nasdaq, Inc.¹²⁹ The Nasdaq Board is not independent of the NASD.¹³⁰ Rather, the Nasdaq Board functions as a committee of the NASD Board.¹³¹ In particular, ultimate authority over Nasdaq affairs rests with the NASD Board.¹³² The NASD Board, moreover, oversees committees dealing with Nasdaq policy issues.¹³³

4. Problems Leading to the Rudman Report

Nasdaq has become one of the World's largest securities

listed security). The NASD has broad discretionary power to consider a security's eligibility for initial and continued inclusion in Nasdaq. NASD Manual, *supra* note 15, ¶ 1803. Among the requirements for inclusion, an issue must have at least two market makers, assets of at least US\$4 million, a minimum bid price of US\$3, and, in the case of common stock, there must be at least 100,000 publicly held shares. *Id.* For initial inclusion, these shares must have a market value of at least US\$1 million. *Id.*

123. 15 U.S.C. § 78k-1 (1994). In complying with the Securities Acts Amendments of 1975, the SEC required that trades on the NMS be reported in real-time, the actual time that they occur. *Id.*; CHASE, *supra* note 40, at 79.

124. CHASE, *supra* note 40, at 79.

125. RUDMAN REPORT, *supra* note 9, at II-2; *see supra* notes 51-58 and accompanying text (explaining difference between exchange-based market and screen-based market).

126. RUDMAN REPORT, *supra* note 9, at I-1. When the NASD first sought a vendor to design Nasdaq, the vendor was to own the system, subject to the NASD option to purchase. *Id.* at II-26. The NASD owned the information on the system. *Id.* The NASD exercised its option to purchase Nasdaq in 1976. *Id.* at II-27.

127. *Id.* at III-1.

128. *Id.* at III-1-III-2. Nasdaq's By-Laws charge the Nasdaq Board with organizing, developing, and operating the computer and communications facilities that serve as Nasdaq, "for the purposes of: (i) supporting the operation, regulation, and surveillance of [Nasdaq] . . . (ii) supporting the efficient clearance and settlement of securities transactions, [and] . . . (iv) assisting the [NASD] in fulfilling its self-regulatory responsibilities." *Id.*

129. *Id.* at III-1.

130. *Id.* at III-2, III-27; *see supra* notes 100-01 and accompanying text (discussing standing and special committees advising NASD Board).

131. RUDMAN REPORT, *supra* note 9, at III-2, III-27.

132. *Id.*

133. *Id.* The Trading Committee and the Listing Qualification Committee, for example, report to the NASD Board but handle Nasdaq policy matters. *Id.*; *see supra* note 100 (discussing NASD's standing committees).

markets.¹³⁴ In spite of this achievement, since mid-1994 the NASD and Nasdaq have been the subject of public criticism.¹³⁵ The source of the criticism was a study indicating that Nasdaq market makers, rather than competing over spreads, were colluding to maintain wide spreads.¹³⁶ Critics implicated the NASD's regulation of Nasdaq for failing to supervise the market makers.¹³⁷ Specifically, reports in the press criticized the NASD's governance of Nasdaq, suggesting that large member firms¹³⁸ control the market to the detriment of small NASD members, individual investors, and the public.¹³⁹

134. RUDMAN REPORT, *supra* note 9, at C-1. Size can be measured by the number of issues listed on the market, the total capitalization of the listed issues, or the daily trading volume. *Id.* Currently, over 5000 issues are listed on the Nasdaq. *Id.* These issues have a total capitalization of over US\$1 trillion. *Id.* The daily volumes have reached 600 million shares. *Id.* In 1994, Nasdaq's trading volume exceeded that of the NYSE. *Inside Nasdaq, Part 1, supra* note 7, at 1.

135. RUDMAN REPORT, *supra* note 9, at C-2. Much of this criticism has been directed at the alleged collusion of market makers in quoting prices. *Inside Nasdaq, Part 1, supra* note 7, at 1. In light of the criticisms directed at the NASD, the Department of Justice and the SEC are investigating the NASD's performance as a SRO. *Id.* The Department of Justice's investigation focuses on alleged collusion among market makers in the setting of the spread, the delayed reporting of trades, and the failure to give the best price available, particularly to individual investors. Scot J. Paltrow, *Probe Launched Into Nasdaq Stock Trading*, L.A. TIMES, Oct. 19, 1994, at 1 [hereinafter *Probe Launched*]; Knight, *supra* note 7, at H1. The delayed reporting of large trades may affect stock prices, possibly for the purpose of manipulating stock prices. *Id.* The SEC's investigation is centered around allegations that the NASD is allowing Nasdaq to function for the benefit of large member firms to the detriment of investors. *Id.*

136. William G. Christie & Paul H. Schultz, *Why Do Nasdaq Market Makers Avoid Odd-Eighth Quotes*, 49 J. FIN. 1813, 1813-15 (1994). See Scot J. Paltrow, *Study Suggests Collusion Among Brokerage Firms Wall Street: Findings by Two Business Professors Indicate a Possible Rigging of Trades on the Nasdaq Market*, L.A. TIMES, May 26, 1994, at 1 (noting that large market maker firms were reluctant to comment on study). In addition, a General Accounting Office report faulted the SEC, the NASD, and the national exchanges for failing to bar permanently unethical brokers, and taking informal disciplinary action that is not reported to the public. Scot J. Paltrow, *GAO Assails Stockbroker Punishment Securities: A Report Chides SEC and the Exchanges for Not Doing Enough to Get 'Rogues' Out of the Business*, L.A. TIMES, Sept. 9, 1994, at 1.

137. Schroeder, *supra* note 7, at 102.

138. RUDMAN REPORT, *supra* note 9, at III-6. Large member firms, however, are a small percentage of total NASD membership. *Id.* at III-4, III-12. Of the approximately 5500 member firms at the end of 1994, the average number of registered representatives at over 5000 was only 20. *Id.* A registered representative is an employee of a member firm, registered with the SEC, who advises clients on securities to buy and sell and receives a commission on the trades he generates. DICTIONARY OF FINANCE, *supra* note 3, at 361.

139. RUDMAN REPORT, *supra* note 9, at C-2; see *Inside Nasdaq, Part 1, supra* note 7, at 1 (outlining various complaints made against NASD's regulation of Nasdaq).

In response to these criticisms, the NASD President and the Chairman of the SEC¹⁴⁰ agreed to a review of the NASD's governance to assess its fulfillment of its self-regulatory obligations.¹⁴¹ In November 1994, the NASD Board adopted a resolution¹⁴² appointing the Select Committee¹⁴³ and promulgated a charter designating its purposes and goals.¹⁴⁴ The charter charged the Select Committee with reviewing the manner in which the NASD carries out its responsibilities as a SRO and the governance structures of the NASD and Nasdaq.¹⁴⁵

The Select Committee limited its review by not considering matters otherwise under review.¹⁴⁶ Pursuant to the charter, the Select Committee considered the historical basis and current structure of the NASD and Nasdaq, conducted nearly two-hun-

140. *DICTIONARY OF FINANCE*, *supra* note 3, at 398-99. The SEC is comprised of five commissioners, each appointed by the President of the United States for five-year terms. *Id.* To ensure the independence of the SEC, no more than three members may be of any one political party. *Id.* The President selects the Chairman of the SEC. *Id.*

141. *RUDMAN REPORT*, *supra* note 9, at I-3.

142. *Id.*

143. *Id.*; *see supra* note 20 (revealing Select Committee members and their affiliations).

144. *Id.* at I-4. Specifically, the charter mandated the Select Committee:

[T]o review the manner in which the NASD carries out its responsibilities as a self-regulatory organization with respect to the regulation and oversight of the Nasdaq Stock Market; and to review the governance structures of the NASD and the Nasdaq Stock Market, including the operation and composition of the Boards, committees and other entities involved in the governance of the corporations.

Id.

145. *Id.*

146. *Id.* at C-2, I-4, I-5. The charter, for example, explicitly excluded areas under investigation by the Department of Justice or the SEC. *Id.* at I-4. The Select Committee elected not to review the NASD's arbitration program, since it was already under review by another NASD Committee. *Id.* at I-5. In addition, the Select Committee did not attempt to examine the Nasdaq market technology, believing such a review was "beyond its particular competence." *Id.* at I-5. The SEC's investigation focuses on allegations that NASD is running Nasdaq for the benefit of the major investment firms, to the detriment of public investors. Knight, *supra* note 7, at H1. The Department of Justice investigation focuses on allegations of collusive price-fixing. Schroeder, *supra* note 7, at 102. The price-fixing allegations focus on a lack of competition between the market makers resulting in a wide spread between bid and ask prices on the market. *Inside Nasdaq, Part 1*, *supra* note 7, at 1. This wide spread allows market makers to profit from the alleged lack of competition, particularly at the expense of small investors, since larger investors, such as institutions, may trade "inside the spread." *Id.* While the Rudman Report does not address these issues specifically, it does address the governance structure that could permit such actions to occur, in violation of NASD rules, and then allow the perpetrators to go unpunished. *RUDMAN REPORT*, *supra* note 9, at I-6.

dred interviews, reviewed NASD's enforcement and disciplinary procedures, and compared the governance structures of other SROs¹⁴⁷ with that of the NASD and Nasdaq.¹⁴⁸ On September 15, 1995, the Select Committee submitted the Rudman Report to the NASD Board, concluding that the NASD had discharged its self-regulatory responsibilities professionally and reasonably.¹⁴⁹

Although the Select Committee's review did not support claims asserting that the NASD is controlled by and for the benefit of Nasdaq market makers or that the NASD uses its regulatory powers to advance the interests of large member firms, it did recommend several organizational changes.¹⁵⁰ The Rudman Report addressed several areas, including corporate structure,¹⁵¹ discipline and enforcement,¹⁵² district committees, internal review,¹⁵³ coordination with other regulators,¹⁵⁴ membership voting,¹⁵⁵ professional staff,¹⁵⁶ individual investors, and the alloca-

147. RUDMAN REPORT, *supra* note 9, at I-6-I-7. In particular, the Select Committee used the NYSE and the Amex exchanges for its comparison. *Id.*

148. *Id.* at I-5-I-7.

149. *Id.* at C-21. The Select Committee stated, however, that these duties were not discharged "with perfection or without difficulty." *Id.*

150. *Id.* at C-21.

151. *Id.* at R-1-R-20. Specifically, the Rudman Report recommended making the Nasdaq Board independent of the NASD Board, establishing an independent subsidiary, NASD Regulation ("NASDR"), to regulate the broker-dealer profession, and increasing the public representation on the NASD Board, Nasdaq Board, and NASDR Board to at least 50%. *Id.* at R-1-R-2.

152. *Id.* at R-20-R-25. In particular, the Rudman Report suggested that the NASDR be kept independent of the NASD, with professional hearing officers to ensure "effective, fair, and professional enforcement." *Id.* at R-20.

153. *Id.* at R-27-R-28. The Rudman Report encouraged the development of an Office of Internal Review to conduct audits of the operations at the NASD and its operating subsidiaries, including district operations. *Id.* The Office of Internal Review would also serve as an ombudsman, receiving and addressing concerns and complaints from any source, whether internal or external. *Id.*

154. *Id.* at R-28-R-29. The Rudman Report advocated the appointment of a liaison within the NASDR to coordinate regulatory efforts with the SEC, state regulators, and the other SROs. *Id.* The goals of such coordination are identifying industry-wide regulatory issues, fostering cooperation with the SEC and other regulators, and reducing duplicative enforcement efforts. *Id.*

155. *Id.* at R-29. The Rudman Report supported the NASD's decision to eliminate the requirement of membership voting on all changes to the Rules of Fair Practice, determining that executing the voting was burdensome and expensive. *Id.* The Rudman Report found satisfactory the NASD's retention of the authority to submit a proposal to membership voting if it is deemed appropriate. *Id.*

156. *Id.* at R-29-R-30. In recommending a greater role for the professional staffs of

tion of financial resources.¹⁵⁷

C. *The European Markets Prior to the Investment Services Directive/EASDAQ*

The EC Treaty¹⁵⁸ allows for the creation of an internal market among the EU Member States.¹⁵⁹ Prior to the issuance of the ISD, European securities markets were primarily self-regulatory, with minimal government regulation.¹⁶⁰ The adoption of the ISD, however, lays the foundation for mutual recognition of securities market regulation between the Member States.¹⁶¹ In addition, the ISD furnishes a framework for the development of a pan-European securities market.¹⁶²

1. Basis in the EU

The EC Treaty¹⁶³ provides for the creation of an internal market, with the abolition of obstacles to the free movement of goods, persons, services, and capital.¹⁶⁴ Beginning in 1985, the European Union changed its approach toward creating an internal market from one of legislative harmonization¹⁶⁵ to that of mutual recognition.¹⁶⁶ In its drafting of the ISD, the European Union mandated mutual recognition of investment services leg-

the NASD, Nasdaq, and the NASDR, the Rudman Report suggests that a more active function will increase the general oversight of the organizations. *Id.*

157. *Id.* at vi-vii.

158. EC Treaty, *supra* note 1, [1992] 1 C.M.L.R. 573.

159. *Id.* art. 3, [1992] 1 C.M.L.R. at 588.

160. Manning G. Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181, 185 (1994) [hereinafter Warren, *Investment Services Directive*]. During the 1980's, for example, seven of the Member States did not require that prospectus disclosures be made to investors, and none of the Member States had a securities regulatory agency. *Id.* The English Companies Act, however, constituted the basis of the 1933 Act. SELIGMAN, *supra* note 64, at 63.

161. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27, at 27 (1993).

162. EASDAQ, *supra* note 11, at 16-17.

163. EC Treaty, *supra* note 1, [1992] 1 C.M.L.R. 573.

164. *Id.* art. 3, [1992] 1 C.M.L.R. at 588.

165. *Id.* art. 100a, [1992] 1 C.M.L.R. at 633-34. See White Paper, *supra* note 1, COM (85) 310 Final at 18, ¶ 61 (stating that Article 100 of EC Treaty cannot continue to be relied upon in attaining genuine common market). See also *id.* at 18, ¶ 62 (explaining that alternate strategy must serve objective of building flexible and expanding market). Future use of legislative harmonization would be limited primarily to "laying down essential health and safety requirements." *Id.* at 19, ¶ 65.

166. *Id.* at 18, ¶ 63 (asserting that mutual recognition, supported by Articles 30 and 36 of EC Treaty, "which prohibit national measures which would have excessively and unjustifiably restrictive effects on free movement").

isolation.¹⁶⁷

2. Trading on the European Secondary Markets Prior to the ISD

Securities regulation outside of the United Kingdom was almost nonexistent until the issuance of the ISD.¹⁶⁸ In the United Kingdom, the Financial Services Act of 1986¹⁶⁹ ("FSA") provided the legislative framework for regulation of securities markets after the "Big Bang."¹⁷⁰ In contrast to the United Kingdom, Germany provides an example of one of the least regulated national markets within the European Union.¹⁷¹

a. United Kingdom

The FSA stipulates the requirements that a SRO must meet to be recognized by the governmental authority.¹⁷² The FSA requires SROs to have rules and procedures that protect investors, to ensure that their members are fit for the investment business

167. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L. 141/27, at 27 (1993). "[W]hereas, by virtue of mutual recognition, investment firms authorized in their home Member States may carry on any or all of the services covered by this Directive for which they have received authorization throughout the Community by establishing branches or under the freedom to provide services . . ." *Id.* O.J. L 141/27, at 27 (1993).

168. Warren, *Investment Services Directive*, *supra* note 160, at 185-86. See SELIGMAN, *supra* note 64, at 63 (establishing English Companies Act as basis for 1933 Act).

169. Financial Services Act, 1986, ch. 60 (Eng.). The United Kingdom intended for the Financial Services Act of 1986 ("FSA") to deviate from the 1933 Act and the 1934 Act, believing that the SEC is too bureaucratic and should not be replicated. Harold D. Bloomenthal, *Financial Services Act 1986*, in 10B INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION 6A-1, 6A-4 (1989) [hereinafter Bloomenthal]. Instead, the FSA created a multi-tiered self-regulatory structure. *Id.*

170. Bloomenthal, *supra* note 169, at 6A-1, 6A-4. The "Big Bang" deregulated the London Stock Exchange, and renamed it the International Stock Exchange ("ISE"). *Id.* at 6A-3; see generally LIFE AFTER BIG BANG (Simon MacLachlan ed., 1987) (discussing potential effects of Big Bang). As a result of this deregulation, the ISE accepted many new members and replaced its exchange-based trading system with a screen-based system of market makers called the Stock Exchange Automated Quotation System ("SEAQ"). *Id.* The SEAQ was modelled after Nasdaq. *Id.*

171. Gerhard Wegen, *Germany*, in INTERNATIONAL SECURITIES LAW 127 (1992).

172. *Id.* at 6A-8. The governmental authority is the Department of Trade and Industry ("DTI"), which delegates many regulatory powers to a private sector Designated Agency, the Securities and Investments Board ("SIB"). *Id.* at 6A-5. These powers may be delegated where the DTI is assured that investors are being afforded an adequate level of protection. *Id.* See also R v. Life Assurance and Unit Trust Regulatory Organisation, Ltd., ex parte Ross, 1 All E.R. 422 (1992) (discussing SRO for life assurance and unit trust business under FSA, court stated purpose of SRO as "intervening in the business of a member to protect investors").

of the organization, and to monitor compliance with and enforce the SROs' rules.¹⁷³ The governing body of a SRO must include public representation to balance the interests of the members of the SRO and the interests of the public.¹⁷⁴

Under the FSA, members of a SRO, as well as persons authorized in another Member State, may engage in the investment business.¹⁷⁵ The laws of the other Member State, however, must afford protection to investors equivalent to that afforded under the FSA.¹⁷⁶ A certificate issued by the Secretary of the Department of Trade and Industry¹⁷⁷ stipulating that the laws of the other Member State comply with the FSA may be relied upon as conclusive evidence of such compliance.¹⁷⁸

In addition to the International Stock Exchange¹⁷⁹ ("ISE"), the United Kingdom has an Unlisted Securities Market¹⁸⁰ and an Alternative Investment Market ("AIM").¹⁸¹ While the ISE provides for stringent listing requirements¹⁸² for foreign and domestic issues,¹⁸³ AIM, launched on June 19, 1995,¹⁸⁴ offers limited

173. Bloomenthal, *supra* note 169, at 6A-8. A SRO "must be able and willing to promote and maintain high standards of integrity and fair dealing in the carrying on of the investment business." *Id.*

174. *Id.*

175. Financial Services Act, 1986, ch. 60, § 31 (Eng.); Bloomenthal, *supra* note 169, at 6A-5.

176. Financial Services Act, 1986, ch. 60, § 31(3)(a) (Eng.); Bloomenthal, *supra* note 169, at 6A-5.

177. Bloomenthal, *supra* note 169, at 6A-5; *see supra* note 172 and accompanying text (discussing role of DTI).

178. Financial Services Act, 1986, ch. 60, § 31(4) (Eng.).

179. Bloomenthal, *supra* note 169, at 6A-3; *see supra* note 170 (defining "International Stock Exchange").

180. G.K. Morse, *United Kingdom, in* 10B INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION 6-1, 6-17 (1989). The Unlisted Securities Market, organized by the ISE, was intended to be a transitional market for small companies. *Id.* at 6-17. The Unlisted Securities Market, however, is due to close at the end of 1996, replaced by the Alternative Investment Market. Christopher Price, *UK Company News: So Far So Good But Tests Await*, FIN. TIMES, Dec. 19, 1995, at 19.

181. Price, *supra* note 180, at 19. Following the Unlisted Securities Market, the ISE developed the Alternative Investment Market ("AIM") to handle the issues of young companies. *Id.*

182. Morse, *supra* note 180, at 6-24. The ISE's listing requirements include a minimum market value. *Id.*

183. AUTHORITY OF THE STOCK EXCHANGE, ADMISSION OF SECURITIES TO LISTING 99, 112 (1973).

184. Price, *supra* note 180, at 19.

listing requirements.¹⁸⁵ Although institutional investors¹⁸⁶ initially voiced concern over AIM's lack of listing requirements, the new market is gaining the investors' confidence.¹⁸⁷

b. Germany

In contrast to those of the United Kingdom, securities markets in Germany are minimally regulated.¹⁸⁸ Although two pieces of federal securities legislation provide a regulatory framework,¹⁸⁹ no federal securities agency exists in Germany.¹⁹⁰ Instead, stock exchanges regulate securities issuance and trading.¹⁹¹ Germany possesses eight stock exchanges,¹⁹² each with its own SRO.¹⁹³ State agencies supervise the SRO for the stock exchange in their jurisdiction.¹⁹⁴ Within this framework, each SRO manages its own exchange,¹⁹⁵ prescribing rules of conduct for its members and regulating trading practices.¹⁹⁶

Prior to the listing of a new issue, the stock exchange conducts an examination of the issuer.¹⁹⁷ During the examination,

185. *Id.* AIM requires no minimum market value and no minimum trading record. *Id.*

186. *DICTIONARY OF FINANCE*, *supra* note 3, at 202. Institutional investors, including mutual funds, pension funds, insurance companies, and college endowment funds trade large volumes of securities. *Id.* Concern may be voiced by institutional investors, rather than individual investors, because individual ownership of securities is a recent phenomenon. Manning G. Warren III, *Global Harmonization of Securities Law: The Achievements of the European Communities*, 31 *HARV. INT'L L.J.* 185, 194 (1990) [hereinafter Warren, *Global Harmonization*]. "Even in the . . . United Kingdom, as late as 1980 less than three percent of the population owned company shares." *Id.* Among the explanations offered are the "insufficient or nonexistent . . . liquidity in European securities markets [and] the absence of regulation affording investor protection." *Id.*

187. Price, *supra* note 180, at 19.

188. Wegen, *supra* note 171, at 127. Insider trading, for example, was not prohibited and was an accepted practice. Warren, *Global Harmonization*, *supra* note 186, at 195.

189. *Id.* at 128. The German Stock Exchange Act (Börsengesetz) provides the basis for stock exchanges, while the Stock Exchange Admission Regulation (Börsenzulassungs-Verordnung) specifies the requirements for listing on a stock exchange. *Id.*

190. *Id.*

191. Eberhard H. Röhm, *Germany*, in 10C *INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION* 8C-1, 8C-15 (1991).

192. *Id.* at 8C-19.

193. Wegen, *supra* note 171, at 128.

194. *Id.*

195. *Id.*

196. Röhm, *supra* note 191, at 8C-16.

197. *Id.* at 8C-22. German stock exchanges cooperate with those of other EU Member States and may exempt issuers admitted to listing on another Member State's

the issuer must meet the listing requirements of the exchange and make disclosures to investors, including the release of annual reports¹⁹⁸ and dividend¹⁹⁹ policies.²⁰⁰ Under the Reform Act of December 16, 1986,²⁰¹ stock exchanges must establish separate markets for unlisted securities.²⁰² These markets facilitate the issuance of securities by SMEs that cannot meet the listing requirements of the official exchange.²⁰³ In addition, an unregulated trade in unlisted securities exists between banks and brokers.²⁰⁴

3. ISD to Enable SMEs to Float Stock/Trade

The European Union, recognizing the importance of SMEs in the European economy,²⁰⁵ issued the ISD.²⁰⁶ In addition, the European Commission²⁰⁷ ("Commission") supported the efforts of the European Venture Capital Association²⁰⁸ ("EVCA") in

exchange within the preceding six months from the prospectus requirement. *Id.* at 8C-70. A prospectus is a formal written offer to sell securities and includes information an investor needs to make an informed decision. *DICTIONARY OF FINANCE*, *supra* note 3, at 341-42.

198. *DICTIONARY OF FINANCE*, *supra* note 3, at 18. An annual report contains the yearly record of the corporation's financial condition. *Id.*

199. *Id.* at 113. Dividends represent distributions of corporate earnings to shareholders. *Id.*

200. Röhms, *supra* note 191, at 8C-22.

201. *Id.* at 8C-26. The Reform Act of December 16, 1986 amended the German Stock Exchange Act. *Id.*

202. *Id.*

203. *Id.*

204. *Id.* at 8C-28. This trading is referred to as "telephone trading" because it occurs by telephone outside the business hours of the exchanges. *Id.* The stock exchanges do not regulate telephone trading. *Id.*

205. Financial Problems, *supra* note 6, COM (93) 528 Final at 7, ¶ 7. The Commission explained that:

The importance of SMEs in Community economic activity is illustrated by . . . figures which show that SMEs comprise 99.9% of total enterprises, [and] provide 70.0% of total employment This trend appears to be strengthening, with SMEs being the principal if not the sole hope of providing major new jobs [T]he economic health of the Community is dependent on a flourishing small firms sector.

Id. at 7, ¶ 7. See *Report on Industrial Competitiveness Urges End to Public Monopolies*, EUR. Soc. POL'Y, Jan. 16, 1996, available in LEXIS, Europe Library, CURNWS File (discussing second Ciampi report of December 12, 1995, on European competitiveness and SMEs' capacity to add value and employment through innovation and technology).

206. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27 (1993).

207. European Capital Market, *supra* note 6, COM (95) 498 Final. See EC Treaty, *supra* note 1, arts. 155-63 (discussing role of European Commission).

208. EASDAQ, *supra* note 11, at 4.

launching a pan-European market.²⁰⁹ The EVCA suggested the creation of the EASD to advise EASDAQ on the organization of European stock markets for growth companies²¹⁰ and SMEs.²¹¹

a. **ISD**

The European Union recognizes the value of supporting the development of SMEs.²¹² For example, the European Union has studied problems confronting SMEs, including the listing requirements of the national exchanges²¹³ and the difficulty in obtaining capital.²¹⁴ Among the actions taken in support of SMEs,²¹⁵ the Council of the European Communities ("Council") has issued the ISD.²¹⁶ With the enactment of the ISD, the Council implemented the regulatory framework for the establishment of a Pan-European securities market.²¹⁷ Among the investment services covered by the ISD are: acting as a broker or account executive²¹⁸ or transmitting orders,²¹⁹ dealing for one's own ac-

209. *Id.* at 1, 16.

210. *DICTIONARY OF FINANCE*, *supra* note 3, at 181. Stocks of growth companies exhibit faster-than-average gains in earnings and tend to be riskier than average stocks, partly because they pay little or no dividends to shareholders. *Id.*

211. EASDAQ, *supra* note 11, at 4. The EASD's other principal objectives are lobbying for favorable legal, financial, and regulatory changes and providing a pan-European forum for participants in the securities industry. *Id.*

212. Financial Problems, *supra* note 6, COM (93) 528 Final at 7, ¶ 7; see *supra* notes 6, 204 and accompanying text (evaluating benefits of encouraging SMEs).

213. Maurice Anslow, *Europe's New Bourse Stresses Its Links With NASDAQ*, *VENTURE CAP. J.*, May 1995, at 26. To obtain "Official Listing" status on a national exchange, a company must be approved by the regulatory authority of its own country and have a three-year trading record. *Id.* at 26.

214. *Small Markets, Big Problems*, *ECONOMIST*, Aug. 20, 1994, at 60 (citing study by Graham Bannock & Partners, U.K. consulting firm). Although several of the Member States' national exchanges attempted to establish markets responsive to the needs of SMEs, these attempts have failed. *Id.* The study suggests that these failures are due to a lack of competition for listings, as well as regulatory obstacles that prevent large institutional investors from investing in the equity issues of SMEs. *Id.*

215. Council Directive No. 90/604/EEC, O.J. L 317/57 (1990) (outlining simplified financial statement requirements for SMEs); Commission Recommendation No. 94/390/EC, O.J. L 177/1 (1994) (suggesting improvements to tax environment of SMEs).

216. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27 (1993).

217. EASDAQ, *supra* note 11, at 16-17.

218. *DICTIONARY OF FINANCE*, *supra* note 3, at 4. An account executive is a "brokerage firm employee who advises and handles orders for clients and has the legal powers of an agent." *Id.* The terms "account executive" and "registered representative" are equivalent. *Id.*

219. Council Directive No. 93/22/EEC, *supra* note 4, annex, O.J. L 141/27, at 46 (1993).

count,²²⁰ underwriting,²²¹ and placements.²²² Market-making is considered covered by "dealing."²²³

Rather than attempting to make the investment services regulatory statutes of the Member States uniform, the European Union has focused its efforts on the harmonization of minimum standards for authorization and mutual recognition.²²⁴ Provided an investment services business is authorized to do business in its home Member State²²⁵ ("Home Member State"), it will be au-

220. *Id.* annex, O.J. L 141/27, at 46 (1993); *see supra* note 56 (discussing responsibilities of market makers in OTC market). Market makers deal for their own accounts because they retain an inventory of securities that they buy and sell to make a market in that security. WESTON & COPELAND, *supra* note 9, at 36.

221. Council Directive No. 93/22/EEC, *supra* note 4, annex, O.J. L 141/27, at 46 (1993). Underwriting is the process by which new securities issues are sold. DICTIONARY OF FINANCE, *supra* note 3, at 491-92. Underwriters, usually investment bankers, form a syndicate to pool the risk of buying a new issue of securities. *Id.* The underwriters then resell the securities to the public, either directly or through dealers. *Id.*

222. Council Directive No. 93/22/EEC, *supra* note 4, annex, O.J. L 141/27, at 46 (1993). *See* INTERNATIONAL SURVEY, *supra* note 25, at 123 (reviewing investment services covered by ISD). Placements, or private placements, are sales of securities directly to institutional investors. DICTIONARY OF FINANCE, *supra* note 3, at 338.

223. Charles Abrams, *The Investment Services Directive*, in FINANCIAL SERVICES IN THE NEW EUROPE: THE COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS 311, 317 (Dennis Campbell and Mickela Moore eds., 1993).

224. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27, at 27 (1993). The "approach adopted is to effect only the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems." *Id.* *See* INTERNATIONAL SURVEY, *supra* note 25, at 119 (discussing concept of mutual recognition). The European Commission accepted that regulation of investment services was necessary. *See* Eva Lomnicka, *The Internal Financial Market and Investment Services*, in EC FINANCIAL MARKET REGULATION AND COMPANY LAW 81-82 (Mads Andenas and Dr. Stephen Kenyon-Slade eds., 1993) (addressing transition from harmonization to mutual recognition). Mutual recognition has been successfully applied in the fields of banking and insurance. Van Gerven & Wouter, *supra* note 1, at 61. A strategy for determining which policies to harmonize and which to leave to mutual recognition was developed in 1985. White Paper, *supra* note 1, COM (85) 310 Final at 19, ¶ 65. Harmonization, in effect, would be reserved for essential health and safety requirements. *Id.* at 19, ¶ 65.

225. Council Directive No. 93/22/EEC, *supra* note 4, art. 1(6), O.J. L 141/27, at 31 (1993). The ISD defines Home Member State as:

- (a) where the investment firm is a natural person, the Member State in which his head office is situated;
- (b) where the investment firm is a legal person, the Member State in which its registered office is situated or, if under its national law it has no registered office, the Member State in which its head office is situated;
- (c) in the case of a market, the Member State in which the registered office of the body which provides trading facilities is situated or, if under its national law it has no registered office, the Member State in which that body's head office is situated.

thorized to do business in other Member States ("Host Member States").²²⁶ This authorization, dubbed a passport, permits access to regulated markets.²²⁷ A regulated market in one Member State may not be prevented by another Member State from giving direct access to firms in the latter Member State through, for example, screen-based trading.²²⁸ The ISD, therefore, provides for equal access to a pan-European securities market, irrespective of the location of the investor, intermediary,²²⁹ or issuer.²³⁰

One of the goals of the ISD is to provide a regulatory framework that protects investors,²³¹ and the ISD recognizes that different investors will have differing levels of expertise, requiring more or less protection.²³² The responsibility for supervising an investment firm remains primarily with the Home Member State.²³³ To this end, Home Member States must establish pru-

Id.

226. *Id.* art. 1(7), O.J. L 141/27, at 32 (1993). The ISD defines Host Member State as "the Member State in which an investment firm has a branch or provides services."

Id.

227. *Id.* O.J. L 141/27, at 27 (1993). The ISD explains the passport as the "grant of a single authorization valid throughout" the European Union. *Id.* See EASDAQ, *supra* note 11, at 16 (discussing concept of ISD passport); INTERNATIONAL SURVEY, *supra* note 25, at 119 (explaining ISD passport); Pauline Ashall, *The Investment Services Directive: What Was the Conflict All About?*, in EC FINANCIAL MARKET REGULATION AND COMPANY LAW 91, 99 (Mads Andenas & Stephen Kenyon-Slade eds., 1993) (describing passport's function).

228. Ashall, *supra* note 227, at 99.

229. DICTIONARY OF FINANCE, *supra* note 3, at 204. An intermediary is empowered to make investment decisions for others. *Id.* An intermediary can be a person or an institution, such as a bank, brokerage firm, or insurance company. *Id.*

230. EASDAQ, *supra* note 11, at 16. "[F]or purposes of this Directive, the business of the reception and transmission of orders also includes bringing together two or more investors thereby bringing about a transaction between those investors." Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27, at 28 (1993). An issuer is a legal entity, such as a corporation, that is empowered to issue a security. DICTIONARY OF FINANCE, *supra* note 3, at 215.

231. Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27, at 27 (1993).

232. *Id.* O.J. L 141/27, at 29 (1993). "[O]ne of the objectives of this Directive is to protect investors; . . . therefore [it is] appropriate to take account of the different requirements for protection of various categories of investors and of their levels of professional expertise . . ." *Id.*

233. INTERNATIONAL SURVEY, *supra* note 25, at 128. The Home Member State's responsibilities include ensuring continued compliance with the initial conditions of authorization, capital requirements, and rules regarding administration, accounting, safekeeping, and recordkeeping. *Id.* at 129-30. In addition, the Home Member State is to ensure that adequate arrangements have been made for safeguarding the rights of investors and minimizing the potential conflicts of interest experienced by the firm. *Id.* at 130. Home Member States are responsible for "supervising the financial soundness

dential rules, many of which are intended to protect investors, to be observed on a continuous basis by investment firms authorized by that Member State.²³⁴ These rules require that investment firms have adequate controls for the safekeeping of investors' securities and money, keep adequate records, and are structured in a manner to minimize the risk of clients' interests being prejudiced by conflicts of interest of the firm.²³⁵ In addition, financial services firms must observe rules of conduct that the Home Member States are required to draw up.²³⁶ These rules of conduct place the protection of the investor at the forefront.²³⁷ The ISD was to be implemented by all Member States by December 31, 1995.²³⁸ As of January 5, 1996, only four Member States

of an investment firm . . . pursuant to Council Directive 94/6/EEC of March 15, 1993 on the capital adequacy of investment firms." Council Directive No. 93/22/EEC, *supra* note 4, O.J. L 141/27, at 29 (1993).

234. *Id.* art. 10, O.J. L 141/27, at 36 (1993); Paolo Clarotti, *The Completion of the Internal Financial Market: Current Position and Outlook*, in EC FINANCIAL MARKET REGULATION AND COMPANY LAW 1, 10 (Mads Andenas & Dr. Stephen Kenyon-Slade eds., 1993). The ISD suggests that the safeguarding of investors' securities consists of keeping them separate from others held, particularly for the investment firm's own account, "except with the investor's express consent." Council Directive No. 93/22/EEC, *supra* note 4, art. 10, O.J. L 141/27, at 36 (1993). In addition, monies must also be safeguarded to prevent "the investment firm's using investors' funds for its own account." *Id.* Investment firms must be structured to minimize "conflicts of interest between the firm and its clients or between one of its clients and another." *Id.*

235. *Id.*; Clarotti, *supra* note 234, at 10 (discussing prudential rules).

236. Council Directive No. 93/22/EEC, *supra* note 4, art. 11(1), O.J. L 141/27, at 37 (1993). The rules of conduct must ensure that an investment firm:

- acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market,
- acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market, . . .
- seeks from its clients information regarding their financial situations, investment experience and objectives as regards the services requested,
- makes adequate disclosure of relevant material information in its dealings with its clients,
- tries to avoid conflicts of interest and, when they cannot be avoided, ensures that its clients are fairly treated, and
- complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its clients and the integrity of the market.

Id.

237. *Id.* See Ashall, *supra* note 227, at 98 (describing responsibilities of firms to distinguish between skills and knowledge of customers).

238. Council Directive No. 93/22/EEC, *supra* note 4, art. 31, O.J. L 141/27, at 45 (1993). Member states were to adopt the ISD by July 1, 1995 and effectuate the provisions of the ISD by December 31, 1995. *Id.*

had implemented fully the ISD.²³⁹

Host Member States may also regulate investment firms doing business within their borders, within the guidelines of the ISD.²⁴⁰ For example, the ISD permits the Host Member States to require compliance reporting²⁴¹ and to impose their own rules of conduct.²⁴² In addition, the ISD expressly permits Member States to impose stricter authorization standards on their home authorized enterprises.²⁴³

b. Role of the EVCA

With the support of the Commission, the EVCA sought to launch a pan-European market.²⁴⁴ In early 1994, the EVCA formed a working group to identify practical solutions to the

239. *Financial Services: Investment Services and Capital Adequacy Rules in Force - Almost*, EUR. REP., Jan. 5, 1996, available in WESTLAW, Euronews Database [hereinafter *Financial Services*]. Sweden, Ireland, the United Kingdom, and France have implemented fully the ISD. *Id.*; *World Watch: International Business*, L.A. TIMES, Jan. 4, 1996, at 4. Italy is expected to pass conforming legislation imminently, while Germany, Belgium, and the Netherlands have implemented partially the ISD. *Financial Services, supra*. Full implementation during the first half of 1996 is anticipated in Belgium, Denmark, Luxembourg, the Netherlands, Austria, Portugal, and Finland, but Germany, Greece, and Spain are expected not to fully implement the ISD until 1997. *Id.*

240. INTERNATIONAL SURVEY, *supra* note 25, at 133-34; Van Gerven & Wouters, *supra* note 1, at 63. The Host Member States may act to prevent or punish irregularities within their State that are contrary to the legal rules they have adopted "in the interest of the general good." Council Directive No. 93/22/EEC, *supra* note 4, art. 19, ¶ 6, O.J. L 141/27, at 40 (1993). Advertisements by investment firms are permitted provided their form and content comply with any rules adopted in the interest of the general good. *Id.* "In the interest of the general good" has been interpreted as a public policy standard that incorporates the protection of consumers of investment services, to the extent that they require such protection. Van Gerven & Wouters, *supra* note 1, at 65. In addition, public policy objectives may include aspects of financial market regulation, such as stability of the financial system. *Id.*

241. Council Directive No. 93/22/EEC, *supra* note 4, art. 19, ¶ 2, O.J. L 141/27, at 40 (1993). In formulating compliance reporting requirements:

Host Member States may require investment firms carrying on business within their territories under the freedom to provide services to provide the information necessary for the monitoring of their compliance with the standards set by the host Member State . . . although those requirements may not be more stringent than those the same Member State imposes on established firms

Id.

242. INTERNATIONAL SURVEY, *supra* note 25, at 133.

243. Council Directive No. 93/22/EEC, *supra* note 4, art. 20, ¶ 5, O.J. L 141/27, at 41 (1993). It is unlikely, however, that this will occur, because firms authorized by other Member States after the adoption of the ISD will be competing with the home authorized domestic firms. Lomnicka, *supra* note 224, at 81, 86.

244. EASDAQ, *supra* note 11, at 1.

problems SMEs faced in raising capital.²⁴⁵ The working group met in June 1994²⁴⁶ to recommend the creation of an organization of market professionals to support and sponsor equity investment.²⁴⁷ In response to the working group's recommendation, the European Association of Securities Dealers²⁴⁸ ("EASD") emerged in November 1994.²⁴⁹ Modelling itself on the NASD, the EASD signifies a non-profit entity regulating the for-profit EASDAQ market.²⁵⁰

c. EASD

The principal objectives of the EASD include advising EASDAQ on the organization of European stock markets for growth companies²⁵¹ and SMEs.²⁵² The EASD intends to act as a pan-European network of investment services providers.²⁵³ The EASD members, holding passports issued under the ISD, will be able to coexist on a single regulated securities market.²⁵⁴ The EASD will create and support the EASDAQ market.²⁵⁵

d. EASDAQ

Further discussions of the EVCA working group led to the EASDAQ initiative.²⁵⁶ By March 1995, the concept of EASDAQ

245. European Capital Market, *supra* note 6, COM (95) 498 Final at 7, ¶ 17. Venture capital funds are in a unique position to experience the shortage of capital available to SMEs because they often invest in companies during the early stages of growth. Financial Problems, *supra* note 6, COM (93) 528 Final at 19-20, ¶ 33. Because the funds have a limited time horizon, and the funds' investors expect some level of liquidity, funds need to realize their investments after a period of time. *Id.* at 19, ¶ 33.

246. European Capital Market, *supra* note 6, COM (95) 498 Final at 7, ¶ 18.

247. EASDAQ, *supra* note 11, at 4. Equity investments represent ownership interest held by shareholders in a corporation. DICTIONARY OF FINANCE, *supra* note 3, at 127.

248. EASDAQ, *supra* note 11, at 4.

249. *Id.*

250. *Id.* at 4, 8. As of November 1995, the EASD had 60 members, representing investment banks, stockbrokers, and market makers from Europe and the United States. *Id.* at 4.

251. DICTIONARY OF FINANCE, *supra* note 3, at 181. Growth stocks exhibit faster-than-average gains in earnings and tend to be riskier than average stocks, partly because they pay little or no dividends to shareholders. *Id.*

252. EASDAQ, *supra* note 11, at 4. The EASD's other principal objectives are lobbying for favorable legal, financial, and regulatory changes, and providing a pan-European forum for participants in the securities industry. *Id.*

253. *Id.* at 8.

254. *Id.* at 16-17.

255. European Capital Market, *supra* note 6, COM (95) 498 Final at 8-9, ¶¶ 22-23.

256. EASDAQ, *supra* note 11, at 5.

appeared to be an achievable goal and the EASD initiated the raising of capital.²⁵⁷ Within eight weeks, EASD reached its target financing of ECU 1 million.²⁵⁸

EASDAQ's mission is to establish and operate a pan-European, regulated screen-based stock market.²⁵⁹ In May 1995, EASDAQ incorporated in Belgium²⁶⁰ with the goal of providing a liquid,²⁶¹ efficient, and fair market.²⁶² EASDAQ expects to become operational in the second half of 1996.²⁶³ As of November 1995, EASDAQ was discussing with the Belgian Commission for Banking and Finance²⁶⁴ ("CBF") its formal application for recognition as a regulated stock market.²⁶⁵ Brokers and dealers from all the Member States will be eligible to join the market, provided they obtain a passport from their Home Member State.²⁶⁶

257. *Id.*

258. *Id.* Estimates of the expected financing required over the next few years have ranged as high as ECU10 million. See Anslow, *supra* note 213, at 26 (stating that EASDAQ will require ECU10 million to become operational, with expected breakeven point in EASDAQ's fourth year).

259. EASDAQ, *supra* note 11, at 1.

260. *E.U. EASDAQ -2: To be Located in Belgium*, DOW JONES NEWS SERV., Feb. 21, 1996, available in WESTLAW, Euronews Database [hereinafter *E.U. EASDAQ 2*]. Belgium was selected because the local authorities accept documents in four languages, perceptions of the nation as politically neutral, Belgium's early adoption of the ISD, and the perception that the Belgian Commission for Banking and Finance ("CBF") is one of the strictest regulatory authorities. *Id.*

261. *DICTIONARY OF FINANCE*, *supra* note 3, at 233-34. Liquidity is a characteristic of a security with enough units outstanding that trades can occur without a substantial impact on price. *Id.* A liquid assets is one that can easily be converted into cash. *Id.*

262. EASDAQ, *supra* note 11, at 1.

263. *Id.* See Charlene Lee, *Heard in Paris: New Market in France Has Risk, Potential*, WALL ST. J. EUR., Feb. 22, 1996, at 10 (stating expected start date of September 1996).

264. EASDAQ, *supra* note 11, at 17. The CBF is the primary regulatory agency in Belgium for securities law. André Bruyneel & Jan Peeters, *Belgium*, in *INTERNATIONAL SECURITIES LAW* 19, 20 (1992). The CBF's responsibilities include bank regulation, supervision of the primary market, regulation of all financial intermediaries, and, to a certain extent, supervision of the secondary market. *Id.* EASDAQ must obtain the approval of the CBF because it chose to organize in Belgium and, therefore, requires recognition by the CBF as a regulated stock market. EASDAQ, *supra* note 11, at 2.

265. EASDAQ, *supra* note 11, at 2. Prior to filing an application, the governing structure must be in place, the technical platform must be specified, the Rule-book for Members must be written, and the capital commitments to take EASDAQ to break-even must be raised. *Id.* Upon approval of the application, EASDAQ will then be considered a regulated securities market for the purposes of the ISD. *Id.* at 17. In March 1996 EASDAQ raised sufficient capital to gain the CBF's recognition as a regulated market. Richard Gourlay, *EASDAQ Paves the Way for September Launch: Planned Europe-Wide Stock Market Passes Capital Threshold*, FIN. TIMES, Mar. 25, 1996, at 21.

266. EASDAQ, *supra* note 11, at 17.

EASDAQ anticipates that quotations²⁶⁷ will be transmitted from companies in all Member States.²⁶⁸

As of November 1995, EASDAQ consisted of forty-three shareholders²⁶⁹ and a Board of Directors²⁷⁰ ("EASDAQ Board") of seventeen individuals.²⁷¹ EASDAQ intends for the EASDAQ Board to represent the interests of all parties involved in the success of the market.²⁷² These constituencies include: shareholders,²⁷³ EASD members,²⁷⁴ quoted companies, and investors.²⁷⁵ Of the seventeen board members, eight are shareholders of EASDAQ and one is the President of EASDAQ.²⁷⁶ Ten of the seventeen members either are members of the EASD or have an affiliate that is a member of the EASD.²⁷⁷

EASDAQ's governing structure has not yet been established.²⁷⁸ The proposed structure encompasses the CBF as the primary regulatory authority, the EASDAQ Board, the EASDAQ market authority,²⁷⁹ and an independent international appeal body.²⁸⁰ The CBF's responsibilities will entail reviewing and ap-

267. *Id.* at 17-18. Quotes will be transmitted using a computer-based trading system and brokers will be able to execute trades. *Id.* at 18. Companies with less than three years' trading history will be able to gain admission to EASDAQ. *Id.* It remains a question, however, whether European institutional investors will invest in unlisted issues. Anslow, *supra* note 213, at 26.

268. EASDAQ, *supra* note 11, at 17-18.

269. *Id.* at 6. The 43 shareholders, from 10 countries, including the United States, are investment banks, brokers, venture capital funds, and Nasdaq. *Id.*

270. *Id.* at 7, 17. Members of the EASDAQ Board include the President of EASDAQ, a representative of Nasdaq, and representatives from various venture capital and brokerage firms. *Id.* at 7.

271. *Id.* at 7.

272. *Id.* The EASDAQ Board "must be a powerful, effective and highly credible body, adding to the successful development of the market and representing all stakeholders." *Id.*

273. *Id.* at 6. The commitment of over ECU1 million came from the EASDAQ shareholders. *Id.*

274. *Id.* at App. 1.

275. *Id.* at 7.

276. *Id.* at 6-7.

277. *Id.* at 7. Public representatives do not constitute a majority of the EASDAQ Board. *Id.*

278. *Id.* at 17. As of November 1995, EASDAQ and EASD were still discussing the potential governing structure of the market with the appropriate regulatory authorities. *Id.*

279. *Id.* The EASDAQ market authority will consist of senior EASDAQ executives. *Id.*

280. *Id.* EASDAQ is in the process of defining this independent international appeal body. *Id.*

proving the rules and procedures of the market, ensuring that EASDAQ personnel and members follow the rules and procedures, and approving the appointments of key EASDAQ executives by the EASDAQ Board.²⁸¹ The EASDAQ Board will formulate and review the rules and procedures of the market and appoint the key EASDAQ personnel.²⁸² The EASDAQ market authority, consisting of senior EASDAQ executives, will serve as the administrative and operational staff of the market.²⁸³ The independent appeal body will be available to review certain decisions made by EASDAQ executives, such as applications for membership in the market and admission of securities for trading.²⁸⁴ EASDAQ intends to be a highly regulated market because it attributes the past failures of minimally-regulated secondary markets to their failure to gain the confidence of investors.²⁸⁵

In October 1995, the International Securities Market Association²⁸⁶ ("ISMA") announced its agreement to build the EASDAQ trading system²⁸⁷ to operate beside its own trade confirmation system ("TRAX").²⁸⁸ Like Nasdaq, the ISMA-developed system will disseminate through a computer network the price

281. *Id.*

282. *Id.*

283. *Id.*

284. *Id.*

285. *Id.* at 14. Inclusion requirements will be similar to those set by Nasdaq. *Id.*; see *supra* note 122 and accompanying text (discussing Nasdaq inclusion requirements); *E.U./EASDAQ -3: To Be Strictly Regulated*, DOW JONES INT'L NEWS SERV., Feb. 21, 1996, available in WESTLAW, Euronews Database (quoting EASDAQ's director, Pickles, commenting that institutional investors require confidence provided by highly regulated market). Pickles' statements are confirmed by institutional investors' apprehension of the light regulation of AIM, the ISE's market for young companies. Price, *supra* note 180, at 19; see *supra* notes 181-87 and accompanying text (discussing establishment of AIM).

286. EASDAQ, *supra* note 11, at 2. See generally *Europe Ready for Opening of New Bourses in 1996*, EUR. VENTURE CAP. J., Jan. 1, 1996, available in WESTLAW, Euronews Database [hereinafter *Europe Ready*] ("ISMA is a self-regulatory organisation which had been founded in 1989 as the Association of International Bond Dealers to provide stability for the expanding Eurobond market. Currently ISMA, which had changed its name in 1992, has over 860 member firms from 48 countries.")

287. EASDAQ, *supra* note 11, at 18.

288. *Id.* at 2. "TRAX" is ISMA's trade confirmation and tracking system and is connected to over 290 subscribers worldwide. *Id.* TRAX, designed for the international securities market, has been tailored to accept all types of securities, including internationally traded stocks. *The European Stock Market - A Step Closer*, ISMA Press Release, Oct. 30, 1995, reprinted in EASDAQ, *supra* note 11, at App. 3.

quotations of market makers.²⁸⁹ Trades will be executed over the telephone²⁹⁰ and must be reported within three minutes on the computer network.²⁹¹ Quotes entered on the computer network by market makers will be binding and will be available to all EASDAQ members simultaneously.²⁹² EASDAQ will own the intellectual property rights to the trading system and will have the exclusive use of it.²⁹³ ISMA will operate the trading system on behalf of EASDAQ for an initial period of five years.²⁹⁴

The EASDAQ anticipates rapid growth.²⁹⁵ One study identified a total of 475 companies seeking a stock market listing in the next three years.²⁹⁶ Nearly half of the companies showed interest in listing with EASDAQ.²⁹⁷ In another survey, two-thirds of biotechnology companies queried chose EASDAQ as their first choice for raising equity financing.²⁹⁸ In addition, EASDAQ intends to invite qualifying European companies currently listed on Nasdaq to apply for an EASDAQ listing.²⁹⁹

Nasdaq currently contributes to the establishment of EASDAQ.³⁰⁰ Nasdaq is a shareholder of EASDAQ, has a representative on the board of EASDAQ, and is providing additional assistance.³⁰¹ EASDAQ expects that many securities will seek dual listings on EASDAQ and Nasdaq.³⁰² In addition, EASDAQ plans to duplicate Nasdaq's market maker structure, believing that the

289. EASDAQ, *supra* note 11, at 18.

290. *Id.*

291. *Id.*

292. *Id.*

293. *Id.* at 2.

294. *Id.* at 18.

295. *Id.* at 1. "EASDAQ has made estimates of worst and best case scenarios, the median of which is that there will be 50 companies admitted to trading after one year of operation, 200 companies after three years and 500 companies after five years." *Id.*

296. *Id.* at 12-13. The study looked at firms in France, the Netherlands, Spain, and the United Kingdom. *Id.* at 12; *Small, but not yet Beautiful*, *ECONOMIST*, Feb. 25, 1995, at 80.

297. *Id.* at 13.

298. *Id.*

299. *Id.* There are currently 74 qualifying European companies. *Id.*

300. *Id.* at 1.

301. *Id.* at 1-2, 18. EASDAQ will not use the same trading system as Nasdaq, however, because it is expected to be too complex for the smaller number of firms to be quoted. *Id.* at 18; *see supra* notes 286-94 and accompanying text (describing system to be developed by ISMA).

302. EASDAQ, *supra* note 11, at 1, 11. The advantages to companies obtaining such a dual listing include the extension of trading hours from 7 to 12. *Id.* at 11.

competition between market makers will best serve investors.³⁰³

II. *THE RUDMAN REPORT*

The Select Committee concluded that the NASD's governance structure failed to adapt to the growth and evolution of Nasdaq.³⁰⁴ Evaluations of the self-regulatory structure of securities markets, including the Rudman Report, have ranged from calls for greater reliance on the free market³⁰⁵ to calls for greater intervention by the Federal Government.³⁰⁶ The Select Committee, while not evaluating the self-regulatory system governing the securities industry, was generally supportive of the SRO format.³⁰⁷ The Select Committee determined that Nasdaq should be governed by an entity independent of that regulating the broker-dealer industry.³⁰⁸

A. *Overview of the Rudman Report and its Recommendations*

The Select Committee determined that the NASD's existing governance structure blurs the distinction between its duty to regulate the broker-dealer profession and its duty to oversee Nasdaq.³⁰⁹ The Rudman Report recommends the creation of a new,

303. *Id.* at 10. Like Nasdaq, EASDAQ also plans to require two market makers for an issue to be listed. *Id.*; see *supra* note 119 and accompanying text (referring to Nasdaq inclusion requirements).

304. RUDMAN REPORT, *supra* note 9, at C-21.

305. George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. U. CHI. 117, 118 (1964).

306. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 672-73 (1984) [hereinafter *Mandatory Disclosure*].

307. RUDMAN REPORT, *supra* note 9, at I-5, R-3. Addressing the extent to which change in the governance structure of Nasdaq was required, the Select Committee stated that:

A divorce (as opposed to some separation) [between the NASD and Nasdaq] would be undesirable . . . because it would remove the regulator of the broker-dealer profession entirely from the dealer market. This would sacrifice a key benefit of the self-regulatory system, which links industry expertise with industry regulation, so that each is informed and enhanced by the other.

Id. at C-9.

308. *Id.* at C-9; see *supra* note 41 and accompanying text (defining broker-dealer profession); see *supra* note 120 (defining dealer); see *supra* note 219 (defining transmission of orders, as used in ISD).

309. RUDMAN REPORT, *supra* note 9, at C-21. Prior to the Rudman Report, discipline and enforcement were conducted as peer reviews. *The Nightly Business Report* (Community Television Foundation of South Florida, Inc. broadcast, Sept. 19, 1995) (interviewing former Senator Rudman). "We believe the time has come for this market . . . to have a regularized series of hearings done in a professional manner." *Id.*

independent subsidiary of the NASD.³¹⁰ This new entity will be responsible for regulating member firms,³¹¹ assuring increased public representation on the NASD Board and Nasdaq Board,³¹² and giving greater responsibility to the professional staffs of the NASD and its subsidiaries.³¹³ The recommendations, therefore, suggest changes to the current governance structure to minimize potential conflicts of interest³¹⁴ and to dilute the power of the NASD Board,³¹⁵ with the goal of bolstering investors' confidence in the NASD's policies without defeating the self-regulatory scheme.³¹⁶

1. NASDR

The Rudman Report advocates that regulation of the broker-dealer profession should be performed independent of the regulation of Nasdaq.³¹⁷ It recommends that this be accomplished by the creation of NASD Regulation, Inc.³¹⁸ ("NASDR"), an independent operating subsidiary of the NASD.³¹⁹ The

310. RUDMAN REPORT, *supra* note 9, at C-23.

311. *Id.*

312. *Id.* at C-24.

313. *Id.* at C-27.

314. *Id.* at C-21. The NASD, for example, owns Nasdaq's trading systems and must regulate the competing systems owned by NASD members. *Id.*

315. *Id.* at C-21-C-22. "[T]he governing Board charged with regulating the NASD's member firms should be separate and independent from the governing Board responsible for overseeing the Nasdaq market." *Id.* at C-22.

316. *Id.* at C-21.

317. *Id.* at C-22.

318. *Id.* at C-23, R-12-R-14. The Select Committee recommended the creation of NASDR to direct the regulation of the broker-dealer profession. *Id.* at C-23. In particular, NASDR would establish Rules of Fair Practice for the broker-dealer profession, administer the discipline and enforcement procedures, administer an Office of Professional Hearing Officers, conduct arbitrations, oversee all district offices, and establish its own annual budget and strategic plan. *Id.* at R-12.

319. *Id.* at C-23. The NASDR was expected to begin operation in the first quarter of 1996. *Mary Schapiro Inches Toward the Private Sector*, INSTITUTIONAL INVESTOR, Jan. 1996, at 12 [hereinafter *Mary Schapiro*]. The NASD formed the NASDR in November 1995 and named Mary Schapiro the first head of NASDR. Elizabeth Macdonald, *Sic 'Em*, WORTH, May 1996, at 90. The NASD did not appoint the NASDR Board members, however, until April 1, 1996. Deborah Lohse, *NASD Names 23 Governors to Boards in Move Boosting Investor Advocates*, WALL ST. J., Apr. 2, 1996, at B9 [hereinafter *Lohse, NASD Names Governors*]. Ms. Schapiro, formerly chair of the Commodity Futures Trading Commission and a commissioner of the SEC, hopes that the new structure will truly separate regulation from the remainder of the business. *Mary Schapiro, supra*, at 12; Deborah Lohse, *New Top Cop at the NASD Talks Tough*, WALL ST. J., Mar. 25, 1996, at C1 [hereinafter *Lohse, New Top Cop*]. Ms. Schapiro states that instituting any changes re-

NASDR's mandate is to regulate the broker-dealer profession.³²⁰ Enforcement of the NASD's Rules of Fair Practice and federal securities laws, the primary concerns of the NASDR Board,³²¹ would become independent of responsibility for Nasdaq.³²² The NASDR Board and the Nasdaq Board, however, would remain linked through their common parent, the NASD, to benefit from the SRO format.³²³

The NASD Board would retain ultimate responsibility for policy-making and oversight as the parent entity and the statutory SRO.³²⁴ The Rudman Report urges that the NASD Board grant substantial deference to the Nasdaq Board and the NASDR Board.³²⁵ Board members would be selected by each entity's respective nominating committee.³²⁶ Nominating committees would be composed equally of individuals affiliated with NASD member firms and members of the public.³²⁷

2. Public Representation

The Rudman Report recommends increased public representation in order to bolster confidence in the NASD's policies without defeating the self-regulatory scheme.³²⁸ In particular, the Nasdaq Board and the NASDR Board each would have fifty percent public membership.³²⁹ The NASD Board would have a

quired by the SEC upon the completion of its investigation of the NASD will be a priority. Lohse, *New Top Cop*, *supra*, at C1; *see supra* note 135 (discussing SEC's investigation of NASD).

320. RUDMAN REPORT, *supra* note 9, at C-23. "[O]ur focus is clear; it's regulation. . . . I care about market development the way any investor would, but . . . it won't take one scintilla of my attention." Macdonald, *supra* note 319, at 90 (quoting Mary Schapiro, first NASDR chief).

321. RUDMAN REPORT, *supra* note 9, at R-13-R-14. *See* RUDMAN EXHIBITS, *supra* note 97, at D (proposing composition of NASDR Board).

322. RUDMAN REPORT, *supra* note 9, at R-13-R-14.

323. *Id.* at R-8-R-9. "[T]he NASD would have ultimate responsibility for the policy, rulemaking and regulatory matters entrusted to [a SRO under the 1934 Act]." *Id.* at R-8.

324. *Id.* at C-24.

325. *Id.* The NASDR and Nasdaq Boards, for example, would select their own Chief Executive Officers ("CEOs"). *Id.* The NASD Board would have authority to reject or dismiss such CEOs. *Id.* It would be expected, however, that such authority would be exercised only in exceptional circumstances. *Id.*

326. *Id.*

327. *Id.*

328. *Id.* at C-21. Since NASD members will continue to be fairly represented, the NASD's status as a SRO would continue. *Id.*

329. *Id.* at C-22. The Rudman Report suggests that public members should not be

majority of public members.³³⁰ The Rudman Report suggests that any governing bodies with substantial policy-making or oversight authority have strong public representation.³³¹ In addition, the Select Committee approved the NASD's decision to establish, within Nasdaq, an office devoted to the representation of the interests of the individual investor in policy-making and regulation.³³²

3. Independent Professional Staff

In addition to the separation of the governing boards, the Rudman Report recommends that the professional staffs of the boards be independent from one another.³³³ Because the boards will consist of a greater number of public representatives, the professional staffs will be expected to advise the boards on technical matters.³³⁴ Professional staffs will also be required to consult with all relevant constituencies regarding policy development and rule-making.³³⁵

While the narrowing of the NASD Board's operating responsibilities will require a relatively small professional staff,³³⁶ the Select Committee recommended the creation of the Office of Internal Review.³³⁷ The Office of Internal Review would conduct regular internal audits³³⁸ of the operations of the NASD

affiliated with NASD member firms, but should have "sufficient knowledge, experience and interest in the securities industry or markets to play a meaningful role in governance, and should represent a wide spectrum of skills and interests." *Id.* at C-22, C-23. The Select Committee proposes that the Nasdaq Board be composed of the CEO of Nasdaq, eight public members, four "market maker" representatives, and four industry representatives. RUDMAN EXHIBITS, *supra* note 97, at E. The CEO of the NASD would be a non-voting member of the Nasdaq Board. *Id.* The NASDR Board would be composed of the CEO of the NASDR, 11 representatives of member firms elected by the NASD Districts, 3 at-large industry representatives, and 14 public members. *Id.* Again, the CEO of the NASD would be a non-voting board member. *Id.*

330. RUDMAN REPORT, *supra* note 9, at C-22.

331. *Id.*

332. *Id.* at R-30. The NASD's Issuer Affairs Committee endorses many of the recommendations of the Rudman Report and favors an attempt to better address the needs of individual investors. DeMott, *supra* note 100, at 12.

333. RUDMAN REPORT, *supra* note 9, at C-22.

334. *Id.* at R-11.

335. *Id.*

336. *Id.* at R-17.

337. *Id.* at R-27.

338. *Id.* at C-26, R-27. In effect, the Office of Internal Review would audit the internal operations and procedures of the NASD and its subsidiaries. *Id.* "A principle goal of internal audits is to investigate and appraise the effectiveness with which the

and its subsidiaries.³³⁹ The Office of Internal Review would also serve as an ombudsman for receiving and addressing concerns and complaints from any source regarding any aspect of the NASD, Nasdaq, or the NASDR.³⁴⁰ To ensure its independence, the Office of Internal Review would be administered by the NASD Board and NASD President, jointly.³⁴¹

B. Criticisms of the Rudman Report

Critical responses to the Rudman Report, and existing securities regulation in general, diverge from one another because of disagreements over the adequacy of existing regulation.³⁴² Some critics, for example, contend that federal regulation of securities markets is unnecessary because government should not interfere in the operation of the free market.³⁴³ In addition, critics have disagreed over inadequacies in the solutions offered by the Rudman Report.³⁴⁴ While some critics suggest that the Select Committee's efforts were a ploy by the NASD to limit future governmental regulation,³⁴⁵ others contend that more extreme measures are required if Nasdaq is to be a fair and efficient market.³⁴⁶

1. Free Market Argument

While Congress has dismantled or diminished many of the regulatory programs of the 1930's,³⁴⁷ the 1933 Act and the 1934 Act have maintained their support as well as their structure.³⁴⁸

various organizational units of the [entity] are carrying out their assigned functions." O. RAY WHITTINGTON & KURT PANY, PRINCIPLES OF AUDITING 11 (11th ed. 1995).

339. RUDMAN REPORT, *supra* note 9, at R-27.

340. *Id.*

341. *Id.* at R-28.

342. See Stigler, *supra* note 305, at 117 (arguing that creation of SEC has been of little benefit to investors); cf. *Mandatory Disclosure*, *supra* note 306, at 669 (finding justification for federal securities laws).

343. Stigler, *supra* note 305, at 120-24.

344. See Schroeder, *supra* note 7, at 102 (suggesting NASD's appointment of Select Committee was intended to prevent additional governmental regulation);

345. Schroeder, *supra* note 8, at 102.

346. Patrick J. Healy, *Nasdaq Reform: Take Another Look*, CFO, Mar. 1996, at 10; Deborah Lohse, *Critic to Nasdaq: Sell Thyself to the Public*, WALL ST. J., Apr. 15, 1996, at A11A [hereinafter Lohse, *Critic to Nasdaq*]; see *supra* note 7 and accompanying text (examining criticisms of NASD's oversight of Nasdaq).

347. *Mandatory Disclosure*, *supra* note 306, at 669. Communications and transportation, for example, have been deregulated in recent years. *Id.*

348. *Id.*

The SEC also has retained its political support.³⁴⁹ Some commentators question, however, the extent to which federal regulation of securities markets is economically efficient.³⁵⁰ For example, a 1963 Report,³⁵¹ resulting from the review of the securities markets and the SEC, suggested that the existence of any fraud justified additional regulation of the securities markets.³⁵² In response, however, a commentator conducted a study to determine how investors fared before and after the creation of the SEC.³⁵³ The study concluded that investors gained little financially from the creation of the SEC.³⁵⁴

2. Rudman Report is Ineffectual

Criticisms of the potential effectiveness of the Rudman Report are twofold.³⁵⁵ Some commentators suggest that the Rudman Report fails to recommend substantive changes because the Select Committee represents the NASD's efforts to avoid greater

349. Stigler, *supra* note 305, at 117.

350. *Mandatory Disclosure*, *supra* note 306, at 670 (noting that "[f]raud was unlawful in every state in 1933; we did not need a federal law to penalize lying and deceit"). The authors believe the justification for federal securities laws lies in the efficiencies in their enforcement compared with the enforcement of state securities laws, particularly since many new issues are sold interstate. *Id.* at 679.

351. SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963) [hereinafter 1963 SPECIAL STUDY].

352. Stigler, *supra* note 305, at 119. The Report of the Special Study of the Securities Market stated that "[t]here is no evidence that these [improper selling] practices are typical of how business is conducted by most of the larger firms, but regardless of their frequency they represent problems too important to be ignored." 1963 SPECIAL STUDY, *supra* note 351, pt. 1, at 268. "The mere fact that there have been any losses at all is sufficient reason to consider whether there are further adjustments that should be made for the protection of investors." *Id.* at 400.

353. Stigler, *supra* note 305, at 120-21.

354. *Id.* at 121. The most significant difference between the 1920's and the 1950's was the extent to which the issuance of new stocks had decreased. *Id.* at 122. The author concluded that regulation by the SEC succeeded in decreasing the number of new issues. *Id.* The decrease in issues was not limited to poor investments, however, as shown by the relative consistency in the stock prices. *Id.* See Bill Barnhart, *Competition the Answer to Nasdaq Sins*, CHIC. TRIB., Sept. 18, 1995, at § 3(1) (citing president of Arizona Stock Exchange's view that SEC is to blame for inequities in operation of Nasdaq). Instead of trying to create a national market system the SEC should be concerned with fostering competition between the securities markets. *Id.*; see *supra* note 119 (explaining NMS).

355. See Schroeder, *supra* note 7, at 102 (suggesting NASD used Select Committee to avoid additional government regulation); Knight, *supra* note 7, at H1 (suggesting self-regulation is ineffective).

governmental regulation.³⁵⁶ Other commentators suggest that self-regulation's inherent conflicts of interest necessitate increased governmental regulation of securities markets.³⁵⁷

a. Rudman Report Fails to Recommend Substantive Changes

The NASD admits to its efforts to limit governmental regulation of the securities industry.³⁵⁸ Some critics suggest that the NASD's appointment of the Select Committee illustrated an attempt to forestall reforms by the SEC or Congress.³⁵⁹ Other critics allege that the NASD inadequately fulfilled its regulatory obligations by not developing fully a new computer system used to analyze suspicious trading until the government launched its investigations.³⁶⁰

b. Replace Self-Regulatory Structure with Increased Governmental Regulation

Although self-regulation of U.S. securities markets has existed since the passage of the 1934 Act,³⁶¹ small market makers, investors, and academics have called for the dissolution of the self-regulatory system.³⁶² These proponents argue that only government action will reform Nasdaq.³⁶³ Critics³⁶⁴ cite the ongo-

356. Schroeder, *supra* note 7, at 102.

357. Knight, *supra* note 7, at H1; *see supra* note 7 and accompanying text (reviewing public criticisms of NASD's oversight of Nasdaq).

358. NASD, *supra* note 72, at 115. "The [NASD] has been successful in many instances in preventing the enactment of unnecessary or undesirable regulatory legislation proposed by the SEC." *Id.*

359. Schroeder, *supra* note 7, at 102. "It's pretty clear that the [Rudman Report] is intended to mollify the SEC and even the Justice Department, and allow self-regulation to continue." Dominic Bencivenga, *Rudman Report; NASD Action Could Ease Regulators' Concerns*, N.Y.L.J., Oct. 5, 1995, at 5 (quoting Lester Brickman, professor at Benjamin N. Cardozo School of Law, Yeshiva University Law School). Others have interpreted the appointment of the Select Committee as a tacit admission that change is warranted. Knight, *supra* note 7, at H1.

360. William Power, *Nasdaq Police Have 'Radar' Guns Drawn*, WALL ST. J., Dec. 18, 1995, at C1.

361. 15 U.S.C. § 78o-3; *see supra* note 16 (outlining delegation of SEC's authority to SROs).

362. *Inside Nasdaq, Part 1*, *supra* note 7, at 1; *see supra* note 7 (reviewing public criticisms of NASD's oversight of Nasdaq).

363. Knight, *supra* note 7, at H1.

364. *See* Christie & Schultz, *supra* note 136, at 1814 (finding "implicit agreement among market makers to avoid using odd-eighths in quoting bid and ask prices and that a large number of market makers per stock is not necessarily synonymous with competition"). Other critics include small market makers, who find large market makers dis-

ing investigations of the NASD by the Department of Justice³⁶⁵ and the SEC as indicative of the problems of self-regulation.³⁶⁶ Another critic contends that the NASD would be better able to govern Nasdaq if it sold the market to the public.³⁶⁷

C. *Support/Praise for the Rudman Report Approach*

Although the Maloney Act³⁶⁸ established the self-regulatory framework for the OTC market,³⁶⁹ Senator Maloney voiced concern about unnecessary regulation of the securities markets.³⁷⁰ He promoted the SRO format as a form of cooperative regulation, in which the industry would take the lead.³⁷¹ The SEC also

couraging changes in the spread. Knight, *supra* note 7, at H1. When one small market maker reduced the spread on Intel Corporation, for example, a large market maker sent a message over the computer lines: "Pathetic." *Inside Nasdaq, Part 1, supra* note 7, at 1. "The big issue is whether a [SRO] can regulate its members." Knight, *supra* note 7, at H1 (quoting Harold Bradley, chief stock trader for Twentieth Century mutual fund family, which invests billions of dollars in stocks traded on Nasdaq).

365. BLACK'S LAW DICTIONARY 864 (6th ed. 1990). An executive department of the Federal Government, the Department of Justice represents the Federal Government in legal matters, enforces federal laws, and furnishes legal counsel in federal cases. *Id.*

366. *Probe Launched, supra* note 135, at 1; *see supra* note 135 and accompanying text (discussing matters under investigation by Department of Justice and SEC). EASDAQ officials do not appear overly concerned by Nasdaq's regulatory problems. Josh Martin, *USA: Success Despite Scandals*, EUROMONEY, Dec. 21, 1995, at 14. They stress the importance of Nasdaq's record in bringing small, growth-oriented companies to market. *Id.*

367. Healy, *supra* note 346, at 10. While "segregation of the market and regulatory functions . . . would unquestionably be an improvement over the status quo[,]. . . a more efficient way to reform Nasdaq [is to] sell it." *Id.* Mr. Healy, the NASD's former director of financial policy and strategy, acknowledges that the sale of Nasdaq addresses only the governance issues confronted in the Rudman Report. *Id.*; Lohse, *Critic to Nasdaq, supra* note 346, at A11A. The sale of Nasdaq, therefore, would not necessarily resolve the issues being investigated by the Department of Justice or the SEC. Healy, *supra* note 346, at 10; *see supra* note 135 (discussing SEC and Department of Justice investigations).

368. Maloney Act of 1938, 15 U.S.C. § 78o (1994); *see supra* note 72 and accompanying text (describing genesis of Maloney Act).

369. NASD, *supra* note 72, at 109; *see supra* note 72 and accompanying text (reviewing legislative history of Maloney Act).

370. U.S. Senator Francis Maloney, Radio Address (Feb. 25, 1938), in 83 APP. TO THE CONG. REC. 789, 790 (1938). "Because of the tremendous amount of regulation proposed and imposed in these few years, I approached this subject of a regulation of [OTC] securities markets with caution." *Id.*

371. 83 CONG. REC. 4451 (1938). Senator Maloney explained that:

Under this bill the Federal Government, through the [SEC], says to the investment bankers of the country, 'You may create your own association or associations. You may provide your own rules and your own regulations. We want you to run your own business. We want a representation, however. We want a right of review and supervision.'

encouraged the adaptation of the SRO structure to the OTC market, believing it to be in the best interests of the investment business and the public.³⁷² The Rudman Report found that the early rationales for self-regulation remain valid.³⁷³ Current supporters of the NASD point to its success over the past three decades in organizing the OTC market, once the refuge of companies that could not meet the NYSE's listing requirements.³⁷⁴ Some proponents attest that if the market's success has come at the expense of regulation, the NASD's adoption of the Rudman Report's recommendations indicates the NASD's willingness to improve regulation to ensure the success of the market.³⁷⁵

While the Select Committee did not evaluate the self-regulatory system governing the securities industry, it was generally supportive of the SRO format.³⁷⁶ This is in spite of what the Rudman Report considers the inherent conflicts of interest in the system.³⁷⁷ Those who support self-regulation claim that the technical aspects of the securities industry are best understood by members of the industry.³⁷⁸ In addition, legislators and gov-

Id.

372. William O. Douglas, Chairman, SEC, Address Before the Bond Club of Hartford (Jan. 7, 1938), *in* 83 APP. TO THE CONG. REC. 68, 69 (1938). Seeking the support of the financial community for the Maloney Act, Mr. Douglas explained that:

This type of self-regulation has unquestioned advantages. From the viewpoint of the business they are obvious. Self-discipline is always more welcome than discipline imposed from above. From the broad public viewpoint, such regulation can be far more effective Self-regulation of this kind can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription.

Id.

373. RUDMAN REPORT, *supra* note 9, at I-5, R-3.

374. Knight, *supra* note 7, at H1.

375. Macdonald, *supra* note 319, at 90, 92. "At the end of the day, people aren't going to use the market unless they think its fair." *Id.* (quoting Mary Schapiro, first NASDR chief).

376. RUDMAN REPORT, *supra* note 9, at I-5, R-3. Congress and the SEC, as well as the securities industry, created the self-regulatory system. *Id.* at I-5. It is up to Congress and the SEC, therefore, to change the SRO format, if change is necessary. *See* 15 U.S.C. § 78o (1994) (providing for registered securities associations to oversee OTC market). The self-regulatory system allows the industry expertise to monitor the industry. *Silver v. NYSE*, 373 U.S. 341, 371 (1963) (Stewart, J., dissenting) ("The purpose of the self-regulation provisions of the [1934 Act] was to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry.").

377. RUDMAN REPORT, *supra* note 9, at R-3.

378. U.S. Senator Francis Maloney, Radio Address (Feb. 25, 1938), *in* 83 APP. TO

ernment regulators argue that it is in the members' best interest to prevent behavior that may cause the public to lose faith in the market, particularly where the market is a commercial enterprise.³⁷⁹ Even where self-regulation has been supported, however, the professional staffs have been deemed determinative of the SRO's success by government regulators.³⁸⁰

III. EASDAQ SHOULD ADOPT THE SUGGESTIONS MADE IN THE RUDMAN REPORT FOR IMPROVING NASDAQ

The EASD and EASDAQ illustrate similarities with the NASD and Nasdaq.³⁸¹ The NASD contends that its market maker framework provides investors with the most favorable stock price by requiring the market makers to compete with one another,³⁸² and EASDAQ plans to duplicate the market maker system.³⁸³ The NASD's employment of the Rudman Report's suggestions will provide adequate solutions to present Nasdaq problems. To ensure the fair and efficient operation of the mar-

THE CONG. REC. 789, 790 (1938). "[The Maloney Act] is written upon the theory that regulation can best be achieved by the efforts of honest brokers and dealers themselves." *Id.*

379. *Id.* "If the investing public knew that the investment field was properly supervised, there would be a greater confidence, and it seems to me much more business." *Id.* In addition, Nasdaq competes with the NYSE and other exchanges and reacts to competitive pressures. Barnhart, *supra* note 354, at 1. For example, when major issuers sought a short sale rule, and threatened to leave Nasdaq if such a rule was not adopted, the Trading Committee recommended adoption of the rule the following week. Hal Lux, *Rudman Report Gives Rare Look Into NASD's Inner Workings: Ad Hoc, Ill-Informed Decision-Making the Norm*, INV. DEALERS' DIG., Sept. 25, 1995, at 7.

380. See, e.g., William L. Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 245 (1963). Cary, then-Chairman of the SEC, generalized about effective self-regulation:

[S]uccess depends in substantial part on the adequacy and ability of the professional staff and the amount of responsibility vested in them. This in turn rests upon the wisdom and vision of the board of governors. But the staff provides a continuity and objectivity which is needed to raise standards in the industry. I appreciate the philosophy — particularly of the NASD — that the members should regulate their fellow members, but as the scope of self-regulation enlarges, it will become increasingly arduous without an effective staff.

Id.

381. See *supra* notes 300-08 and accompanying text (discussing Nasdaq's influence of EASDAQ).

382. See *supra* notes 83-84 and accompanying text (explaining Nasdaq' market maker system).

383. See *supra* note 303 and accompanying text (describing EASDAQ's adoption of Nasdaq's market maker system).

ket, therefore, the EASD and EASDAQ should adopt several suggestions made to the NASD and Nasdaq in the Rudman Report.

A. *EASDAQ Will Follow Nasdaq*

The EASD and EASDAQ model themselves on the NASD and Nasdaq.³⁸⁴ The services covered by the ISD³⁸⁵ resemble those provided by NASD members and Nasdaq.³⁸⁶ The ISD, therefore, was a necessary prerequisite to the creation of a pan-European market based on Nasdaq.³⁸⁷ EASDAQ's governance structure patterns that of Nasdaq,³⁸⁸ and EASDAQ is hoping to duplicate the success of Nasdaq.³⁸⁹

While the replication of NASD and Nasdaq in the European Union will serve the needs of many constituencies,³⁹⁰ the conflicts of interest of which the U.S. market has been accused may also be replicated because such conflict of interest are inherent in the self-regulatory framework.³⁹¹ Given the limited securities market regulation³⁹² and the current usage of SROs in the Member States,³⁹³ however, the self-regulatory framework is the optimal governance structure for EASDAQ. EASDAQ must mitigate the potential conflicts of interest to attract the investors required

384. *See supra* notes 300-03 and accompanying text (discussing Nasdaq's influence of EASDAQ).

385. *See supra* notes 218-22 and accompanying text (enumerating investment services covered by ISD).

386. *See supra* notes 105-08 and accompanying text (discussing functions of NASD members trading on Nasdaq).

387. *See supra* note 217 and accompanying text (referring to ISD as regulatory requirement for establishment of EASDAQ).

388. *See supra* note 250 and accompanying text (discussing EASD as modelled on NASD).

389. *See supra* note 366 (discussing EASDAQ's perception of SEC and Department of Justice investigations of Nasdaq). EASDAQ measures Nasdaq's success by its tremendous growth, the increased number of initial public offerings in the United States, and Nasdaq's position as the market in the United States with the most issues traded. EASDAQ, *supra* note 11, at 10-11.

390. *See supra* notes 273-75 and accompanying text (discussing constituencies of EASDAQ).

391. *See supra* notes 377-79 and accompanying text (describing conflicts of interest inherent in self-regulatory framework).

392. *See supra* notes 160, 168 and accompanying text (discussing limited securities regulation by Member States).

393. *See supra* notes 172-75 and accompanying text (discussing SROs in United Kingdom); *see also supra* notes 193-96 and accompanying text (discussing SROs in Germany).

to make the market a success.³⁹⁴ Without the confidence of investors, EASDAQ will not be sufficiently liquid to enable SMEs to raise the capital they require to grow.³⁹⁵ EASDAQ, therefore, must balance the needs of all its constituencies: the desire of investors for a fair market,³⁹⁶ the need of SMEs for a liquid market,³⁹⁷ and the requirement of the EASD members for a profitable market.³⁹⁸

The national securities markets in the European Union, recognizing the growing internationalization of the markets,³⁹⁹ are introducing additional securities regulation aimed at attracting individual investors from their own nations, as well as institutional investors from the international community.⁴⁰⁰ This additional regulation is primarily an extension of the existing self-regulatory structure.⁴⁰¹ EASDAQ adoption of a self-regulatory structure like that of Nasdaq, therefore, is not consistent with regulation of the securities market for the purpose of balancing its members' needs with those of the investors it hopes to draw.

B. *The Rudman Report Adequately Addresses Nasdaq's Deficiencies*

The NASD premises its support for the market maker framework on the assumption that competition among the market makers will produce the most favorable stock price for investors.⁴⁰² If investors do not agree, they will not purchase stocks

394. See Ingo Walter & Roy Smith, *The Worldwide Battle for Money*, STERNBUSINESS, Winter 1996, at 6-7 (excerpting INGO WALTER & ROY SMITH, GLOBAL BANKING (forthcoming 1996)). "The institutional investors of the United States . . . have made their impact on developing Euro-equity markets by demanding the same high standards of research, trading and brokering they enjoy at home." *Id.*

395. See *supra* note 245 and accompanying text (discussing liquidity needs of SMEs).

396. See *supra* notes 186-87 and accompanying text (discussing investors' concerns with minimally regulated markets).

397. See *supra* note 245 and accompanying text (discussing financing requirements of SMEs).

398. See *supra* note 245 and accompanying text (explaining interests of venture capital funds).

399. See Warren, *Global Harmonization*, *supra* note 186, at 185-87 (discussing internationalization of securities markets).

400. See *id.* at 188-89 (discussing increased regulation of national securities markets).

401. See *supra* note 169 (discussing FSA and preference for SROs over governmental regulation).

402. See *supra* notes 83-84 and accompanying text (explaining Nasdaq's market maker system).

quoted on Nasdaq.⁴⁰³ To increase the liquidity of their issues, companies then will be forced to move their listings to an alternative market, such as an exchange.⁴⁰⁴ The NASD and Nasdaq, therefore, will adapt to the requirements of the market or lose business.⁴⁰⁵ The inherent conflicts of interest in the self-regulatory format can be minimized through the functioning of competitive forces.

The NASD's establishment of the Select Committee in response to public criticism of its regulation of Nasdaq suggests that the competitive forces in the market function properly.⁴⁰⁶ The dissemination of information through academic studies⁴⁰⁷ and the press⁴⁰⁸ armed the public, allowing it to voice outrage at possible inequities in the management of Nasdaq.⁴⁰⁹ The NASD reacted by chartering the Select Committee⁴¹⁰ and implementing many of its suggestions.⁴¹¹ The NASD recognized that protecting its self-interest required adopting new procedures or losing issuers and investors to competing securities markets.

The segregation of the disciplinary responsibilities of the NASD into the NASDR creates an independent entity charged with the enforcement of NASD rules and procedures.⁴¹² This independence allows the NASDR to focus on the regulation of Nasdaq without the influence of powerful constituencies.⁴¹³ While the NASDR's independence can be maintained only if it is

403. See Barnhart, *supra* note 354, at 1 (discussing SEC's increase from 100 to 500 of unlisted OTC securities that Chicago Stock Exchange is authorized to trade).

404. See *supra* note 379 and accompanying text (discussing competitive pressures exerted by major issuers on Nasdaq).

405. See *supra* note 57 and accompanying text (discussing source of profits made by market makers).

406. See *supra* notes 354, 379 and accompanying text (discussing influences of competitive pressures on fairness of securities markets).

407. See *supra* note 136 and accompanying text (discussing academic study indicating possible collusion among market makers in setting spreads).

408. See *supra* note 7 and accompanying text (reviewing criticisms of NASD's governance of Nasdaq).

409. See *supra* notes 7, 136, 146 and accompanying text (discussing studies and criticisms of Nasdaq).

410. See *supra* notes 20-21, 143-45 and accompanying text (discussing Select Committee establishment).

411. See *supra* note 319 and accompanying text (discussing implementation of NASDR).

412. See *supra* notes 317-22 and accompanying text (establishing NASDR as autonomous from NASD).

413. See *supra* notes 317-32 and accompanying text (discussing Rudman Report's recommendation for creation of NASDR).

staffed by individuals who support fair and consistent regulation of the market, early evidence indicates that the NASDR is developing into such an independent body.⁴¹⁴

The Rudman Report adequately addresses the inadequacies of the NASD's governance of Nasdaq by focusing on the source of the criticisms of the NASD, the self-regulatory structure.⁴¹⁵ The inherent conflicts of interest in the self-regulatory structure fostered an environment in which market makers allegedly could collude⁴¹⁶ and large market makers allegedly could dominate smaller investment firms and individual investors.⁴¹⁷ The Rudman Report addresses the NASD's structural deficiencies while allowing the self-regulatory structure that produced Nasdaq's successes to continue.⁴¹⁸

C. *EASDAQ Should Adopt the Rudman Report's Suggestions*

EASDAQ has established its mission as providing a regulated securities market that is liquid, efficient, and fair.⁴¹⁹ To ensure fulfillment of this mission, the EASD and EASDAQ should adopt several suggestions made to the NASD and Nasdaq in the Rudman Report. These suggestions address the need for additional public representation,⁴²⁰ a strong commitment to independent disciplinary review,⁴²¹ and professional management.⁴²² Because the EASD will govern EASDAQ under a self-regulatory framework similar to the structure under which the NASD governs Nasdaq, EASDAQ will encounter the same problems faced by Nasdaq.⁴²³ Adoption of the Rudman Report's

414. See *supra* note 319 (discussing recent hiring of new NASDR chief).

415. See *supra* notes 144-46 and accompanying text (discussing Rudman Report's focus on NASD's governance of Nasdaq).

416. See *supra* note 136 and accompanying text (discussing study finding collusion among market makers).

417. See *supra* note 150 and accompanying text (discussing dominance by large market makers of Nasdaq governance).

418. See *supra* notes 149, 307 and accompanying text (discussing Rudman Report's support for self-regulatory structure).

419. See *supra* note 28 and accompanying text (outlining mission of EASDAQ).

420. See *supra* notes 328-32 and accompanying text (discussing Rudman Report's recommendations for increased public representation in NASD governance).

421. See *supra* notes 317-32 and accompanying text (reviewing Rudman Report's suggested creation of NASDR).

422. See *supra* notes 309-41 and accompanying text (reviewing recommendations of Rudman Report).

423. See *supra* notes 251-52 and accompanying text (discussing EASD's governance of EASDAQ).

suggestions will lend credibility to EASDAQ's self-regulatory structure because the result will be equal bargaining power amongst the constituencies the EASD, as an SRO, is intended to represent.

European venture capitalists are playing a major role in the establishment of EASDAQ because their industry depends upon a liquid market for the equity flotations of SMEs.⁴²⁴ EASDAQ will not be a liquid market, however, unless it can attract investors.⁴²⁵ EASDAQ is aware that its market must be strictly regulated given the lower listing requirements demanded of the market for SMEs and the assurances of a fair market that investors demand prior to investing.⁴²⁶ EASDAQ should be equally sensitive to the perception of self-dealing that can accompany the self-regulatory structure.⁴²⁷

Investors will perceive that the inherent conflict of interest in the self-regulatory format is minimized when constituencies besides those affiliated with the SRO are represented.⁴²⁸ The Rudman Report's concern with public representation on the NASD Board and the Nasdaq Board are equally relevant to the EASD and EASDAQ. Currently, fifty-nine percent of the EASDAQ Board consists of EASD members.⁴²⁹ The success of a securities market depends on the liquidity of the market,⁴³⁰ which is achievable only if the market can attract investors.⁴³¹ In turn, investors are attracted to markets that are perceived as fair.⁴³² Adequate public representation on the governing boards of the market and its SRO assures investors that the market is treating

424. *See supra* notes 208-09, 244-47 and accompanying text (outlining role of EVCA in establishing EASDAQ).

425. *See supra* note 261 and accompanying text (discussing market liquidity).

426. *See supra* notes 260, 285 and accompanying text (describing EASDAQ's intention of becoming highly regulated market).

427. *See supra* note 7 and accompanying text (discussing suggestions of self-dealing by NASD in its governance of Nasdaq).

428. *See supra* notes 312, 328-32 and accompanying text (explaining benefits to individual investors of public representation within NASD's governance structure).

429. *See supra* note 270 and accompanying text (describing EASDAQ Board). Ten of the 17 members of the EASDAQ Board, or 58.82%, are EASD members. EASDAQ, *supra* note 11, at 7.

430. *See supra* note 261 (defining liquidity).

431. *See supra* notes 186-87 and accompanying text (discussing concerns that AIM will not attract investors).

432. *See supra* notes 180-87 and accompanying text (describing U.K. markets' attempts to attract investors).

them fairly.⁴³³

Public representation, however, is not sufficient to avoid conflicts of interest. If the growth of EASDAQ achieves its potential, conflicts of interest will pit one EASD member against another.⁴³⁴ EASDAQ must commit, therefore, to the prevention of unfair practices. Where such actions cannot be prevented, enforcement of the rules and procedures governing the market is imperative.⁴³⁵ The enforcement, however, must follow procedures that ensure the protection of the parties' rights.⁴³⁶ Not only the market, but the disciplinary process, must be fair to maintain the confidence of the market's constituencies.

EASDAQ, in its desire to replicate the successes of Nasdaq,⁴³⁷ remains unconcerned about the potential conflicts of interest in a self-regulatory environment.⁴³⁸ Although EASDAQ intends to include in its governance structure an independent appeals body,⁴³⁹ it is not clear that the appeals body will consider appeals from disciplinary procedures.⁴⁴⁰ In the alternative, EASDAQ should provide for regulation of the market by an entity unaffiliated with the EASD to ensure that enforcement of EASDAQ's rules and procedures is conducted in an unbiased manner.

The self-interest of the EASD Board in the success of EASDAQ will be a key to its achievement.⁴⁴¹ This self-interest, however, may cloud the decisions of EASD Board members. A professional staff can prevent any particular member of the EASD from exercising undue influence in the management of the market, provided it is sufficiently independent not to be intimidated

433. See *supra* notes 328-32 and accompanying text (discussing Rudman Report's rationale for adding public representation to NASD's governance structure).

434. See *supra* note 7 and accompanying text (discussing criticisms of NASD's governance of Nasdaq).

435. See *supra* notes 318-21 and accompanying text (discussing NASDR's enforcement responsibility).

436. See *supra* note 319 and accompanying text (discussing NASDR's creation of discipline and enforcement procedures).

437. See *supra* note 366 (discussing EASDAQ's perceptions of Nasdaq).

438. See *supra* note 366 (describing EASDAQ reaction to SEC and Department of Justice investigations of NASD practices).

439. See *supra* note 280 and accompanying text (discussing EASDAQ's independent international appeals body).

440. EASDAQ, *supra* note 11, at 17.

441. See *supra* notes 370-80 and accompanying text (discussing self-regulation of securities industry).

by the members.⁴⁴² This professional staff can prevent the concentration of power in the most powerful EASD members,⁴⁴³ most likely the investment banks⁴⁴⁴ that will be required to sponsor SMEs seeking inclusion on EASDAQ.⁴⁴⁵

CONCLUSION

The commitment of the EASD and EASDAQ to the types of regulatory suggestions made in the Rudman Report will strengthen the support of the Member States for the creation of a market intended to meet the needs of the European Union as a whole. These needs include greater liquidity, a more competitive high-technology industry, growth potential of employment by SMEs as their futures improve, and support for the entrepreneur in providing a method of raising capital and exiting from the then-public company. Echoing the successes of Nasdaq need not come at the price of replicating the controversies that have surrounded it. Therefore, the adoption by EASDAQ of the Rudman Report's suggestions for Nasdaq will ensure the success of EASDAQ as a fair and efficient securities market.

442. See *supra* notes 333-34 and accompanying text (discussing Rudman Report's recommendation of stronger professional staff).

443. See *supra* note 133 and accompanying text (discussing Trading Committee).

444. *DICTIONARY OF FINANCE*, *supra* note 3, at 210. An investment banker acts as an intermediary between the issuer of securities and investors. *Id.*

445. See *supra* note 285 and accompanying text (discussing inclusion requirements for EASDAQ).

**FORDHAM
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**INDEX
VOLUME 19**

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NUMBER 5

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