

EUROPEAN UNION REGULATION OF ELECTRONIC COMMUNICATION NETWORKS: STIFLING GLOBAL INTEGRATION OF SECURITIES MARKETS

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I. INTRODUCTION

Alternative trading systems, also known as Electronic Communication Networks ("ECNs"),¹ have become integral to the modern securities markets, providing investors with enhanced flexibility and reduced trading costs, as well as competition to the established securities exchanges.² In the U.S. alone, ECNs account for approximately 30% of the total share volume and 40% of the dollar volume traded in Nasdaq securities.³ ECNs account for approximately 3% of total share and dollar volume in listed securities.⁴ In contrast, in 1993 ECNs accounted for 13% of share volume in Nasdaq securities and 1.4% of listed share volume.⁵

Because ECNs have proliferated within U.S. markets and the Securities and Exchange Commission ("SEC") has addressed the integration of ECNs into the securities markets⁶, it is advantageous to describe what they are and how they operate in terms described in a recent SEC study.⁷ In simplest terms, ECNs bring buyers and sellers together for electronic execution of trades.⁸ In the U.S., the SEC has defined an ECN as any electronic system that widely disseminates to third parties orders entered into it by an exchange market maker or over-the-counter ("OTC") market maker, and permits such orders to be executed in whole or in part.⁹ At the time of

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¹ June 2000 U.S. Securities and Exchange Comm'n., *Special Study: Electronic Communication Networks & After Hours Trading*, available at <http://www.sec.gov/news/studies/ecnafter.htm> [hereinafter *Special Study*].

² *Id.*

³ *Id.* "Nasdaq" stands for the National Association of Securities Dealers' Automated Quotations.

⁴ *Id.*

⁵ *Id.*

⁶ Exchange Act Rule 11Ac1-1, 17 C.F.R. § 240 (2002), SEC Concept Release No. 34-38672, International Series Release No. IS-1085; Fed. Reg. 30485 (June 4, 1997). See also Regulation of Exchanges and Alternative Trading Systems, SEC Release No. 34-40760; File No. S7-12-98; 63 Fed. Reg. 70844 (Dec. 22, 1998). Effective date: April 21, 1999., available at <http://sec.gov/rules/final/34-40760.txt> [hereinafter Release No 34-40760].

⁷ *Special Study*, *supra* note 1.

⁸ Technically, ECNs do not "list" securities, they offer trading to interested parties in securities listed on other exchanges.

⁹ 17 C.F.R. § 240.

the SEC study, there were nine ECNs operating within the U.S. securities markets, Instinet arguably being the industry leader.¹⁰

ECNs provide many market services to their subscribers, which include retail investors, institutional investors, market makers, and other broker-dealers.¹¹ For example, ECN subscribers can enter limit orders into the ECN, usually through a custom computer terminal or a direct dial-up.¹² The ECN will post those orders on the system for other subscribers to view.¹³ The ECN will then match contra-side orders for execution.¹⁴ Usually, the buyer and seller remain anonymous to each other and the trade execution reports will list the ECN as the contra-side party.¹⁵ "In addition, subscribers may use features such as negotiation or reserve size, and may have access to the entire ECN book (as opposed to the "top of the book") that contains important real-time market data regarding depth of trading interest."¹⁶ Because ECNs provide significant savings in execution costs, they present international competitive challenges to established markets.

In the European Union ("EU"), securities regulations have not yet categorized these new trading systems in any of the Member States.¹⁷ Because of the driving forces in technological advances, the increasingly international character of markets, and the emergence and international use of ECNs, the SEC implemented Regulation ATS in 1998.¹⁸ The U.S. is currently the only nation to implement securities regulations addressing

¹⁰ *Special Study*, *supra* note 1.

¹¹ *Id.*

¹² *Id.* A limit order is defined as the following: [A]n order that sets a specific price (Limit Price) that is the highest a buyer will pay or the lowest a seller wants to receive. Buyer will accept price lower than limit and seller higher than limit. It may be a Day or GTC (Good Until Canceled) order. If no price is indicated, the order is a market order by default.

Zack's Glossary of Financial Terms, available at <http://my.zacks.com/education/index.php3> (last visited Jan. 25, 2001).

¹³ *Special Study*, *supra* note 1.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ As of the time of this Note, Tradepoint is the only ECN based out of the EU and operating within its markets. Tradepoint is a recognized Investment Exchange under section 37(3) of the U.K. Financial Services Act 1986. The Exchange does not have a physical trading floor, but is a screen based electronic market for the trading of securities. Tradepoint Financial Networks, Plc; Notice of Application for Limited Volume Exemption From Registration as an Exchange Under Section 5 of the Securities Exchange Act, SEC Release No. 34-40161, International Series Release No. 1144, 64 Fed. Reg. 37146 (July 9, 1998).

¹⁸ Regulation ATS categorizes ECNs as "alternative trading systems," which is defined as "any organization, association, person, group of persons, or system . . . that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange...." 17 C.F.R. § 242.300(a)(1)(2001).

ECNs.¹⁹ The SEC allows ECNS to be categorized under Regulation ATS as either broker-dealers or as a national securities exchange for regulatory purposes, depending on the desire of the ECN and the satisfaction of minimum requirements.²⁰

This note examines how ECNs are currently regulated within the European Union and how the recent move toward integration of the European securities markets requires regulatory action by the EU for efficient integration of ECN systems into their markets. In part II, this note begins by describing the background of ECNs and how these systems are revolutionizing the securities market. Part III examines the impact that ECNs have made in securities markets on a global scale. This section also assesses how new innovations have acted in concert with ECNs to achieve a Pan-European securities market integration. Next, part IV describes the recent regulatory initiatives effecting the integration of ECN technology into the international securities industry. Part V scrutinizes the concerns that have come to light as ECNs increasingly gain market share and proliferate on an international scale. Finally, part VI suggests how the EU may achieve efficient market integration. This note concludes that as the EU leads in global regulatory efforts to stimulate efficient market integration via ECNs, there are several weaknesses and unaddressed issues within these efforts.

II. BACKGROUND

Markets seek to achieve the most efficient execution for securities transactions.²¹ Efficiency in execution is conventionally achieved by promoting competition within the securities industry.²² Competition in this industry fosters positive impacts on order flow, liquidity, execution costs, and spreads.²³ The recent innovation of ECNs has stimulated increased

¹⁹ 17 C.F.R. § 242.300(a)(1)(2001).

²⁰ 17 C.F.R. § 242.300(a)(1)(2001). In rare cases, an ECN may petition the SEC to seek exemption from Regulation ATS in section 5 of the regulation if the Commission determines that "such an order is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanisms of, a national market system." 17 C.F.R. § 242.300. Tradepoint has successfully received a section 5 exemption to operate in the U.S. on a limited basis.

²¹ Jonathon R. Macey & Maureen O'Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17 (1999), available at <http://www.sec.gov/rules/concept/s71697/ohara1.htm7>.

²² *Id.* at 18.

²³ Arthur Levitt, *The Future of Our Markets: Dynamic Markets, Timeless Principles*, 2000 COLUM. BUS. L. REV. 1, 1 (2000). Liquidity is the "ability to turn an asset into cash. A highly liquid asset is easy to sell because an active market exists that sets prices which are continuously adjusted for supply and demand. An example is a listed stock or mutual fund. A less liquid asset is real estate or a collectible." Zack's Glossary of Financial Terms, available at <http://my.zacks.com/education/index.php3> (last visited Jan. 25, 2001).

concern over the issues of lower transaction costs to retail investors, reduced market impact costs, anonymity, passive pricing, specialized services, ease of access to institutional investors as well as retail investors, and expanded product ranges.²⁴ However, regulators must ensure that competitive forces in the markets do not sacrifice quality in their efforts. Thus, regulators must find a balance between beneficial regulation and market forces to achieve the most efficient market system.

However, technology has outpaced regulatory efforts on an international scale. ECNs now account for 30% of all trade volume on the NASDAQ.²⁵ In London, ECNs account for a smaller but growing percentage of trading on the London Stock Exchange. Tradepoint, established in 1996 as a for-profit exchange, currently has over eighty members, including institutions and broker-dealers.²⁶ Instinet, founded in 1969, is the largest global agency broker and arguably the leader in electronic trading technology.²⁷ Currently, Instinet is a member of twenty exchanges in North America, Europe and Asia.²⁸ Instinet offers equity trading, research, and direct electronic access to all operators in the global markets.²⁹ Recently, Instinet and Tradepoint reached an agreement to facilitate access to each other's markets (*i.e.*, U.S. investors may trade European securities on Instinet which then routes the orders through Tradepoint's system).³⁰

Existing regulations merely try to pigeonhole ECNs into conventional scopes of industry regulations. These actions have been inconsistent at best. In the EU, ECNs can practically circumvent regulatory efforts in the most regulatory EU Members by registering as an exchange in only one Member State.³¹ In the U.S., the regulations are even more peculiar. If the ECN is a domestic entity, it may register as an exchange or as a broker-dealer under Regulation ATS.³² If it is a foreign entity, it may possibly circumvent the entire registration procedure by seeking a Section 5

²⁴ *Special Study*, *supra* note 1.

²⁵ *Id.*

²⁶ Press Release, Instinet Forms Consortium to Acquire 54% of Tradepoint for 14 Million Pounds, available at http://about.reuters.com/investment/new_releases/art_6-5-1999_id142.asp.

²⁷ Instinet Corporate Information/About Instinet, available at http://www.instinet.com/corp_info/about.stml.

²⁸ Markets and Exchanges, available at http://www.instinet.com/equity_marketplace/exchanges/overview.shtml.

²⁹ *Id.*

³⁰ Press Release, Instinet Forms Consortium to Acquire 54% of Tradepoint for 14 Million Pounds, available at http://about.reuters.com/investment/new_releases/art_6-5-1999_id142.asp.

³¹ The Investment Services Directive ("ISD") in the EU, ISD/93/22/EEC, as discussed *infra* Part IV, has allowed Tradepoint to effectively bypass registration regulations of host EU Members under the "single passport" principle whereby mutual recognition of authorized exchanges is required.

³² *Special Study*, *supra* note 1; 17 C.F.R. § 242.300(a)(1)(2002).

Exemption if it meets certain low volume requirements as interpreted by the SEC.³³

Regardless of how ECNs are classified, the reality is that they operate as exchanges. The inconsistency in regulations for an industry of international character raises significant concerns that will be addressed later in this note.³⁴ Where regulatory barriers existed before, technology has facilitated access to foreign exchanges. In effect, the current situation provides for the proliferation of ECNs across borders on an international scale without adequate regulation. As ECNs continue to proliferate and gain market share, advantages and incentives will naturally arise in certain nations. For example, in the EU, ECNs may be able to provide their automated trading services within several nations by virtue of operating out of the Member State with the lowest level of regulation.

III. MARKET IMPACT

A. CURRENT MARKET STATUS

In the summer of 2000, Instinet and Tradepoint Financial Networks, plc ("Tradepoint") reached an agreement that facilitates electronic access to the securities markets across the Atlantic.³⁵ Sixteen European nations and the U.S. have obtained access to each other's equities markets by way of the agreement.³⁶ Furthermore, the recent adoption of the Euro in the EU and the permanent establishment of foreign exchange rates between Euro-adopting Member States have fueled Pan-European trading in the markets.³⁷ U.S. investors have access to 230 Continental European equities and all of the constituents of the major European indices.³⁸ It is only a matter of time before an automated currency converter is implemented into ECN systems to further facilitate international securities transactions.

Currently, the financial markets in Europe are taking further steps towards full integration with Tradepoint which is arguably at the forefront of

³³ *Special Study*, *supra* note 1 (explaining exemption criteria).

³⁴ See discussion *infra* Part IV.

³⁵ Press Release, Instinet Forms Consortium to Acquire 54% of Tradepoint for 14 Million Pounds, available at http://about.reuters.com/investment/new_releases/art_6-5-1999_id142.asp. Through a Consortium, Instinet acquired a majority interest in Tradepoint.

³⁶ The fifteen Member States of the EU and the U.S. may make securities transactions through Tradepoint or Instinet which route orders through each other's systems.

³⁷ BBC News, Business, Tradepoint, Swiss Launch Exchange, available at http://news.bbc.co.uk/1/hi/english/business/newsid_826000/826131.stm (last visited Dec. 17, 2001).

³⁸ Tradepoint Financial Networks PLC, *Tradepoint and the SWX Swiss Exchange to Create Virt-X-An exchange for pan-European bluechip stocks*, available at http://www.instinet.com/news/press_releases/pr7_11_00.shtml (last visited Apr. 17, 2002).

this augmentation.³⁹ Tradepoint announced an agreement of a new venture with SWX on July 10, 2000 in which they will form a new Pan-European blue chip exchange that will be called "virt-x."⁴⁰ Among the terms of the agreement, all trading will be conducted within a single regulatory environment supervised by the FSA.⁴¹ Tradepoint has already been designated as a Regulated Market throughout Europe under the Investment Services Directive.⁴² This designation allows it, as virt-x, to offer trading in the shares of companies listed by a competent authority or other approved organization.⁴³ The virt-x market was launched on June 25, 2001 and was completed on July 9, 2001.⁴⁴ Instinet announced that it would provide access through its systems on June 25, 2001.⁴⁵ "Virt-x will combine Tradepoint's Pan-European blue chip market . . . with SWX's highly functional EBS trading system to create a fully integrated Pan-European exchange."⁴⁶ Since the announcement of the deal, Tradepoint's average daily volumes have risen from 41 million pounds to 73 million pounds since it was launched in July.

It is anticipated that virt-x will offer its European and U.S. members the following advantages: direct trading in the constituents of all major European indices on one exchange with one rule book, an electronic

³⁹ *Id.*

Tradepoint is a Recognized Investment Exchange supervised by the Financial Services Authority and is a regulated market under the Investment Services Directive. Based in London, Tradepoint offers institutional fund managers and broker-dealers the opportunity to trade directly with each other, with equal and anonymous access to the market. Tradepoint currently provides trading in approximately 2,000 listed UK equities. Tradepoint ads approximately 230 continental European equities, supporting trading in all the constituents of the major European indices, specifically: FTSE EuroTop 300, MSCI Euro Index, MSCI Pan-Euro Index, DJ Stoxx 50, DJ Euro Stoxx 50, Dax 30, CAC 40 and MIB 30.

⁴⁰ *Id.*

⁴¹ Financial Services Authority (FSA).

⁴² ISD/93/22/EEC.

⁴³ Tradepoint Financial Networks PLC, *Tradepoint and the SWX Swiss Exchange to Create Virt-X-An exchange for pan-European bluechip stocks*, available at http://www.institutet.un/news/press_releases/pr7_11_00.shtml (last visited Apr. 17, 2002). In short, this directive allows for any exchange approved in a member state to automatically be approved as an exchange for regulatory considerations by other member states. The idea of this directive was to further financial integration within the EU by providing a cohesive framework to operate under. Council Directive 93/22, 1993 O.J. (L 141) 27, corr. at 1993 O.J. (L 170) 32 and (L 194) 27 [hereinafter *ISD*].

⁴⁴ See Press Releases, available at <http://tradepoint.co.uk>.

⁴⁵ *Instinet Expands Global Exchange Memberships; Provides Access to Virt-x*, available at http://instinet.com/news/press_releases/pr_jun25_2001.shtml 17.

⁴⁶ Tradepoint Financial Networks PLC, *Tradepoint and the SWX Swiss Exchange to Create Virt-X-An exchange for pan-European bluechip stocks*, available at http://www.institutet.un/news/press_releases/pr7_11_00.shtml (last visited Apr. 17, 2002). EBS is the name of the Swiss trading system.

anonymous order book, a fully integrated trading system, a clearing and settlement model with a central counter-party for cross border trading provided by London Clearing House, significant scope for cost savings, and multi-currency capability, among other advantages.⁴⁷

B. CURRENT MARKET TRENDS

Frits Bolkestein, the commissioner of the European Union, addressed many trends regarding the integration of the European markets and ECNs.⁴⁸ While addressing the trends, Bolkestein pointed out a major impediment towards integration: "the length of time that it takes to legislate for a European Directive means that any legislation that we draft can take three, four, sometimes five years before it is in effect in all Member States, and that is assuming that negotiations and implementation go smoothly."⁴⁹

1. Market Defragmentation

Market defragmentation in the EU is one trend that has facilitated market integration. Most EU member states have adopted the Euro, which is the major catalyst for change by enhancing the price transparency of all European markets.⁵⁰ The internet is also facilitating the process.⁵¹ Even in those Member States not part of the "eurozone" (i.e., UK, Sweden, and Denmark)⁵², many exchanges and investment service providers have moved to pricing in Euro,⁵³ thereby reducing market fragmentation.

2. Market Cooperation

Moreover, five other key trends are taking an effect. First, there has been increased cooperation between existing exchanges, leading to mergers.⁵⁴ Such mergers have the possibility of delivering additional cost-savings and enhanced performance in terms of liquidity and price-discovery. As the process of merging accelerates, and provided competition concerns

⁴⁷ Stanley Reed, *Commentary: The Battle for Europe's Blue Chips (Int'l ed.)*, BUSINESS WEEK ONLINE, (July 24, 2000), available at http://www.businessweek.com/2000/00_30/b3691196.htm.

⁴⁸ Frits Bolkestein, *Visions of the European Financial Markets* (June 9, 2000), available at http://europa.eu.int/comm/internal_market/en/speeches/spch208.htm.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ Eurozone refers to Member States that have implanted the use of the euro.

⁵⁴ Frits Bolkestein, *Visions of the European Financial Markets* (June 9, 2000), available at http://europa.eu.int/comm/internal_market/en/speeches/spch208.htm.

are overcome, the EU will be on the way to constructing markets of considerable global size and scope.⁵⁵

3. Technology Advancements

The next trend is the development of e-commerce and other technology. The number of on-line brokerage accounts in Europe is increasing rapidly.⁵⁶ These occurrences will ease the distance related impediments to investment services, without regard to national or legal boundaries.

Surveys are already showing that half of on-line brokerage companies trade on a cross-border basis and most of these are active on a number of national exchanges. Thus, there is already a blurring of boundaries between trading systems and service providers.⁵⁷ Alternative Trading Systems ("ATS") are emerging in competition with the traditional exchanges.⁵⁸ They have made less dramatic inroads in the EU than in the U.S., but they are developing in certain niche activities.⁵⁹ Bolkestein contends that the EU's concern is to ensure that the integration of ECNs does not result in an undesirable fragmentation of European liquidity, and that all trading functions providing similar services are placed on level regulatory footing.⁶⁰

4. Specialized Markets

Another trend to note is that in recent years, there has been a growing interest in more specialized markets concentrating on smaller high-risk companies.⁶¹ However, the number of companies served by these markets still remains low in the EU, with around 650 companies listed on Easdaq, AIM and Euro.NM combined in July 1999 compared to nearly 5000 companies listed on Nasdaq in the U.S.⁶² The fact remains that in terms of raising capital, and especially early-stage venture capital, the EU is still far behind the U.S.⁶³

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Frits Bolkestein, *Visions of the European Financial Markets* (June 9, 2000), available at http://europa.eu.int/comm/internal_market/en/speeches/spch208.htm.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

5. Increased Use of Financial Markets

A fourth trend to note is the way in which European households are beginning to use financial markets. Reports suggest that over 500,000 more Germans invested in securities last year than the year before.⁶⁴ Bolkestein expects the assets managed by unit trusts and other forms of collective investment to quadruple over the coming decade.⁶⁵

6. Consolidation of Clearing and Settlement

The fifth trend is that the EU is seeing the beginnings of consolidation of clearing and settlement: the high costs of clearing in Europe - currently estimated to be eight times higher than in the U.S. - are coming under the spotlight.⁶⁶ Therefore, market users are pressing for consolidation of these systems at a European level.⁶⁷ Merging firms have become among the major players in advocating for consolidation.⁶⁸

The EU has not addressed the financial market situation or the trends that Commissioner Bolkestein has enumerated. For a U.S. domiciled ECN to operate in the EU, the ECN must become registered as an exchange in a EU Member State.⁶⁹ Under current EU regulations, described *infra* in section IV, the ECN will automatically be allowed to offer its trading services throughout the EU by virtue of registering as an exchange in one Member State.⁷⁰ However, many barriers exist regarding consistent regulation of ECNs, thus impeding their efficient integration into EU markets.

IV. RECENT REGULATORY INITIATIVES

Why do we need regulation? The SEC raised some concerns while implementing Regulation ATS. The SEC stated that the inconsistencies at that time of Regulation ATS's adoption created disparities that affect investor protection and the operation of the markets as a whole.⁷¹ Without consistency, inadequate surveillance of ECNs for market fraud and

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ ISD/93/22/EEC.

⁷⁰ *Id.*

⁷¹ Release No. 34-40760, *supra* note 6.

manipulation might result.⁷² Just as this was an issue of national scale within the U.S. markets, it is a major issue within the EU markets. In order to better integrate ECNs into the international market system, the current regulatory structure needs to be modernized.

In a 1994 Discussion Paper, the Securities and Investments Board ("SIB") indicated that the current diversity of regulatory provisions applicable to trading services "is not conducive to the cost-effective achievement of regulatory coherence."⁷³ In response, the EU passed the Investment Services Directive ("ISD").⁷⁴ This directive is arguably the most important regulation in the EU affecting international securities markets.

A. THE INVESTMENT SERVICES DIRECTIVE

The ISD's major provisions are intended to provide: (1) common minimum authorization; (2) mutual recognition of the license granted in the home state by all other Member States or "host states"; (3) prudential rules establishing common minimal financial soundness standards among the Member States; (4) certain guiding principles for adoption of conduct-of-business rules by the host states; (5) direct access to each Member State's domestic stock exchange for both outside investment firms and banks; (6) requirements for concentration of securities trading in regulated markets which preserve investor choice to trade in less-regulated off-exchange markets; (7) minimum transparency rules for regulated markets; and (8) reciprocity for non-EU firms to participate in the newly integrated marketplace.⁷⁵

Although raised during the legislation of the ISD, the EU decided not to address fundamental questions regarding market structure and transactional disclosure, including: (1) whether securities markets should be divided into wholesale and retail segments; (2) whether the markets should be quote-driven and screen based or order-driven and floor-based; and (3) whether securities markets should be fully transparent, with real time reporting of price and volume information, or relatively opaque, with minimal or delayed reports to protect investment firms' market positions.⁷⁶

⁷² *Id.*

⁷³ The SIB is a private limited company, formerly reporting to the Chancellor of the Exchequer with responsibility for the regulation of the UK investment market, in accordance with the Financial Services Act 1986. It was replaced by the Financial Services Authority (FSA) in October 1997.

⁷⁴ ISD/93/22/EEC.

⁷⁵ Manning Gilbert Warren III, *The European Union's Investment Services Directive*, 15 U. PA. J. INT'L BUS. L. 181, 184 (1994).

⁷⁶ *Id.* at 183.

The decision of the EU to sidestep these issues may have parochial effects. In essence, the ISD covers two major issues: regulation of investment firms and regulation of securities markets.⁷⁷ In general, it prescribes a system of "a single passport", under which a business regulated in one Member State may conduct business in the entire EU without further regulatory requirements on behalf of host countries.⁷⁸ Two controversial issues are encompassed within this regulation. The first is the question of what is a regulated market? And second, the level of transparency is vehemently debated among Member States because of their protectionist agendas in preserving competitive advantages for domestic firms.

B. UNSETTLED ISSUES OF THE ISD

1. Regulated Markets

A regulated market is a regularly functioning securities market.⁷⁹ Being a regulated market represents a potential competitive advantage.⁸⁰ If that market wishes to operate on a community-wide basis, being "regulated" enables it to provide remote access terminals to traders in other Member States.⁸¹ Pursuant to the "single passport" principle, article 15(4) of the ISD provides that regulated markets are entitled to provide trading screens to investment firms based in other Member States without having to seek approval from the relevant foreign authority.⁸²

2. Transparency

Transparency of trading implies the scope and updatedness of available information with regard to executed trades.⁸³ The ISD's transparency provisions were also subject to intense controversy and are consequently quite vague.⁸⁴ Some parties argue that stringent transparency rules were critical to ensuring an adequate level of investor protection and to reducing risks of distortion between competing markets.⁸⁵ In a way,

⁷⁷ Amir N. Licht, Discussion Paper, *Regional Stock Market Integration in Europe* (Mar. 1997), available at http://www.cid.harvard.edu/caer2/html/framsets/fr_auth.htm.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

transparency was presented as a proxy for quality.⁸⁶ Others argue that limited secrecy regarding trading transactions was essential to the protection of market makers, and thus, of market liquidity.⁸⁷ These two positions arise because of different driving forces in European markets.⁸⁸

For example, in a typical order-driven market, a high level of transparency may improve the market's functioning as a price discovery mechanism.⁸⁹ On the other hand, in a typical quote-driven market, dealers commit capital to provide liquidity.⁹⁰ Full transparency would undermine their ability to unwind positions they are obliged to take as market makers.⁹¹ By publicizing their exact position they would make themselves vulnerable to trading in adverse conditions.⁹² Transparency in this context includes the timely display of orders, market depth, and last sale reporting.⁹³ If minimum transparency standards are not required, an ECN might lack transparency and inhibit the pricing discovery process or create unfair informational advantages.⁹⁴ ECN operations should be subject to transparency standards appropriate to their operations. However, it must be recognized that complete transparency in relation to, for example, institutional-size orders may be counter-productive.⁹⁵

From an international perspective, transparency will come to play a vital role in the integration of ECNs. There is currently no international standard on regulation of ECNs. Tradepoint, an exploding electronic exchange in the UK, is the first ECN type of company to cross international waters into the U.S. by way of a Section 5 exemption in which it registered as a low-volume exchange.⁹⁶ Securities regulators attempt to classify ECNs

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Regulation of Alternative Trading Systems in Europe*, Fesco/00-064c (Sept. 2000), available at <http://www.europefesco.org/documents/recentpub/00-064c.pdf>.

⁹⁵ Amir N. Licht, Discussion Paper, *Regional Stock Market Integration in Europe* (Mar. 1997), available at http://www.cid.harvard.edu/caer/2/html/framsets/fr_auth.htm.

⁹⁶ Order Granting Limited Volume Exemption from Registration as an Exchange Under section 5 of the Securities Exchange Act, SEC Release No. 34-41199, International Series Release No. 1189, 64 Fed. Reg. 14953, 14956 (Mar. 29, 1999). A Section 5 Exemption allows for an exemption under Section 5 from registration as a national securities exchange under Section 6 of the Securities Exchange Act of 1934 ("Exchange Act") on the basis of expected low volume. Under the proposed Exemption, the Exchange would be exempt so long as (i) the average daily dollar value of trades (measured on a quarterly basis) involving a U.S. Member did not exceed \$40 million, and (ii) its worldwide average daily volume (measured on a quarterly basis) did not exceed ten percent of the average daily volume of the LSE [London Stock Exchange]. The limitation on the Exchange's worldwide trading volume would ensure that the Commission could

through current regulations instead of addressing them head-on. The U.S. has incorporated Regulation ATS and the U.K. has registered Tradepoint as an exchange, in which it thus obtains all the benefits of an exchange via the ISD.⁹⁷

3. Reciprocity of ISD Provisions

The ISD provides for reciprocity among Member States.⁹⁸ Foreign ECNs may possibly infiltrate EU markets by complying with the "national treatment" approach imposed by the ISD.⁹⁹ To satisfy the national treatment condition, the non-EU country must provide EU investment firms the same competitive opportunities available to domestic investment firms.¹⁰⁰ The ISD also provides for continuing review to determine whether non-EU states are providing national treatment and "effective market access" to EU firms.¹⁰¹ These provisions raise the question as to whether an ECN is a bona fide investment firm as interpreted by the EU. Additionally, questions arise regarding the level of discretion provided by the terms "national treatment" and "effective market access."¹⁰²

(A) Investment Firm Classification

As interpreted by the EU, the term "investment firm" is defined to include "any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis."¹⁰³ Investment services includes: (1) the reception and transmission of orders on behalf of investors as well as the execution of those orders; (2) dealing for one's own account; (3) managing portfolios for a discretionary client-by-client basis; (4) underwriting or placing issues.¹⁰⁴ These services must relate to certain investment instruments according to the annex of the ISD.¹⁰⁵ These instruments include: (1) transferable securities and mutual fund units; (2) money market instruments; (3) financial futures contracts; (4) forward

reevaluate the appropriateness of the low volume exemption should the Exchange achieve significant volume relative to the LSE. SEC Release 34-40161; see also *supra* note 17.

⁹⁷ ISD/93/22/EEC.

⁹⁸ Warren, *supra* note 75, at 216.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* at 194.

¹⁰⁴ *Id.* at 195.

¹⁰⁵ *Id.*

interest rate agreements; (5) interest-rate, currency and equity swaps; and (6) options to dispose or acquire any of the covered instruments.¹⁰⁶

(B) Exchange Classification

Under the EU's definition of investment firm, ECNs assuredly qualify as such. However, Tradepoint is classified as an exchange in London.¹⁰⁷ In the U.S., Tradepoint has received a Section 5 exemption enabling it to operate as a low-volume exchange.¹⁰⁸ Due to the inherent operations of Tradepoint as an ECN, it is also an investment firm. Thus, within the EU, a discrepancy arises as to whether an ECN is an investment firm or an exchange.¹⁰⁹ Seemingly, Tradepoint is the only ECN licensed as an exchange that is taking advantage of the ISD to offer Pan-European services.

4. EU Regulatory Framework Creates a Barrier to Market Entry for Foreign ECNs

ECNs foreign to the EU have yet to penetrate the EU markets. Potential barriers to the entry of foreign ECNs include the EU's discretionary use of the terms "national treatment" and "effective market access."¹¹⁰ These two terms, encompassed within the ISD, are quite ambiguous. For example, does the SEC's granting of a Section 5 exemption qualify as giving EU based ECN's "national treatment" or "effective market access" under these definitions?

This possibility seems unlikely. The SEC's Section 5 Exemption allows Tradepoint to operate as a low-volume exchange.¹¹¹ The restrictions applied to Tradepoint do not exist for domestic ECN's. Domestic exchanges may operate under Regulation ATS as either exchanges or broker dealers.¹¹² The Section 5 exemption was based on a calculated ratio of transactions

¹⁰⁶ *Id.* at 196.

¹⁰⁷ Tradepoint Financial Networks PLC, *Tradepoint and the SWX Swiss Exchange to Create Virt-X-An exchange for pan-European bluechip stocks*, available at http://www.institutet.un/news/press_releases/pr7_11_00.shtml (last visited Apr. 17, 2002).

¹⁰⁸ SEC Release No. 34-41199, *supra* note 96, at 14953.

¹⁰⁹ In most EU jurisdictions, ECN's have the choice of being licensed either as an exchange or as an investment firm. Where an ATS operator seeks investment firm status, it is subject to a regime that focuses predominantly on investor protection. ATS operators that apply for exchange licensing are subject to regulation more focused on market integrity. See Regulation of Alternative Trading Systems in Europe, *supra* note 94, at 24.

¹¹⁰ Warren, *supra* note 75, at 217.

¹¹¹ SEC Release No. 34-41199, *supra* note 96, at 14953.

¹¹² 17 C.F.R. § 242.300(a)(1)(2001).

through Tradepoint with the transactions executed through the LSE.¹¹³ The basis of low volume was not in respect to transactions on an U.S. exchange.¹¹⁴ As stated in section I, ECNs in the U.S. combined provide for over 30% of all volume on the Nasdaq.¹¹⁵ This share of the volume is a considerable amount more than the counterpart in the EU.

However, the EU does not provide for any exemptions within its Member States. Thus, a question arises as to whether the granting of a section 5 exemption to Tradepoint, actually allowing it to operate as an exchange within the U.S., qualifies as "national treatment" to allow non-EU ECNs to operate within the EU. Within the current regulatory framework, Tradepoint is the only ECN operating within the EU and it is classified as exchange in London as explained *supra*. Since EU officials have not directly addressed how they will regulate ECNs within the EU, the regulation of Tradepoint provides the only guide to non-EU ECN's contemplating operations within the EU.

Currently, the regulatory framework is arguably inefficient. The barriers to entry described within the regulatory framework considerably hinder open and efficient competition. Tradepoint is unable to efficiently compete with U.S. domiciled ECNs due to the low-volume restrictions. Non-EU ECNs seem to have to register as an investment firm by way of first becoming an exchange within a Member State. Non-EU ECNs currently gain access to foreign markets either by incorporating and capitalizing an EU subsidiary in one of the EU nations or by creating an affiliation with EU investment firms so that they can indirectly operate within the EU.¹¹⁶ These methods are undoubtedly inefficient. The cost for registering as an exchange, and compliance costs associated with these operations in every Member State individually, is a high barrier to entry for foreign competitors.

If the EU implemented a regulation such as Regulation ATS, foreign ECNs may still not qualify under its "national treatment" standard. The EU would have an incentive to impose limitations on the volume of the ECNs since the SEC has restricted volume on Tradepoint's operations. Thus, non-EU ECN's seeking operations within the EU need to assess this potential low-volume barrier to participating in EU markets.

¹¹³ SEC Release No. 34-41199, *supra* note 96, at 14957. The SEC found that the transactions executed through Tradepoint accounted for less than 1% of the transactions executed on the LSE.

¹¹⁴ *Id.*

¹¹⁵ *Special Study*, *supra* note 1.

¹¹⁶ Warren, *supra* note 75, at 217. Instinet has succeeded in this endeavor. This U.S. company uses a combination of the described procedures to tap into EU markets. See Press Release, Instinet Forms Consortium to Acquire 54% of Tradepoint for 14 Million Pounds, available at http://about.reuters.com/investment/new_releases/art_6-5-1999_id142.asp.

The international discrepancies in regulatory efforts raise several concerns regarding competition and efficiency within the securities industry. Regulatory efforts in the EU are the most stifling since they have yet to provide an alternative to ECNs.

V. OTHER CONCERNS

With different regulations among Member States, the ECNs may suffer from "race to the bottom phenomena" within the EU.¹¹⁷ ECNs will have incentive to migrate to countries with lower standards through "regulatory arbitrage."¹¹⁸ Many concerns are included in this possibility. Among them are concerns of market fragmentation/reduced liquidity, increased systemic risk, absence of self-regulatory program/unfairness, and lack of coordination with exchange markets.¹¹⁹

A. MARKET FRAGMENTATION/REDUCED LIQUIDITY

The fragmentation concern is that trading interest might be split widely among multiple exchanges and ECN operations, "resulting in a loss of the liquidity that would otherwise be provided by a central market."¹²⁰ Similar concerns have arisen with multiple exchanges in a single jurisdiction (e.g., Hong Kong prior to 1986, Australia, and a number of European markets) where a consolidation was later made or is being considered.¹²¹

B. INCREASED SYSTEMIC RISK

The systemic risk concern arises where an ECN becomes of sufficient size and importance that its operational or financial failure could materially disrupt the market.¹²² Similar concerns exist with exchange markets, clearinghouses, brokers, and banks.¹²³ In all of these areas, the applicable regulatory regimes should impose minimum standards of

¹¹⁷ "Race to the bottom" refers to the situation where regulations become more relaxed and less costly in comparison to other jurisdictions in order to attract businesses from other competing jurisdictions.

¹¹⁸ "Regulatory Arbitrage" refers to a situation where companies seek jurisdictions with laws more favorable to their interests.

¹¹⁹ Consultation Paper, *Report of the SFC Working Group on Automated Trading Systems*, section 5.13 (Feb. 1997), available at <http://www.hksec.org.hk/eng/consult/003.htm> (last visited Dec. 17, 2000).

¹²⁰ *Id.* at 5.14.

¹²¹ *Id.*

¹²² *Id.* at 5.17.

¹²³ *Id.*

operational and financial capabilities appropriate to the functions performed.¹²⁴

C. ABSENCE OF SELF-REGULATION/UNFAIRNESS

Many exchanges act as self-regulatory organizations, meaning they are responsible in the first instance for regulating their market and members.¹²⁵ An ECN that is not an adequate self-regulator or is not otherwise subject to adequate regulatory oversight may thus lack integrity.¹²⁶ This concern also raises an issue of fairness. The operation of a self-regulatory program entails considerable expense. On the other hand, exchanges generate significant revenue from listing fees, sale of transaction data, and membership fees.¹²⁷ In the view of some, these revenues may offset an exchange's self-regulatory obligations.¹²⁸ Thus, the regulatory authority should be vigilant to ensure that ECN operations do not enjoy unfair or inappropriate advantages in relation to the functions they perform versus those of exchange markets.¹²⁹

D. LACK OF COORDINATION

"The coordination concern, for example, relates to situations where an exchange temporarily suspends trading in a stock pending a company announcement, but an ECN continues trading."¹³⁰ Similarly, 24-hour trading in an ECN environment may not be subject to the same information disclosure requirements as exchange trading.¹³¹ In this regard, and depending on the circumstances, it may be desirable for ECN operators to disclose that the home market may be suspended or subject to a corporate announcement.¹³² Depending on the sophistication of users of the ECN, it also may be desirable for the ECN to suspend trading in line with the exchange market.¹³³ This would likely be required by the exchange if the ECN operator were an exchange member. However, this would be difficult where the ECN provides trading services in foreign shares where the home

¹²⁴ *Id.*

¹²⁵ *Id.* at 5.18.

¹²⁶ *Id.*

¹²⁷ *Id.* at 5.19.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 5.20.

¹³¹ *Id.*

¹³² *Id.* at 5.21.

¹³³ *Id.*

market for the shares is not mature and the ECN operator is not a member of the exchange in that market.¹³⁴

VI. CONCLUSION: POSSIBLE SOLUTIONS TO EFFICIENT INTEGRATION

The EU must approach integration with the protection of investors as the primary objective. A possible means of achieving efficient integration is adopting a comprehensive approach to transparency, whereby all trading systems should be subject to transparency requirements to a standard acceptable to all Member States of the EU. Implementing such a standard would require a comprehensive approach to trade reporting and surveillance whereby the regulatory system must have overall arrangements which fosters confidence that trading activities will be tracked and monitored in a way which will enable detection of market abuse and misconduct.¹³⁵ The regime for non-exchange trading systems must ensure similar standards of conduct for users of these systems as for users of exchanges. However, establishing similar standards could be the responsibility of self-regulatory organizations or an organization with power delegated by the EU, rather than the responsibility of the system operator. Finally, regulators will have to keep in mind the different driving forces among the markets, some are quote driven and others are order-driven.

Open competition will only get integration so far in the EU. Currently, ECNs only have a door open through the UK. By way of the Investment Services Directive, ECNs may operate as a Pan-European ECN as long as they become a registered exchange in a Member State (e.g., as Tradepoint has done in the UK). Thus, open competition in the EU markets is severely limited in contrast to the more efficient open competition system in the U.S. If the EU is to achieve true market integration, regulatory efforts will need to be implemented even if only temporary in nature.

¹³⁴ *Id.*

¹³⁵ *Id.*

TRADEMARK LAW & ENFORCEMENT IN CHINA: A TRANSNATIONAL PERSPECTIVE

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I. INTRODUCTION

Deng Xiaoping's¹ effort to encourage the economic development of the People's Republic of China has made China, with a population of more than one billion consumers, a magnet for international companies as well as counterfeiters of their products. International companies have been eager to enter and service this vast market, but some have found much to their surprise, that their goods are already available in China – or at least counterfeits of their goods.²

Issues surrounding the transfer of intellectual property across national borders have provoked intense discussions during the last three decades.³ At the core is the desire to obtain protected intellectual property quickly and inexpensively irrespective of its current holders' proprietary rights and profit motives.⁴ Particularly with regard to developing countries, some commentators have pointed out that the necessity of intellectual property represents a fundamental paradox because those countries cannot afford it.⁵ However, a country hungry for technology learns quickly that the engine that drives technological advancement is the effective protection of intellectual property rights. The People's Republic of China is such a country.

China has reached a stage in its development where it increasingly recognizes the value of a strong intellectual property protection regime. The country aspires, as part of its drive for even faster economic development, to join the league of industrialized countries with such regimes. In recent years, China has made bold strides to reform its domestic intellectual property legislation, and thus making its shores safer for foreign trademarks, patents, and copyrights. The country has also, within a remarkably short

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¹ Deng Xiaoping, now deceased, was the former Secretary General of the Communist Party of the People's Republic of China.

² Stuart C. McCormack, *The Trademark Forum: Counterfeits in China*, 77 TRADEMARK REP. 133, 133 (1987).

³ RALPH H. FOLSOM ET AL., INTERNATIONAL BUSINESS TRANSACTIONS 720 (3rd ed. 1995).

⁴ *Id.*

⁵ See, e.g., Scott A. McKenzie, *Global Protection of Trademark Intellectual Property Rights: A Comparison of Infringement and Remedies Available in China versus the European Union*, 34 GONZ. L. REV. 529, 552 (1998-1999).