COLUMBIA LAW SCHOOL/COLUMBIA BUSINESS SCHOOL
Capital Markets Regulation
Professors Merritt B. Fox and Lawrence R. Glosten
L6347/ B8326-001, Fall 2018

COURSE OUTLINE

Course Summary:

This course, a joint offering of the Law School and the Business School, concerns the regulation of capital markets – the markets that provide financing for businesses through stocks, bonds, and other financial instruments. The functioning of capital markets largely takes place through the national stock exchanges, such as the New York Stock Exchange, NASDAQ, and BATS, and through so-called dark pools, internalization, and other forms of over-the-counter trade. These markets serve vital social functions, including providing liquidity for investors and incorporating information into prices, which in turn serve as vital guides for the real economy. The ability of capital markets to perform these functions is importantly shaped by the rules governing the persons who operate, and trade in, these markets.

The course will begin with a consideration of the major domestic capital market institutions. It will then address the economic theory that explains how trading and capital markets operate and the incentives that motivate their various players. These beginning segments lay the groundwork for a more informed discussion of the substantive law that governs capital markets. In particular, we will consider (1) the regulation of market structure, including the information available to various market participants, the rules governing the nature of trade, and the variety and rules of trading venues; (2) the regulation of broker-dealers, who intermediate trading, including their legal duties and regulatory structure; (3) various controversies regarding the modern stock market, including dark pools and high-frequency trading; and (4) the regulation of traders, including manipulation, short selling and informed trading.

By the end of the course, students should be equipped to analyze with sophistication important law and public policy issues, such as high frequency trading, dark pools, short selling, financial transaction taxes, and securities market structure. The class is a blend of statutory and case law, economics, and the consideration of topical issues. It should be of value to any student interested in a career involving the capital markets, securities, or with an interest in the functioning and social value of markets.

This course focuses on capital markets and trading, in contrast to Securities Regulation, which concerns the regulation of the issuers of stocks and bonds, and their agents, in connection with the primary offering and secondary trading of securities.

Required Materials:

Class Readings Packet (composed of the readings listed in the syllabus)

- **Statutes & Rules Packet** (composed of the statutory provisions listed in the syllabus)

Throughout the semester, we will include relevant timely news articles and other materials as part of the required course readings that will be the subject of class discussion. We will provide you with these articles via Courseworks or email.

Please have ready access to all relevant required readings for each class.

Syllabus:

Preliminary Caveats: The readings below are assigned for and should be completed in advance of the associated class day. The provided dates are based on the pace that we anticipate. If variations from this schedule are needed, they will be noted in class.

I. The Institutions & 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.

A. Class #1 – Tuesday, Sep. 4

Course mechanics, introduction and market characteristics

1. **Course Outline**

2. **Michael Lewis**, **(page __)** *The Wolf Hunters of Wall Street: An Adaptation from 'Flash Boys: A Wall Street Revolt', by Michael Lewis*, New York Times Magazine, March 31, 2014

3. **Merritt Fox, Lawrence Glosten, & Gabriel Rauterberg**, *The Economic and Legal Structure of Trading Markets* [hereinafter, FGR Book], Introduction and Chapter 1, Parts I-III & V **(page__)**

B. Class #2 – Thursday, Sep. 6

The social value of markets

1. **Friedrich Hayek**, **(page__)** *The Use of Knowledge in Society,* American Economic Review, XXXV, No. 4, pp. 519-30 (1945)

2.

3. **FGR Book,** Introduction and Chapter II) **(page 53)**

C. Class #3 – Tuesday, Sep. 11

Capital market vocabulary and mechanics

1. **FGR Book,** Chapter I, Part IV **(page __)**

D. Class #4 – Thursday, Sep.. 13

Mechanics and the economics of markets

FGR Book, Chapter III (not including the Appendices) **(page __)**

E. Class #5 – Tuesday, Sep. 18

Economics of markets

1. **Larry Harris**, *Trading and Exchanges: Market Microstructure for Practitioners*, Oxford University Press 2003 – Chapter 14 (Bid/Ask Spreads) **(page __) [MSP note: We should just include a copy of this this chapter in the reader]**

F. Class #6 – Thursday, Sep. 20

Economics of markets

1. Previous class readings continued

G. Class #7 – Tuesday, Sep. 25

Dealer markets, bond markets

1. Previous class readings continued.

H. Class #8 –Thursday, Sep. 27

Failed markets

1. **John C. Coffee, Jr**., **(page__)** *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, published at Chapter 7 of Merritt B. Fox and Michael A. Heller, Corporate Governance Lessons from Transition Economy Reforms, Princeton University Press, pp. 272-314

2. **Vikas Bajaj and Stephen Labaton**, **(page__)** *Big Risks for U.S. in Trying to Value Bad Bank Assets*, New York Times (Feb. 2, 2009)

I. Class #9 – Tuesday, Oct. 2

1. **MIDTERM EXAM FOR FIRST 50 MINUTES OF CLASS**

Failed markets, continued

2. Previous class readings continued.

II. The Regulation of Traders (including manipulation, short selling, & trading on non-public information)

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. Rules restricting short selling, including the deregulatory oriented Reg. SHO and temporary short sale reregulation of the shares of financial intermediaries, will be considered from an economic theory perspective as well. Lastly, persons who trade on the basis of non-public information can make supernormal profits. This highly regulated phenomenon will also be considered from the market microstructure point of view, in order to determine which informed trades are socially desirable and which are socially undesirable.

A. Class #10 – Thursday, Oct. 4

The legal landscape

1. Securities Exchange Act, Section 9, 10(b) and Section 15(c)(1)

2. Securities Act of 1933, Section 17(a)

3. Securities Exchange Act, Rules 10b-5

B. Class #11 – Tuesday, Oct. 9

Economics of manipulation

1. **FGR Book,** Chapter VI **(page __)**

C. Class #12 – Thursday, Oct. 11

Manipulation cases

1. In the Matter of Yoshikawa, **(page __)** Admin. Proc. File No. 3-12057, Release No. 34-53731 (SEC 2006).

2. **Excerpts from Thomas Lee Hazen**, **(page__)** Securities Regulation Cases and Materials (Seventh Edition), Chapter 13 (Manipulation) (pp. 862-866)

3. United States v. Mulheren, **(page __)** 938 F.2d 364 (2d Cir. 1991)

4. **Steve Thel**, **(page__)** *$850,000 in Six Minutes – The Mechanics of Securities Manipulation*, 79 Cornell L. Rev. 219 (1994) (Excerpt)

5. Markowski v. SEC, **(page__)** 274 F.3d 525 (D.C. Cir. 2001)

D. Class #13 – Tuesday, Oct. 16

Manipulation and HFT, Spoofing in futures markets

1. Previous class readings continued.

E. Class #14 – Thursday, Oct. 18

Informed trading

1. **FGR Book,** Chapter V **(page __)**

F. Class #15 – Tuesday, Oct. 23

Informed trading (continued)

1. Previous class readings continued.

G. Class #16 – Thursday, Oct. 25

Law and Economics of short selling

1. **FGR Book,** Chapter VII **(page __)**

III. The Regulation of Market Structure

The rules by which a securities market operates are important determinants of 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. Other rules concerns which venues orders may be sent to and allowable prices for quotations and for executed transactions.

A. Class #17 – Tuesday, Oct 30

Introduction to capital market transparency

1. **Craig Pirrong**, **(page __)** *The Thirty Years War, Securities & Investment*, Regulation (Summer 2005)

2. **Concept Release on Equity Market Structure**, **(page __)** 17 C.F.R. 242, Release No. 34-61358 (2010) (excerpt)

B. Class #18 – Thursday, Nov. 1

Overview of Reg NMS

1. **Mary M. Dunbar**, **(page __)***Market Structure: Regulation NMS*, SIA Compliance and Legal Division, Annual Seminar (2006)

2. **Excerpt from Coffee, Sale & Henderson**, **(page__)** Securities Regulation: Cases & Materials (13th Edition 2015) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 10, Regulation of the Securities Markets, pp. 628–639; begin reading below the middle of the page on p. 628 at "What Did Regulation NMS Do?"; stop reading just before the problem at the bottom of p. 639).

3. **Excerpt from Coffee, Sale & Henderson**, **(page __)** Securities Regulation: Cases & Materials (13th Edition 2015) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 10, Regulation of the Securities Markets, pp. 680-682; begin reading at the very bottom of p. 680 at "Section 5. Market Data" through the bottom of p. 682)

4. **Excerpt from Coffee, Sale & Henderson**, **(page__)** Securities Regulation: Cases & Materials (13th Edition 2015) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 10, Regulation of the

Securities Markets, pp. 685–688; begin reading at the very top of p. 685 at "Section 7. Self Regulation in the Securities Industry")

5. **Excerpt from Coffee, Sale & Henderson**, **(page__)** Securities Regulation: Cases & Materials (13th Edition 2015) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 11. Regulation of Broker-Dealers, pp. 689 – 700; stop reading just before "Problems" on p. 700)

6. Section 11A of the Securities Exchange Act of 1934

C. Class #19 – Tuesday, Nov. 6

1. Please be prepared to answer the questions in the NMS Problem Set (to be posted on courseworks)

2. Set of Regulation National Market System Rules: Rules 600-607, 610, 611, and 612 of the Securities Exchange Act of 1934 (also skim all of Reg ATS and read ATS Rule 301)

D. Class #20 – Thursday, Nov. 8

1. Continuation of NMS Problem Set

E. Class #21 – Tuesday, Nov 13

Assorted Reg NMS topics

1. **Larry Harris**, Trading and Exchanges: Market Microstructure for Practitioners, Oxford University Press 2003 – Chapter 5 (pp. 101-02 on transparency only) **(page __) [MSP note: We should just include a copy of this this chapter in the reader]**

2. **[MSP note: these chapters seemed unnecessary in light of the book chapters and the topics covered in class]**

IV. The Regulation of Broker-Dealers

Broker-dealers serve a crucial intermediating function between the buyer and seller with respect to almost all secondary trading of stock. For example, direct trading on a stock exchange or an ATS is only open to broker-dealer members. Similarly internalized trading can only be undertaken by a broker-dealer. And one or more broker-dealers would be involved in any purchase or sale of an OTC stock as well. We address the many facets of broker-dealer activity, including: the broker's duty of best execution; the size and disclosure of mark-ups when a customer directly buys from, or sells to, a dealer rather than through a broker; receipt by brokers of

payments to steer customers' order flow to a particular market; the abandonment of fixed commissions; obligations under the anti-fraud rules of federal securities law; obligations to only recommend securities to customers when there is a reasonable basis for the recommendation and the security is suitable for that customer; and various other forms of customer protection established by federal law, SEC rulemaking, self-regulatory organization rules, or state and common law.

A. Class #22 – Thursday, Nov. 15

The legal landscape of broker regulation

1. Securities Exchange Act of 1934, Sections 3(a)(4), 3(a)(5), 3(a)(54), 6, 10(b), 15(a), 15(b), 15A, 15B, 15C, and 19 (review for substance)

2. Securities Act of 1933, Section 17(a)

3. Securities Exchange Act, Rules 10b-5

4. **Review Excerpt (already assigned for March 26)** from **Coffee, Sale & Henderson**, Securities Regulation: Cases & Materials (13th Edition 2015) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 11. Regulation of Broker-Dealers, pp. 689 – 700; stop reading just before "Problems" on p. 700)

5. **FGR Book,** Chapter VIII **(page __)**

6. Sample Brokerage Trade Confirmation, **(page __)**

7. Charles Hughes & Co., Inc. v. SEC, **(page___)**139 F.2d 434 (2d Cir. 1943)

B. Class #23 – Tuesday, Nov 20

Best Execution and Broker-Dealer Compensation

1. Newton v. Merrill Lynch, **(page ___)** 259 F.3d 154 (3rd Cir. 2001)

2. Sections of complaint, motion to dismiss briefing, and motion to dismiss order from Klein v. Ameritrade. (to be posted on courseworks)

3. SEC v. First Jersey Securities, **(page__)** 890 F. Supp. 1185 (S.D.N.Y. 1995)

C. Class #24 – Tuesday, Nov. 27

Broker-Dealer Compensation (continued) and Consumer Protection Issues

1. Shivangi v. Dean Witter, **(page__)** 825 F.2d 885 (5th Cir. 1987)

2. Rule 15c1-7 of the Securities Exchange Act of 1934

3. **Larry Harris**, Trading and Exchanges: Market Microstructure for Practitioners, Oxford University Press 2003 – pp. 166-68 **(page __) [MSP note: We should just include a copy of this these pages in the reader]**

4. FINRA Rule 2111. **(page__)** Recommendations to Customers (Suitability)

5. Hanly v. SEC, **(page__)** 415 F.2d 589 (2d Cir. 1969)

6. FINRA Rule 2510. **(page___)** Discretionary Accounts

7. David Raymond Koos, Former Registered Representative, **(page ___)** New York Stock Exchange Hearing Panel Decision 01-122, August 1, 2001

V.

Issues in the Modern Stock Market

The stock market has changed dramatically in the last three decades. The advent of an electronically linked, multiple venue limit order book system creates distinctive efficiencies, but also poses new problems. We will address several of these new issues concerning the structure, fairness, and efficiency of the modern market, including the activity of high-frequency traders, the operation of dark pools, and monetary inducements for order flow.

D. Class #25 – Thursday, Nov. 29

Recent regulatory developments—dark pools and maker/taker

1. Readings forthcoming

E. Class #26, Tuesday, Dec. 4

"Electronic front running" and other HFT issues

1. Readings forthcoming

F. Class #27, Thursday, Dec. 6

Regulatory discussion

1. Readings forthcoming