

Public and Private Rule Making in Securities Markets

by Paul G. Mahoney

Executive Summary

Recent corporate scandals have ignited debate over appropriate rules for accounting and corporate governance. The debate has largely ignored an important preliminary question: who should set standards of corporate governance and disclosure for publicly traded companies? This paper argues that stock exchanges have substantial advantages, in comparison with government bodies, as the primary regulators of corporate governance, disclosure, and accounting. Those advantages stem from superior incentives. Stock exchanges gain from investors' willingness to trade and accordingly have an incentive to provide any cost-effective rules that will increase investor welfare.

There are several standard arguments against increasing the role of exchanges in setting disclosure and governance rules. One is that exchanges have market power, which dulls their incentive to set optimal rules. Another is that competition

for listings will make exchanges reluctant to enforce their rules. A third is that disclosure rules have external effects that an exchange cannot internalize. Finally, it is argued that exchanges may lack sufficiently varied enforcement tools to ensure compliance with their rules. Under current practice, the primary threat exchanges can hold over listed companies is delisting, which may be too large a penalty for some violations and too slight for others.

Only the last of those is a significant obstacle, and even that can be resolved contractually to some extent. Listing agreements could call for fines and other penalties for violation of rules. Nevertheless, government agencies have a clear advantage in investigating and punishing wrongdoing. A natural solution, then, would be to maintain the Securities and Exchange Commission as an enforcement agency but cede much of its rule-making authority to the exchanges.

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The case for allowing exchanges to determine standards of corporate governance and disclosure rests on incentives, not expertise.

Introduction

Debates over appropriate standards for corporate governance and accounting, once the province of specialist journals and conferences, have become front-page affairs in the wake of recent corporate scandals. Politicians, regulators, journalists, corporate executives, institutional investors, and academics have all weighed in on a variety of once-esoteric issues: Should incentive stock options be treated as an ordinary business expense? Should publicly traded companies be required to separate the posts of chairman and chief executive officer? Should companies be required to change accounting firms periodically?

Each of those questions is important and deserves attention. But relatively little attention has been paid to an issue that is arguably much more important, because it will affect each of the others: who should set standards for corporate governance and disclosure for publicly traded companies?

This paper attempts to analyze that question. The potential standard setters include government bodies such as Congress, state legislatures, the Securities and Exchange Commission or other regulatory bodies, and private entities such as stock exchanges or industry groups. Stock exchanges have substantial advantages, in comparison with government bodies, as the primary regulators of corporate governance, disclosure, and accounting standards. This is an argument, not for the status quo, in which stock exchanges are statutorily appointed as "self-regulatory organizations" under the firm control of the SEC, but rather for a more substantial privatization of the regulatory function.

Perhaps many observers will find this prescription entirely backwards, even dangerous. Conventional wisdom about the various accounting and governance crises of recent months holds that they demonstrate the need for "tougher" regulation and a firmer governmental hand on the wheel. But that badly misconceives the dynamics of the regulatory process.

Incentives Matter

The U.S. securities laws incorporate a limited degree of self-regulation. Securities exchanges and the National Association of Securities Dealers, which operates the National Association of Securities Dealers Automated Quotation System, are "self-regulatory organizations" with authority to adopt and enforce rules for their members and listed companies, to the extent those rules do not conflict with the federal securities laws. The exchanges and the NASD also have disciplinary authority over their members. Both functions, however, are subject to the supervision and ultimate control of the SEC.

The standard argument for self-regulation is that the securities industry has more expertise in the problems and potential solutions associated with securities trading than does a government agency. The argument is not terribly persuasive. All of the information and expertise in the world will be wasted unless the regulator has an incentive to make rules that benefit investors. A regulator with appropriate incentives, on the other hand, could easily hire people with the relevant experience.

The case for allowing exchanges to determine standards of corporate governance and disclosure, then, rests on incentives, not expertise. Exchanges and their members profit from investors' trades. The traditional nonprofit exchange is owned by its members, who typically are brokers. Higher trading volumes on the exchange generate greater profits for brokers. A for-profit exchange can be owned by dispersed investors, many of whom may not be brokers. Such exchanges earn profits from fees paid by listed companies and brokers and by selling market data. More transactions mean more fees and more data that the exchange can sell. Anything, then, that increases the public's eagerness to trade in listed securities is good for exchanges, whether nonprofit or for-profit, mutual or publicly owned.

Political actors, by contrast, are motivated to seek approval in the form of votes and campaign contributions. Their interests span

a much wider set of public policy issues than those related to securities markets. Most important for present purposes, it is clear from centuries of observation that securities markets become salient political topics only in the immediate aftermath of broad and sharp declines in securities prices. As legal historian Stuart Banner has noted, every important regulatory statute in England and the United States from the very start of organized securities markets in the late 17th century was enacted after a market crash.¹

The differences between the incentives facing stock exchanges and those facing politicians, then, are quite stark. Exchanges have an ongoing financial incentive to increase trading volumes. Elected officials, by contrast, have an incentive to avoid blame for market crashes and to respond to crashes in ways that will mollify their constituents. Political actors may respond directly through legislation or indirectly by putting pressure on regulatory agencies.

Political incentives are unlikely to promote optimal market regulation. First and foremost, the incentives facing political actors are considerably more one-sided than those facing market actors. Exchanges and brokers gain when trading volumes are high and lose when volumes are low. By contrast, the political harm that elected officials suffer when a market decline occurs on their watch is typically much greater than the credit they receive when markets are healthy. When markets are rising, the public typically judges its political leaders on some other set of issues—education, prescription drug benefits, and so on. The stock market is politically important only when it is in sharp decline.

That tendency reinforces a ubiquitous, and exceptionally unhealthy, political reaction to market crises. When markets decline, faith in and enthusiasm for the chaotic nature of capitalism—Joseph Schumpeter’s “creative destruction”—decline as well and are replaced by a desire for stability. Thus, at the same time that the likelihood of significant regulatory changes is at its highest, the public’s tolerance for risk is at its lowest. That is a toxic combination.

Those two phenomena combine to create bad regulation because they are so easily exploited by rent-seeking businesses. The lure of stability is the only positive inducement that the would-be monopolist or cartel can offer to consumers. In ordinary times, consumers and political actors are more likely to recognize that they are being offered a terrible deal. The absence of competition does indeed promote stability, in the sense that consumers are spared the difficult task of comparison shopping and are not faced with the tough choice between lower prices and established reputation. The cost, however, is exorbitant. Consumers pay a high price for the monopolist’s goods or services. A really creative monopolist may even discover a way to price discriminate and appropriate most of the consumer surplus.

The history of regulatory efforts in the U.S. securities markets bears this out. The earliest widespread attempt to regulate securities offerings was the so-called blue-sky laws of the early 20th century. Those statutes, enacted by individual states, often required advance permission by a state official to market securities in that state. One obvious and notable feature of those statutes is that they placed greater hurdles in the way of high-risk, high-return securities. Often, companies without a long operating history, or those whose balance sheets contained a large amount of intangible assets, were singled out for harsher treatment. As legal scholars Jonathan Macey and Geoff Miller hypothesized, and I have confirmed empirically, those statutes were shaped by the lobbying efforts of banks that feared competition for depositors’ funds from securities salesmen.² From the outset, then, securities regulation was plagued by the problem of sellers of low-risk investments trying to use the regulatory system to put barriers in the way of sellers of high-risk investments.

The same phenomenon shaped the federal securities laws of the 1930s.³ Some segments of the securities industry warmly welcomed federal regulation and benefited substantially from it. The “bulge bracket” (i.e., the most elite) investment banks of the late 1920s—led

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by J.P. Morgan & Co. and including a few other select firms such as Kuhn, Loeb & Co. and Dillon, Read & Co.—specialized in relatively low-risk securities such as blue-chip bonds and railroad stocks. They also sold through a slow, painstaking process involving multiple syndicates. During the 1920s, however, the securities market changed substantially. Investors in pursuit of higher returns began to include riskier securities in their portfolios. Newer, more aggressive investment banks such as the National City Company began to sell securities rapidly through nationwide sales networks linked by telegraph, rather than through the traditional syndication methods, and to offer volume discounts.

As a result, when Congress decided to regulate public offerings through the Securities Act of 1933, the established investment banks lobbied eagerly for a statute that would slow down the offering process. The Securities Act did just that. Moreover, the investment bankers' trade group helped to shape a separate innovation, the Maloney Act of 1938, which created the National Association of Securities Dealers. The Maloney Act was accurately described as a mini-National Recovery Act for the securities industry. Like the NRA, it granted the regulated industry the right to ban some forms of price competition. A long-standing goal of the NASD's predecessor, the Investment Bankers Association of America, was to make underwriting a "one-price business" by ending all volume discounts. This, the IBAA said, was its primary objective in drafting a code of fair practice under the NRA.⁴ After the Supreme Court held the NRA unconstitutional, Congress revived the fair practice code by enacting the Maloney Act, which explicitly permitted the NASD to outlaw volume discounts.

Investors, therefore, should not feel reassured by reports that Sen. Paul Sarbanes (D-MD) modeled the recently enacted Sarbanes-Oxley Act on the Maloney Act.⁵ Instead, that analogy should remind us that Congress is constantly tempted by the siren song of industry groups who promise that, if given a free hand to stifle competition, they will

make sure that today's problems won't recur. Accepting such a deal is foolish. By their very nature, extreme events are usually followed by more normal times—that is, there's regression to the mean. Whatever problems have occurred, therefore, may be temporary. But the barriers to competition and innovation that they prompt live on well after the memory of the problems which they were intended to address has faded.

Why Not the Exchanges?

Counterarguments against the exchanges as regulators typically fall into four categories.

- *Monopoly.* Because trading in a particular security is a natural monopoly (or, as it is sometimes now expressed, a "network good"), the necessary competitive pressures are absent.
- *Competition.* When push comes to shove, the NYSE would never enforce its rules against a listed company, because that company would threaten to move to Nasdaq, or vice versa. Competition between exchanges for listings will lead to toothless enforcement.
- *Externalities.* Good disclosure and corporate governance rules do not merely benefit the marginal investor who happens to trade in a particular stock at a particular point in time. They have spillover benefits to third parties, including other investors, competitors, and suppliers. An exchange and its members cannot capture all those benefits because they do not contract with those third parties. Accordingly, the exchange will put less than the socially optimal amount of effort into designing and enforcing the rules.
- *Ineffective tools.* Because exchanges control access to the trading mechanism, they have an array of graduated sanctions available against member firms. A brokerage firm might be fined a small amount for a minor violation, suspended

for a few days for a slightly greater one, and expelled for an egregious fraud. The same is not true, however, when it comes to disciplining listed companies. Were an exchange to suspend trading in a listed company's stock, it would harm investors and exchange members as much or more than the listed firm. The primary threat the exchange has against a listed firm is delisting. That, unfortunately, is too great a sanction for lesser violations and perhaps too small a sanction for extreme violations. The absence of graduated punishments means that the exchange's rules will be violated with impunity.

Let us examine these arguments one at a time.

Monopoly

The monopoly argument comes in two varieties. The less sophisticated version simply holds that a monopolist will provide a shoddy product, and therefore an exchange that has a monopoly over trading in a particular asset will provide shoddy rules of corporate governance and disclosure. This is an old argument with an old answer—even monopolists are subject to the demand curve. They can sell their product for more money than a competitive firm can, but not for more than the product's value to the marginal consumer. A rational monopolist will therefore adopt any improvements to the product that cost less than their value to the marginal consumer. We would therefore expect a monopolist exchange to offer the same "product" (that is, the same corporate governance and disclosure rules) as a competitive exchange but to charge a higher price.

The persistence of the notion that monopolists offer a lower-quality product is likely a consequence of the fact that our experiences with monopolists usually involve heavily regulated firms that may not be permitted to raise prices sufficiently to justify improvements in service (utilities are a good example, as was AT&T before deregulation).

Such monopolists provide low-quality products because they can charge only a low-quality price. Absent price regulation, however, the monopolist has ample incentive to improve the product.

The more sophisticated version of the argument notes that an exchange is not a unitary actor but an amalgamation of members offering different services and subject to different demand and marginal cost functions.⁶ Exchange members are heterogeneous; they are brokers, arbitrageurs, market makers, specialists, and others. An exchange's rules, therefore, do not simply determine the amount of the members' profits; they also determine the distribution of those profits. Each group has a strong interest in shaping the rules for its own benefit. The resulting competition among groups for rents will distort the rule-making process, potentially generating rules that are less beneficial to investors than those that would be adopted by a unitary actor.

That is a variant of the monopoly argument because it turns on the exchange having market power—that is, being able to charge a price in excess of marginal cost for its services. Absent market power, there are no rents to distribute and therefore no fights over their distribution.

The question of exchange market power is, unfortunately, unresolved. It is clear that traders desire liquidity, which means that a market is not viable unless it captures "enough" of the trading in a particular stock to ensure liquidity. The more debatable question is whether "enough" is 100 percent of the demand for that stock (in which case trading in a particular security is a pure natural monopoly) or something less (in which case there could be two, or perhaps more, markets for a given stock). A second issue is whether, supposing the market for a stock is a natural monopoly, that monopoly is contestable. If the entire market for a specific stock can migrate at a reasonable cost from one exchange to another, then the incumbent exchange cannot extract a monopoly rent even if it controls 100 percent of trading in the stock. Distributional fights are therefore elim-

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inated. These are empirical questions on which the evidence is not conclusive.⁷

Whatever the merits of the competing theoretical and empirical arguments, they are being overtaken by events. The New York Stock Exchange and Nasdaq unquestionably act as if the market for any given stock is contestable. Each devotes considerable effort to arguing that its trading platform is superior. There is persistent migration from the Nasdaq to the NYSE, but in the past few years there have also been moves in the other direction.⁸ Equally important, it is not inevitable that large firms will end up at the NYSE. As of the beginning of September 2003, 74 of the companies in the Standard & Poors 500 were traded on Nasdaq.⁹

Equally important is the growth of electronic trading networks. Initially, these networks focused on Nasdaq securities because of the NYSE's Rule 390, which restricted off-exchange trading of listed stocks by member firms. Rule 390 was repealed in 2000, however, clearing the way for electronic networks to trade NYSE-listed stocks.¹⁰ Since the repeal, Instinet, the largest electronic network, has accounted for approximately 3 percent of quarterly trading volume in NYSE-listed stocks.¹¹

One measure of the competitive pressure that exchanges feel from electronic networks is the growing movement toward demutualization and for-profit status. Exchanges have traditionally been organized as mutuals—that is, they are owned by their member brokers. They have also been nonprofit entities. The principal constraint on a nonprofit entity is that it may not make distributions in the nature of dividends. Thus a nonprofit exchange cannot charge profit-maximizing transaction fees and distribute the resulting surplus to its members on the basis of their percentage ownership. Instead, it charges reduced fees, with the effect that the benefits of exchange membership are captured only to the extent the member actually consumes the exchange's services.

When an exchange has market power and its members are heterogeneous, members might prefer to distribute economic rents on

the basis of usage rather than ownership.¹² As noted above, the exchange's members care not merely about the size of the rents but also about their distribution. They may choose a set of rules that is not optimal from the investors' perspective, and therefore reduce the size of the rents, in order to achieve a preferred distribution. For-profit exchanges, however, are concerned, not about the distribution of rents, but about the maximization of profits (and thereby the maximization of investor welfare). Nonprofit status allows the exchange's leadership to focus less on the size of the pie and more on how the pie is sliced. This opens up the possibility that inefficient rules will survive because they achieve the desired distribution.

Once an exchange faces substantial competition, however, it can no longer afford the luxury of designing rules to create the desired distribution of rents among its members, because there are no longer any rents to distribute. At that point, the exchange is better off dropping its nonprofit status and creating—and charging for—optimal rules.

This analysis sheds light on a fallacy that has become widespread. Recently, commentators and regulators have expressed great concern that when exchanges convert to for-profit status, they will abandon investor protection in favor of profits.¹³ This conventional wisdom is exactly backwards. The move to for-profit status will *increase* an exchange's incentives to adopt optimal investor protections precisely because such protections lead to greater profits. A for-profit exchange may charge the full marginal cost for its services. It will therefore benefit directly from any improvements in those services that cost less than what investors are willing to pay. The argument against for-profit status is, therefore, simply a variant of the argument against competition, to which we now turn.

Competition

Imagine that exchanges have become the principal source and enforcers of disclosure rules. Now imagine that a large, prominent company is accused of violating those rules.

Will the exchange vigorously investigate the allegation and apply the agreed-upon penalty? Or will it sweep the matter under the rug so as not to offend a powerful constituent? A common assumption is that the company need only threaten to move to a competing exchange. The incumbent exchange, unwilling to risk the loss of a high-profile listed company, will then back down.

University of Chicago Law School professor Daniel R. Fischel and Wharton School economist Sanford J. Grossman have studied that issue at length, but it is worth discussing it here briefly.¹⁴ The analysis in the last paragraph concludes that competition is bad because companies can play exchanges off against one another. It ignores, however, the fact that investors are not innocent bystanders but active participants who can also vote with their feet. If investors care about good disclosure, then they will penalize exchanges that do not enforce their disclosure rules. Competition for companies is profitless unless it is accompanied by successful competition for investors.

That is simply an application of the First Fundamental Theorem of Welfare Economics, which holds that a competitive equilibrium is Pareto optimal. In other words, the allocation (in our case, of rules and enforcement) produced by a competitive process maximizes consumer welfare within the constraints of the consumers' willingness to pay. The corollary for our purposes is that the exchange's gains from keeping the miscreant company will be more than offset by losses caused by investors' reduced desire to trade.

The First Fundamental Theorem of Welfare Economics, like any analytical result, requires some restrictive assumptions. When those assumptions do not hold, we can show that the outcome of the competitive process will not be optimal. One common departure is imperfect information. If investors do not know that the exchange is failing to enforce its rules, they will not react appropriately.

Investors in securities markets, however, have an especially valuable tool for overcoming informational deficits. Securities prices

reflect information. For prices to adjust to an exchange's poor enforcement record, it requires only that a sophisticated few uncover the truth. Those investors respond by trading, which means that prices will reflect the information they have uncovered. The bulk of investors need not have particularly good information—they can free ride on the information produced by others.

The other common departure from optimality comes about through externalities, or circumstances in which third parties who are not participants in the market gain or lose because of transactions in that market. (Externalities are discussed in the next section.)

Finally, one might declare that we should look up from economic theory and view the world around us. Participants in markets are not automatons but people with human emotions and frailties. Will investors really know or care enough to desert an exchange that doesn't punish violations of disclosure rules? Perhaps not, but that is not an argument against exchange regulation *relative* to government regulation. Government bureaus are made up of people, too. Government agencies have ample authority, resources, and motivation to prevent frauds such as Enron and WorldCom, yet they failed as much as investors, broker-dealers, and exchanges.

The point deserves elaboration. Many of the market shortcomings that culminated in the Enron and other scandals are painfully clear in retrospect—but only in retrospect. Before the scandals, it would not have been unreasonable to argue, for example, that firms would be unlikely to go to great lengths to create temporary mispricings of their stock because the move would backfire in the long run. However, this argument is not quite correct in a world in which corporate officers can make tens of millions of dollars instantaneously through the exercise of incentive stock options. In that situation, the benefits of a brief, one-time increase in price may really outweigh the discounted value of future compensation and reputation. That, in turn, suggests that options align managerial and investor incentives only imperfectly.

The move to for-profit status will increase an exchange's incentives to adopt optimal investor protections precisely because such protections lead to greater profits.

The score stands at Market 0, Regulators 0. That is not an argument in favor of government regulation.

For options to work properly, managers must face strong constraints from accountants and securities analysts who attempt to spot misleading disclosures. Put differently, when managers have great incentives to mislead, accountants and analysts must also have strong incentives to prevent deception.

Unfortunately, the incentives facing accountants and analysts have been moving in precisely the opposite direction. One of the striking trends in financial services over the past few decades has been the service providers' dreams of becoming "one-stop shops." This led accounting firms to offer auditing, financial advisory, tax, and legal services. It led Citigroup to bring commercial banking, investment banking, securities analysis, mutual funds, and insurance under one roof. Such combinations offer operating efficiencies and customer convenience. But both the service providers and their customers seem to have underestimated the associated costs that stem from ubiquitous conflicts of interest. Those conflicts dulled the accountants' and analysts' incentives to keep managers honest.

That, in broad outline, is the case for more regulation. But there is one enormous hole in the analysis. Regulators did no better than investors at appreciating and taking steps to prevent problems before the consequences became obvious. Let us begin with incentive options. The sources to which a sensible regulator might turn for guidance—academic opinion, the financial press, and so on—did not identify the problem with sufficient clarity and forcefulness to make a difference. Prior to the recent scandals, it was widely accepted among academic lawyers and economists that incentive options closely aligned the interests of managers and investors. Only in hindsight does it appear that options may have an undesired side effect because they increase in value as the volatility of the stock increases. Thus, options enable managers to profit from volatility and not only from increases in value. That, in turn, can provide a huge payoff from a temporary mispricing. Perhaps the market failed to notice the prob-

lem, or perhaps boards of directors concluded that the risk was outweighed by the substantial tax benefits to the firm of using options rather than cash compensation. A 1993 tax law amendment disallowed as a deductible business expense any executive compensation exceeding \$1 million unless it is "performance based." Certainly, Congress failed to recognize that it was creating potentially bad incentives.

The story differs only in the details when we turn to conflicts of interest facing the accounting industry. Some commentators—in both the private sector and the SEC—warned that those conflicts were a substantial problem.¹⁵ Investors, however, did not appear to view the problem as serious until it was too late. After the recent scandals, investors changed their views about the problem, which prompted some accounting firms to divest their advisory businesses and some investment banks to make changes in their analysts' practices.

Meanwhile, Congress and the SEC did not act to address the problem in advance, in part because of the strong resistance to the proposed reforms by accounting firms and investment banks. Only after the scandals did the political salience of accounting and analyst conflicts of interest reach a level that permitted legislative change. To sum up, then, prior to the recent scandals, investors did not act aggressively because they did not appreciate the magnitude of the problem, and regulators did not act aggressively because it was not politically expedient. At the end of the episode, the score stands at Market 0, Regulators 0. That is not an argument in favor of government regulation.

The government's after-the-fact response may seem more vigorous because it is more highly visible. With considerable fanfare, Congress has prohibited accounting firms from providing certain nonaudit services to audit clients and instructed the SEC to make rules to improve the independence of securities analysts. The market's solutions, however, are considerably harder to spot. Markets send their commands through prices. Having learned the hard way that excessive option-

based compensation, or the combination of audit and consulting services, can create bad incentives, investors will react. But investors do not call press conferences or hold hearings—they simply revalue assets. We won't know the results until time has passed and researchers have had an opportunity to look carefully at the clues that prices provide.

We should also keep in mind that political actors and regulators seeking more regulatory authority have every incentive to overstate the contribution of failures of accounting and corporate governance to the stock market's decline. Although the conflict-of-interest problems outlined above undoubtedly contributed to Enron's collapse, it seems plausible that the proximate cause of that collapse was a failed business model.¹⁶ Managers who tried to hide debt through off-balance-sheet entities, and analysts who credulously or deceitfully predicted continued rapid growth, may have made the collapse more violent. The absence of conflict-of-interest problems, however, probably would not have prevented it. Moreover, we cannot easily determine how much of the price declines that followed the revelations of accounting frauds were a consequence of investors' revaluation of the earning power of the assets and how much reflected investors' fears of lawsuits and regulatory overreaction. Thus, if it turns out that investors viewed the conflict-of-interest problems as relatively minor, that is not proof that the investors were foolish.

It is obvious that investors, like all humans, fall short of the perfect cognition and calculation required for optimal outcomes. This is a large part of the standard argument for regulation. But it is a deeply flawed argument. We cannot expect either markets or regulators to achieve perfection. The critical question is whether private or public actors will do better at setting rules. That question just takes us back to the beginning—to incentives, which favor the exchange.

Externalities

The argument that exchanges have strong incentives to provide optimal disclosure and

governance rules turns on the idea that the exchange can profit from providing such rules by capturing larger trading volumes and perhaps charging higher fees. High-quality disclosure and governance rules increase investor wealth by increasing the accuracy of prices and reducing the ability of corporate promoters and managers to misappropriate corporate assets.¹⁷

Not all of these benefits, however, accrue to the marginal investor—the party whose willingness to pay for improved disclosure and governance is critical to the analysis. Accurate prices and faithful corporate management also help competing firms, suppliers, and employees. The exchange does not sell its services to all of those other benefited parties, so it cannot charge them for the benefits the exchange confers. Similarly, some of the benefited parties are inframarginal traders who would have traded under either low- or high-quality rules. The exchange also does not capture a share of the benefits received by those inframarginal traders. Because it bears all of the costs and captures only part of the benefits of writing and enforcing high-quality rules, the exchange will underprovide them. Externalities create a wedge between private and social optimality.

Of course, all economic activities generate some externalities. When the manufacturer of my favorite breakfast cereal invests in improving the taste, I am in a better mood after eating breakfast, to the benefit of my family and colleagues. The manufacturer can't force those third parties to pay for the benefit thus conveyed, and it will therefore invest too little, from a social perspective, in improving the taste of the cereal. But we readily recognize such external effects as trivial—as occupying one end of a spectrum. A factory dumping toxic wastes into a river upstream from a town that uses the river for drinking water and recreation is at the other end of the spectrum.

A substantial majority of academics and policymakers would agree that the external effects in the breakfast cereal case are too small to justify government intervention, whereas

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those in the second case are too large to justify confidence that the invisible hand of the market will solve the problem. Empirical hunches about the size of externalities tend to drive attitudes toward regulation in many settings. Advocates of regulation believe that externalities are often very large and the perverse incentives created by the government's intervention are typically small, while advocates of private solutions believe the opposite. For the purposes of this paper, it is not necessary to settle that debate here; it suffices to ask whether the externalities present in securities markets are closer to the breakfast cereal or toxic waste end of the spectrum.

The claim most frequently advanced in the academic literature is that disclosure rules affect competitors of the disclosing company.¹⁸ In particular, disclosures enable competitors and potential competitors to learn about the disclosing firm's costs and revenues. Companies would therefore prefer to disclose less than the socially optimal amount in order to hide information from competitors.

At bottom, the concern must be that, absent disclosure, there will be too little entry. Public policy doesn't (or shouldn't) care about the purely distributive question of whether Company A or Company B gets a profitable business opportunity. Instead, we care that neither A nor B has the opportunity to make more than the competitive level of profit. If it is easy to identify industries or products in which above-average profits are available, entry into those businesses will whittle the profit down to the competitive level. If the externality problem is large, then, it is because companies can hide their profitability and thereby earn excessive profits quietly without fear of new entry.

The net effect of disclosure and governance rules on entry, however, is likely negative. Compliance with these rules is costly. Some of the costs vary with the size of the company. An outside accounting firm charges more for a more complex audit, and a larger company usually requires more in-house compliance staff. But some costs are fixed—even a very small publicly traded firm

usually needs some in-house legal and accounting staff to prepare disclosure documents and monitor compliance with governance rules. Those costs are a barrier to new entry. It is, accordingly, unlikely that maximizing the amount of required disclosure is a good way to maximize competition among publicly traded firms. The dominant externality argument in the academic literature, then, is not very convincing.

Poor Enforcement Tools

The strongest reason to be concerned about an exchange's ability to write and enforce disclosure and governance rules is that it lacks good enforcement tools. The exchange's principal threat is to delist a company that violates its rules. That is an excessive sanction for minor violations and accordingly not credible. It is an insufficient sanction for egregious violations, particularly those prompted by "last period" concerns.

Assume, for example, that a company finds itself in severe financial distress, but that fact is not yet publicly known. The company's officers face the decision of whether to make complete and accurate disclosures or to conceal the company's true position. They may believe that concealment could enable them to raise new capital and weather the crisis. By contrast, full and prompt disclosure will quickly lead to bankruptcy. To make the hypothetical as compelling as possible, let us assume that mere concealment would not constitute actionable fraud, so the exchange's sanctions are the only relevant ones.

In that situation, the company has nothing to lose from concealment if the only sanction is delisting. If the company discloses, it will become bankrupt. If it conceals and the exchange discovers the deception, the company will be delisted. Assuming that the stigma of delisting in those circumstances destroys the market for the company's securities, the worst that can happen is bankruptcy. There is no marginal deterrence of concealment.

An exchange faces a similarly troubling problem if it tries to withhold its primary benefit—listing and its attendant liquidity—

in response to less serious violations. The exchange could merely suspend listing for a brief period rather than terminate it, but most of the cost of the lost liquidity would be imposed on investors rather than the corporate wrongdoers.

There is no technical barrier, however, to an exchange developing a more targeted and varied set of sanctions. The listing contract between a company and the exchange is just that—a contract. Like any other contract, it may include detailed remedy provisions in the event of breach. For example, the listing agreement could provide a schedule of fines for delays and shortcomings in disclosure documents. The listed company could be required to post a deposit from which the exchange could deduct those fines. As lawyers often say, a contract is a “private law” between the parties and can detail their rights and obligations as the parties think appropriate.

It is only natural to ask why exchanges do not write such detailed contracts. If contracting could solve the enforcement problem, we would expect to see exchanges write enforcement procedures into their listing agreements. That is unrealistic, however, under the current regulatory regime. The exchanges have relatively little authority over listed companies compared to the SEC. An exchange's principal enforcement responsibility is with respect to its member broker-dealers. We therefore learn very little about what is feasible and desirable from observing exchange behavior in a world where the SEC writes and enforces disclosure rules for publicly traded companies.

Of course, exchanges didn't write detailed enforcement procedures into their listing contracts during the pre-SEC era either. Perhaps this shows that exchanges were unwilling to spend the resources necessary to ensure that their disclosure and governance standards were followed. But drawing that conclusion may simply be succumbing to the nirvana fallacy—i.e., letting the best get in the way of the good. In the pre-SEC era, the level of disclosure by listed companies was better than that of over-the-counter firms. Similarly, companies listed on more prestigious exchanges dis-

closed more than those listed on less prestigious exchanges. Clearly, the exchanges did not achieve perfection, but by the standards of their day they did quite well.

A more important issue for a contemporary exchange might be investigation rather than sanctioning. In order to impose punishments that actually deter, an exchange must be able to determine when a company has broken the rules. Government investigators have powerful tools, such as subpoena and search-and-seizure powers, that an exchange lacks. Faced with a recalcitrant company, it is much more effective to break down the door than to threaten a lawsuit or delisting.

Once again, the problem can be solved to a significant extent by contract. The listing agreement can ensure the exchange's employees unrestricted access to a listed company's personnel and records, with a provision for significant fines if the listed company chooses not to cooperate. Exchanges already typically require that member organizations (such as brokerage firms) permit examination of their books and records by exchange personnel.¹⁹ Were exchanges, rather than the SEC, the primary regulators of listed company disclosure, they might decide to put a similar provision into their listing agreements. Despite those contractual solutions, it would be naïve to argue that exchanges would have as effective a set of investigation and enforcement tools as the SEC possesses today. It is undeniable that a government agency backed by the state's monopoly of force has an edge in investigating and punishing wrongdoing. Perhaps the most effective arrangement, then, would be a mixture of private rule making and government enforcement.

The exchange's principal threat is to delist a company that violates its rules. That is an excessive sanction for minor violations and accordingly not credible.

Ancient History: The 1920s

We need not limit ourselves to a purely theoretical discussion because there are actual examples of securities exchanges acting as the principal regulators of disclosure, accounting, and governance standards for publicly traded firms. Prior to the enactment of the federal

There is no technical barrier to an exchange developing a more targeted and varied set of sanctions.

securities laws, stock exchanges played that role in the United States. State “blue-sky” laws regulated public offerings, but they were based on a regulatory theory entirely different from that underlying disclosure laws. Disclosure rules seek to make information available to the market so that investors can judge the merits of securities offered for sale. Blue-sky laws, by contrast, were based on the paternalistic notion that state officials should decide which securities were “safe” enough to be offered for sale. Accordingly, those laws did not aim to make information available to the investing public, which was assumed to be incapable of evaluating information.

Public offerings were also subject to disclosure rules that had been developed by courts under the rubric of the fiduciary duties of corporate directors, officers, and promoters.²⁰ Generally speaking, those who sold securities to the public had a duty to disclose conflicting interests, such as the fact that the sellers stood to gain from the sale of property to the corporation or the fact that the sellers would earn a commission were the offering successful. Those disclosure requirements were focused, however, on conflicts of interest, not on making information about corporate performance available to the investing public. Stock exchange listing standards were the most important means of achieving the latter objective.

The New York Stock Exchange first adopted listing standards in 1856.²¹ Listed companies were required to make specified financial information available to the exchange and its members. By the late 1920s, the mandated information for newly listed companies included audited annual balance sheets and income statements, and listed companies were strongly encouraged to provide quarterly financial reports.²² The existence and effectiveness of stock exchange listing standards in the pre-SEC era are obviously relevant to the current debate. The theoretical arguments for and against exchange regulation of corporate governance and disclosure must be evaluated in light of the historical evidence.

There is little debate over whether the NYSE’s pre-SEC listing standards were sub-

stantively defective—they were not. They mandated, in rough outline, the principal types of financial information that forms the backbone of mandated disclosures today. The SEC based its early disclosure forms on the NYSE’s listing standards, reinforcing the notion that those standards were reasonably comprehensive. Obviously, views about the appropriate level of disclosure have evolved since the 1930s, but it is not a controversial proposition that the NYSE’s stated listing standards were adequate for their time.

The debate is over whether those standards were actually enforced and respected. The accepted wisdom is that the federal securities laws were adopted precisely because exchange regulation was ineffective. Listed companies, critics argue, flouted the NYSE’s standards without consequences. Unfortunately, lawyers and policymakers have uncritically accepted the claims of the New Deal proponents of federal regulation. When scholars have ventured beyond the polemics and looked at the evidence directly, a different picture has emerged.

Contemporary observers were impressed with the extent of disclosures made by exchange-listed companies. Columbia University corporate law professor Adolph Berle, who helped shape much of the banking and securities legislation of the New Deal, noted in his 1932 classic study, *The Modern Corporation and Private Property*, that a substantial amount of financial information was available to investors.²³ We can easily verify the accuracy of Berle’s assessment by picking up a bound volume of Moody’s or Standard & Poor’s investment manuals from the 1920s. Those volumes contain income statements and balance sheets for thousands of companies. A quick perusal is sufficient to verify that companies traded on an exchange provided more comprehensive and detailed financial statements than companies traded over the counter.

More recently, economist George J. Benston has extensively studied pre-SEC disclosure practices. He discovered a very high rate of compliance with the NYSE’s listing requirements.²⁴ I have separately examined the claim that poor disclosure enabled large

traders to manipulate stock prices and found that the evidence did not support the claim.²⁵ Stuart Banner, although principally concerned with enforcement actions against brokers, describes the NYSE's enforcement efforts in the late 1800s.²⁶ His description is sharply at odds with the notion that the NYSE was unable or unwilling to police its members (and, by extension, its listed companies). The evidence available to us suggests that in the pre-SEC era, listed companies substantially complied with the NYSE's listing standards and the resulting disclosures were sufficient to permit investors to make informed investment decisions.

Modern History: The Aftermath of Enron

Both the NYSE and the Nasdaq have proposed changes to their listing standards, subject to the SEC's approval, in light of the governance and accounting scandals. It is, of course, difficult to determine precisely how the exchanges would have altered their listing standards if left to their own devices. The Sarbanes-Oxley Act, which was making its way through Congress as the exchanges' proposals were being formulated, mandates some of the rule changes ultimately proposed. The SEC also took considerable interest in the exchanges' deliberations. Nevertheless, within the narrow scope of the discretion left to the exchanges, the proposed changes provide insight into the exchanges' views of good corporate governance.

The revised listing standards include the following provisions:²⁷

1. Listed companies must have a majority of independent directors.
2. Independent directors must meet periodically in executive session without management.
3. Listed companies must increase the role of independent directors in nomination and compensation decisions. The NYSE proposals require nominating and com-

pensation committees composed entirely of independent directors, while the Nasdaq proposals permit decisions by an independent committee or a majority of independent directors. Both the NYSE and Nasdaq rules tighten the definition of "independence" for audit committee members as required by the Sarbanes-Oxley Act.

4. Shareholders must approve adoption of stock option plans (Nasdaq) or equity-based compensation plans generally (NYSE), subject to exceptions.
5. Listed companies must adopt codes of conduct covering legal and ethical responsibilities.

The NYSE proposals also contain a new enforcement tool. The exchange may send a public reprimand letter to a listed company that violates a listing standard. The commentary to the proposed new rule observes the problems noted above—delisting or suspension hurts investors as much as it does the company's management. Adverse publicity is an alternative sanction that, although less severe, also has fewer third-party effects.

Those changes, together with the Sarbanes-Oxley Act, create an interesting experiment regarding the difference between exchange regulation and SEC regulation. Two groups of listed companies have protested quickly and vociferously against portions of the new listing standards. One consists of foreign companies. In general, the NYSE has exempted foreign listed companies from its requirement of an independent audit committee. European companies with two-tier board structures (particularly those, like German companies, with mandatory union participation) find it difficult to set up committees of genuinely independent directors. The Sarbanes-Oxley Act, however, directs the SEC to make independent audit committees mandatory. A group of German companies has accordingly requested that the SEC exempt them from the audit committee requirement.

A second concerned group consists of small businesses. They are worried, among

The evidence suggests that in the pre-SEC era, listed companies substantially complied with the NYSE's listing standards and the resulting disclosures were sufficient to permit investors to make informed investment decisions.

Rule making by actors whose wealth is at stake and who face competitive pressure to get the rules right will be better than rule making by government actors.

other things, about the cost of recruiting a sufficient number of independent directors to have a majority-independent board. This listing requirement, however, is not mandated by Sarbanes-Oxley, so the NYSE and the Nasdaq will have to decide whether to build in exceptions to the rule for smaller firms. Thus the SEC on one hand, and the NYSE and the Nasdaq on the other, must directly confront a cost/benefit question regarding new listing standards. Are the costs to investors of deterring some foreign companies, or small businesses, from listing greater or less than the costs of failing to hold a steady line on the new listing standards? The theoretical discussion above suggests that the exchanges will be more likely to arrive at the correct answer because they have a direct financial incentive to do so. Watching the SEC, the NYSE, and the Nasdaq as they try to determine how strictly to apply the new listing standards may shed new light on the comparative efficacy of exchange and agency regulation.

The Best of Both Worlds?

Imagine that the Securities Act of 1933 and the Securities Exchange Act of 1934 were amended to remove all substantive provisions regarding disclosure, accounting standards, proxy regulation, and takeover regulation and to divest the SEC of its rule-making authority over such matters. However, the statutes retained their anti-fraud provisions and authorized the SEC to investigate and impose civil sanctions against listed companies (and their officers, directors, and affiliates) that violate any disclosure or corporate governance rules promulgated by the exchange or other market on which they are traded.

The resulting system would combine the advantages of the exchanges' superior incentives to adopt optimal rules and the government's unique enforcement tools. We could expect competing exchanges to adopt disclosure, accounting, and governance standards that are closer to optimal than those adopted by Congress and the SEC. Of course, anyone

who believes that more regulation is always better will find such a proposal manifestly unwise, because exchanges might choose not to replicate some parts of the current regulatory structure. But competition will provide the necessary incentive for exchanges to select rules that they believe will appeal to investors, given their costs.

For what it is worth, I suspect that the immediate result of such a change would not be dramatic, just as the immediate results of federal regulation in the 1930s were not dramatic. The infant SEC borrowed liberally from the NYSE's listing standards to write its initial disclosure forms. Similarly, exchanges would surely borrow liberally from existing precedents—including not only SEC forms but market-tested alternatives such as typical Eurodollar disclosure documents. Unlike existing law, however, those standards would have to survive the market's fitness test on an ongoing basis.

Conclusion

Conventional wisdom has it that recent corporate governance and accounting scandals demonstrate the need for more government and less private regulation of securities markets. The case rests on the fact that the securities industry developed practices (such as the close integration of investment banking and securities analysis, or auditing and consulting) that were in retrospect not optimal, and investors arguably failed to react with sufficient alarm. Conveniently ignored is the fact that regulators failed as well.

Regulation by hindsight may be emotionally soothing, but it is not be the best way to prevent yet unknown problems. In a dynamic setting like the securities markets, self-interest is the most powerful tool available for adjusting rapidly to changing conditions. That suggests that rule making by actors whose wealth is at stake and who face competitive pressure to get the rules right will be better than rule making by government actors.

Notes

1. See Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690–1860* (New York: Cambridge University Press, 1998).
2. See Geoffrey P. Miller and Jonathan Macey, “Origins of the Blue Sky Laws,” *Texas Law Review* 70 (1991): 347; and Paul G. Mahoney, “The Origins of the Blue Sky Laws: A Test of Competing Hypotheses,” *Journal of Law and Economics* 46, no. 1 (April 2003): 229–51.
3. This section follows Paul G. Mahoney, “The Political Economy of the Securities Act of 1933,” *Journal of Legal Studies* 30, no. 1 (2001): 1–31.
4. See “Meeting of Board of Governors of Investment Bankers Association of America to Be Held Feb 10–11 to Consider Fair Practice Rules for Investment Banking Code,” *Commercial and Financial Chronicle* 138 (February 3, 1934): 782.
5. See “New Rules on Accountants, but Also Questions,” *New York Times*, July 26, 2002, p. C1. Title I of Sarbanes-Oxley creates a Public Company Accounting Oversight Board that regulates auditing firms and their activities. The compliance and financial costs imposed by this new body will create barriers to entry for smaller firms, thus consolidating the position of the Big Four accounting firms, which now have significant market power to raise the rates for their audit services.
6. Craig Pirrong has provided the most rigorous form of the argument. See Craig Pirrong, “A Theory of Financial Exchange Organization,” *Journal of Law and Economics* 43, no. 2 (2000): 437–72; and Craig Pirrong, “The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation,” *Journal of Law and Economics* 38, no. 1 (1995): 141–206.
7. For evidence of exchange market power, see Craig Pirrong, “The Organization of Financial Exchange Markets: Theory and Evidence,” *Journal of Financial Markets* 2, no. 4 (1999): 329–57. By contrast, other commentators look at the structure of financial exchanges and see considerable competition, both among trading platforms and between exchanges and their members, for the provision of order execution services. See, e.g., Marshall E. Blume, “The Structure of U.S. Equity Markets,” in *Brookings-Wharton Papers on Financial Services*, ed. Robert E. Litan and Richard Herring (Washington: Brookings Institution Press, 2002), pp. 35–60; and Benn Steil, “Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences,” in *Brookings-Wharton Papers on Financial Services*, pp. 61–91.
8. The first voluntary move to Nasdaq of a company that met the NYSE’s continued listing standards was in 2000. See “Nasdaq Concludes Record Share and Dollar Volume; Year Composite Index Finishes Lower,” M2 Presswire, January 23, 2001.
9. Standard & Poor’s website, www.spglobal.com/indexmain500_data.html, visited October 15, 2003.
10. See Exchange Act Release No. 42758, 65 *Fed. Reg.* 30175 (May 10, 2000).
11. Instinet website, www.instinet.com/trade_data/trade_data_quarter.shtml, visited October 15, 2003.
12. See Pirrong, “The Theory of Financial Exchange Organizations.”
13. See, e.g., International Organization of Securities Commissions, Discussion Paper on Stock Exchange Demutualization, December 2000; Norman S. Poser, “The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation,” *University of Pennsylvania Journal of International Economic Law* 22, no. 3 (2001): 497–540 (“regulators see a conflict between the duty of the managers of a publicly owned stock exchange to maximize profits for the benefit of its shareholders and their regulatory obligation to protect investors”). A good overview of the arguments regarding the compatibility of for-profit status and self-regulation appears in Roberta S. Karmel, “Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges,” *Hastings Law Journal* 53, no. 2 (2002): 367–430.
14. See Daniel R. Fischel and Sanford J. Grossman, “Consumer Protection in Futures and Securities Markets,” *Journal of Futures Markets* 4 (1984): 273.
15. See, e.g., Tamar Frankel, “Accountants’ Independence: The Recent Dilemma,” *Columbia Business Law Review* 2000, no. 2 (2000): 261–74; and “Auditory Discomfort: Auditors under Fire,” *The Economist*, January 13, 2000 (discussing SEC concerns about accountants’ nonaudit services), www.economist.com/research/articlesBySubject/PrinterFriendly.cfm?Story_ID=274092&subjectID=1290116.
16. See Christopher L. Culp and William A. Niskanen, eds., *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations* (New York: John Wiley and Sons, 2003).
17. Although debates over securities regulation typically focus on the first of these harms, I have argued that the second—the fact that poor disclosure helps corporate promoters and managers to

misappropriate assets without being detected—is the greater harm, and the one to which securities disclosure norms were originally addressed. See Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems," *University of Chicago Law Review* 62 (1995): 1047.

18. See Merritt B. Fox, "Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?" *Michigan Law Review* 95, no. 8 (1997): 2498–2629; and Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review* 70, no. 3 (1984): 669–715.

19. See, e.g., NYSE Rule 304(h)(4).

20. See Easterbrook and Fischel.

21. See Stuart J. Banner, "The Origin of the New York Stock Exchange, 1791–1860," *Journal of Legal Studies* 27, no. 1 (1998): 113–40.

22. The discussion herein draws from Paul G. Mahoney, "The Exchange as Regulator," *Virginia Law Review* 83 (1997): 1453.

23. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1932; reprint, New Brunswick, NJ: Transaction Publishers, 1991).

24. See George J. Benston, *Corporate Financial Disclosure in the UK and the USA* (New York: Lexington Books, 1976); George J. Benston, "An Appraisal of the Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements," *Law and Contemporary Problems* 41 (Summer 1977): 30; and George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review* 63 (1973): 132.

25. See Paul G. Mahoney, "The Stock Pools and the Securities Exchange Act," *Journal of Financial Economics* 51 (1999): 343–69.

26. See Banner, "The Origins of the New York Stock Exchange."

27. See "Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee," June 6, 2002, www.nyse.com/pdfs/corp_govreport.pdf. A summary of Nasdaq's most recent (as of September 10, 2003) corporate governance proposals can be found at www.nasdaq.com/about/Corp_Gov_Summary.pdf.

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