

## Capital Markets Regulation

**B8326-001/L6347**

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### REQUIRED COURSE MATERIAL

Larry Harris, *Trading & Exchanges: Market Microstructure for Practitioners* (2003)

You will also need a copy of the Coffee & Sale Securities Law Statutory Supplement. The 2013 edition is preferable but you can probably work adequately with the 2012 edition. The rest of the materials for the course will be provided in a bound casebook.

### COURSE DESCRIPTION

This course, a joint offering of the Law School and the Business School, concerns the regulation of capital markets: The Exchanges and the variety of other institutions devoted to the trading of securities. Secondary trading markets perform three important social functions. They provide liquidity for investors, allow more efficient allocation of risk, and incorporate information into prices (which in turn serve as vital guides to real economic activity). The reliability and effectiveness with which capital markets perform these functions and their costs of operation are determined in significant part by the rules governing the persons who operate, and trade in, these markets. As of late, the efficacy of the equity market has been called into question in, for example, *Flash Boys* by Michael Lewis. Meanwhile, SEC Commissioners have called for a major review of the equity markets. This course will investigate many of the issues that will be discussed in the coming years.

The course will begin with a consideration of major domestic and transnational capital market institutions. It will then address the economic theory that explains how capital markets operate and the incentives that motivate the various players. These beginning segments lay the groundwork for a more informed discussion of the substantive law that governs capital markets. The course, with its focus on persons who operate or trade in

capital markets, should be distinguished from Securities Regulation, which is devoted primarily to the regulation of the behavior of issuers and their agents in connection with the primary offering and secondary trading of their securities.

## **COURSE OBJECTIVES**

By the end of the course, students should be equipped to analyze seriously important law and public policy issues generated by such topical phenomena as algorithmic and high frequency trading, the “flash crash,” “mini-crashes,” dark pools, short selling, centralized clearing, the rule of reg NMS in the current structure of trading, the tick size and “rigged” markets.

## **ASSIGNMENTS**

### *I. Class Participation, Attendance and Seating Chart.*

Your overall class participation for the term will be graded and count 20% of your grade for the course. Many of classes will be taught by Socratic method. While students will be called upon randomly from the class list, volunteer discussion is encouraged as well. Class participation will be judged upon overall class performance including both responses when you are called on and voluntary participation.

Regular attendance is expected. You should plan to attend class unless there is special reason such as illness or a pressing conflict that would prevent you from doing so.

A requirement for passing the course is signing the electronic seating chart. Please continue to sit in the seat selected so that we can get to know you as quickly as possible. Also, if you do not sit in your seat, you will give the appearance of being chronically absent, which, as noted above, will negatively affect your grade.

### *II. Exams*

The final exam will be 2-1/2 hours and will be a regular in-class exam at the scheduled time. The final exam will count 60% of your grade. You will be allowed to bring all materials associated with the course, your own notes, and outlines prepared by you and others in the class.

There will be a 40 minute midterm at the beginning of class, September 30, 2014. The midterm will count 20% of your grade. It will focus on the materials and lectures concerning the economics of securities markets that will be the bulk of the first part of the course. Again, you will be allowed to bring all materials associated with the course, your own notes, and outlines prepared by you and others in the class. You will not be able to use a computer to write your answers to the midterm. Please come early so that you can get settled. The exam will begin promptly at the beginning of the class hour. When the exam is completed, we will conduct a regular class until the end of the class period.

## **Summary of Evaluation**

Participation	20%
Midterm	20%
Final Exam	60%

## Topics Covered

### *I. The Institutions and Economics of Securities Markets*

The course will begin with a survey of the different types of securities markets, the persons who participate in them, and the fundamental mechanics of their operation. The social functions of securities markets - providing investors with liquidity, allocating risk and aggregating information through pricing - will be considered followed by an exploration of how markets perform these functions, i.e., market microstructure analysis. The role played by regulation will be introduced by case studies of markets that have failed and disappeared.

### *II. Regulation of Market Structure*

The rules by which a securities market operates are important determinants in how well it performs its various social functions, its real costs of operation, who among the participants - the various types of traders and market actors such as brokers, dealers and exchanges - profit and who do not, and the capacity of market institutions to innovate to perform these functions better and/or at less real cost. One such set of rules relates to transparency: who knows (and when) the prices at which securities are being offered and sold (“bid” and “ask” quotes) and the prices at which actual trades occurred. A second set concerns execution by brokers of customer orders: the broker’s best execution and fiduciary duties to its customer, the abandonment of fixed commissions, rules covering the special situation where a broker matches its own customers’ buy and sell orders (“internalization”), and the receipt by brokers of payment to steer their customers’ order flow to a particular market. A third set of rules concerns the size and disclosure of markups when a customer directly buys from, or sells to, a dealer rather than through a broker. A fourth set of rules concerns procedures to assure that the parties to an executed trade actually perform their respective contractual obligations (clearance and settlement and broker and exchange guarantees of performance).

### *III. Regulation of Traders*

The economics of market microstructure can help our understanding of a variety of kinds of regulations relating to traders. Traders may try to influence prices in ways that permit them to buy low and sell high when there has been no change in the economic fundamentals of the securities involved. The meaning of “manipulation” will be considered both in terms of market microstructure economics and under the Exchange Act. Practical difficulties of proof will be assessed as well. The special rules governing trades by underwriters, issuers and others following an initial public offering will also be examined. Persons who trade on the basis of non-public corporate information (“insider trading”) can make supernormal profits. This highly regulated phenomenon will also be considered from the market microstructure point of view. Rules restricting short selling, including the recent deregulatory oriented Reg SHO and even more recent temporary short sale reregulation of the shares of financial intermediaries, will be considered from an economic theory perspective as well.