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NOTE

Bucking the Trend: The Unsupportability of Index Providers' Imposition of Licensing Fees for Unlisted Trading of Exchange Traded Funds

I. INTRODUCTION

Exchange traded funds (ETFs) are popular investment products that have recently generated substantial investment press, several new regulations, huge earnings for the securities markets, and potential legal conflicts that will likely lead to major litigation. ETFs are derivative securities that represent ownership in funds, unit investment trusts, or depositary receipts with portfolios of securities designed to track the performance and dividends of specific securities indices.[1] ETFs track indices by holding a representative sampling of securities in the index, thus approximating investment results of the index as a whole.[2] They may or may not hold all the stocks in a

1. There will inevitably be discrepancies between the performance of the index and the ETF. *See, e.g.*, Prospectus: Standard & Poor's Depositary Receipts (SPDRs) A-3 (Jan. 26, 2000) [hereinafter Spiders Prospectus] ("[T]he market price of each individual SPDR may not be identical to the net asset value of such SPDR."), http://www.nasdaq.com/reference/prospectus_spy.pdf. The funds are designed, however, to track indices with a low level of error, perhaps less than five percent. *See, e.g.*, Exchange Act Release No. 34-46,299, 67 Fed. Reg. 51,907, 51,914 n.25 (Aug. 9, 2002) ("As with its Equity ETFs, Barclays represents that the [fixed income] Funds will have a tracking error relative to the performance of their respective underlying indices of no more than 5%.").

2. *See* Spiders Prospectus, *supra* note 1, at A-2 ("The SPDR Trust holds all of the common stocks of the Standard & Poor's 500 Composite Stock Price Index (S&P 500 Index) and is intended to provide investment results that, before expenses, generally correspond to the price and yield performance of the S&P 500 Index."); Vanguard Total Stock Market VIPERs, 5 (May 24, 2001) [hereinafter VIPERs Prospectus] ("Some index funds hold *each* stock found in their target indexes [sic] in about the same proportion as represented in the indexes [sic] themselves. This is called a 'replication' method. . . . [T]he Vanguard Total Stock Market Index Fund uses a 'sampling' technique.") http://www.nasdaq.com/reference/prospectus_vipers.pdf; Prospectus: Nasdaq-100 Trust, Series 1, Nasdaq-100 Index Tracking Stock, A-1, (Jan. 31, 2003), [hereinafter

particular index in weighted proportion.[3] Exchange traded funds, while conceptually similar to mutual funds, trade more like common stock because their net asset value is determined throughout the day.[4] A mutual fund's net asset value is determined at the end of the trading day after the fund manager has made his trades.[5] Exchange traded funds, however, trade rapidly in response to changes in the value of fund components and "changes in prices of options and futures contracts on the funds."[6] A large enough bloc of ETF shares, called a "creation unit," may be exchanged for stock in the companies forming the tracking portfolio.[7] Exchange traded funds are popular with investors because they offer a diversified, low-cost, tax-efficient method of investing.[8]

There are several players in the ETF market: the index provider, the ETF creator and issuer, the securities markets, and the

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QQQ Prospectus] ("The Trust holds all of the common stocks of the Nasdaq-100 Index (the "Index") and is intended to provide investment results that, before expenses, generally correspond to the price and yield performance of the Index."), http://www.nasdaq.com/reference/prospectus_qqq.pdf; *see also*, SEC Notices, 67 Fed. Reg. 51,916, 51,917 (Aug. 9, 2002) (describing how the iShares Russell Funds track the securities in the underlying index through a "passive" or indexing approach); Exchange Act Release No. 34-46,298, 67 Fed. Reg. 51,614, 51,614-15 (Aug. 8, 2002) (stating that iShares tracks the Morgan Stanley Capital International Japan Index through "portfolio sampling").

3. *See, e.g.*, Spiders Prospectus, *supra* note 1, at A-3 (stating that the securities are adjusted "to conform to periodic changes in the identity and/or relative weightings of the S&P 500 Index Stocks"); VIPERs Prospectus, *supra* note 2, at 5 (stating that the Fund's advisers choose a "representative sample of stocks . . . that resembles the index in terms of industry weightings").

4. Exchange Traded Fund—ETF, *at* http://www.investopedia.com/terms/e/etf.asp (last visited Feb. 21, 2004).

5. *See id.*

6. Exchange Act Release No. 34-45,246, 67 Fed. Reg. 1527, 1528 (Jan. 11, 2002).

7. *See, e.g.*, Spiders Prospectus, *supra* note 1 at A-2 ("SPDRs can be redeemed only by tendering to the Trust 50,000 SPDRs. . . ."); Prospectus: Diamonds Trust, Series 1 at A-2 (Feb. 23, 2000) [hereinafter Diamonds Prospectus], http://www.nasdaq.com/reference/prospectus_dia.pdf; QQQ Prospectus, *supra* note 2 at A-1; *see also* Exchange Act Release No. 34-46,306, 67 Fed. Reg. 51,916, 51,918 n.14 (Aug. 9, 2002) ("The Commission notes tbat unlike typical open-end investment companies, where investors have the right to redeem their fund shares on a daily basis, investors in ETFs can redeem them in creation unit size aggregations only."); Exchange Act Release No. 34-43,926, 66 Fed. Reg. 9731, 9732 (Feb. 9, 2001) (noting in connection with the Boston Stock Exchange that an ETF based on the S&P Global 100 "can only be redeemed in Creation Units of 50,000 Fund Shares, principally in-kind for a specified portfolio of stocks held by the Fund then comprising the Deposit Securities"); Exchange Act Release No. 34-46,299, 67 Fed. Reg. 51,907, 51,909 (Aug. 9, 2002) (noting in connection with the NYSE that iShares will be issued in groups of 50,000 or more called Creation Unit Aggregations and only Creation Unit Aggregations may be redeemed).

8. "These products are a dream—for financial service marketers and for. . . investors alike. . . . They are low-cost, tax efficient, provide ample diversification among groupings of large businesses, and they are among the least time consuming of all investing strategies." Bill Mann, *The Age of the Exchange Traded Fund*, MOTLEY FOOL, FOOL.COM, *at* http://www.fool.com/news/foth/2000/foth000721.htm.

individual investors. Each stands to profit tremendously from the popularity of these products. The free-market structure designed by Congress, however, makes it nearly impossible for index providers to maintain financial interests in ETFs based on their indices. This Note examines the difficulties that arise when index providers nonetheless attempt to maintain a financial interest in ETFs based on their indices by charging licensing fees to secondary exchanges that sell ETFs. Consideration of these problems leads to a surprising conclusion: the index providers' practice of imposing licensing fees on secondary exchanges for ETFs is without support in market regulation law, trademark law, or economic policy. Without a clear basis for imposing the licensing fees, the fees are an unjustified burden ultimately borne by the investing public. The current practice should not be tolerated by exchanges that presently pay such fees.

Part II of this Note examines the history of exchange traded funds, the concept of unlisted trading privileges, and their interrelation in the current competitive landscape of the ETF market. The legislative history of the Unlisted Trading Privileges Act of 1994 (UTP Act) shows that Congress intended to eliminate procedural formalities and encourage inter-market competition for efficiency.[9] The latter purpose is apparent in the current environment, as inter-market competition for ETFs can be seen driving efficiency. Part III argues that the current practice of imposing licensing fees on secondary exchanges is contrary to the congressional policies embodied in the UTP Act. Part IV contends that a trademark-based, intellectual property argument for licensing fees, while intuitively appealing, does not withstand scrutiny because (1) index providers do not have a protectable interest in their marks as used in ETFs on secondary exchanges and (2) even if index providers could establish a protectable interest, secondary exchanges can defend on the ground that they are making a fair use of the index providers' marks. Part V examines possible economic justifications for the imposition of licensing fees on secondary exchanges. For example, the negative effects of market fragmentation might suggest that index providers should employ licensing fees to control the circumstances of ETF trading. Professors Amihud and Mendelson argue that securities issuers, having a clear incentive to increase the liquidity of their claims, should be the sole determiners of where and how those claims are traded.[10] Part V then responds to the application of Amihud and Mendelson's argument, concluding that such application cannot justify

9. H.R. REP. NO. 103-626 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299.

10. *See infra* section V.B.

licensing fees. Ultimately, secondary-exchange licensing fees are not supportable under current law. Furthermore, there is no reason to change the law to accommodate such licensing fees because the economic policy arguments are ultimately not compelling. Absent these justifications, the burden such licensing fees place on the market and the investing public should not be tolerated.

II. BACKGROUND

A. History of Exchange Traded Funds

In the early 1990s, Nathan Most, a product development specialist at the American Stock Exchange (Amex), wanted to create an investment fund that traded like a stock but was also a depositary receipt for the shares in the fund.[11] Although the Investment Company Act of 1940 did not contemplate such a creature, the first ETF, Spiders, was carefully designed and issued in 1993.[12] Exchange traded funds are issued by a fund that invests in a portfolio of securities designed to provide investment results that attempt to track the total return of the underlying security index.[13] Since 1993, the market for ETFs has grown to more than 120 products with total assets valued near $80 billion.[14] The vast majority of ETFs are listed on the Amex,[15] and some, like Spiders, were even created by that

11. Bruce Kelly, *Spider-Woman Sees Funds Take Hold on Wall Street; Active Management Next Thread,* CRAIN'S N.Y. BUS., Aug. 6, 2001, at 13; Bruce Kelly, *ETFs: Bliss for This Spider-Woman*, INVESTMENT NEWS, July 30, 2001, at 1 [hereinafter Kelly, *ETFs*].

12. Kelly, *ETFs*, *supra* note 11. For example, because the ETF is essentially a hybrid between a stock and a mutual fund, the Amex legal team had to determine whether the ETF would be treated like a mutual fund or a stock. *Id.* at 2. Investors receive a prospectus when they buy shares in a mutual fund, but the minute to minute trading of ETFs might have rendered such a requirement cost prohibitive. *Id.* Regulators had to be convinced that adequate disclosure could be made to investors without requiring a full prospectus whenever shares in an ETF were purchased. *See id.*

13. To be clear, this fund is the creator and issuer of the shares in the ETFs, not the index provider. For example, Diamonds are issued by the DIAMONDS Trust, but the prospectus disclaims: "The Trust, based on the DJIA, is not sponsored, endorsed, sold, or promoted by Dow Jones. . . ." Diamonds Prospectus, *supra* note 7, at A-1; *see also* Spiders Prospectus, *supra* note 1, at A-1 ("The Trust . . . is not sponsored by or affiliated with Standard & Poor's or the McGraw Hill-Companies, Inc."); ETF Advisors Trust, Exchange Act Release No. IC-25,725, 67 Fed. Reg. 57,464, 57,464 (Sept. 10, 2002) (describing an investment company's SEC application for certain exemptions from the Investment Company Act of 1940 to create a fixed-income ETF based on various Ryan Treasury indices).

14. Kelly, *ETFs*, *supra* note 11.

15. For example, in May 2002, the Amex listed 117 of 119 ETFs. Andrew Brent, *Competition for ETF Market Heats Up: NYSE, AMEX Waive Fees to Attract Listings*, MUTUAL FUND MARKET NEWS, May 6, 2002 (quoting Bob Rendine, senior vice president at the Amex).

exchange.[16] Among the most popular ETFs are Spiders, based on the Standard & Poor's 500 index; Diamonds, based on the Dow Jones Industrial Average; and Vanguard's VIPERS, tracking the Wilshire 5000 Total Market Index.[17] The QQQ, which tracks the Nasdaq-100 index,[18] is the most liquid security in the United States.[19] It was created by Nasdaq and then licensed to the Amex until June 2005, when it was expected to return to Nasdaq after that market had become a national exchange.[20] The competition in the burgeoning ETF market is fierce. To fully understand the current competitive environment, however, it is necessary to first examine the concept of unlisted trading privileges.

B. Unlisted Trading Privileges

1. Introduction

The general rule is that an exchange may not trade a security unless it is listed on that exchange.[21] The Securities Exchange Act, however, provides for a concept known as unlisted trading privileges (UTP).[22] Simply put, any security listed on one registered national exchange (or the Nasdaq) can be traded on any other exchange

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16. Spiders Prospectus, *supra* note 1, at Front Cover (identifying SPDR sponsor PDR Services LLC as "Solely Owned by American Stock Exchange LLC").

17. *Id.*; Diamonds Prospectus, *supra* note 7, at Front Cover; VIPERs Prospectus, *supra* note 2, at 2.

18. QQQ Prospectus, *supra* note 2, at Front Cover. The Nasdaq-100 Index is composed of the one-hundred largest nonfinancial companies on the Nasdaq, divided into the following nine Industry Groups, in descending order of weight: computer and office equipment, computer software/services, telecommunications, retail/wholesale trade, biotechnology, health care, services, manufacturing, and transportation. Nasdaq-100, Nasdaq-100 Index Tracking Stock, http://www.nasdaq.com/asp/indexshares.asp?symbol=QQQ (last visited Feb. 21, 2004). The top ten holdings of the QQQ are, in descending order of weight: Microsoft Corp., Intel Corp., Cisco Systems Inc., Qualcomm Inc., Nextel Communications, Inc., Amgen Inc., Dell Inc., Comcast Corp., eBay Inc., and Oracle Corp. *Id.*

19. SEC Notices, 67 Fed. Reg. 9489, 9490 (Mar. 1, 2002) (proposing to increase the fees for its index information, because, in part, the ETFs "based on the NASDAQ 100 Index is the United States' most heavily traded ETF, averaging over 60 million daily share volume").

20. QQQ Prospectus, *supra* note 2, at Front Cover (identifying sponsor Nasdaq Financial Products Services, Inc. as "owned by The Nasdaq Stock Market, Inc."); Isabelle Clary, *Island Sets ECN Record for QQQs Volume*, SEC. INDUSTRY NEWS, Mar. 25, 2002. The term "ECN" is an acronym for electronic communications network. ECNs function as securities markets. *See infra* notes 88-90 and accompanying text.

21. 15 U.S.C. § 78*l*(a) (2000).

22. § 78*l*(f).

pursuant to unlisted trading privileges.[23] The UTP mechanism frustrates what would otherwise be a very profitable strategy for the national exchanges, i.e., to be the only place where a certain popular security could be traded. This strategy will hereinafter be referred to as "substantive competition." The alternative to substantive competition is "efficiency competition," which occurs when multiple exchanges offer the same product and must consequently compete for order flow by offering it at a better overall price. Using this terminology, unlisted trading privileges frustrate substantive competition and force exchanges into efficiency competition with each other. If a security is popular enough, other exchanges will exercise their unlisted trading privileges to offer it despite not having the benefit of listing fees.[24] The resultant competition will not be for another unique product, but for order flow in the shared product. Orders will flow to the exchange that can provide a more efficient and liquid market for the particular security.[25] Competition has in fact led to more efficient markets. As Brandon Becker, Director of the SEC's Market Regulation Division, observed, "[t]he introduction of new technologies that benefit investors has been the result of competition between and among markets and market participants."[26] Inter-

23. § 78*l*(f)(1). The text simply provides that "[n]otwithstanding the preceding subsections of this section, any national securities exchange, in accordance with the requirements of this subsection and the rules hereunder, may extend unlisted trading privileges to (i) any security that is listed and registered on a national securities exchange, subject to subparagraph (B); and (ii) any security that is otherwise registered pursuant to this section, or that would be required to be so registered except for the exemption from registration provided in subparagraph (B) or (G) of subsection (g)(2) of this section, subject to subparagrapb (E) of this paragraph." *Id.* The exchange that has the listing agreement with the issuer is the "primary exchange." The exchange that trades a security pursuant to unlisted trading privileges is the "secondary exchange."

24. See infra notes 66-73 where the New York Stock Exchange (NYSE) did precisely this, determining that the QQQ was too popular and potentially lucrative not to offer it.

25. To offer a concrete example, if Security A is listed on tbe NYSE, it can be traded on the National Stock Exchange (NSE), Chicago Stock Exchange (CHX), Pacific Stock Exchange (PCX), Philadelphia Stock Exchange (Phlx), or Boston Stock Excbange (BSE) pursuant to the UTP. Because Security A can be purchased in any of a number of different markets, there will be inter-market competition over providing a better trading experience, faster execution, tighter spreads, lower transaction fees, etc. If Security B is available only on the NYSE, there is no competition that will force the NYSE to become more efficient in these areas vis-à-vis Security B.

26. *See Financial Markets and Trading Privileges: Hearing on H.R. 4535 Regarding the Market 2000 Report and the Unlisted Trading Privileges Act of 1994 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce,* 103d Cong. (June 22, 1994) [hereinafter Becker Congressional Testimony] (testimony by Brandon Becker, Director, Division of Market Regulation, SEC), *available at* 1994 WL 14189229; *see also Financial Markets and Trading Privileges: Hearing on H.R. 4535 Regarding the Market 2000 Report and the Unlisted Trading Privileges Act of 1994 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce,* 103d Cong. (June 22, 1994) [hereinafter Ketchum Congressional Testimony] (testimony of Richard Ketchum, Executive Vice President and Chief Operating

market competition is perhaps the best way to create an investor-friendly marketplace.[27]

2. Legislative History of the Unlisted Trading Privileges Act of 1994

Congress specifically addressed unlisted trading privileges with the Unlisted Trading Privileges Act of 1994.[28] The legislative history of that act describes the role Congress envisioned unlisted trading privileges would play in the market. Prior to 1936, exchanges were free to trade any security whether it was listed or unlisted with very little oversight or regulation.[29] The Securities Exchange Act of 1934 was amended in 1936 to eliminate this practice, except as provided in section 12(f).[30] As originally envisioned in 1936, the national exchanges would have to apply to the Securities and Exchange Commission for permission to exercise their unlisted trading privileges for each security.[31] There was also a statutory minimum of ten days for notice and opportunity for hearing while the SEC examined each application.[32] Under the system envisioned, a national exchange generally had to wait between forty-five and sixty days to extend UTP to every single security.[33] The effect was to provide the listing exchange with a monopoly over the trading of that security while the other exchanges waited for SEC approval of their UTP application.[34] When the secondary exchanges finally entered the market for a particular security, the listing exchange had a competitive advantage due to the initial, yet temporary, monopoly. As Richard Ketchum of NASD, Inc. testified before Congress: "It is during these first few weeks (within the forty-five to sixty day application period) that expectations are set about the competitiveness of the

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Officer, National Association of Securities Dealers, Inc.) (agreeing with Becker testimony), *available at* 1994 WL 14189248.

27.

> "The [National Association of Securities Dealers ("NASD")] strongly believes that tbe best markets for investors result from vigorous, fair competition. [The NASD] support[s] a presumption of free and open competition among all markets, unless a strong reason can be found to rebut that presumption. . . . [The UTP Act] promotes competition in the marketplace by allowing the regional stock exchanges to compete for order flow with the listing exchange and the third market. . . ."

Ketchum Congressional Testimony, *supra* note 26; *see also infra* section V.A.

28. Pub. L. No. 103-389, 108 Stat. 4081 (1994) (codified at 15 U.S.C. § 78*l*(f)).

29. H.R. REP. NO. 103-626, at 2 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299, 3300.

30. *Id.*

31. *Id.* at 2-3, *reprinted in* 1994 U.S.C.C.A.N. at 3300-01.

32. *Id.* at 3, *reprinted in* 1994 U.S.C.C.A.N. at 3301.

33. *Id.* at 4, *reprinted in* 1994 U.S.C.C.A.N. at 3302.

34. *Id.* (describing this as the "principal effect" of the old UTP application procedure).

various markets for that security's trading, and will thus influence where orders for that security will be traded in the future."[35] The SEC application procedure unquestionably had substantive effects on inter-market competition.

The application procedure outlined in the 1936 amendments to the Securities Exchange Act quickly became a mere formality, however. No UTP application was disapproved by the SEC after 1939.[36] The Commission processed hundreds of UTP applications each year, approving every one of more than 1,600 filed in 1993.[37] Virtually no comments were submitted by interested parties from 1983 to 1993.[38] While some issuers continued to assert an interest in where their securities were traded, the SEC had only to find that the extension of UTP would be "consistent with the maintenance of fair and orderly markets and the protection of investors" in order to force an issuer to accept unwanted UTP of its securities.[39] In *Ludlow Corp. v. SEC*, for example, Ludlow argued that it would be injured by the Boston Stock Exchange's (BSE) unlisted trading of Ludlow shares.[40] Ludlow argued that unlisted trading on the BSE might destabilize trading in Ludlow stock on the New York Stock Exchange (NYSE), where it was listed, thereby impairing Ludlow's ability to raise equity capital in the future.[41] Despite finding an injury-in-fact to Ludlow, the D.C. Circuit held that the SEC met the requirements of the statute and allowed the grant of UTP to the BSE.[42] Such deference by reviewing courts to the SEC was typical in cases where securities issuers objected to the extension of UTP to their securities.[43] The end

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35. Ketchum Congressional Testimony, *supra* note 26.

36. H.R. REP. NO. 103-626 at 3, *reprinted in* 1994 U.S.C.C.A.N. at 3301.

37. *Id.* For every application, "the Commission . . . is forced to process each UTP application individually, ensure that notice of the application has been published in the Federal Register for a minimum of 10 business days, evaluate the application, and issue an approval order." *Id.*

38. "Comments on exchange UTP applications are rare, and the Commission annually issues hundreds of orders granting exchange UTP applications on a routine basis." *Id.* at 13, *reprinted in* U.S.C.C.A.N at 3311 (letter from Arthur Levitt, SEC Chairman). Brandon Becker, the Director of the Division of Market Regulation at the SEC informed the Committee that "[UTP application review] is a time-consuming, paper-intensive process where we have not identified any commentary that we have received that would justify the amount of resources we commit to it." *Id.* at 3, *reprinted in* U.S.C.C.A.N. at 3301 n.5.

39. Ludlow Corp. v. SEC, 604 F.2d 704, 708 (D.C. Cir. 1979) (citing 15 U.S.C. § 78*l*(f)(2) (1976)).

40. *Id.* at 706.

41. *Id.*

42. *Id.* at 711.

43. *See, e.g., id.*; *see also* Champion Parts, Inc. v. Oppenheimer & Co., 878 F.2d 1003, 1008 (7th Cir. 1989) ("To the extent there is a common law right to a stable and informed market for shares of stock, and we doubt there is such an animal, that right belongs to shareholders, not to

result was that application to the SEC for extension of unlisted trading privileges became a mere formality that only delayed a nonlisting exchange's ability to extend UTP to already-listed securities.

To eliminate this procedural formality, Congress passed the Unlisted Trading Privileges Act of 1994.[44] The Act was intended to increase efficiency competition among the markets by eliminating the procedural formality of exchange application to the SEC.[45] According to the Act's House Report, "[n]ew Section 12(f) . . . enhances the opportunity for competition among exchanges by removing regulatory delays caused by requirements for exchange application, notice, and approval that currently exist under Section 12(f) of the Exchange Act."[46] The immediate practical effects of the UTP Act were elimination of procedural formalities and a subsequent increase in inter-market competition. Such competition was intended to lead to an increase in market efficiency, as demonstrated by tighter spreads, faster execution, lower transaction costs, and more liquid markets.[47]

The SEC, perhaps taking its cue from Congress, has demonstrated its commitment to the idea that fostering inter-market competition is to the advantage of investors. Although Congress' belief that the delay necessitated by SEC approval was too long prompted passage of the UTP Act of 1994, it was possible that a brief initial period of consolidated trading would be beneficial.[48] The issue arose in the context of initial public offerings (IPOs), which were often extraordinarily volatile because of heavy trading at the very beginning of an IPO.[49] Concerned by the perceived volatility of IPOs, Congress

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an issuer"); Golden Nugget, Inc. v. Am. Stock Exch., Inc., 828 F.2d 586, 590-91 (9th Cir. 1987) (rejecting issuer's claims of misappropriation, violation of trademark laws and unfair competition).

44. Pub. L. No. 103-389, 108 Stat. 4081 (1994) (codified at 15 U.S.C. § 78*l*(f) (2000)).

45. Congress, in 1994, had some evidence that "the delays caused by the UTP application and approval process may have anticompetitive impacts." H.R. REP. NO. 103-626, at 4 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299, 3302. Therefore, the Committee believed that the UTP Act would "benefit investors by further enhancing competition." *Id.* at 5, *reprinted in* 1994 U.S.C.C.A.N. at 3303.

46. *Id.* at 2, *reprinted in* 1994 U.S.C.C.A.N. at 3300. Even before the UTP Act, the D.C. Circuit noted the congressional goal of inter-market competition, writing that "[u]nlisted trading . . . is an indispensable part of Congress' plan that securities markets compete with one another" and "Congress found unlisted trading to be an essential element of the national securities market system." *Ludlow Corp.*, 604 F.2d at 709-10.

47. The goal of the UTP Act was to "serve to further the underlying objectives of the Exchange Act with respect to free, open and competitive markets for all existing securities." H.R. REP. NO. 103-626, at 6, *reprinted in* 1994 U.S.C.C.A.N. at 3304. For a definition of bid-ask spreads, see *infra* note 175.

48. H.R. REP. NO. 103-626, at 4-6, *reprinted in* 1994 U.S.C.C.A.N. at 3302-04.

49. *Id.* at 6, *reprinted in* 1994 U.S.C.C.A.N. at 3304.

granted a two-day monopoly over IPOs to the listing exchange, subject to subsequent SEC rulemaking.[50] After a period for study and notice and comment rulemaking, the SEC decided to eliminate that delay.[51] The SEC received seven letters commenting on the proposal to eliminate the waiting period, all of which were in favor of the proposal.[52] An exchange may now exercise its unlisted trading privileges after a single trade is reported to the Consolidated Tape.[53] Despite some worries about possible price volatility and consequent widening of spreads in the heavy volume often characteristic of the early days of an initial public offering,[54] the SEC action creates inter-market competition almost immediately for a security making an IPO.[55]

The purpose of the Unlisted Trading Privileges Act of 1994 was to increase efficiency competition among markets by eliminating any lingering possibility of substantive competition through delay in UTP extension.[56] After the first trade is reported to the Consolidated Tape, the security may be traded on any exchange.[57] This immediate

50. 15 U.S.C. § 78*l*(f)(1)(B)-(C) (2000).

51. Unlisted Trading Privileges, Exchange Act Release No. 34-43217, 65 Fed. Reg. 53,560, 53,560 (Sept. 5, 2000) ("[A] national securities exchange will be permitted to begin trading an IPO issue immediately after the first trade in the security is reported by the listing exchange to the Consolidated Tape.").

52. *Id.* at 53,562. One letter, from Schwab, directly addressed the issue of inter-market competition: "Schwab also commented in support of the amendment. Schwab argued that the current delay is an impediment to free and open competition in the listed markets, noting that it insulates the primary market from competition and precludes valuable price discovery." *Id.*

53. *Id.* at 53,560. The Consolidated Tape is "[a] high-speed system that continuously provides the last sale price and volume of any securities transaction in listed stocks to the public." New York Stock Exchange, Consolidated Tape, *at* http://www.nyse.com/glossary/glossary.html (last visited Feb. 27, 2004). The following exchanges participate in the Consolidated Tape: the American Stock Exchange (Amex), the Boston Stock Exchange (BSE), the Chicago Board Options Exchange (CBOE), the National Stock Exchange (NSE), the Chicago Stock Exchange (CHX), the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the Pacific Stock Exchange (PSE), and the Philadelphia Stock Exchange (PHLX). *Id.*

54. A 1998 study the CHX, NSE, and PSE cited acknowledged the concerns, but found that "there is no empirical basis for the contention that multiple exchange trading on the first day of an IPO adversely affects market quality, either by increasing price volatility or widening bid-ask spreads. In fact, the evidence indicated that listed IPOs that are not traded on more than one exchange can be more volatile than dually or multiply listed IPOs." Unlisted Trading Privileges, 65 Fed. Reg. at 53,561.

55. This result is precisely what the SEC action intended. *Id.* at 53,562-63 ("Removing the one-day trade delay will enhance competition among linked markets, consistent with . . . the Exchange Act.").

56. *See* H.R. REP. NO. 103-626, at 2 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299, 3300.

57. This action currently is subject to the restraints licensing fees impose, which cause exchanges to change their fee schedule, necessitating notice and comment rule making. *See infra* notes 116-123 and related discussion.

competition was designed to improve market quality and efficiency.[58] A 1998 study cited by the CHX, NSE, and PCX found that

> the price volatility of IPOs and spin-offs traded on only one exchange was approximately 30% higher than that of the IPOs and spin-offs that were traded on at least two exchanges. In addition, in its comparison of bid-ask spreads, the study showed that there was no statistically significant difference between the two groups.[59]

The empirical evidence suggests that even one or two days of consolidated trading of IPOs fails to improve market quality, and may actually harm investors.[60]

Investors do not stand to benefit as much from consolidated trading of securities because, when only one exchange sells a security, there is no external competitive pressure to increase efficiency.[61] Under current regulations, no exchange can have a unique and profitable trading opportunity because UTP allow the same securities to be traded in multiple markets after a single trade on the listing exchange. Any profitable security will be extended UTP by at least one secondary exchange, which will then compete for order flow with the primary, listing exchange. The only way left for markets and exchanges to compete with each other is on an efficiency level.[62] Exchanges try to attract order flow in shared products by having lower transaction fees, tighter spreads, faster executions, and high quality

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58. Unlisted Trading Privileges, 65 Fed. Reg. at 53,562.

59. *Id.* at 53,561.

60. The SEC found that "the current one-day trading delay provides no real benefits and actually inhibits competition among markets" and that "enhanced competition in an IPO should benefit investors by providing increased opportunities for order execution." *Id.* at 53,562-63.

61. NYSE and Nasdaq fought to get Bank of New York (BoNY) to list its potentially highly lucrative ETFs on their respective exchanges. "Nasdaq has offered millions of dollars to BoNY in marketing services as an incentive to snag their product . . . ." Jessica Sommar, *ETF War Heats Up: Nasdaq, NYSE Fight for New BONY Funds*, N.Y. POST, Dec. 19, 2001, at 47. Suppose that NYSE gets BoNY to exclusively trade its ETFs on the Big Board. Without unlisted trading privileges, there would be no external pressure on the NYSE to offer lower transaction fees or tighter spreads for BoNY products because the NYSE would have a monopoly on the trading of those ETFs. One could argue that BoNY itself would put pressure on NYSE to become more efficient because that would increase liquidity and BoNY's ETFs' value. BoNY's pressure, however, likely would be considerably less than the pressure Nasdaq or the Amex would exert in competing for order flow. *See also infra* notes 85-87 and accompanying text.

62. Schwab made this point in comments regarding the proposed elimination of the waiting period when it "noted that the delay will hamper ECNs that choose to register as exchanges, and provides an unfair advantage to ECNs that are not regulated as exchanges." Unlisted Trading Privileges, 65 Fed. Reg. at 53,562. Electronic communication networks such as Island generally have an efficiency advantage over the national exchanges. *See infra* notes 88-90 and accompanying text. Unless ECNs become registered exchanges, they operate "outside" the Securities Exchange Act of 1934. Such external pressure for efficiency from ECNs, Schwab argues, is too much to overcome for national exchanges that are burdened by SEC regulations. Unlisted Trading Privileges, 65 Fed. Reg. at 53,562 n.23. The important point is that the competition is on an efficiency level, and does not contemplate substantive competition for exclusive trading opportunities.

market makers or specialists. The competition in the ETF market, encouraged by unlisted trading privileges, drives efficiency to the benefit of investors.

C. Competition and Efficiency in the Exchange Traded Fund Market

The cutthroat competition between markets over ETFs underscores the desirability of a substantial share in the ETF market. It also plainly shows the financial importance of ETFs to the securities markets and index providers. The availability of this important revenue source motivates securities markets to jockey for position in the ETF trade. A brief description of the current competitive landscape follows to demonstrate inter-market competition driving market efficiency.

The Amex originally developed the ETF in 1993 and has since then been the listing exchange for the vast majority of ETFs.[63] The Amex is primarily a derivatives market,[64] and it is thought to need ETF revenues to compete with the NYSE.[65] In perhaps the most highly visible sign of inter-market competition over ETFs, the NYSE, for the first time in its history, exercised its unlisted trading privileges over some of the most popular ETFs that were then listed and traded on the Amex.[66] The Amex had previously faced competition in the ETF market from the regional exchanges and other markets, but the Big Board never threatened the Amex's hegemony.[67] As Kevin McNally, an ETF analyst and vice president at Salomon Smith Barney

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63. *See supra* note 15. The world's first ETFs, however, were traded on the Toronto Stock Exchange as early as 1990. Gordon Platt, *Exchange Traded Funds Growth Continues, Even in a Down Market*, GLOBAL FIN., Nov. 2002, at 46, 46. Because this Note is restricted to American trading systems, the Amex may be properly considered the birthplace and home of most ETFs for present purposes.

64. Amex lists 117 of 119 domestic ETFs, while NYSE has only one ETF paying a listing fee. Brent, *supra* note 15. The QQQ has become one of the most important securities on the Amex, accounting for more than one-third of the Amex's ETF trading volume on an average day. Bruce Kelly, *Amex, Big Board Wage Price War Over ETFs: Amex Halting Fees to Blunt NYSE Move*, INVESTMENT NEWS, July 23, 2001, at 1.

65. The Amex depends on ETFs for about 30 percent of its bottom line. Gregory Bresiger, *War of Exchanges Over ETFs*, TRADERS MAG., Aug. 1, 2001. "Amex needs to focus on ETFs and derivatives rather than its shrinking equities business." *Consolidation Process Will Likely Continue in Securities Industry*, SEC. INDUSTRY NEWS, July 15, 2002, at 2 (interviewing Steve McLaughlin, founder and managing partner of Financial Technology Partners).

66. Zach Kouwe, *Brokers Raise Concerns Over ETF's in Bear Hunter Meeting*, WALL ST. LETTER, July 9, 2001, at 1, 7; Sommar, *supra* note 61 ("For the first time in the 200-year history of the venerable institution, the NYSE this year resorted to offering a product it does not list, the most popular ETF known as tbe QQQ.").

67. *See generally* Kelly, *supra* note 64 (discussing tbe NYSE's move to suspend fees on ETF trading).

described the unprecedented move by the NYSE: "If it were the Boston Stock Exchange coming in to UTP [ETFs], it wouldn't make a big difference. But the New York Stock Exchange? That's a big difference."[68]

In early 2002, the NYSE further exercised UTP over twenty-seven more Amex ETFs.[69] In addition to exercising its unlisted trading privileges, the NYSE became more aggressive in the ETF market by going head to head with the Amex for ETF trading volume.[70] The competition continued when, in the summer of 2002, the NYSE exercised its UTP yet again, this time to cover a series of seven fixed-income ETFs listed on the Amex.[71] The Amex responded, announcing a plan in August 2002 to exercise UTP over 120 Nasdaq-listed stocks.[72] This move created the opportunity to trade the QQQ (which is based on the Nasdaq-100 Index), all 100 stocks in that index, and twenty other Nasdaq stocks in the S&P 500 all at the same national market[73]

Another clear example of the battle between the Amex and NYSE over ETFs is the elimination of transaction charges. The NYSE eliminated transaction charges for ETFs in an effort to lure more of the lucrative business to its trading floor.[74] The Amex followed suit to prevent order flow from being diverted to the now more efficient NYSE.[75] The NYSE even convinced two of its ETF specialists to waive

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68. *Id.* at 1.

69. *NYSE To Trade 27 Additional AMEX-Listed ETFs*, WALL ST. LETTER, Feb. 18, 2002, at 2 ("[T]he New York Stock Exchange will phase in unlisted trading privileges for 17 Merrill Lynch HOLDRs, nine sector SPDRs and the Standard & Poor's Mid-Cap 400 throughout the year."). The NYSE only lists one ETF, the iShares S&P Global 100, which is not one of the largest ETFs. Dow Jones Newswires, *NYSE Adds 27 Funds to Exchange Trading*, WALL ST. J., Apr. 15, 2002, at C21.

70. "The New York Stock Exchange and the American Stock Exchange are going to war over exchange traded funds." Bresiger, *supra* note 65.

71. *Another ETF Blow by Big Board*, TRADERS MAG., Aug. 1, 2002 ("The NYSE's plan is a damaging but not fatal hlow to the Amex, which has pioneered an array of ETFs but watched helplessly as volume was picked up by other players."), 2002 WL 11694864.. The Amex responded to this latest UTP by suspending transaction charges indefinitely on the NYSE-listed iShares. *AMEX Puts ETF Transaction Charges on Hold*, WALL ST. LETTER, Aug. 5, 2002, at 9.

72. Isabelle Clary, *Amex Rolling Out Nasdaq Stocks Auction-Style*, SEC. INDUSTRY NEWS, Aug. 12, 2002, at 15.

73. *Id.*

74. The NYSE proposed to eliminate transaction fees on UTP ETFs on August 6, 2001. Exchange Release Act No. 34-44,622, 66 Fed. Reg. 41,079 (July 30, 2001). "The New York Stock Exchange and the American Stock Exchange have engaged in a pricing battle over ETFs, trying to lure asset managers to their respective floors. As the NYSE has eliminated transaction fees on ETFs, Amex has done the same all in an attempt to become the leading exchange for ETFs." Brent, *supra* note 15.

75. The Amex explained that it eliminated transaction fees "to maintain a competitive, level playing field. We're not going to allow [the NYSE] to gain any sort of competitive advantage." *Id.*

their commissions entirely for a temporary period.[76] Unlike the Amex, however, the NYSE does not have additional revenue from ETF listing fees due to the unlisted status most ETFs enjoy on the NYSE.[77] The waiving of fees therefore represents a strong commitment by the NYSE to become a major player in the ETF arena.

Another indicator of the competition is the concern at the NYSE over the Amex's competing market maker system.[78] NYSE floor brokers worried that they could not compete for order flow with the Amex's competing market makers.[79] Competing market makers theoretically add liquidity to a security by allowing the market makers to trade for their own accounts alongside the specialists for the security.[80] The Amex's professional dealers could trade larger orders than ordinary investors, giving the Amex the larger and more liquid market and preventing ETF order flow from following the unlisted trading privileges to the NYSE.[81] The floor brokers' concern, whether well-founded or not, reinforces the notion that the two exchanges were engaged in a real battle over ETFs.

Faced with the aforementioned concerns, the NYSE proposed a specific rule change in an effort to stay competitive with the Amex.[82] The NYSE therefore proposed to amend its front end systemic capture (FESC) rule to compete with other exchanges that do not have FESC

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76. Kouwe, *supra* note 66, at 7. Bear Hunter Structured Products Trading and Spear, Leeds & Kellogg Specialists waived their commissions for three months for ETF orders executed within five minutes. *Id.*

77. The competitive lowering of costs caused potentially large revenue losses. The transaction fees on both the NYSE and Amex immediately prior to the fee suspension were as follows: 63 cents per 100 shares for specialists, 73 cents per 100 shares for registered traders, and 60 cents per 100 shares for off-floor broker/dealers. Brent, *supra* note 15. In the first quarter of 2002, the Amex traded an average of almost 32.5 million shares daily. *Id.* This translates to revenue loss between $195,000 per day and $237,250 per day. *See id.* (providing prior Amex transaction fee rates and trading volume). The NYSE is without some additional profits available to the Amex. Due to the unlisted status of 31 ETFs on the NYSE, the exchange also misses out on $155,000 in initial listing fees and $62,000 annually thereafter. *Id.* (providing prior NYSE listing fee rates).

78. Kouwe, *supra* note 66, at 1.

79. *Id.*

80. *Id.* at 7. For example, on the Nasdaq, market makers hold a certain number of shares to facilitate trading. Investopedia, Market Maker, *at* http://www.investopedia.com/terms/m/marketmaker.asp (last visited Feb. 27, 2004). Market makers buy securities from sellers and sell to buyers, accepting the risk of holding stocks in the interim. *Id.* They quite literally make the market for a security by "matching" buyers and sellers. Specialists perform a substantially similar market creation and maintenance function, and the terms are interchangeable for present purposes.

81. Kouwe, *supra* note 66, at 7.

82. Exchange Act Release No. 34-45,246, 67 Fed. Reg. 1527 (Jan. 11, 2002).

requirements.[83] The lack of a FESC rule permitted the other exchanges to execute faster trades than was possible on the NYSE, resulting in their having more liquid markets.[84]

The battles are not limited to providing a more efficient and more liquid trading environment. When Bank of New York (BoNY) proposed to create its own ETFs, the NYSE and Nasdaq engaged in a bidding war to entice BoNY to list with their respective markets.[85] Nasdaq offered millions of dollars in marketing services to sweeten the deal for Bank of New York.[86] Such enticements are trivial when compared to the potential upside of gaining a strong toehold in the ETF market, which may have a market potential at least as large as the $1 trillion invested in mutual funds.[87]

The national stock exchanges face stiff competition not only from each other, but also from the over-the-counter market and from electronic communications networks (ECN) such as Island. Electronic communications networks provide securities markets (not registered national exchanges) that offer lightning-fast trade execution and can steal some of the volume from the national exchanges.[88] On March 19, 2002, Island ECN set a record for an electronic communications network when it captured 45 percent of the market share volume in the QQQ.[89] Although there are complaints that Island is not "playing fair,"[90] such competition may nonetheless drive market efficiency exactly as Congress envisioned. If Island ECN is not ordered to "slow

83. The NYSE's FESC rule requires that all orders in any security be entered into an electronic database before they are represented to the auction market. Exchange Act Release No. 34-43,689, 65 Fed. Reg. 79,145, 79,145 (Dec. 18, 2000). The NYSE proposed to enter orders within ninety seconds after the representation to the auction market in order to speed up the trades and compete with other ETF markets. 67 Fed. Reg. at 1528.

84. 67 Fed. Reg. at 1528.

85. Sommar, *supra* note 61.

86. *Id.*

87. *Id.* (quoting Amex officials).

88. "[A]lthough Amex often has better prices than Island on the QQQs, it is difficult to access Amex's best prices, while Island offers lighting-fast speed of execution and cancellation." Isabelle Clary, Fast-Growing Island Closer to Exchange Filing, SEC. INDUSTRY NEWS, Dec. 10, 2001, at 1, 33.

89. Clary, *supra* note 20. Island also captured 24 percent of Spiders, 24 percent of Diamonds and 32 percent of Merrill Lynch's HOLDRs, on that date. *Id.* By comparison, the Amex accounted for 36 percent of Spiders and 27 percent of Diamonds. *Id.*

90. "The SEC's Regulation ATS of 1998 'requires alternative trading systems that trade 5 percent or more of the volume in national market system securities to . . . disseminate the best-priced orders in those national market system securities displayed in their systems, including institutional orders, into the public quote stream.' " Clary, *supra* note 88, at 33. Island, whose QQQ share regularly exceeds five percent, is not complying with this regulation, prompting complaints from the Amex. *Id.*

down," the Amex's only option to stay competitive will be to speed up its own trading; in other words, to become more efficient.

There are two important lessons in this overview of the competition among markets for the ETF trade. The first is that inter-market competition can, and does, increase efficiency. The competition is forcing the markets to become more efficient as no market allows another to gain an advantage. This can be seen most clearly in the elimination of transaction charges by NYSE and the Amex.[91] It can also be seen in the success that Island ECN has had in increasing its volume in the QQQ by offering an efficient, electronic method for trading.[92] The second lesson is that all the players in the highly lucrative ETF business have strong incentives to maintain a financial stake in these products. All markets, specialists, dealers, and investors have strong incentives to bring the highest volume of orders to their markets. Likewise, index providers wish to maintain some financial stake in the ETFs once they begin trading on the exchanges because of the high volume of the most popular ETFs. The next section examines the conflicts that arise when index providers attempt to exercise control over properly created ETFs in the market.

III. CHARGING LICENSING FEES FOR ETFS CONTRADICTS CONGRESSIONAL INTENT IN ENCOURAGING UNLISTED TRADING

There is an inherent tension between competitive free market principles and allowing index providers to continue to profit from properly created ETFs. The index providers can only continue to profit from the use of their indices in ETFs if they can exercise control over the ETF in the market. However, allowing self-interested private actors to limit availability of products in the market runs counter to the basic understanding that open competition is the best incentive for exchanges to become more efficient. Allowing index providers to control ETFs in the market, or a particular market's access to certain ETFs, seems contrary to the best interests of investors, which are served by wide availability and low transaction costs. Index providers who attempt to control or limit the exchanges that may trade certain ETFs are undermining the congressional purpose and intent of unlisted trading privileges.

91. *See supra* notes 74-77 and related discussion.

92. *See supra* notes 88-90 and related discussion.

A. *The Current Practice of Charging Licensing Fees for ETFs*

Index providers primarily attempt to control ETFs based on their indices by charging a licensing fee to markets that desire to offer those ETFs. The common practice is to require licensing agreements before an ETF can be traded, even traded on a secondary exchange pursuant to unlisted trading privileges.[93] For example, the Boston Stock Exchange pays a licensing fee to Dow Jones to trade Diamonds pursuant to unlisted trading privileges.[94] The Amex also had a licensing agreement with Dow Jones granting the Amex the rights to use the Dow Jones trademarks in connection with the trading of Diamonds.[95] The Amex licensing agreement with Dow Jones left open some question as to whether Dow Jones could deny the National Stock Exchange (NSE) the ability to trade Diamonds.[96] The Amex also pays licensing fees for several other ETF products, and passes those fees through to its specialist units.[97] As another example, the Philadelphia Stock Exchange (Phlx) pays a licensing fee to Nasdaq for the UTP trading of the QQQ.[98]

Further examples are abundant. The primary terms of the Phlx licensing agreement with Nasdaq appear to be a disclaimer of liability to protect Nasdaq, and a license that permits the Philadelphia Stock Exchange to use the name "Nasdaq-100 Index Tracking Stock."[99] The Chicago Stock Exchange (CHX) proposed to change its fee schedule to allow for the assessment of marketing fees on ETFs to which it had extended unlisted trading privileges.[100] Indeed, the CHX wrote that "the marketing fee would be assessed only against ETF

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93. For example, in proposing to pass through licensing fees to third parties, the Amex wrote that "the Nasdaq Stock Market imposes a license fee on other exchanges that trade the QQQ pursuant to unlisted trading privileges, and such fee is being, or can be, passed on to the specialist on at least one regional exchange." Exchange Act Release No. 34-45,972, 67 Fed. Reg. 37,884, 37,885 (May 30, 2002).

94. *Boston Exchange Starts Trading Diamonds*, WALL ST. LETTER, Mar. 26, 2001, at 2.

95. *In re* Application of the American Stock Exchange, Exchange Act Release No. 34-42,312 (Jan. 4, 2000), http://www.sec.gov/litigation/opinions/34-42312.htm..

96. *Id.* Dow Jones originally told the National Stock Exchange that the NSE was not permitted to trade in Diamonds because of an exclusive license agreement between Dow Jones and the Amex. *Id.* Later, Dow Jones told the NSE that it was "studying the pros and cons of extending the licensing of Diamonds to additional exchanges." *Id.*

97. Exchange Act Release No. 34-45,727, 67 Fed. Reg. 18,962, 18,962 (Apr. 17, 2002). Interestingly, the Amex proposed to pass through any licensing fee whether it is associated with a listed security, or one traded pursuant to unlisted trading privileges. *Id.*

98. *See* Exchange Act Release No. 34-43,717, 65 Fed. Reg. 80,976, 80,979 (Dec. 22, 2000).

99. *Id.* "Nasdaq-100 Index Tracking Stock" is the proper name of the ETF, whose ticker symbol is QQQ. QQQ Prospectus, *supra* note 2, at Front Cover.

100. Exchange Act Release No. 34-45,282, 67 Fed. Reg. 3517, 3518 (Jan. 24, 2002).

products, which *almost always* have an associated licensing fee."[101] The Nasdaq imposes a licensing fee on exchanges that trade the QQQ pursuant to unlisted trading privileges.[102] Licensing fees thus appear to be the common practice among index providers, and exchanges apparently either pay the fee unquestioningly, or pass the fee through to the specialist who is allocated that ETF.

The licensing fees charged by index providers can be substantial, especially for the more popular ETFs. For example, when the Amex proposed to pass through any licensing fees for the QQQ to the specialist unit allocated that security, Susquehanna Investment Group (Susquehanna), the Amex specialist for the QQQ, submitted a letter in objection.[103] Susquehanna stated that the licensing fee would be approximately five million dollars annually for the QQQ alone.[104] Susquehanna argued that even if the fee were not imposed on the specialist alone, but allocated between the specialist and the crowd, the licensing fee would "'make no economic sense' under current competitive market conditions."[105] Susquehanna further contended that "a licensing fee imposed on Susquehanna would be discriminatory and anti-competitive."[106] Susquehanna claimed that the increased costs for specialists would impede the specialists' ability to offer competitive spreads.[107] Although the Amex's proposed pass-through became effective despite Susquehanna's objections,[108] the very fact that the objections were made demonstrates the non-trivial nature of the licensing fees. The imposition of licensing fees has the potential to become a substantial burden on the market for ETFs, especially if, as Susquehanna suggested, it impedes the market makers' or specialists' ability to offer competitive spreads.

B. The Index Providers' Argument for the Imposition of Licensing Fees

At first glance, index providers seem to have a proprietary interest in their indices, which would be sufficient to support licensing

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101. *Id.* at 3518 n.6 (emphasis added).

102. Exchange Act Release No. 34-45,972, 77 SEC Docket 2017 (May 21, 2002) (stating the Nasdaq policy as understood by the Amex), 2002 WL 1042146, *3.

103. *Id.* at *2-3.

104. *Id.* at *2.

105. *Id.* (citing Susquehanna letter of Mar. 1, 2002).

106. *Id.* at *3 (discussing letter of May 2, 2002 from Wilmer, Cutler & Pickering on behalf of Susquehanna).

107. *Id.* The Amex answered this objection by noting that specialists are merely required to make fair and orderly markets under prevailing market conditions, and that a licensing fee is irrelevant to this requirement. *Id.*

108. *Id.* at *4 (rule change effective May 16, 2002).

fees for derivatives thereon. The index providers have invested substantial resources creating, maintaining and marketing the index. For example, Nasdaq proposed to increase its fees in part because ETFs were deriving their value from the Nasdaq indices.[109] According to Nasdaq, "[s]upporting derivative products has required Nasdaq to increase the resources that it devotes to data quality, timeliness, and redundancy for the underlying indexes [*sic*]."[110] Beyond the mere construction of an index, Nasdaq has to invest considerable resources in "establishing relationships with issuers of [ETFs], and monitoring their use of Nasdaq Index Information to ensure that it is used properly."[111] The index provider has a strong interest in controlling who has access to the index and how it is used.

If an exchange is permitted to trade an ETF without the index provider's permission, the exchange is free-riding on the index's good name and mark. Apart from the free-rider reaping where he has not sown, a "bad" use of index information may potentially damage the index provider, at least in the minds of the investing public, even though there was no connection between the ETF and the index provider. Nasdaq noted that market data vendors who simply redistribute Nasdaq Index Information create risk for Nasdaq.[112] If mere redistribution is considered risky, use of the index as the basis for an investment product would likely be more so.

Consider this hypothetical example. The Law Review Stock Exchange (LRE) is a struggling securities exchange that depends almost entirely on unlisted trading to stay afloat. The LRE extends its unlisted trading privileges to Diamonds and the QQQ, hoping that the reputation of the two underlying indices will be sufficient to draw ETF order flow to the LRE and relieve some of the LRE's economic distress. The LRE will advertise and market that these two popular products are available on the Law Review Exchange. The LRE is not only *permitted* to market the products as having the stability of the DJIA and Nasdaq behind them, but is *required* to disclose such information in either a prospectus or product information sheet.[113] The index providers will argue that the LRE has exploited their

109. Exchange Act Release No. 34-45,472, 67 Fed. Reg. 9489, 9489-90 (Mar. 1, 2002) (proposing a 400 percent increase in the fee, from $500 per month to $2000 per month).

110. *Id.* at 9490.

111. *Id.* at 9491.

112. *Id.* This risk may be substantial, as Nasdaq is concerned with potential legal "exposure" due to the fact that "more investors have more money tied to the calculation of Nasdaq indexes [sic]." *Id.*

113. *See infra* note 164 and accompanying text.

reputations in the financial arena without compensation.[114] The index providers no longer have the opportunity to write to the SEC and object to a proposed extension of UTP because the formalities of notice and comment rulemaking were eliminated in 1994.[115] An index provider might plausibly suffer some harm, if only through a loss of incentive to create indices, if exchanges are permitted to capitalize on the indices' good names without compensation. Notwithstanding the potential harm to index providers, licensing fees contradict the two congressional policies underlying the UTP Act of 1994: elimination of procedural formalities and enhancement of inter-market competition.

C. Contradiction with Congressional Intent and Policies

Licensing fees reintroduce precisely the same procedural formalities that the UTP Act of 1994 sought to eliminate. Suppose a national exchange is required by a particular index provider to pay a licensing fee for the "permission" to trade ETFs pursuant to unlisted trading privileges. The exchange would rationally pass the licensing fee on, probably having the market maker or specialist allocated each ETF pay the licensing fee for that ETF. The specialist will attempt to pass the fee on as well, perhaps by offering wider spreads to investors.[116] The licensing fee will be passed on until it reaches the investor, because no actor in the chain will pay the licensing fee without recouping that cost somewhere. Most exchanges appear to employ this strategy and pass the fees on to specialists.[117] However,

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114. Dow Jones made this argument in a misappropriation suit against the Chicago Board of Trade, which wanted to create a futures contract based on the DJIA. Bd. of Trade of Chi. v. Dow Jones & Co., 456 N.E.2d 84, 85, 88 (Ill. 1983) ("Defendant [Dow Jones] argues that plaintiff seeks to exploit defendant's reputation for accuracy and impartiality without compensating it for its good will."). Apart from the basic unfairness of tbe misappropriation argument, very real negative consequences might ensue from unlicensed trading of securities. As previously noted, Ludlow argued that unapproved trading of its shares on the BSE might destabilize the market for Ludlow shares, thereby impairing Ludlow's ability to raise capital. *See supra* notes 40-43 and accompanying text; *see also* Champion Parts, Inc. v. Oppenheimer & Co., 878 F.2d 1003, 1007 (7th Cir. 1989) (alleging that non-disclosures by defendants interfered with an informed market for its shares whicb "interfered with Champion's ability to raise equity capital and find investment bankers willing to manage the placement of its shares"). These arguments did not prevail in either case. *Id.*; Ludlow Corp. v. SEC, 604 F.2d 704, 711 (D.C. Cir. 1979).

115. Unlisted Trading Privileges Act of 1994, Pub. L. 103-389, 108 Stat. 4081 (codified at 15 U.S.C. § 78*l*(f) (2000)).

116. Susquehanna, the Amex specialist for the QQQ, suggested that if it were required to pay a licensing fee, it could not offer competitive spreads, meaning that investors would end up paying the fee. *See supra* notes 103-108 and accompanying text.

117. *See, e.g.*, Excbange Act Release No. 34-45,727, 67 Fed. Reg. 18,962, 18,962 (Apr. 17, 2002) (proposing a pass through of licensing fees to specialists, Amex allocated an ETF whose index provider charges a licensing fee).

to pass new licensing fees on to specialists, the exchange will usually have to change its fee schedule.[118] To change the fee schedule, the exchange will have to go through precisely the same notice and comment rulemaking formalities that Congress sought to eliminate in 1994, and the SEC completely eliminated when it reduced the two-day waiting period after an IPO to just one trade.[119] Therefore, there is a de facto, if not regulatory, application procedure before an exchange can extend UTP to an ETF that carries a licensing fee.

Under 17 C.F.R. § 240.12f-5 changes to fee schedules are immediately effective, despite having to go through notice formalities.[120] Immediate effectiveness seems to render the contradiction with congressional policy an inconsequential detail. However, the main purpose of the UTP Act was to eliminate procedural formalities and inconsequential details.[121] The temporary monopoly argument may fall prey to an immediate rule change.[122] The fact remains that Congress, with the UTP Act, created a presumption in favor of the secondary exchanges. Rather than a presumption against UTP, requiring specific approval before each extension, there is now a presumption in favor of UTP. The only way to stop UTP is for the SEC to make a specific rule denying unlisted trading privileges.[123] Licensing fees impose a de facto requirement of obtaining a specific rule change from the SEC, thereby shifting the presumption back to its pre-1994 state where specific approval of a rule was required before extending unlisted trading privileges.

The congressional policy of encouraging inter-market competition is also potentially threatened by licensing fees. The de facto procedural formality that presently exists with licensing fees may not actually hinder competition because of the immediate effectiveness of fee schedule changes. However, as the Amex's

118. 17 C.F.R. § 240.19b-4(f)(2) (2003).

119. Pub. L. No. 103-389, 108 Stat. 4081 (codified at 15 U.S.C. §78*l*(f)); Unlisted Trading Privleges, Exchange Act Release No. 34-43,217, 65 Fed. Reg. 53,560 (Sept. 5, 2000).

120. 17 C.F.R. § 240.12f-5 (2003).

121. H.R. REP. NO. 103-626, at 2-7 (1994), *reprinted in* 1994 U.S.C.C.A.N 3299, 3300-05.

122. *But see supra* notes 103-108, where Amex's fee change was not an immediate change or inconsequential detail because Susquehanna's objections to the pass-through necessitated at least a response from Amex and the SEC. It is possible for fee pass-throughs to result in temporary monopolies if the specialists strenuously object to the proposed fee change. In that case, the exchange might not extend UTP until it could recoup the licensing fee, giving the listing exchange a temporary monopoly on the ETF trading. Recognizing this possibility, the present argument assumes the more likely scenario: such objections would not be successful and would be avoidable with only cursory action.

123. 15 U.S.C. § 78*l*(f)(2)-(3) (specifying the circumstances under which the SEC may suspend unlisted trading privileges).

dealings with Susquehanna showed, immediate effectiveness is not necessarily a smooth process.[124]

More problematic, the same rationale used to support licensing fees would also justify anticompetitive exclusive trading agreements. The contradiction at an efficiency competition level is currently only theoretical because index providers do not seem to be limiting the exchanges that trade ETFs.[125] Any exchange that pays the licensing fee can trade most ETFs. But, if an index provider may impose a licensing fee, it can likewise wholly exclude any or all exchanges from trading that ETF. This may be done through outright exclusion, or by fixing the licensing fee such that only the most successful exchanges could afford it. Permitting an index provider to favor one exchange over all others reintroduces substantive competition at the expense of the efficiency competition created by the UTP Act of 1994.[126] While the current practice is merely a drag on efficiency, the very same rationale would permit exclusive trading agreements, which are decidedly anticompetitive.

Despite a seemingly promising argument in favor of the current practice of licensing fees, imposition of such fees runs counter to congressional intent on two fronts. First, licensing fees reintroduce procedural formalities by creating a de facto rule change requirement so that the fee may be passed on. Second, the very same rationale that would support licensing fees in their current form would also support exclusive licensing and trading agreements—a situation plainly contrary to Congress' policy of inter-market competition. The following section examines more closely the index providers' potential legal arguments in support of licensing fees, ultimately concluding that such arguments are unpersuasive entirely apart from the conflict with the congressional policy of the UTP Act.

IV. INTELLECTUAL PROPERTY JUSTIFICATIONS FOR ETF LICENSING FEES ARE UNSATISFACTORY

An index provider might assert that the unlicensed use of its mark by secondary exchanges advertising ETFs violates its trademark protected property rights. The claim against exchanges exercising UTP for ETFs is that the exchange gains the benefit of the index provider's reputation, good name, and resources invested in the index without compensating the index provider. While a trademark-based

124. *See supra* notes 103-108 and accompanying text.

125. But see *supra* notes 95-96 and accompanying text, which raised some question as to whether Dow Jones would permit the National Stock Exchange to extend UTP to Diamonds.

126. Pub. L. No. 103-389, 108 Stat. 4081 (1994) (codified at 15 U.S.C. § 78*l*(f)).

argument might at first seem an attractive justification for the index providers requiring licensing agreements, it ultimately cannot withstand scrutiny.[127] Specifically, index providers do not have a protectable interest in properly created ETFs that would allow them to limit trading opportunities. Moreover, secondary exchanges have a defense to infringement because they are making a fair use of the index providers' marks.

A. Index Providers Do Not Have a Legally Protectable Interest that Would Permit Them to Control Properly Created ETFs

First, the trademark argument assumes that index providers actually do have a protectable interest in the index as it is used in an ETF on a secondary exchange.[128] However, index providers cannot

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127. State law claims, sounding in either property or tort, are likewise unavailing as the UTP Act of 1994 would preempt any state law permitting imposition of licensing fees on secondary exchanges. 108 Stat. 4081. When a state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," the state law must yield. Capital Cities Cable, Inc. v. Crisp, 467 U.S. 691, 699 (1984) (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1914)). Any state law that could serve as a basis for licensing fees would be contrary to the policies of the UTP Act of 1994. *See supra* Part III.C. The common law tort of misappropriation may be a promising claim for index providers against secondary exchanges who do not pay licensing fees. Index providers, however, have no proprietary interest in the ETFs that could be misappropriated. *See* Golden Nugget, Inc. v. Am. Stock Exch., Inc., 828 F.2d 586, 590-91 (9th Cir. 1987) (holding that the misappropriation claim failed because Golden Nugget had no property interest in the common stock held by its shareholders); *infra* Part IV.A. A claim of unfair competition or unfair trade practices likely will fail, as index providers generally do not compete with secondary exchanges or the ETF issuers. *See* Int'l News Serv. v. Associated Press, 248 U.S. 215, 245-46 (1918) (affirming an injunction *against a competitor* who had misappropriated plaintiff's news stories). Any in-depth examination of state law claims would be state specific and thus beyond the scope of this Note. For present purposes, the general remarks above suffice to demonstrate tbat it is likely that any state law claim would fail.

128. Standard & Poor's, Dow Jones, and the Nasdaq require a licensing agreement before an investment group creates an ETF that tracks their respective indices. *See* Spiders Prospectus, *supra* note 1, at B-64; Diamonds Prospectus, supra note 7, at B-49; QQQ Prospectus, *supra* note 2, at B-50. Intuitively, it is reasonable that the index provider's permission should be required before that index is used to create a product that is profitable for everyone except the index provider. If an ETF based on a given index were created without the permission of the index provider, the creator of the ETF would reap the benefits of the index's diversity and solid track record, without investing any research, labor, or expertise. This intuition is consistent with recent legal reasoning. It is clear from *McGraw-Hill Co. v. Vanguard Index Trust* that an ETF may not be created without the express permission of the index provider. 139 F. Supp. 2d 544, 556 (S.D.N.Y. 2001) (holding that the existing licensing agreement between S&P and Vanguard did not permit Vanguard to create VIPERs, an ETF based on the S&P 500 Index, (not the same VIPERs referenced *supra,* note 2) without S&P's further permission); *see also* Standard & Poor's Corp. v. Commodity Exch., Inc., 538 F. Supp. 1063, 1071 (S.D.N.Y. 1982) (granting preliminary injunction to S&P to stop Comex's unlicensed use of the S&P 500 Index to create new futures contracts on the basis that Comex had misappropriated the index and the "skills, expenditures, labor and reputation of S&P"), *aff'd,* 683 F.2d 704 (2d Cir. 1982). This Note does not examine the creation or listing of exchange traded funds. Interestingly, the economic policy justification

determine or limit the exchanges which may trade an ETF based on that index.[129] The Ninth Circuit compared trading derivative securities to a transaction for a used car, an analogy that also applies to index providers and ETFs.[130] Two persons engaged in a transaction for a used car are not infringing on a manufacturer's mark when they talk about the product as a "BMW" or "Chevrolet."[131] They are just accurately describing the object of the private transaction. In *Golden Nugget*, the Amex accurately described the relevant products as options contracts on Golden Nugget stock.[132] That use did not constitute an infringement on Golden Nugget's mark.[133] Indeed, the court specifically held that Golden Nugget did not have a protectable interest in the markets where its shares are traded because it had retained no "proprietary rights in the shares of its stock that would allow it to control the manner or means of resale of its shares."[134] Imposing a licensing fee on a secondary exchange is nothing more than an attempt to "control the manner or means of resale" of shares in a certain ETF.[135] Just as Golden Nugget retained no proprietary interest in the shares after their initial issuance and the car

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discussion, *see infra* Part V, applies to listing exchanges. However, there might be a legal justification for licensing fees imposed on the listing exchange or the issuing fund. Both these issues are beyond the purview of this Note. Rather, this Note examines tbe imposition of licensing agreements on secondary exchanges that merely extend their unlisted trading privileges to an ETF already created and listed on another exchange.

129. *See Golden Nugget*, 828 F.2d at 590 (holding that a corporation does not have a protectable interest in limiting the exchanges which may trade in its stock or in put and call option contracts based upon its stock); *see also* Champion Parts, Inc. v. Oppenheimer & Co., 878 F.2d 1003, 1008 (7th Cir. 1989) (holding that the corporation has no protectable interesting the market for its shares).

130. *Golden Nugget,* 828 F.2d at 591 ("We see no distinction between shares of stock and second-hand cars in this regard.").

131. *Id.* ("Surely a dealer in a product can describe it accurately by its tradename. . . . Describing the product nondeceptively and by name brand has never been a violation of a manufacturer's trademark."); *see also* Volkswagenwerk Aktiengesellschaft v. Church, 411 F.2d 350, 352 (9th Cir. 1969) (holding that automobile repair shop could advertise that it repaired "Volkswagens" or "VWs" without infringing on trademark); WCVB-TV v. Boston Athletic Ass'n, 926 F.2d 42, 46 (1st Cir. 1991) (holding that television station could use trademarked phrase "Boston Marathon" to describe the event). The Ninth Circuit described these cases "as involving a non-trademark use of a mark—a use to which the infringement laws simply do not apply." New Kids on the Block v. News Am. Publ'g, Inc., 971 F.2d 302, 307 (9th Cir. 1992).

132. *Golden Nugget*, 828 F.2d at 587.

133. *Id.* at 591.

134. *Id.* at 590. Logically, if Golden Nugget did not have a protectable interest in tbe market where its own shares were traded, it would not have a protectable interest in tbe market where derivatives of its shares were traded. Index providers are yet another step logically removed—there is no "market" at all for an index. Instead it is a collection of information designed to be a market barometer. Index providers, therefore, do not have a protectable interest in the market for the derivatives on their indices.

135. *Id.*

manufacturer retains no proprietary interest in the car after initial sale, neither does an index provider have a proprietary interest in an ETF after it has been properly created and issued.[136]

The Seventh Circuit held similarly in *Champion Parts, Inc. v. Oppenheimer & Co.*[137] Champion alleged that Oppenheimer had interfered with "an informed and stable market for shares" of Champion stock because Oppenheimer failed to disclose certain information such as the greater than 5 percent ownership and intention to take over the company.[138] The Seventh Circuit responded that "[n]o case has been cited to us, and our independent research has failed to disclose any case, which holds that an issuer has a property interest in the market for its shares of stock. Indeed the case law is uniform that Champion has no [such] interest. . . ."[139] The court later tempered its language by clarifying that

> Champion correctly observes that it has some interest in the market for its shares since it may choose to raise capital through a future issue of shares. . . . [H]owever that interest is too speculative to give Champion any *protectible* [sic] interest in the market for its shares. To the extent that there is a common law right to a stahle and informed market for shares of stock, and we douht there is such an animal, that right belongs to shareholders, not to an issuer.[140]

By analogy, index providers have no protectable interest that would allow them to determine which exchanges may trade ETFs based on their indices. An index provider does not even have the interest that Champion or Golden Nugget would in the market for their respective shares because an index provider's stock is unrelated

136. One may argue that car manufacturers and index providers are different because there is an ongoing relationship with the index provider that does not exist with the car manufacturer. For cars, there is no ongoing relationship between manufacturers and any consumer (warranties and product liability notwithstanding). But for ETFs, the very identity of the product at any given point in time depends fundamentally on the index provider. There are two responses to this argument. First, an ongoing relationship with the car manufacturer exists, because consumers purchase the manufacturer's good will, not just the physical good. Second, an ongoing relationship does not exist between investors and the index provider. Rather, investors share an ongoing relationship with the issuing fund. The index provider makes a single agreement with the Fund the same way a car manufacturer makes and sells a single car to a retailer. The Fund has a licensing agreement with the index provider because there is a protectable interest at the time the ETF is created. *See supra* note 128 and accompanying text. In contrast, the investors who trade ETFs after issuance have no relationship whatsoever to the index provider.

137. Champion Parts, Inc. v. Oppenheimer & Co., 878 F.2d 1003, 1007-08 (7th Cir. 1989) (holding that an issuer's "interest in the market for its shares . . . is too speculative to give Champion a *protectible* [sic] interest").

138. *Id.* at 1005, 1007. Investors at Oppenheimer used techniques such as side-by-side buying and stock parking to avoid arousing suspicions that they were attempting to obtain a controlling interest in Champion Parts and then liquidate the firm. *Id.* at 1005.

139. *Id.* at 1008 (citing *Golden Nugget*, 828 F.2d 586).

140. *Id.*

to the ETF it is asserting the right to control.[141] Thus, *Golden Nugget* and *Champion Parts* both suggest that index providers do not have a protectable interest such that they could limit the markets permitted to trade the ETFs based on their indices.[142]

When an index provider imposes a licensing fee on a secondary exchange, it asserts an interest that the Seventh and Ninth Circuits have held is not legally protectable.[143] By charging licensing fees, index providers assert the right to determine which exchanges may and which may not trade a properly created ETF based on that index. It is important to remember that the index provider will have a valid licensing agreement with the fund that creates and issues the ETF.[144] However, by charging licensing fees, index providers are reaching beyond creation and issuance to markets where the ETF shares are resold like so many used cars in the *Golden Nugget* analogy. Upon examination, the trademark argument that seemed a promising justification for licensing fees does not withstand scrutiny.

B. Secondary Exchanges May Take Advantage of the Fair Use Defense

Suppose that the index providers could establish a protectable interest that would permit them to control which markets could trade ETFs based on their indices. The fair use defense to infringement would still be available to secondary exchanges extending UTP to an ETF that carries a licensing fee.[145] The Lanham Act provides that it is a defense to infringement if

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141. Index providers may contend that competition from ETFs trading in the same market may interfere with a future issue of their shares. While Nasdaq and Vanguard are not publicly traded companies, Dow Jones and McGraw-Hill, S&P's parent company, are publicly traded. Diamonds and Spiders may therefore trade in the same market as Dow Jones and McGraw-Hill stock. However, Diamonds are not related to Dow Jones stock, hut instead to a Dow Jones product. The value of Dow Jones stock most likely would be unaffected by "competition" with Diamonds. The point remains that if a company does not have a sufficient interest to control the market for its own shares, surely it cannot control the market for ETFs merely based on one of that company's products.

142. This conclusion does not suggest that index providers never have a protectable interest in their indices. Once the index is licensed to an ETF-issuing fund, however, there is no continuing protectable interest such that index providers could prohibit trading of the properly created ETF on any exchange. If an index provider wishes to prevent the use of its index in connection with ETFs, it can deny a license to the issuing fund in the first place. Once that license has been issued, however, the index has no continuing protectable interest in the ETF that would permit it to impose a licensing fee before unlisted trading on a secondary exchange.

143. *Champion Parts*, 878 F.2d at 1007-08; Golden Nugget, Inc. v. Am. Stock Exch., Inc., 828 F.2d 586, 590-91 (9th Cir. 1987).

144. *See supra* note 128.

145. Trademark Act of 1946 (Lanham Trade-Mark Act), 15 U.S.C. § 1115(b)(4) (2000).

> the use of the name, term, or device charged to be an infringement is a use, otherwise than as a mark, of the party's individual name in his own business, or of the individual name of anyone in privity with such party, or of a term or device which is descriptive of and used fairly and in good faith only to describe the goods or services of such party, or their geographic origin.[146]

Plainly reading the text, secondary exchanges would not be liable for infringement because they are merely using the index providers' marks to the extent that they are descriptive of the ETFs available on that exchange. Exchange traded funds are like cars in the sense that the trademark *must* be used to accurately describe the product; there is no way to inform investors about ETFs without mentioning by name the index upon which the ETF is based.[147]

The case law indicates that the fair use defense should indeed protect secondary exchanges from index providers' claims of infringement when they extend UTP to an ETF. The last disjunct of the fair use defense applies when the alleged infringer describes a product that he himself does not produce.[148] Secondary exchanges extending unlisted trading privileges have no proprietary interest in the ETF or the index. The product being described is not their own, but the index provider's, by way of a licensing agreement with the ETF creator.[149] Where the trademark describes the mark holder's product, not the alleged infringer's, a three part analysis has been applied.[150]

> First, the product or service in question must be one not readily identifiable without tbe use of the trademark; second, only so much of the mark or marks may be used as is reasonably necessary to identify the product or service; and third, the user must do nothing that would, in conjunction with the mark, suggest sponsorship or endorsement by the trademark holder.[151]

146. *Id.*

147. Judge Kozinski made a similar point in *New Kids on the Block v. News America Publishing, Inc.*, 971 F.2d 302, 308 (9th Cir. 1992) ("It is no more reasonably possible, however, to refer to the New Kids as an entity than it is to refer to the Chicago Bulls, Volkswagens, or the Boston Marathon without using the trademark.").

148. § 1115(b)(4). When the act requires that the fair use "describe the goods or services *of such party*," the reference is to the allegedly infringed-upon party. *Id.* (emphasis added). The statutory language may not directly apply to the present situation because the ETF issuing fund is an intermediary between the allegedly infringing secondary exchanges and the allegedly infringed-upon index providers. The product described is not "of" the index provider but is "of" tbe issuing fund. This point is mentioned only in passing, and this Note will assume that the index provider has a stronger connection with the secondary exchange than may actually exist.

149. The ETF "belongs to" the index provider only insofar as the index provider has a licensing agreement with the creator of the Fund allowing the ETF to track the provider's index. *See supra* note 128.

150. *New Kids on the Block*, 971 F.2d at 308.

151. *Id.*

Judge Kozinski and the Ninth Circuit applied that test in *New Kids on the Block v. New America Publishing, Inc.* to hold that newspapers identifying the pop band as the subject of public opinion polls did not infringe upon the intellectual property rights of the band.[152] Applying the same three-part test to ETFs shows that secondary exchanges are not infringing on the index providers' marks.

First, exchange traded funds are not readily identifiable without resort to the mark of the index. A Volkswagen or BMW cannot readily be identified without using those marks. One could not describe Spiders as an ETF that tracks the S&P 500 without using that mark, or listing all 500 companies (or at least those that are in the tracking portfolio).[153] It is nearly impossible, especially given the rigid disclosure requirements,[154] to offer, trade, or inform the investing public about a particular ETF without using the mark of the index provider whose index is the basis for that fund. The first element of the defense is satisfied.

Second, secondary exchanges are justified in using the entire mark, especially given the requirement that the secondary exchanges provide a product information guide or prospectus.[155] Admittedly, it is possible to refer to the "Standard & Poor's 500 Index" without using that entire mark. Because the S&P 500 Index is the most prominent market index composed of 500 companies, mere reference to "the 500" may communicate the relevant information to one familiar with the securities markets and financial matters. However, in the interest of full disclosure to the investor, full use of the mark is reasonably necessary to identify the index which is tracked by the particular ETF. The second element is likewise satisfied.

Third, investors should not believe that the index provider has authorized trading of the ETF on this particular exchange. Even assuming that some investor confusion is possible, there is no reason to think that such confusion would cause any harm to the index provider. The First Circuit addressed a similar issue in *WCVB-TV v. Boston Athletic Association.*[156] The appellee television station broadcast a footrace and identified it as the "Boston Marathon" without a licensing agreement from appellant Athletic Association.[157] The court found that even if there were some confusion about the

152. *Id.* at 308-09.

153. *See supra* note 147. Listing the assets is not an easy task. That project occupies fifteen pages of the Spiders Prospectus. Spiders Prospectus, *supra* note 1, at B-13 to B-27.

154. *See infra* notes 160-165 and accompanying text.

155. *See infra* notes 160-165 and accompanying text.

156. 926 F.2d 42 (1st Cir. 1991).

157. *Id.* at 44.

sponsorship of the event, it was harmless because there was no evidence that the television station would profit from viewers wrongly thinking that it had an agreement with the race organizers.[158] Relying in part on this finding that any possible confusion would be inconsequential, the Court affirmed the denial of the Boston Athletic Association's request for an injunction.[159]

On a certain level, the average investor is like the average television viewer. Once the ordinary investor is sure that he is doing nothing illegal, he probably does not care whether the Chicago Stock Exchange has paid a licensing fee to Nasdaq for the ability to UTP the QQQ. The average investor would care about the licensing agreement only insofar as such a fee would be passed on to him. Intuitively, the average investor would prefer that the secondary exchanges *not* pay licensing fees if that meant tighter spreads and lower transaction costs for him.

Additionally, the strict disclosure requirements imposed on exchanges that trade ETFs make it unlikely that investors will actually be confused as to the nature of relationships between the exchanges and index providers. There is very little possibility of confusion where secondary exchanges provide a prospectus or product information brochure to investors.[160] For example, the NYSE has stated that it is the general rule to provide information circulars to its members when new investment products become available on the exchange.[161] These information circulars contain a statement regarding NYSE members' responsibility to "deliver a prospectus to

158. *Id.* at 46 ("Indeed, one would ordinarily believe that television viewers . . . wish to see the event and do not particularly care about the relation of station to event-promoter.").

159. *Id.* at 47.

160. *See, e.g.*, Exchange Act Release No. 34-46,298, 67 Fed. Reg. 51,614, 51,616 (Aug. 8, 2002) ("The Commission believes that NYSE's proposal [to UTP the iShares MSCI Japan Index Fund] should provide for adequate disclosure to investors relating to the terms, characteristics, and risks of trading the Fund. All investors in the Fund, including those purchasing the Fund on NYSE pursuant to UTP, will receive a prospectus or a Product Description regarding the product." (citation omitted)). The SEC used the same language in connection with the NYSE's proposal to UTP Vanguard's VIPERs, iShares Russell 2000 Index Funds, iShares Russell 2000 Value Index Funds, and iShares Russell 2000 Growth Index Funds. Exchange Act Release No. 34-46,306, 67 Fed. Reg. 51,916, 51,918 (Aug. 9, 2002); *see also* Exchange Act Release No. 34-46,299, 67 Fed. Reg. 51,907, 51,915 (Aug. 9, 2002) (granting Barclays an exemption enabling dealers to trade Barclays ETF shares on a secondary market without delivering a prospectus. Instead, "sales in the secondary market must be accompanied by a 'product description,' describing the ETF and its shares"); 67 Fed. Reg. at 51,917 (representing that "As with all ETFs, the [New York Stock] Exchange will distribute an information circular to its members in connection with the trading of the ETFs"). Even NASD members trading equity ETFs through ECNs must deliver product descriptions in connection with sales of ETF shares. 67 Fed. Reg. at 51,915 n.29 (citing NASD Rules 4420(i)(2) and 4420 (j)(2)).

161. 67 Fed. Reg. at 51,917.

[all] investors purchasing shares of the ETFs. . . ."[162] Before an exchange may extend UTP, the exchange must satisfy the SEC requirement that adequate measures have been taken to fully inform the investing public, whether by prospectus, product description, or information circular to exchange members.[163] The prospectus, product description, or information circular should clearly explain on which index the ETF is based, what entity actually created the ETF, and the process used to track the index.[164] To avoid any intellectual property issues, the exchanges should inform the public that there is no licensing agreement with the particular index provider.[165] The possibility of confusion is minimal, and the risk of harm that could result from that confusion is even smaller. The third element of the *New Kids on the Block* test is satisfied.[166] The Lanham Act's fair use defense, therefore, would be available to protect secondary exchanges that extend unlicensed UTP to ETFs.

Index providers do not have a protectable interest that would allow them to limit the markets that may engage in unlisted trading of ETFs based on their indices.[167] Assuming that a trademark infringement argument can be launched against the secondary exchanges that extend unlicensed UTP, the secondary exchanges are merely engaging in fair use by accurately describing another's product. The Lanham Act's fair use defense protects the secondary exchanges as long as they do not mislead the public or use more of the index provider's mark than is reasonably necessary. Even if investors did become confused, which is unlikely, such confusion would be inconsequential.

Current regulation, which incorporates unlisted trading privileges, does not permit index providers' current practice of imposing licensing fees on secondary exchanges. Nor does the practice gain a legal foothold with an intellectual property argument. The

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162. *Id.*

163. *See, e.g.*, *id.* ("The Commission believes that NYSE's proposal *should* provide for adequate disclosure to investors. . . ." (emphasis added)); *Id.* at 51,616 (including identical language).

164. Such information is made clear in several prospectuses. *E.g.*, Spiders Prospectus, *supra* note 1, at A-2 to A-3; VIPERs Prospectus, *supra* note 2, at 1, 5; Diamonds Prospectus, *supra* note 7, at A-2 to A-3; QQQ Prospectus, *supra* note 2, at A1 to A2.

165. Nasdaq has required the Philadelphia Stock Exchange to make precisely this disclosure, in addition to certain disclaimers, in a licensing agreement allowing it to trade the QQQ on an unlisted basis. Excbange Act Release No. 34-43,717, 65 Fed. Reg. 80,976, 80,979 (Dec. 22, 2000).

166. This conclusion assumes that prospectuses, information circulars, and product description brocbures actually are distributed in strict accordance with SEC regulations.

167. *See supra* Part IV.A.

burden licensing fees place on the market is unsupportable under current law.

V. ECONOMIC POLICY JUSTIFICATIONS FOR ETF LICENCING FEES ARE UNSATISFACTORY

The argument against licensing fees is incomplete without a consideration of economic policy. If licensing fees would be more efficient or create more wealth than the current legal status quo, a legal argument against licensing fees rings somewhat hollow. Unlisted trading privileges were designed, at least in part, to foster inter-market competition by eliminating the possibility of competition for unique trading opportunities.[168] It therefore follows that no discussion of licensing fees, which restrict a secondary exchange's ability to extend unlisted trading privileges, is complete without examining the competitive effects that the licensing fee might have. This section examines the conventional wisdom regarding inter-market competition, but notes that concerns about market fragmentation may suggest an argument in favor of licensing fees. A particular form of this argument, focusing on issuer control of trading environment, is briefly described and then applied to index providers' imposition of licensing fees. The following section responds to that argument, ultimately concluding that the proposed issuer control theory does not support licensing fees.

A. Inter-Market Competition May Not Be the Answer

The current regulatory regime is driven by inter-market competition. The conventional wisdom is that inter-market competition leads to more efficient markets, ultimately benefiting investors. For example, the SEC generally makes certain findings when it evaluates a proposal's effects on inter-market competition. The Commission usually finds that the proposal to extend UTP to a security "will provide investors with a convenient and less expensive way of participating in the securities market."[169] The SEC also often finds that UTP "can produce added benefits to investors through the

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168. H.R. REP. NO. 103-626, at 5-6 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299, 3303-04.

169. Exchange Act Release No. 34-43,773, 66 Fed. Reg. 838, 842 (Jan. 4, 2001); Exchange Act Release No. 34-45,718, 67 Fed. Reg. 18,965, 18,970 (Apr. 17, 2002); Exchange Act Release No. 34-46,306, 67 Fed. Reg. 51,916, 51,918 (Aug. 9, 2002); *see also* Exchange Act Release No. 34-46,306, 67 Fed. Reg. 51,907, 51,914 (Aug. 9, 2002) (substituting "fixed income markets" for "securities markets" as appropriate for the ETF and omitting "and less expensive"); Exchange Act Release No. 34-46,298, 67 Fed. Reg. 51,614, 51,615 (Aug. 8, 2002) (substituting "foreign securities" for "securities" as appropriate for the ETF).

increased competition between other markets trading the product."[170] Congress believes that fostering inter-market competition benefits investors.[171] The regional exchanges agree with the conventional wisdom; the Boston Stock Exchange wrote in a proposal to the SEC that "this increased competition among markets can benefit investors."[172]

This conventional wisdom applies in specific instances as well as in theory. The previously described battle between the NYSE and the Amex over ETFs and transaction charges is perhaps the clearest example of inter-market competition at work, driving efficiency and lowering costs.[173] When Spiders and Diamonds began trading on multiple markets, the additional volume helped to lower spreads,[174] which can measure the cost of trading.[175] It is commonly understood that inter-market competition increases efficiency by lowering transaction costs as the markets attempt to draw order volume to their floors.

170. *See e.g.*, 67 Fed. Reg. at 51,615; 67 Fed. Reg. at 51,918.

171. Ludlow Corp. v. SEC, 604 F.2d 704, 709 (D.C. Cir. 1979) ("Unlisted trading, therefore, is an indispensable part of Congress' plan that securities markets compete with one another. At present the smaller exchanges earn much revenue from unlisted trading. Exchanges like the BSE must be able to trade securities on an unlisted basis to compete with the NYSE and, indeed, to survive.").

172. Exchange Act Release No. 34-43,926, 66 Fed. Reg. 9731, 9734 (Feb. 9, 2001).

173. *See supra* notes 74-77 and related discussion.

174. *NYSE To Trade 27 Additional Amex-listed ETFs*, *supra* note 69 ("[T]he additional ETF trading volume flowing through previous UTP arrangements has helped whittle away the spread between bid and ask prices. For example, the spread between DIAMOND pricing dropped from 25 cents to 7 cents, and SPDRs fell from 15 cents to three cents . . . .").

175. The bid-ask spread is the difference between the lowest amount a seller will accept for a security and the highest amount a bidder will pay for the same security. For example, if a bidder wants to buy a security at no more than $50, but no seller will sell for less than $51, the bid-ask spread is $1. Broker-dealers use the spread to negotiate securities transactions in a market with imperfect information. The bid-ask spread is a measure of liquidity because it amounts to a transaction cost; the higher the broker-dealer's risk in temporarily holding a large amount of the security, the higher the transaction costs, and the lower the liquidity of the security. One analyst believes that "investors will benefit from the increased competition. Spreads will most likely narrow." Kelly, *supra* note 64, at 1 (quoting Kevin McNally, an ETF analyst and vice president at Salomon Smith Barney). Moreover, the SEC applied the conventional wisdom in ruling on the Amex's proposal to allow side-by-side trading and integrated market making. ("'Side-by-side trading' refers to the trading of securities and related derivative products at the same location, though not necessarily by the same specialist. . . . 'Integrated market making' refers to the trading of securities and related derivative products by the same specialist and/or specialist firm." Exchange Act Release No. 34-46,213, 67 Fed. Reg. 48,232, 48,233 nn.9-10 (July 23, 2002)). The SEC found that "the potential improvements to liquidity and quality of the markets in ETFs and TIRs and their related options by the Amex's proposal outweigh the regulatory concerns [of misuse of material, non-public information]." *Id.* at 48,236. "TIR" is an acronym for "Trust Issued Receipt," which for present purposes is a type of ETF.

Despite its widespread acceptance, some argue that application of policy that is based on conventional wisdom favoring inter-market competition may have some negative effects. Some analysts believed that investors would not actually benefit from the NYSE and the Amex eliminating transaction fees for ETFs. As one analyst noted, "The suspended fees will likely benefit the asset managers and the brokers, but investors will still be charged commissions. The downside for [investors] might be a reduction in liquidity . . . ."[176] Multimarket trading of ETFs might fractionalize the market, reducing liquidity.[177] Fragmenting the market can lower liquidity because "[s]omeone might be raising the bid on one exchange while someone else is lowering an ask on another exchange, and there's no guarantee they'll ever find each other . . . ."[178] Several brokers at the NYSE had similar concerns when that exchange first extended unlisted trading privileges to certain Amex ETFs.[179] While the conventional wisdom is that inter-market competition drives efficiency, that very same competition may cause fragmentation, thereby reducing liquidity and depressing value.

B. The Amihud and Mendelson Argument for Issuer Determination of Trading Circumstances

Seizing on the negative effects of market fragmentation, Professors Yakov Amihud and Haim Mendelson argue that issuers of securities ought to have the exclusive right to determine how and where their securities are traded.[180] Amihud and Mendelson logically start with the premise that issuers of securities have an incentive to maximize the liquidity of the market for their security because that will maximize value.[181] Having the same security traded in multiple markets has an indeterminate effect on the security's liquidity, and consequently its value.[182] Amihud and Mendelson cite several

176. Brent, *supra* note 15, at 2.

177. *Id.*

178. *Id.*

179. *See* Kouwe, *supra* note 66, at 7 (quoting an NYSE broker as saying, "'I think we will be taking some volume away from tbe Amex, but ultimately we may be depleting the total volume traded in these ETFs because there is no longer one central point of execution'").

180. Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411, 1464 (1996).

181. *Id.* at 1428, 1431 ("Illiquidity costs affect securities values because investors require compensation for bearing these costs. As a result securities with higber illiquidity costs will have lower values .... [Securities issuers therefore] pursue policies directed at increasing the liquidity of their publicly traded claims.").

182. *Id.* at 1433-41 (finding that "[b]oth theory and empirical evidence thus show that multimarket trading is beneficial in some cases and harmful in others").

empirical studies demonstrating the indeterminate effects of multimarket trading on a security's liquidity.[183] In one study, prices for NYSE and Amex listed stocks rose significantly, on average, on the day a regional exchange announced an application for UTP; 53 percent of stocks enjoyed a decline in bid-ask spreads, while 47 percent experienced an increase.[184] In another study, the Boston Stock Exchange and National Stock Exchange had experimental programs where their brokers could compete for orders for NYSE stocks without quoting narrower spreads; 67 percent of the stocks had a decline in bid-ask spreads and 33 percent experienced an increase.[185] Because multimarket trading benefits some issuers while harming a substantial minority, Amihud and Mendelson propose that the issuer be the sole determiner of where and how its securities are traded.[186] Those issuers who benefit from multiple market trading would be permitted to engage in that practice, while those issuers who would be harmed could consolidate all trading of their claims to a single market of their choosing.[187]

Amihud and Mendelson further argue that the current regulatory regime is flawed because it takes a "one size fits all" approach to market regulation when the evidence suggests that a significant minority of issuers would fare better with different rules.[188] Moreover, the current multimarket regime encourages a race to the bottom among markets as they attempt to attract traders by allowing them to violate the rules of better-organized markets.[189] The authors contend that the race to the bottom makes regulatory oversight by the SEC necessary.[190] Both these problems could be solved, argue the authors, if individual issuers were given the exclusive authority to determine where and how their securities were traded.[191] The end results of the issuer-control scheme would be as follows: (1) there would be no need for regulatory oversight by the SEC because issuers

183. One current statistic not available to the authors shows that the increased trading volume due to unlisted trading of Diamonds and Spiders has resulted in lower spreads. *NYSE to Trade 27 Additional AMEX-listed ETFs*, *supra* note 69, at 2 ("[T]he spread between DIAMOND pricing dropped from 25 cents to 7 cents, and SPDRs fell from 15 cents to three cents").

184. Amihud & Mendelson, *supra* note 180, at 1439 (citing Walayet A. Khan & H. Kent Baker, *Unlisted Trading Privileges, Liquidity, and Stock Returns*, 16 J. FIN. RES. 221 (1993)).

185. *Id.* at 1440 (citing Robert Battalio et al., Do Competing Specialists and Preferencing Dealers Affect Market Quality? An Empirical Analysis (Nov 15, 1995) (unpuhlished manuscript, on file with Amihud & Mendelson)).

186. *Id.* at 1441-42.

187. *Id.*

188. *Id.*

189. *Id.* at 1445.

190. *Id.*

191. *Id.* at 1442.

would force the markets to self-regulate; (2) securities values would be maximized by issuers who could determine the most liquid market for their securities; and (3) security holders as a group would benefit from the increased liquidity of markets and corresponding increased value of their securities.[192]

Amihud and Mendelson's scheme would apply special rules to derivative securities like ETFs.[193] This would be necessary because, in cases where an issuer did not permit trading on a particular exchange, the rule of exclusive issuer control could be circumvented by creating a derivative security that mirrored the performance of that security but was issued by a firm willing to allow trading on that exchange.[194] Amihud and Mendelson propose a "fair use" rule that would not permit such an end-run if the derivative security's value is accurately predictable from the value of the original security alone.[195] Such a derivative security could not be traded without the underlying security issuer's consent.[196]

The Amihud and Mendelson proposal seems to support index providers and licensing fees. Some ETFs may benefit from trading in multiple markets, but some may suffer decreased liquidity and value. Those ETFs that are harmed by multimarket trading should be permitted to consolidate trading in a single market. The licensing fee is one mechanism that can be used to control the trading environment of ETFs. If the QQQ's liquidity is increased by multiple market trading, a licensing agreement would be granted to any exchange desiring to trade the QQQ. If, however, Spiders' liquidity is decreased by multiple market trading, the licensing agreement would be granted to a single exchange, presumably the one with the "best" rules for investors in Spiders. If licensing fees were indeed the logical result of

192. *Id.* at 1445-47.

193. The term "derivative" denotes a security whose value is determined either explicitly or implicitly by the value of another security. The most obvious example is the stock option contract, whose value depends on the value of the underlying stock.

194. Amihud & Mendelson, *supra* note 180, at 1455 (noting that the "most obvious contingent claims are stock options"). Consider the following example: The issuer of security A ("Issuer") determines that A's liquidity and value are maximized through consolidation; thus, the NYSE is the only market where security A may be traded. The Law Review Exchange, desirous of the volume of security A, decides to create and issue security B. Security B is a derivative whose value is exactly tied to security A's value. The Law Review Exchange, as the issuer of security B, permits trading on the LRE. Despite the attempt to consolidate trading of security A on the NYSE by Issuer, the LRE effectively has fragmented the market for security A by creating and trading the functional equivalent of A— security B.

195. Amihud & Mendelson, *supra* note 180, at 1455.

196. *Id.* at 1461 ("The prices of security *A* can be used in any contract *B* without the consent of *A*'s issuer unless either (i) *B* is a traded derivative security with respect to *A*; or (ii) *B* is a traded derivative security with respect to some security *C* that is itself a traded derivative security with respect to *A*.").

the Amihud and Mendelson proposal, there would be an economic policy justification for imposition of such fees. Namely, there would be an absolute increase in liquidity, and thus value, when ETFs currently harmed by multimarket trading were permitted to consolidate. Such an economic justification would weigh heavily in favor of licensing fees, despite their lack of legal basis. The following section argues that this economic policy justification, while appealing at first blush, is ultimately chimerical.

C. Response to the Amihud and Mendelson Argument

Two main points render such an economic justification for licensing fees unpersuasive. First, their proposal, as applied in the ETF context, does not account for the different incentives of index providers and issuers. Second, the Amihud and Mendelson proposal does not accomplish its goal of eliminating the currently problematic "one size fits all" regulatory approach. Moreover, while the problems of a "one size fits all" approach at the issuer level motivate the proposal, such an approach benefits investors *as a group*. These problems strongly suggest that the Amihud and Mendelson proposal cannot serve as an economic policy justification that would save licensing fees from a lack of legal justification.

1. There Is a Relevant Distinction Between Issuers and Index Providers

First, there is a relevant distinction between ETF issuers and index providers. If the issuers of ETFs were charging licensing fees, Amihud and Mendelson would presumably applaud. But issuers are not currently imposing licensing fees on secondary exchanges for ETFs. Rather, index providers are doing so.[197] Substituting "index providers" for "issuers" in the Amihud and Mendelson proposal ignores a critical difference in incentives between the two groups. The central assumption of the issuer-control proposal is that issuers have an incentive to increase liquidity because liquidity benefits investors as a group and makes raising equity capital in the future easier.[198] The index provider does not have the same incentives as the issuer of the ETF to maximize liquidity.

The index provider has no reason to increase the liquidity of an ETF that uses its index because the index's value is entirely

197. *See supra* Part III.A.

198. Amihud & Mendelson, *supra* note 180, at 1416 ("The issuer, therefore, has the incentive to select the trading regime that will maximize the value of its securities.").

independent of the ETF. Increasing the liquidity of the ETF has no impact on the index provider, except insofar as the provider collects licensing fees on a per transaction basis. In that case, the index provider does have the incentive to increase liquidity of the ETF to maximize its licensing fee. This argument for licensing fees, though, presumes the conclusion that index providers could *already* charge licensing fees.[199] Moreover, the issuer of the ETF already has an incentive to increase the ETF's liquidity and can be expected to act rationally on that incentive.[200] The index providers' licensing fees would be a duplicative method of creating the same incentive for a different party. Any liquidity benefits will already be achieved by the issuer. Giving index providers the same control will not result in additional liquidity benefits. If a licensing fee is charged, exchanges will pass the fee through to the specialists or market makers.[201] The specialists or market makers will then recoup that charge from the investing public. Thus, the investing public will pay greater transaction costs without receiving the benefits of additional liquidity.

To highlight the difference between index providers and issuers, consider the following: The Law Review 50 is an index of the fifty largest firms listed on the Law Review Exchange. It is created and maintained by Vandy Group, Inc. Vandy Group licensed the Law Review 50 index to Issuer for use in Issuer's new ETF. Issuer has determined that multimarket trading of the new ETF will maximize liquidity; Issuer therefore permits trading on the Amex, the NYSE, and the LRE. However, Vandy Group disapproves of the LRE, and refuses to grant the LRE a license. What happens when an issuer wants multimarket trading, but the index provider refuses to license some, or all, exchanges? The converse is equally problematic: Vandy Group believes multiple market trading is a valuable advertising opportunity, and so grants licenses to the Amex, NYSE, and the LRE. Issuer wants to consolidate trading on the Amex. Allowing both issuer and index provider to control trading circumstances could lead to a stalemate. It is at best unclear how these conflicts should be resolved. It is clear, however, that application of the Amihud and Mendelson proposal to ETFs is problematic.

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199. Index providers can charge licensing fees to the issuing trust of the ETF, and these fees may be on a per transaction basis. Thus, the index provider would have an incentive to maximize liquidity of the ETF. The argument that such an incentive is duplicative, however, still applies. No additional liquidity benefits will flow to investors as a result of the index providers' incentives. There also is no guarantee that issuers and index providers will agree on what trading circumstances will maximize liquidity.

200. *Id.* at 1415 ("[T]he issuer has the clearest incentive to choose the most efficient trading regime for its securities."); *see also* notes 181-187 and accompanying text.

201. *See, e.g.*, *supra* note 93 and accompanying text.

Because ETFs are strong derivatives of a particular index, Amihud and Mendelson's analysis of derivatives might support another argument in favor of licensing fees.[202] The authors conclude that for "traded derivative securities," the issuer of the underlying security must grant permission before the derivative can be traded.[203] It would seem to follow that, if ETFs are derivatives of indices, the index provider should have the relevant stake in the ETF to assert control over its trading environment in the form of a licensing fee.

Assuming ETFs meet Amihud and Mendelson's test for traded derivative securities, the rationale for allowing the index provider to control the trading regime still fails because the index provider is not an issuer of a security. The motivation behind Amihud and Mendelson's traded derivative security rule is that some issuers may be harmed by the fragmentation caused by competition between a security and its derivative.[204] If a substantially similar product (the derivative) is available in another market, the problems of market fragmentation arise despite the underlying security issuer's desire to consolidate trading in a single market with issuer-favorable rules.[205] However, no matter how perfectly an ETF tracks an index, there will be no competition between the two because the former is a security and the latter is a collection of information designed to be a market barometer.[206] The rationale supporting the application of issuer-control theory to derivatives fails in the case of index providers and ETFs because there is no competition between the two.

It might be argued that an index provider, because its mark is being used on the ETF, has an incentive to increase liquidity to enhance its own good name and reputation in the financial world. One may also speculate that trading ETFs in multiple markets might reduce the value of the ETF, thus negatively impacting the reputation of the underlying index. For example, if Diamonds are traded in multiple markets despite Dow Jones' wishes, Diamonds may suffer a

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202. *See supra* notes 1-3.

203. Amihud & Mendelson, *supra* note 180, at 1457-58 ("[O]ur rule will require the issuer's consent before a market may allow public trading in contingent claims, such as listed options, that can serve as substitutes for the underlying traded security.").

204. *Id.* at 1456; *see also* Part V.B.

205. Amihud & Mendelson, *supra* note 180, at 1455-56.

206. It bears mentioning that the Amibud and Mendelson threshold for being a traded derivative security permits the creation of market indices without the underlying security issuer's consent. *Id.* at 1464 (fixing the traded derivative security threshold to "allow the creation of broad market indices without requiring the consent of the issuers of component individual securities."). It is highly unlikely that a single underlying security would be so predictive of an index that the issuer should be able to control the trading environment of the ETF based on it. *Id.* Thus, an ETF could be a traded derivative security of and be in competition with only an index, but not a particular security contained within an index.

negative price impact from illiquidity that could reflect poorly on Dow Jones as an index provider. The following section maintains that even if index providers could establish that they were negatively impacted by ETF illiquidity, other problems with the Amihud and Mendelson proposal would still suggest that it does not supply the needed economic justification to support licensing fees.

2. The "Might Makes Right" Approach Does Not Solve the Problem of "One Size Fits All" Regulation

One substantive concern with the Amihud and Mendelson proposal is that it substitutes a "might makes right" approach for the current "one size fits all" approach.[207] This substitution does not ultimately solve the problem of "one size fits all" regulation. Exchanges will compete with each other for exclusive issuer permission to trade the most popular and profitable securities.[208] There are certain securities issuers (big issuers) that are so popular that it is unlikely an exchange could survive without having any of them permit trading on that exchange. The members of the Major Market Index may be such issuers.[209] Regional stock exchanges such as Cincinnati (now National Stock Exchange), Philadelphia, Boston, and Chicago would suffer most if the NYSE or the Amex obtained exclusive trading agreements with such popular issuers. In 1992, for example, over 97 percent of the trading volume on the regional exchanges was in unlisted NYSE and Amex stocks.[210] Without unlisted trading privileges, it is doubtful that the regional exchanges would be able to survive.

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207. The term "might makes right" is used to describe the situation that follows in the text, where some securities issuers are so powerful that they can demand that the exchanges adopt favorable rules before allowing trading of their claims.

208. If the issuer benefited from multiple market trading, it is unlikely that it would enter into an exclusive trading agreement with any exchange. One can assume, however, that at least some big issuers will consolidate trading. Those big issuers who are indifferent to multimarket versus consolidated trading may be "talked into" exclusive agreements by the exchanges desiring to gain a competitive advantage. The Note is concerned, at this point, with big issuers who would not refuse a profitable exclusive trading agreement, if available.

209. The Major Market Index is an index of twenty large companies computed by the Amex. American Stock Exchange, Other Products, Product Information, List All Indexes, Amex Major Market Index, *at* http://www.amex.com (last visited March 2, 2004). The most heavily weighted stocks in the index are (in descending order): Procter & Gamble, IBM, Chevrontexaco Corp., 3M Co., Altria Group, Johnson & Jobnson, and American Express. American Stock Exchange, Otber Products, Product Information, List All Indexes, Amex Major Market Index, Show Index Components, *at* http://www.amex.com (last visited March 2, 2004).

210. Amihud & Mendelson, *supra* note 180, at 1417 (citing DIV. OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS (1994)).

To secure the big issuers necessary to survival, the exchanges in the Amihud and Mendelson scheme would adopt trading rules and machinery that most favored the big issuers. If not, the big issuers would be powerful enough to demand rule changes before permitting trading on an exchange.[211] When the interests of two issuers diverge, the exchanges would adopt the rule benefiting the one with the larger profit potential. Adopting rules and procedures to benefit the greatest number of big issuers may not benefit a numerically large group of medium- or smaller-sized issuers. Issuers whose interests differ from those of the big issuers would be shut out of the courtship, and would have to live with the rules dictated by the big issuers. However, it is a basic premise of Amihud and Mendelson's argument that one size does *not* fit all.[212] Allowing the big issuers to "capture" the exchanges would bring back the status quo the authors criticize: several issuers would be satisfied with the rules, and several would not. This situation troubles Amihud and Mendelson, but their proposal does not avoid it.

Amihud and Mendelson attempt to respond to this argument by suggesting that an exchange could adopt different rules for different issuers.[213] That suggestion is inconceivable in a functional legal system. If different issuers have different rules on their own suggestion, there are in reality no rules at all. Suppose one issuer wants a rule requiring immediate disclosure of block trades. The exchange adopts it for this issuer, but other issuers need not require disclosure if they would rather not; they have their own, different rules. How is the individual investor to know what he must disclose?[214] Worse, suppose that the first issuer changes its mind, and

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211. As an example of demanded rule changes, ETF Advisors Trust et al., in applying for certain exemptions from the Investment Company Act of 1940, wrote: "Applicants state that any other Exchange that applies for unlisted trading privileges in FITRs [the proposed Fund] *will have to adopt* similar rules [pertaining to Product Descriptions]." ETF Advisors Trust et al., Exchange Act Release No. IC-25,725, 67 Fed. Reg. 57,464, 57,465 (Sept. 10, 2002) (emphasis added). Although this statement merely is a practical application of 17 C.F.R. § 240.12f-5, which requires any UTP exchange to have listing standards comparable to the primary or listing market, the statement is a perfect example of the demands big issuers might make, and to which regional exchanges would have no option but acquiesce.

212. Amihud & Mendelson, *supra* note 180, at 1441 ("'One size fits all' regulation is clearly undesirable.").

213. *Id.* at 1451 ("[A] market may choose to implement different rules for different securities based on their issuers' preferences"). To implement this system, exchanges might have "a menu of . . . rules offered to different securities on the same exchange." *Id.* at 1452.

214. The situation becomes substantially more complicated as the rule becomes more complicated. For example, there are more possible regulations than disclosure and non-disclosure. Some issuers may permit delayed disclosure with a period of delay ranging from seconds to days. It is difficult for the investor to know what to disclose, and even more difficult to know when he must disclose it.

does not wish for its security holders to have to disclose block trades anymore. There seems to be nothing to keep the rule from changing. This lack of predictability and uniformity would undoubtedly make investors wary and have a chilling effect on investment until uniform, predictable rules were adopted.

There is a second substantive problem with the Amihud and Mendelson proposal: their rejection of the "one size fits all" regulatory approach shifts the constraint of uniformity from issuers to the individual investor. Rather than "one size fits all" at the national level, Amihud and Mendelson propose a "one size fits all" scheme at the security-holder level. As they state, "management's decision on the trading regime should serve the interests of the current security holders *as a group*."[215] In effect, a smaller, more fragmented "one size fits all" approach has been substituted for a national "one size fits all." There are two problems with this tactic.

First, the issuer of a security has no interest in the security when it is in the hands of individual holders,[216] so there appears to be no legal basis for allowing the issuer to determine what a particular security holder may do with his shares. Second, it is not necessarily the case that all holders of a particular security will want to, or should, follow the same rules. Consider the following: Procter & Gamble (P & G) has decided that liquidity of its shares is maximized in a market that enforces immediate disclosure of block trades. The Law Review Exchange allows delayed disclosure of block trades. Smith, an individual investor, wants to trade a large block of P & G stock without immediately disclosing that he is doing so. His natural outlet is the Law Review Exchange, but P & G has determined that Smith may not trade his P & G stock on the LRE. Other P & G shareholders do not want to trade without the disclosure requirements, or are indifferent. Rather than all issuers being treated the same under a "one size fits all" approach, Smith and all the other P & G shareholders are treated identically under a "one size fits all" approach.[217]

There is no principled reason for the distinction between security holders and issuers with regards to a "one size fits all" approach. That approach should either be acceptable for both groups, or unacceptable for either. Amihud and Mendelson claim that issuers

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215. Amihud & Mendelson, *supra* note 180, at 1442 (emphasis added).

216. *See supra* note 129 and accompanying text.

217. The problem is evident over time, as well. If immediate disclosure benefits security holders as a group today, there is no guarantee that it will continue to benefit a different group of security holders in ten or twenty years. Yet future security holders are treated the same as present security holders, despite potentially conflicting interests.

will choose the trading regime that is best for their security holders *as a group*.[218] Ironically, the empirical evidence demonstrates that the current regulatory regime benefits issuers *as a group*.[219] The minority of issuers who desired a different trading regime motivated Amihud and Mendelson to devise a system whereby the minority of issuers could design their own rules.[220] However, the minority of security holders who do not agree with the issuer's determination of trading regime are simply out of luck.[221] There appears to be no reason for benefiting issuers on an individual basis while simultaneously benefiting security holders as a group.[222]

Amihud and Mendelson proposed that issuer control of trading regime may increase liquidity and value of the security.[223] Their proposal seems to support index providers that charge licensing fees. On closer scrutiny, though, index providers cannot be substituted for issuers in the theory. Moreover, substantive concerns with the proposal indicate that it does not provide the hoped-for support for licensing fees. It therefore appears that there is no economic policy basis for licensing fees that would justify the current practice.

VI. CONCLUSION

Index providers currently impose licensing fees on secondary exchanges that trade exchange traded funds based on the providers' indices.[224] Exchanges appear for the most part to acquiesce in this

218. Amihud & Mendelson, *supra* note 180, at 1442.

219. 53 percent of stocks in one study and 67 percent in another, enjoyed decreased spreads under the current multimarket trading regime. *See supra* notes 182-185 and accompanying text.

220. Amihud & Mendelson, *supra* note 180, at 1439-40 (referring to the 47 percent and 33 percent minorities as "a sizable proportion" and "a significant proportion," respectively).

221. One may argue that Smith should not be permitted to trade as he desires because he does not maximize the liquidity and value of his securities. First, there is still no legal basis for P&G telling Smith where he may and where he may not trade his securities, regardless of his rationality. *See, e.g.*, Golden Nugget, Inc. v. Am. Stock Exch., Inc., 828 F.2d 586 (9th Cir. 1987). Second, there is little reason to suspect that P&G is familiar enough with Smith's circumstances to know that his trade will in fact decrease liquidity. Short of arguing that Smith cannot exist or should be ignored, the problem of applying a general rule to specific individuals in various circumstances remains.

222. Amihud and Mendelson respond that individual traders have an incentive to deviate from the issuer's plan to increase liquidity. Amihud & Mendelson, *supra* note 183, at 1464-65. Issuers' interests, however, will always be to maximize liquidity, resulting in maximized "overall wealth by reducing the cost of capital in the economy at large." *Id.* at 1465. While this may be true, one can hypothesize that allowing Smith, and only Smith, to execute this particular trade on the LRE would increase liquidity, and thus be in P&G's interests. The problems of "one size fits all" are not avoided when issuers can control trading regime only by general rule.

223. Amihud & Mendelson, *supra* note 180, at 1464-66.

224. *See supra* Part III.A.

practice, paying the licensing fees because of the huge profit potential in the ETF market. One reason for their acquiescence is that the exchanges then pass those fees on to specialists or market makers.

Allowing index providers the opportunity to limit the exchanges permitted to trade ETFs is contrary to congressional policy, as demonstrated by the Unlisted Trading Privileges Act of 1994.[225] First, licensing fees reintroduce de facto procedural formalities that Congress sought to eliminate in passing the UTP Act of 1994. Second, licensing fees reduce inter-market efficiency competition by introducing the possibility of substantive competition.

While a trademark-based argument seems an attractive justification for imposing licensing fees on secondary exchanges, it ultimately does not withstand scrutiny. First, index providers do not have a protectable interest that would allow them to control ETFs that are traded on secondary exchanges.[226] Much like a car manufacturer does not have a protectable interest in the resale of one of its cars, index providers do not have a protectable interest in the resale of ETFs in the marketplace.[227] To the extent that index providers could establish a protectable interest in their marks as used by secondary exchanges trading ETFs, the fair use defense to infringement protects the secondary exchanges.[228] Legal justification for secondary exchange licensing fees is lacking.

Because market fragmentation may reduce liquidity, it is possible that the current policy of promoting inter-market competition is not the most economically efficient. Seizing on that possibility, Professors Amihud and Mendelson argue for the economic benefits of issuer control of trading regime.[229] Because issuers have the best incentive to increase liquidity and value, the professors argue that the issuers should be permitted to determine, perhaps through licensing fees, which exchanges may trade their securities.[230] With regard to ETFs, it was initially hoped that the reasons issuers could be relied upon to demand rules increasing liquidity would also apply to index providers, thus providing an economic justification for licensing fees. However, it is not at all clear that index providers do, in fact, have the same incentives as securities issuers. Assuming that they do, index providers' incentives would be merely duplicative of the issuers' and

225. *See generally* Pub. L. No. 103-389, 108 Stat. 4081 (1994) (codified at 15 U.S.C. § 78*l*(f) (2000)); H.R. REP. NO. 103-626 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3299.

226. *See supra* Part IV.A.

227. *See supra* note 131 and accompanying text.

228. 15 U.S.C. § 1115(b)(4) (2000).

229. Amihud & Mendelson, *supra* note 180, at 1464-66.

230. *Id.* at 1415.

would depend entirely on the provider being able to charge licensing fees.

Apart from the distinction between issuers and index providers, there are substantive concerns with Amihud and Mendelson's proposal. First, the authors argue that "one size fits all" is not a valid regulatory approach.[231] They would substitute a "might makes right" approach whereby the most powerful issuers could demand rules favorable to themselves.[232] Rather than the SEC dictating general rules to all issuers, the big issuers could dictate general rules to all the other issuers. The problems of "one size fits all" regulation are therefore not avoided despite individual determination of trading regime. Second, Amihud and Mendelson find the "one size fits all" approach at the issuer level problematic, but suggest rules that benefit security holders as a group, thereby creating a "one size fits all" approach at the investor level.[233] Ironically, issuers benefit as a group from inter-market competition.[234] There is no principled reason that benefiting investors as a group under the current regulatory regime is unacceptable, but benefiting security holders as a group is permissible under the proposed scheme.

There is no legal or economic justification for the current practice of index providers imposing licensing fees on secondary exchanges for the unlisted trading of ETFs. Index providers have no special status, legal or economic, that permits them to charge such licensing fees. The fees constitute a burden on the market that should not be borne ultimately by the investing public absent some reasonable justification.[235]

Inter-market efficiency competition can drive the elimination of the very licensing fees that may inhibit it. The pass-through of fees to specialists seems to negate the exchanges' incentives to challenge licensing fees. However, the first secondary exchange to successfully challenge licensing fees on ETFs will gain a competitive advantage because its overall trading experience will be cheaper. The logic of market competition suggests that the other exchanges will follow suit and licensing fees will ultimately disappear. A successful challenge

231. *Id.* at 1441.

232. *See supra* Part V.C.2.

233. Amihud & Mendelson, *supra* note 180, at 1441.

234. *See supra* note 219 and related discussion.

235. One may suggest that the burden of licensing fees either will not "trickle down" to the investing public, or it will be so dissipated as to be negligible. This result is possible, though not likely in a system of inter-market competition. Regardless who directly benefits from the elimination of licensing fees, however, the cheaper transaction costs would be an economic improvement in absolute terms. The current practice, at best, does not hold forth the same promise of economic improvement.

will directly benefit investors by reducing their transaction costs, and creating a more efficient, liquid market for the already tremendously popular exchange traded funds.

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