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# COLUMBIA LAW SCHOOL/COLUMBIA BUSINESS SCHOOL Capital Markets Regulation

# Professors Merritt Fox and Larry Glosten L6347\_001, Fall 2021

# COURSE OUTLINE

# Course Summary:

This course, a joint offering of the Law School and the Business School, concerns the regulation of capital markets. In particular, our focus will be on the secondary markets for the trading of stocks, bonds, and other financial instruments, markets whose proper functioning greatly facilitates the original offerings of such instruments by businesses seeking new financing. With respect to stock, this secondary trading largely takes place on 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 traders, including manipulation, short selling and informed trading; (2) 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; (3) the regulation of broker-dealers, who intermediate trading, including their legal duties and regulatory structure; and (4) various controversies regarding the modern stock market, including dark pools, maker-taker fees, payment for order flow, and certain high-frequency trader practices.  
  
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 more generally.  
  
This course focuses on capital markets and trading, in contrast to Securities Regulation, which primarily 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:**

* **Merritt Fox, Larry Glosten & Gabriel Rauterberg,** *The New Stock Market: Law, Economics, and Policy*. Readings listed in the syllabus as “**The New Stock Market**”)
* **Class Readings Packet** (composed of the readings listed in the syllabus, other than in The New Stock Market)

Available in the “Files” section of CourseWorks

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

Available in the “Files” section of CourseWorks

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.

## Class #1 – Thursday, September 9th

Course mechanics, introduction and market characteristics

### Course Outline

### **Michael Lewis**, **(Class Readings Packet)** 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

### **Alexander Osipovich,** **(Class Readings Packet)** *High-Frequency Traders Push Closer to Light Speed With Cutting-Edge Cables*, Wall Street Journal, December 15, 2020

### **The New Stock Market,** Introduction and Chapter 1, Parts I-III & V

## Class #2 – Tuesday, September 14th

Introduction to the legal structure of regulation and capital market vocabulary

### **The New Stock Market**, Chapter 1, Part IV

## Class #3 – Thursday, September 16th

### The social value of markets

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

### **The New Stock Market**, Chapter 2

## Class #4 – Tuesday, September 21st

Mechanics and the economics of markets

### **The New Stock Market,** Chapter 3 (except Appendices).

## Class #5 – Thursday, September 23rd

Economics of markets

### **Larry Harris**, *Trading and Exchanges: Market Microstructure for Practitioners*, Oxford University Press 2003 – Chapter 14 (Bid/Ask Spreads) **(Class Readings Packet)**

## Class #6 – Tuesday, September 28th

Economics of markets

### **The New Stock Market,** Chapter 3, Appendices

## Class #7 – Thursday, September 30th

Dealer markets, bond markets

### Previous class readings continued

## Class #8 – Tuesday, October 5th

Failed markets

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

* + 1. **Fail Markets** - note to come **(CourseWorks)**

## Class #9 – Thursday, October 7th

### **MIDTERM EXAM FOR FIRST 50 MINUTES OF CLASS**

Failed markets, continued

### Previous class readings continued.

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

**II.**

The economics of market microstructure can help our understanding of a variety of kinds of regulations relating to traders. 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. Traders may also 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. Finally, 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.

## Class #10 – Tuesday, October 12th

Informed trading

* + 1. Securities Exchange Act, Section 10(b) and Rule 10b-5

### **The New Stock Market,** Chapter 5.

## Class #11 – Thursday, October 14th

Informed trading (continued)

* + 1. **The New Stock Market,** Chapter 6

## Class #12 – Tuesday, October 19th

Manipulation: Economics and the legal landscape

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

### Securities Act of 1933, Section 17(a)

### **The New Stock Market,** Chapter 7

### **Daniel Fischel & David Ross,** (Class Readings Packet) *Should the Law Prohibit “Manipulation” in Financial Markets?* (Excerpt)

* + 1. **Steve Thel, (Class Readings Packet)** *$850,000 in Six Minutes: The Mechanics of Securities Manipulation* (Excerpt)

## Class #13 – Thursday, October 21st

Manipulation cases

### United States v. Mulheren, **(Class Readings Packet)** 938 F.2d 364 (2d Cir. 1991)

### Markowski v. SEC, **(Class Readings Packet)** 274 F.3d 525 (D.C. Cir. 2001)

### In the Matter of Yoshikawa, **(Class Readings Packet)** Admin. Proc. File No. 3-12057, Release No. 34-53731 (SEC 2006).

## Class #14 – Tuesday, October 26th

Manipulation and HFT, Spoofing in futures and equity markets

### Previous class readings continued.

### Lawrence R. Glosten, **(Class Readings Packet)** *SEC v Taub and Shmalo*

### Expert Report of Terrence Hendershott **(CourseWorks)**

## Class #15 – Thursday, October 28th

Short selling

### **The New Stock Market,** Chapter 8

# The Regulation of Market Structure

**III.**

# 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.

**No Class Tuesday, November 2nd (Election Day)**

## Class #16 – Thursday, November 4th

Introduction to capital market transparency

### **Craig Pirrong**, **(Class Readings Packet)** *The Thirty Years War, Securities & Investment*, Regulation (Summer 2005)

### **Concept Release on Equity Market Structure**, **(Class Readings Packet)** 17 C.F.R. 242, Release No. 34-61358 (2010) (excerpt)

## Class #17 – Tuesday, November 9th

Overview of Reg NMS

1. **Excerpt from Coffee, et al.,** **(Class Readings Packet)**
2. Securities Regulation: Cases & Materials (14th Edition 2020) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 8, Regulation of the Securities Markets, pp. 675-682; begin reading below the middle of the page on p. 675 at “What Did Regulation NMS Do?” through the bottom of p. 682).
3. Reading concerning Market Data to come **(CourseWorks)**
4. **Excerpt from Coffee, et al., (Class Readings Packet)**
5. Securities Regulation: Cases & Materials (14th Edition 2020) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 8, Regulation of the Securities Markets, pp. 722-726; begin reading at the very top of p. 722 at “Section 8. Self Regulation in the Securities Industry” through the bottom of p. 726)
6. Section 11A of the Securities Exchange Act of 1934

## Class #18 – Thursday, November 11th

### Please be prepared to answer the questions in the NMS Problem Set (to be posted on CourseWorks)

### 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)

## Class #19 – Tuesday, November 16th

### Continuation of NMS Problem Set

**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.

Class #20 – Thursday, November 18th

The legal landscape of broker regulation

### 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)

### Securities Act of 1933, Section 17(a)

### Securities Exchange Act, Rules 10b-5

### **Excerpt from Coffee, et al.,** **(Class Readings Packet)**

### Securities Regulation: Cases & Materials (14th Edition 2020) (excerpt is from Part III, Regulation of Trading in Securities, Ch. 11. Regulation of Broker-Dealers, pp. 727-740; stop reading just before “Problems” on p. 740)

### The New Stock Market, Chapter 9

### Sample Brokerage Trade Confirmation, **(Class Readings Packet)**

### Charles Hughes & Co., Inc. v. SEC, **(Class Readings Packet)** 139 F.2d 434 (2d Cir. 1943)

## Class #21 – Tuesday, November 23rd

Best Execution and Broker-Dealer Compensation

### SEC v. First Jersey Securities, **(Class Readings Packet)** 890 F. Supp. 1185 (S.D.N.Y. 1995)

### Shivangi v. Dean Witter, **(Class Readings Packet)** 825 F.2d 885 (5th Cir. 1987)

### Rule 15c1-7 of the Securities Exchange Act of 1934

### FINRA Rule 2111. **(Class Readings Packet)** Recommendations to Customers (Suitability)

### Hanly v. SEC, **(Class Readings Packet)** 415 F.2d 589 (2d Cir. 1969)

**No Class Tuesday, November 25th (Thanksgiving Holiday)**

## Class #22 – Tuesday, November 30th

### Broker-Dealer Compensation (continued) and Consumer Protection Issues

### Readings continued

### FINRA Rule 3260. **(Class Readings Packet)** Discretionary Accounts

### David Raymond Koos, Former Registered Representative, **(Class Readings Packet)** New York Stock Exchange Hearing Panel Decision 01-122, August 1, 2001

### Arnold and Porter, **(Class Readings Packet)** The SEC’s Regulation Best Interest, Form CRS, and Investment Adviser Interpretations, June 27, 2019

### FINRA, Reg BI and Form CRS Firm Checklist **(Class Readings Packet)**

**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, new order types, and monetary inducements for order flow.

Class #23 – Thursday, December 2nd

1. **The New Stock Market,** Chapters 4 and 10

## Class #24 – Tuesday, December 7th

### **The New Stock Market,** Chapters 10, 11 and 12 and Conclusion

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

### Excerpts from SEC Discussion of Proposed Rule 6c-11 **(Class Readings Packet)**

## Class #25 – Thursday, December 9th

### Readings forthcoming