SOME PROBLEMS WITH STOCK EXCHANGE-BASED SECURITIES REGULATION

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INTRODUCTION

In The Exchange as Regulator,1 Paul Mahoney makes a number of important contributions to our understanding of securities regulations and the structure of stock exchanges. Mahoney's article sheds light on several aspects of the history of U.S. and British securities regulation and, in doing so, challenges some of the key assumptions that justified the establishment, and may be argued to justify the continued existence, of the present regulatory system.

In particular, Mahoney contests two commonly held beliefs. The first is that the type and level of regulations imposed by the New York Stock Exchange and other exchanges prior to the New Deal were substantially more lenient than the type and level of regulations imposed by the Securities Exchange Act of 1934. Mahoney argues that in four important areas—disclosure, manipulation, margin rules, and short selling—the Exchange Act did not significantly alter the pre-existing regulatory structure.2 The second belief challenged by Mahoney is that governmental oversight of internal exchange rules (on commissions, broker/dealer functions, and the like) limited the ability of exchanges to extract consumer surplus from the trading public. Mahoney argues that any such limitations are more likely due to conflicts of interest between brokers and dealers and to competition among exchanges than to governmental oversight.3 In both of these respects, Mahoney's article is a continuation of an ongoing study of the historical foundations of the regulatory system as we know it.4

To me, however, the most innovative and provocative arguments Mahoney makes lie outside the historical realm. Mahoney argues that regulatory authority over many important aspects of securities trading should de-
volve to the stock exchanges. It is to this proposal that the bulk of my Commentary is addressed.

Mahoney sees several forces at work that make stock exchanges a regulator superior to the federal government (and, at least implicitly, to other regulatory bodies as well). First, he argues that exchanges have strong incentives to adopt rules that benefit investors in order to attract transactions to the exchange and thereby maximize profits to exchange members. Second, he argues that regulatory competition by (decentralized) exchanges is likely to result in a superior set of rules than a (centralized, non-competitive) system of governmental regulation. Third, he argues that, compared to exchanges, governmental regulators suffer from a shortage in information, experience, and incentives. Although Mahoney correctly identifies three important factors that bear on the question of how to design an optimal regulatory system, I am not fully convinced that we should discard the present system in favor of an exchange-based regulatory structure.

Part I of my Commentary addresses the extent to which the profit-maximizing incentives of an exchange will induce it to adopt rules that benefit investors. Part II of my Commentary addresses the argument that exchanges are superior regulators due to regulatory competition among exchanges or due to greater regulatory expertise.

I. SECURITIES REGULATION AND EXCHANGE MEMBER PROFITS

What factors determine the amount of profits exchange members earn? A main source of profits for exchange members is brokerage commissions. The amount of brokerage commissions, in turn, depends on the number of companies listed on the exchange, the trading volume per firm, and the commission per trade. I will leave aside commission per trade, which, as Mahoney recognizes, raises separate concerns, and focus on the other two factors.

As a matter of corporations law, the board of directors decides whether and where to list the stock of its company for trading. This general authority

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5 Mahoney, supra note 1, at 1454-55. The exact contours of what constitutes "securities regulation" and what constitutes "corporate law" remain to be specified. For purposes of this Commentary, I assume that, unless specifically excepted by Mahoney, all rules dealing with the buying and selling of securities and all disclosure requirements are included in the scope of "securities regulation."

6 Id. at 1457-59. For simplicity, I will ignore the problems that are raised when securities regulations generate externalities.

7 Id. at 1477-91.

8 Id. at 1491-96.

9 Other sources of profits include listing and other fees and profits from proprietary trading by exchange members.

10 Mahoney, supra note 1, at 1487-88 (noting that fixed brokerage commissions are more difficult to justify than other exchange rules).
of the board includes the power to delist stock and to have it listed on a different exchange.\textsuperscript{11} Thus, the question of whether companies will list their stock on the exchange that adopts securities regulations that maximize the value of the stock resembles the question of whether companies will choose a state of incorporation and adopt charter provisions that maximize the value of the stock. (I will refer to the corporation law of the state of incorporation and the provisions in the charter as terms of the “corporate contract.”)

Whether a company has an incentive to adopt corporate contract terms that maximize the value of the firm has been hotly debated,\textsuperscript{12} and it would be beyond the scope of this Commentary to reiterate the particulars of that debate. Although this debate has not resulted in a consensus on optimal policy, it has generated at least two salient propositions that are significant to the present context. First, incentives to choose value-maximizing corporate contract terms are lower with respect to “mid-stream” changes in the corporate contract (e.g., reincorporation decisions subsequent to an initial public offering) than with respect to the “initial” corporate contract (e.g., the choice of state of incorporation when the company goes public).\textsuperscript{13} Second, incentives to choose value-maximizing terms are lower with respect to terms that inhibit the operation of disciplinary devices—specifically hostile takeovers and proxy contests—than with respect to other terms.\textsuperscript{14}

These propositions are directly applicable to the issue of whether a system of exchange-based securities regulations will lead to value-maximizing rules. Since state law requires no shareholder vote before a company “moves” from one stock exchange to another,\textsuperscript{15} incentives for managers to engage in opportunistic relistings for personal benefit are, if anything, higher than incentives

\textsuperscript{11} See, e.g., Del. Code Ann. tit. 8, § 141(a) (1991) (granting the board of directors authority over the “business and affairs” of the corporation).


\textsuperscript{13} See Bebchuk, Federalism, supra note 12, at 1458-61, 1470-75. As Bebchuk notes, reincorporation decisions in this context include decisions \textit{not} to change a company’s state of incorporation to a state with potentially superior laws. Id. at 1460.

\textsuperscript{14} See Romano, supra note 12, at 52-84; Bebchuk, Federalism, supra note 12, at 1467-70.

\textsuperscript{15} Stock exchange rules, of course, could require a shareholder vote for such a move. See, e.g., N.Y.S.E. Rule 500, N.Y.S.E. Guide (CCH) ¶ 2500, at 4231 (October 1993) (requiring for voluntary delisting, approval by security holders by a “substantial number” of individual holders of the particular security). Such stock exchange rules raise two concerns. First, stock exchanges may face difficulty enforcing such rules. See infra text accompanying notes 43-49. Second, to the extent that relisting stock is made excessively difficult (e.g., by requiring a supermajority vote by shareholders to relist), incentives to provide rules that benefit investors are attenuated. Both of these problems can be overcome by authorizing a majority of shareholders (without approval by the board of directors) to relist securities as a matter of law.
to engage in opportunistic reincorporations or charter amendments. And to the extent that the scope of powers relegated to stock exchanges includes the power to adopt tender offer regulations, disclosure requirements for large shareholders, rules prohibiting brokers from voting stock absent specific instructions by the beneficial owners, and the like, stock exchange rules could significantly affect the operation of the market for corporate control.

With respect to a large portion of what we presently conceive as securities regulations, it is thus questionable whether the incentive of exchanges to adopt rules that maximize the number of companies whose stock is listed on the exchange will lead to the promulgation of rules that maximize the value of these companies. At least as a theoretical matter, it is therefore not clear that a system of exchange-based regulations would be superior to a system of federal regulations or to some form of mixed system (e.g., a system of regulatory authority divided by type of regulation or a system with federally prescribed minimum standards).

As for trading volume, other things being equal, higher volume is beneficial to exchange members, as it increases commission income and profits. The effect of higher trading volume on investor welfare, however, is more ambiguous. Higher trading volume is beneficial inasmuch as it increases liquidity and inasmuch as investors trade to rebalance their portfolio or for similar reasons. In a recent article, however, Lynn Stout has suggested that stock trading to a substantial extent is motivated by disagreements over the proper value of a company's stock and that such trading does not increase collective investor welfare. While one need not agree with all of Stout's analysis, her basic argument—that it is not possible for both a buyer who thinks a stock is undervalued and a seller who thinks a stock is overvalued to

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18 See, e.g., Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520, 560-62 (faulting the New York Stock Exchange for expansive interpretation of its rule that, on "routine matters," brokers have discretion on how to vote client shares absent specific instructions and for not enforcing its rule that brokers may not vote client shares absent instructions on other matters).
19 See id. at 545-50 (suggesting that insider trading rules and control person liability discourage activism by institutional investors and thus increase powers of managers).
20 The present system, in which exchanges have some regulatory powers, is one possible variant of a mixed system.
come out ahead in their trade—is undoubtedly right. Thus, rules that encourage such speculative stock trading, while beneficial to stock exchange members, may lower collective investor welfare.

Indeed, Paul Mahoney himself (in a comment on Lynn Stout's article) has submitted that the mandatory disclosure requirements imposed by the Securities Exchange Act have the insidious effect of encouraging wasteful speculative trading. In explaining why securities analysts favor the mandatory disclosure system, even though evidence suggests that mandatory public disclosures contain little or no new information, Mahoney notes:

The rhetoric of mandatory disclosure provides support for the analyst's claim to unsophisticated investors that successful investing requires the analysis of firm-specific data. Analysts would therefore want to have as much noise on hand as possible in order to accommodate the broadest possible range of irrational trading strategies.

This does not mean that all disclosure is bad. Brokers might be required to disclose that the evidence suggests that the client will do no better by following the broker's advice than by throwing darts at the stock page. Requiring such disclosure would be analogous to making a casino disclose the house's edge on games of chance. The current system of mandatory disclosure is more analogous to making the casino disclose which slot machines have paid off, in which order, in the last month—this does not improve the gambler's odds at all, but it may encourage those gamblers who profess to see a "pattern" in the slot machine payoffs.

In other words, Mahoney argues that stock analysts and brokers favor disclosure rules that are beneficial to themselves but detrimental to investors. It follows that, at least in some circumstances, the incentives of stock analysts and brokers to favor rules that most benefit investors may be limited.

But won't managers look out for the welfare of their stockholders by listing the company's stock at an exchange whose rules discourage excessive speculative trading? Alas, managers do not have any apparent reason to do so. The problem with speculative trading is that all stockholders tend to favor it: Those stockholders who themselves engage in speculative trading believe that their speculative profits will exceed the costs of trading, and those stockholders who trade only for portfolio purposes—to rebalance their port-

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24 See Stout, supra note 21, at 667-91 (arguing that, at the margin, heterogeneous-expectations trading does not produce social benefits commensurate to its costs).
25 Mahoney, supra note 22.
27 Mahoney, supra note 22, at 743-44.
folio or to invest or obtain cash—benefit from the enhanced level of liquidity produced by speculative traders.\textsuperscript{28} Since stockholders like speculative trading and since such trading does not affect the company’s profits, managerial incentives to limit it are likely to be low or nonexistent.\textsuperscript{29} Thus, to the extent that securities regulations affect the amount of speculative trading, stock exchanges may not have proper incentives to adopt rules that maximize investor welfare.

II. REGULATORY COMPETITION AND COMPETENCE

The second prong of Mahoney’s argument that stock exchanges make good securities regulators is that competition among exchanges and a high level of regulatory competence will assure that regulations are properly designed. These forces, of course, are to an important extent contingent on the ones discussed in Part I: Regulatory competition and competence will produce rules that maximize investor welfare only if companies list their stock at the exchange whose rules maximize investor welfare. If companies list their stock at the exchange that, say, offers rules that most inhibit hostile control changes, regulatory competition and competence will result in highly effective anti-takeover rules, but not in rules that maximize investor welfare.\textsuperscript{30}

\textsuperscript{28} See Stout, supra note 21, at 683-88 (discussing positive effect of heterogeneous-expectations trading on liquidity).

\textsuperscript{29} If the volume of speculative trading is related to the ability to accomplish a hostile takeover, managers may have incentives to prefer rules that limit speculative trading.

\textsuperscript{30} The history of the New York Stock Exchange ("NYSE") one-share-one-vote rule may be instructive in this regard. The NYSE rule against dual class stock was significantly stricter than the respective provisions by the American Stock Exchange ("AMEX") and the National Association of Securities Dealers Automated Quotation system ("NASDAQ"). In the 1980s, dual class recapitalizations became a popular takeover defense, and the NYSE feared that it would lose listings to the AMEX or NASDAQ. It thus proposed to relax its one-share-one-vote rule. In response, the Securities and Exchange Commission ("SEC") adopted Rule 19c-4, Voting Rights Listing Standards—Disenfranchisement Rule, 17 C.F.R. \$ 240.19c-4 (1997), reprinted in [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,247, at 89,208 (July 7, 1988), requiring exchanges and the NASDAQ to adopt a version of the one-share-one-vote rule. Rule 19c-4, however, was struck down by the United States Court of Appeals for the District of Columbia Circuit as being beyond the SEC's regulatory authority. See Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990). Eventually, and with some SEC involvement, the NYSE, the AMEX, and NASDAQ adopted a uniform listing standard resembling Rule 19c-4. See Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 748-51 (2d ed. 1995).

Depending on one’s view of the merits of a one-share-one-vote rule—and most academic commentators have endorsed some version of that rule, see, e.g., Ronald J. Gilson, Evaluating Dual Class Common Stock: The Relevance of Substitutes, 73 Va. L. Rev. 807 (1987) (endorsing principles of Rule 19c-4); Jeffrey N. Gordon, Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 Cal. L. Rev. 1 (1988) (arguing that the SEC should prohibit the listing on the AMEX and NASDAQ of stock delisted from the NYSE because of violations of the NYSE’s one-share-one-vote rule); Louis Lowenstein, Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson, 89
This issue aside, it is not clear that stock exchanges are the type of regulatory bodies that will most vigorously compete and have the greatest expertise with respect to securities regulations. Casual empiricism suggests that a company is most likely to list its stock in the country in which the company is headquartered and that, in most countries, one stock exchange holds a dominant position.\textsuperscript{31} Even in the United States, whose capital markets are the largest and the most developed, there are only two major markets on which stocks are traded.\textsuperscript{32} Moreover, both individual and institutional investors predominantly buy stock of domestic corporations.\textsuperscript{33} In short, at least presently, there is little international or intra-national competition among stock exchanges. While this may change—because of further internationalization of securities trading, changes in technology, or changes in the regulatory environment along the lines Mahoney suggests—\textsuperscript{34} we cannot be confident that the market for stock listings that will evolve will be one characterized by vigorous competition rather than a near monopoly or oligopoly.

Of course, the present system of federal securities regulation does not involve competition either. Regulation by stock exchanges thus would, to say the least, not result in a decrease in regulatory competition. But governmental regulation does not have to be monopolistic. In corporate law, for example, it is argued that we have a system of competition among governmental bodies—the states—to play host to corporations.\textsuperscript{35} Similar governmental competition seems possible for securities regulations either among the states of the union, which could earn the equivalent of corporate franchise fees from being a "host" state for corporations that "opt" into their regimes for securities regulation,\textsuperscript{36} or among nations. To the extent that regulatory com-

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\textsuperscript{31} See, e.g., Germany, Operations Management, Mar. 11, 1996, at 16 (reporting that, in 1995, the Frankfurt Stock Exchange, one of eight German stock exchanges, accounted for 75% of the total volume of equities traded).

\textsuperscript{32} See U.S. Bureau of the Census, Statistical Abstract of the United States 1996, at 524-25 tbls.809-10, 812 (116th ed.) (1995 trading volume of stock on the NYSE was $3,110 billion and on NASDAQ was $2,398 billion; 1994 stock trading volume did not exceed $100 billion on any other exchange).


\textsuperscript{34} Mahoney, supra note 1, at 1477-78 (noting that the presence of governmental regulation may have reduced the number of competing exchanges and that international competition among exchanges is increasing).

\textsuperscript{35} I hedge slightly because it is unclear how many states actively participate in this competition.

\textsuperscript{36} If regulatory power is devolved upon states, the system of securities regulation would have to be integrated with the system of corporation laws. In particular, it may be desirable to permit companies to be subject to the laws of one state with respect to securities regulations and to the laws of a different state with respect to corporation laws. A federal structure would be needed, first, to set up such a dual system and, second, to resolve any
petition is desirable, it is at least worth considering whether a more competitive regulatory structure would ensue from competition among states or nations than from competition among stock exchanges. 37

Finally, with respect to regulatory competence, there are some aspects of securities regulation that are more competently handled by governments and other aspects that are more competently handled by stock exchanges. Stock exchanges may be expected to be more competent than governmental regulators for two reasons. The first is the equivalent of the competition argument: Stock exchanges, as private institutions, have a greater incentive than do governments to become competent in order to survive in a competitive environment. As discussed, the significance of this argument will depend on both the degree of competition among stock exchanges and whether exchange-based regulation is compared with mandatory federal regulation or with state-based regulation.

Second, stock exchanges, in the course of their normal (i.e., non-regulatory) business activities, may obtain information that aids them in the design of certain securities regulations. For example, stock exchanges may have such information about whether and when stabilizing trades are desirable to facilitate a distribution of newly issued stock. 38 The degree of an exchange’s competence advantage on this front will vary with the type of regulation.

On the other hand, governmental regulators are likely to have a competence advantage when it comes to enforcing regulations. I use the phrase “enforcing regulations” broadly to encompass three separate aspects: the power to pass binding rules, the sanctioning of violations, and the policing for violations.

At least in the first instance, the regulatory power of securities exchanges would derive from the consent of those regulated. Companies that decide to list their stock on an exchange, and brokers and dealers who engage in transactions on the exchange, would be required to consent to being bound by the regulations of the exchange. The exchange would thus have power to regulate the actions of listed companies and exchange members. The basis, however, on which the exchange could pass regulations that bind investors at large—such as disclosure requirements for large shareholders, 39 margin rules, 40 or rules against stock price manipulation 41—is not evident. To be sure,

37 See id. at 42-44 (arguing that a system of state regulation is preferable to a system of exchange-based regulation).
Congress could pass a law authorizing exchanges to adopt such regulations and make these regulations binding on the world at large. But such a broad delegation of governmental powers to private bodies, if constitutionally permitted, would raise other concerns.

Even to the extent that an exchange has the power to adopt regulations, it is limited in its ability to sanction violations of its regulations. In particular, an exchange would lack the right to impose criminal sanctions for violations of its rules, and it might even be limited in its power to impose fines. Thus, at least where criminal sanctions are part of the optimal sanction scheme, governments play an important role in defining and enforcing securities regulations. The most important criminal aspect of the securities laws is presumably securities fraud—and Mahoney does not suggest that regulatory power over securities fraud be relegated to exchanges. But criminal prosecutions of other violations of the securities laws—for example, of the insider trading rules, the margin rules, or the broker-dealer registration and reporting requirements—do occur, and the case that such criminal enforcement is undesirable has not (yet) been made. Thus, from the perspective of optimal sanctioning, it may be desirable for the government to retain regulatory authority beyond securities fraud.

A final problem with delegating regulatory powers to exchanges is that exchanges have imperfect incentives to police violations of their rules. In areas where violations otherwise often remain undiscovered—and I believe many aspects of securities regulation fall in this category—policing has two

42 See A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495, 537 (1935) (stating that Congress cannot delegate legislative authority to trade or industrial groups).
43 Without some federal law delegating regulatory power to stock exchanges, the duty of listed companies to comply with stock exchange rules would presumably be based on contract. If a company violates these rules, the exchange may delist the company's stock or get damages for breach of contract, but may face difficulty in assessing supra-compensatory fines. See, e.g., Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1290 (7th Cir. 1985) (holding that supra-compensatory "penalty" clauses in contracts are not enforceable).
44 See Steven Shavell, Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent, 85 Colum. L. Rev. 1232 (1985) (discussing when criminal sanctions are desirable).
45 Mahoney, supra note 1, at 1470-71.
49 See, e.g., United States v. Eucker, 532 F.2d 249 (2d Cir. 1976) (indictment concerning false broker-dealer financial statement), cert. denied, 429 U.S. 1044 (1977); Loss & Seligman, supra note 48, at 4779 n.73.
50 Exchanges may also have access to fewer means for policing their rules than the federal government would have. See, e.g., 18 U.S.C. § 2518 (1994) (regulating use of wiretaps).
effects: It increases the likelihood of detecting violations, and it increases the likelihood of finding and punishing the violator. The first effect, however, is one that an exchange may prefer to do without. From the perspective of an exchange, the optimal image to convey to the public is that no violations of its rules occur, an image that is blunted by the discovery of violations, even if the violator is found and punished. Thus, to the extent that an exchange believes that, absent policing, certain violations are likely to remain undiscovered, its incentives to engage in such policing are substantially reduced.  

Outside enforcers such as the federal government have no equivalent stake in maintaining a public image that no violations occur. Thus, outside enforcers may be superior to stock exchanges in policing violations of securities regulations.

CONCLUSION

I have argued that stock exchanges are subject to significant incentive and enforcement problems when it comes to designing and administering securities regulations. This, of course, is at best a partial analysis of who is the best securities regulator. Governmental regulation entails its own severe incentive and enforcement problems. Because of these problems, if we were to start at square one, I would be favorably disposed towards Mahoney's general suggestion to transfer a large portion of regulatory power to securities exchanges. Policymakers in countries that are at or close to square one—those without an established system of securities regulation—would thus be well advised to consider Mahoney's proposals seriously.

In the United States, however, we are more than sixty years beyond square one. Before endorsing a major structural reform, it is prudent to ask how well the present system is performing. While the present system of securities regulation is far from perfect, the U.S. securities markets have grown at impressive rates, investor confidence in the system is high relative to other countries, companies have been able to raise substantial amounts of capital,
trading is cheap, and liquidity is high. Maybe these developments are due to other reasons; maybe things would have been even better under a system of exchange-based regulation; or maybe we just got lucky in that the Securities and Exchange Commission became one of the more competent regulatory agencies. But as there are good reasons to believe that securities regulation by exchanges will also be far from perfect, I would hesitate to discard the whole system as we know it for something that is unknown: possibly better, but possibly much worse than what we have.

Romano, supra note 12, at 136-37 (presenting comparative data on capital market size and trading volume in selected countries and noting differences in level of stock ownership concentration).