



COLUMBIA LAW SCHOOL/COLUMBIA BUSINESS SCHOOL
Capital Markets Regulation
Professors Glosten and Fox
L6347/ B8326-001, SPRING 2018

BIDDING SYLLABUS
PRELIMINARY COURSE OUTLINE

Course Summary:

This course, a joint offering of the Law School and the Business School, concerns the regulation of capital markets: the New York Stock Exchange, NASDAQ and the wide 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.

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 their 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.

By the end of the course, students should be equipped to seriously analyze important law and public policy issues generated by such topical phenomena as algorithmic trading, the “flash crash” and mini-crashes, off-exchange trading (including dark pools), trading based on non-public information, manipulation, short selling, financial transaction taxes, and cross-border securities trading.

Required Materials:

- **Larry Harris**, *Trading & Exchanges: Market Microstructure for Practitioners* (2003)
- **Class Readings Packet** (composed of the readings listed in the syllabus other than in Harris)
- **Statutes & Rules Packet** (composed of the securities code 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 Courseweb or email.

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

Syllabus:

Preliminary Caveat: The dates provided here are based on the pace that we anticipate. If variations from this schedule are needed, they will be noted in class.

This Course Outline provides specific reading assignments only for the first five weeks of the course. Specific reading assignments and reading materials for the classes starting on Oct. 7 through the end of the term will be provided in advance of that date in a Part II of the Class Materials.

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.

II. The 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. The Regulation of Liquidity Provision & Related Services

Buy and sell orders from traders do not always arrive in a way that permits simultaneous matches. In such situations, liquidity providers (i.e., market makers) supply liquidity services by buying and selling securities for their own account. The role of specialists in reducing systemic risk, including a review of their performance during the 1987 crash and liquidity-provision obligations then and now, will also be considered. The move from quotations in increments no smaller than an eighth of a dollar to quotations in increments of one cent and the effects of this move on investor costs of trading (the “bid/ask spread”) and on market quality will also be considered. We will also consider the role of brokers as the agents who allow traders to access markets, examining their legal obligations to their clients.

IV. 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, including a non-conventional examination of areas of legal, yet controversial trading based on non-public information.