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Cover Page Footnote

Fleckner@post.harvard.edu. For very helpful discussions, suggestions, and general critique, I am grateful to Howell E. Jackson as well as to Stavros Gkantinis, Apostolos Gkoutzinis, and Noah D. Levin. The normal disclaimers apply. An earlier version of this Article has been a discussion paper of the John M. Olin Center's Program on Corporate Governance, Working Papers, http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers.htm (last visited Mar. 6, 2005).

ARTICLES

STOCK EXCHANGES AT THE CROSSROADS

*Andreas M. Fleckner**

INTRODUCTION

Nemo iudex in sua causa—No one shall judge his own cause. Ancient Rome adhered to this principle,¹ the greatest writers emphasized it,² and the Founding Fathers contemplated it in the early days of the republic: “No man is allowed to be a judge in his own cause; because his interest would certainly bias his judgment, and, not improbably, corrupt his integrity.”³

We might add to this well-known principle another idea: No one shall judge a competitor’s cause. The reasoning is similar: If one passes judgment on a competitor, it will affect her own position in the competition and therefore bias her judgment.

When it comes to the future organization of our stock exchanges—the very heart of our economy—the application of both principles becomes complicated. As it turns out, we might very soon witness stock exchanges, empowered by Congress as judges over the securities markets, that are in a position to judge both their own and their competitors’ causes.

With increased competition caused by deregulation, technological advances, and globalization, the organization of stock exchanges is at a crossroads. Traditionally, stock exchanges were organized as not-for-profit organizations, founded and owned by brokers and dealers who managed

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1. Code Just. 3.5.0 (Valens, Gratianus & Valentinianus 346) (“ne quis in sua causa iudicet vel sibi ius dicat”); Code Theod. 2.2.0 (“ne in sua causa quis iudicet”); Dig. 5.1.17 (Ulpian, Ad Edictum 22) (“iniquum est aliquem suae rei iudicem fieri”).

2. Johann W. von Goethe, *Iphigenie auf Tauris* 4.4 (1787) (“auch wir sind nicht bestellt, uns selbst zu richten”); Lucius A. Seneca, *De Beneficiis* 2.26.2 (“nemo non benignus est sui iudex”). The principle has also been referred to in famous legal works. *See, e.g.,* Louis D. Brandeis, *Other People’s Money: And How the Bankers Use It* 23 (1914) (“The weakness of human nature prevents men from being good judges of their own deservings.”).

3. *The Federalist* No. 10, at 50 (James Madison) (J.R. Poole ed., 2005).

“their” stock exchange like an exclusive club, with high barriers for new entrants and a regional or even national monopoly, comparable to a medieval gild. Today, domestic and international competition increasingly compel stock exchanges to give up their exclusivity, undergo restructuring, and become publicly traded for-profit companies, a process referred to as demutualization.⁴ At first glance, it might seem incestuous that stock exchanges themselves issue stock. But in fact this development brings a kind of normalization: The public corporation—the most efficient organizational form for large enterprises—will help stock exchanges catch up with domestic and international competitors.

Notwithstanding these benefits, Congress and the Securities and Exchange Commission (“SEC” or “Commission”) should not be indifferent toward the ongoing transformation, inasmuch as demutualization and the prospect of bringing stock exchanges public challenge the well-trying regulatory system that has served this economy over such a long time. Therefore, well aware of the problems that come with the process of demutualization, the SEC has put forward amendments to adjust the regulatory regime to the new organizational reality.⁵ In developing these proposals, the Commission could draw on previous studies by the General Accounting Office,⁶ the International Organization of Securities Commissions (“IOSCO”),⁷ the World Bank,⁸ and the Asian Development Bank.⁹ Wisely, however, the Commission so far has moved slowly in enacting the rules, allowing more time for thorough consideration, a chance that especially Congress has used to get a picture of the debate.¹⁰

4. The process has sometimes been referred to as “companization.” See Ruben Lee, *What Is an Exchange?* 35-36 (1998) [hereinafter Lee, *What Is an Exchange?*]; Ruben Lee, *The Future of Securities Exchanges*, in *Brookings-Wharton Papers on Financial Services* 1, 18 (Robert E. Litan & Richard Herring eds., 2002) [hereinafter Lee, *The Future of Securities Exchanges*]. In recent years, however, demutualization (or demutualisation) has become the standard term.

5. *Fair Administration and Governance of Self-Regulatory Organizations*, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126 (Dec. 8, 2004). The comment period was later extended by six weeks. See *Fair Administration and Governance of Self-Regulatory Organizations*, Exchange Act Release No. 34-51019, 70 Fed. Reg. 2,829 (Jan. 18, 2005).

6. U.S. Gen. Accounting Office, *Securities Markets: Competition and Multiple Regulators Heighten Concerns About Self-Regulation* (2002).

7. Int’l Org. of Sec. Comm’ns, *Issues Paper on Exchange Demutualization* (2001) [hereinafter IOSCO on Exchange Demutualization]; see also Int’l Org. of Sec. Comm’ns, *Discussion Paper on Stock Exchange Demutualization* (2000).

8. John W. Carson, *Conflicts of Interests in Self-Regulation: Can Demutualized Exchanges Successfully Manage Them?* (World Bank Policy Research, Working Paper No. 3183, 2003), available at <http://ssrn.com/abstract=636602>. Although the article does, pursuant to the disclaimer made at its beginning, not necessarily represent the World Bank’s view, the article itself expressly says what the “Bank believes.” See, e.g., *id.* at 1.

9. *Demutualization of Stock Exchanges: Problems, Solutions, and Case Studies* (Shamshad Akhtar ed., 2002). This is the most comprehensive work on demutualization, with contributions from various authors.

10. *Regulation NMS and Recent Market Developments: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2005); *Self-Regulatory Organizations: Exploring the Need for Reform: Hearing Before the Subcomm. on Capital*

While many observers have early recognized the importance of the demutualization process, including selected regulatory concerns,¹¹ this Article offers the first comprehensive discussion of the regulatory challenges that come with demutualization and listing of stock exchanges, most importantly the conflicts of interest that arise when stock exchanges regulate themselves and their competitors.

Part I gives an overview of the stock exchanges' function and organization. Exchanges are complicated and sophisticated institutions, not only organizing stock markets but regulating them as well, with the latter being the main source of the tensions that arise when stock exchanges themselves become publicly traded.

Part II identifies increasing competition as the main force that drives the transformation of stock exchanges into for-profit companies. This part outlines the factors that foster competition, examines the marketplaces that compete, shows what they compete for, and explains why demutualized and publicly traded stock exchanges have competitive advantages over marketplaces organized in the traditional mutual form.

Part III develops the conflicts of interest that arise when stock exchanges demutualize and go public. Wearing two different hats, those of player and referee, as stock exchanges do, creates tensions. The main concern identified herein is not that publicly traded stock exchanges might systematically under-regulate or overregulate their markets—this would put in danger the stock exchange's core assets, their integrity and trustworthiness, and would therefore not be a wise move in the long run. Rather, the concern is that publicly traded stock exchanges will be too soft in regulating themselves and too severe in regulating competitors. Even if we assume that stock exchanges will not deliberately favor their own interests over others', we should nevertheless be concerned with the

Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services, 109th Cong. (2005) [hereinafter *Self-Regulatory Organizations: Exploring the Need for Reform*].

11. See Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, 15 *J. Applied Corp. Fin.* 105 (2002); Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?*, 21 *Nw. J. Int'l L. & Bus.* 657 (2001); Roberta S. Karmel, *Demutualization of Exchanges as a Strategy for Capital Market Regulatory Reform*, in *Focus on Capital: New Approaches to Developing Latin American Capital Markets* 269 (Kenroy Dowers & Pietro Masci eds., 2003); Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 *Hastings L.J.* 367 (2002) [hereinafter *Karmel, Turning Seats into Shares*]; Ruben Lee, *Changing Market Structures, Demutualization and the Future of Securities Trading*, in *Brookings-Wharton Papers on Financial Services* 283 (Robert E. Litan & Richard Herring eds., 2003); Lee, *The Future of Securities Exchanges*, *supra* note 4; Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 *Va. J. Int'l L.* 583 (2001); Jonathan R. Macey & Maureen O'Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 *Stan. L. Rev.* 563 (2005); Benn Steil, *Changes in the Ownership and Governance of Securities Exchanges: Causes and Consequences*, in *Brookings-Wharton Papers on Financial Services*, *supra* note 4, at 61.

unconscious influences that tend to arise from conflicts of interest.¹² William H. Donaldson, the former chairman of the New York Stock Exchange (“NYSE”) and of the SEC, perhaps captured this best when he noted that, like everyone else, stock exchanges “are not immune from governance missteps.”¹³ But unlike someone else, we might want to add, missteps by stock exchanges tend not to be limited to certain areas but to shake the economy as a whole. That is why the governance of stock exchanges requires more attention than the organization of other institutions, and probably also more intervention by official authorities such as Congress and the SEC.

With that in mind, but also adhering to the idea of regulatory restraint, Part IV puts forward some modest amendments to the current regulatory structure that would, without greatly diminishing the regulatory powers of stock exchanges, significantly mitigate the conflicts of interest that come with demutualization and going public. The proposal is three pronged. First, the regulatory arm of demutualized stock exchanges should be separated from the other business units. Second, this separated regulatory arm should report not to the board of directors of the stock exchange, but rather to the SEC. Third, self-listed stock exchanges and their affiliates should be required to have a second listing at another stock exchange.

To simplify matters, this Article addresses only stock markets registered as national securities exchanges.¹⁴ Similar problems arise when other stock markets operate for profit and go public (most notably the Nasdaq Stock Market, before it became itself a national securities exchange).¹⁵

12. The U.S. Supreme Court has emphasized this in a slightly different context. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 187-92 (1963) (discussing conflicts of interest of investment advisers).

13. William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm’n, Address at the Open Meeting Regarding SRO Governance Rule Proposal (Nov. 9, 2004), available at <http://www.sec.gov/news/speech/spch110904whd.htm>; see also Siobhan Hughes, *SEC Moves Ahead to Strengthen Governance of U.S. Stock Markets*, Wall St. J., Nov. 10, 2004, at C3.

14. See Securities Exchange Act of 1934 § 6, 15 U.S.C. § 78f (2000).

15. The Nasdaq Stock Market had filed an application with the Securities and Exchange Commission (“SEC” or “Commission”) to become a marketplace recognized as a national securities exchange as early as in March 2001. See *The Nasdaq Stock Market, Inc.; Notice of Filing of Application for Registration as a National Securities Exchange Under Section 6 of the Securities Exchange Act of 1934*, Exchange Act Release No. 34-44396, 66 Fed. Reg. 31,952 (June 13, 2001). After years of discussion and numerous amendments, the SEC has now approved Nasdaq’s exchange registration application. See *In the Matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange; Findings, Opinion, and Order of the Commission*, Exchange Act Release No. 34-53128, 71 Fed. Reg. 3550 (Jan. 23, 2006); Press Release, Nasdaq, SEC Approves Nasdaq’s Exchange Registration Application (Jan. 16, 2006) available at http://www.nasdaq.com/newsroom/news/pr2006/ne_section06_005.stm.

I. BACKGROUND

Stock exchanges are intermediaries: They bring together sellers and buyers, investors and issuers, and, through information distribution, informed and uninformed market participants. Although these are more constituencies than other financial institutions have, that fact alone would not call for special attention.

What makes stock exchanges out of the ordinary is that they are both regulators and regulated entities: regulators insofar as they oversee the market they organize, and at the same time regulated to the extent that they are subject to the SEC's control and supervision. The United States Supreme Court calls this hybrid system a "policy of self-regulation by the exchanges coupled with oversight by the SEC."¹⁶

This introductory part identifies the functions that stock exchanges perform,¹⁷ followed by a discussion of their organizational structure and how it is influenced by the regulatory regime.¹⁸ The introduction concludes with an overview of the current organization of the marketplaces for stocks in the United States, as well as of the most important competitors abroad.¹⁹

A. Functions of Stock Exchanges

The Securities Exchange Act of 1934 defines an exchange as

[an] organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.²⁰

This circular definition helps little either in determining whether a certain marketplace is a stock exchange²¹ or in understanding what functions a stock exchange actually performs. The circularity of the statutory definition is not so much a legislative lapse as a nice illustration and inevitable consequence of the modern stock exchange's complexity. In structuring their main activities, we might identify stock exchanges as market

16. *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 667 (1975).

17. *See infra* Part I.A.

18. *See infra* Part I.B.

19. *See infra* Part I.C.

20. Securities Exchange Act § 3(a)(1), 15 U.S.C. § 78c(a)(1) (2000). The definition is further described in 17 C.F.R. § 240.3b-16 (2005).

21. The question of what constitutes an exchange has been tested in the well-known dispute between the SEC and the Chicago derivatives markets. *See Bd. of Trade v. SEC*, 923 F.2d 1270 (7th Cir. 1991); *Bd. of Trade v. SEC*, 883 F.2d 525, 535-36 (7th Cir. 1989). For a general overview, see John C. Coffee, Jr. & Joel Seligman, *Securities Regulation* 624-27 (9th ed. 2003). For more details, see Lee, *What Is an Exchange?*, *supra* note 4, and Therese H. Maynard, *What Is an "Exchange"?—Proprietary Electronic Securities Trading Systems and the Statutory Definition of an Exchange*, 49 Wash. & Lee L. Rev. 833 (1992).

organizers,²² as information distributors,²³ as market regulators,²⁴ as standards setters,²⁵ and finally, to an increasing degree, as business enterprises.²⁶

1. Market Organizers

The critical function of stock exchanges is to provide a marketplace where stocks, i.e., shares in the corporation's equity, can be easily bought and sold. Like other parts of the financial market, stock markets serve the economy, and by extension the public, in at least three regards: They bring together those who demand (corporations) and those who supply capital (investors). They allow investors to reduce their risk by spreading their investments. And they make those investments liquid enough to invest and divest without significant price changes. We refer to these functions collectively as "providing liquidity."²⁷ Stock exchanges, by definition, have always and will always perform this role.

What has changed over the last two centuries is how stock exchanges organize the trade in stocks, how they operate the facilities where buyers and sellers can easily come together, agree on prices, and exchange money for stocks. Until two decades ago, the heart of a stock exchange was its trading floor, where the so-called floor brokers met, negotiated, and agreed upon the price for stock transfers, mainly executed for their principals. But—as will be seen throughout this Article—trading floors have become a deserted place and an obsolescent trading model. As in many other industry sectors, humans are increasingly getting replaced by computers, with stock exchanges maintaining electronic systems that match buy and sell orders automatically.²⁸ Not surprisingly, aside from regulatory expenses, stock exchanges today spend most on information and communication technology.

2. Information Distributors

Of increasing importance is the stock exchanges' function as distributors of the information they generate in the price discovery process. Such information takes two primary forms, and its knowledge is critical from two main perspectives.

22. See *infra* Part I.A.1.

23. See *infra* Part I.A.2.

24. See *infra* Part I.A.3.

25. See *infra* Part I.A.4.

26. See *infra* Part I.A.5.

27. See Coffee & Seligman, *supra* note 21, at 8-9.

28. The question of whether floor specialists are desirable is far beyond the scope of this Article. For the purposes of this Article, it is sufficient to recognize that marketplaces for stocks worldwide are to an increasing extent organized without floor brokers and that such marketplaces compete with traditional stock exchanges. For a recent contribution to the discussion, see Puneet Handa et al., *The Economic Value of a Trading Floor: Evidence from the American Stock Exchange*, 77 J. Bus. 331 (2004).

The first set of information consists of the trades that have been executed, including the volume, the price, and to some extent the parties involved. Information of that type has a considerable economic value,²⁹ as it helps provide a vast number of financial services, such as furnishing market reports, analyzing stocks, recommending certain securities for buy and sell, and so forth. Moreover, information about previous trades is needed for numerous related business purposes, the most important application being derivatives, which are financial instruments whose value is derived from an underlying asset such as stocks.³⁰ For the price discovery of such stock-based derivatives, it is critical to get the latest stock prices. Aside from these business purposes, information about settled trades has a paramount regulatory function, as it is the very basis of market surveillance and helps detect securities fraud such as insider trading or market manipulation.

The second kind of market data that stock exchanges offer is quotes. These are prices at which market participants are willing to buy securities (“bid quotes”) or sell (“ask quotes”), with the difference being the so-called spread. To some degree, the knowledge of quotes allows prediction of future stock prices, making that knowledge very valuable to traders. Moreover, quotes have a critical regulatory function in the U.S. securities markets to the extent that broker-dealers are expected to choose the marketplace with the best available quotes for their clients (known as the duty of “best execution”).³¹

3. Market Regulators

The key function to be addressed in this Article is the stock exchanges’ role as regulators of the market they organize, a mandate that includes all elements of market regulation, from making rules over compliance surveillance to enforcement. All market participants and affiliates, particularly the broker-dealers that trade on the market and the issuers of the traded shares, are subject to rules that stock exchanges enact particularly for their marketplace. Moreover, stock exchanges are empowered to monitor the participants’ compliance with the regulatory regime, not only with respect to their own rules but also with federal and state law and rules promulgated thereunder, most importantly by the SEC. By doing so, stock exchanges perform an important role to provide for fair trading and accurate

29. See J. Harold Mulherin et al., *Prices Are Property: The Organization of Financial Exchanges from a Transaction Cost Perspective*, 34 J.L. & Econ. 591 (1991). See generally Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,270-75 (Dec. 8, 2004).

30. See generally John-Peter Castagnino, *Derivatives: The Key Principles 1* (2003); Simon Firth, *Derivatives: Law and Practice 1.004* (2004); Group of Thirty, *Derivatives: Practices and Principles 28* (1993).

31. See *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3d Cir. 2001); *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266 (3d Cir. 1998). For an overview of the duty of best execution, see Coffee & Seligman, *supra* note 21, at 38, 657-60.

price discovery, both critical components in fostering investor confidence. For the case in which someone fails to abide by any of the rules, the stock exchanges are vested with numerous enforcement powers, from fining violators to permanently banning them from the marketplace.

The stock exchanges' function as market regulators is—in contrast to market organization—not innate. There are two main reasons for this notion. First, it is questionable whether stock markets need be regulated at all: Other markets operate without any special rules, relying instead primarily on the traders' caution (*caveat emptor*) and secondarily on the common law rules concerning fraud. Second, market regulation, if deemed necessary, need not be vested in the stock exchanges themselves. Instead, it might be good, or even better policy to confer this mandate upon someone other than the market organizer. These issues are far from being clearly decided.³² Indeed, some commentators even argue for moves in the opposite direction, in favor of increasing the stock exchanges' powers to regulate the market.³³

4. Corporate Governance Standards Setters

Stock exchanges regulate their issuers through so-called listing rules, the most famous of which is the NYSE Listed Company Manual. However, a considerable number of stock exchange listing rules are more than regulations providing for fair trading, aiming not at bettering the quality of trading but at increasing the quality of the traded products: the companies, the stocks of which are sold and bought. We call such listing rules “corporate governance rules.”³⁴ Noteworthy examples are rules about continued disclosure,³⁵ takeover defense,³⁶ stockholder power,³⁷ the composition of the issuer's board,³⁸ and the establishment of specific board

32. See *Self-Regulatory Organizations: Exploring the Need for Reform*, *supra* note 10; Concept Release Concerning Self-Regulation, 69 Fed. Reg. at 71,256; Securities Industry Association, Reinventing Self-Regulation (Oct. 14, 2003), http://www.sia.com/market_structure/html/siawhitepaperfinal.htm; see also Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, Wall St. J., Dec. 31, 2003, at A1; Aaron Lucchetti, *As Exchanges Become Profit-Seekers, Concerns Rise Over Risk to Investors*, Wall St. J., Nov. 8, 2005, at C1.

33. Most noteworthy is Paul G. Mahoney, *The Exchange as Regulator*, 83 Va. L. Rev. 1453 (1997).

34. See NYSE, Inc., Listed Company Manual § 303A.00-13 (2006), available at <http://www.nyse.com/Frameset.html?displayPage=/about/listed/1022221393251.html> (titled the section as “Corporate Governance Standards”); see also Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. Rev. 325 (2001). But see Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 Bus. Law. 1461 (1992) (arguing that listing rules further no purpose of the Securities Exchange Act and are therefore invalid). See generally NYSE, Inc., *supra*, §§ 301-15.

35. See, e.g., NYSE, Inc., *supra* note 34, § 203.

36. See, e.g., *id.* § 308.00.

37. See, e.g., *id.* § 312.03.

38. See, e.g., *id.* § 303A.

committees.³⁹ Hence, as former SEC chairman William H. Donaldson observed, in addition to organizing trading, stock exchanges play a “critical role in our securities markets as standard setters for listed companies.”⁴⁰ One reason why stock exchanges are so critical in this regard is that their powers to regulate corporate governance issues reach significantly farther than the powers of the SEC, as held in the landmark *Business Roundtable* case.⁴¹

Corporate governance listing rules are anything but a recent emergence; the New York Stock Exchange developed such rules no later than in the mid-nineteenth century.⁴² The aim of such rules was, and still is, to improve the corporate governance of listed companies. Although one can trade stocks of badly managed companies just as well as the stocks of those well managed, usually sincere investors are likely to prefer the latter. Therefore, stock exchanges have a strong incentive to look at the quality of the products offered on their markets, an insight that will be critical in many parts of this Article.

5. Business Enterprises

By fulfilling the above-mentioned functions (market organization, information distribution, market regulation, and standards setting), stock exchanges carry on a business enterprise. While the business of running an exchange is not necessarily a commercial (i.e., for-profit) business, it is definitively a business, and as for every business, those who run it and own it want to retain and improve its standing. If a stock exchange’s management fails to defend the market share of its exchange or loses issuers to competing stock exchanges, it can expect to be ousted sooner or later (likely sooner if the business is for-profit). So, even though stock exchanges have regulatory powers, they are—irrespective of their actual organization and their plans to make profit or not—still businesses rather than governmental bodies or agencies, where the pressure for good performance is normally much lower.

Like in other business companies, expenses and income matter, and management tends to focus on cutting the former and increasing the latter. The main expenses of stock exchanges are in maintaining and regulating the

39. See, e.g., *id.* § 303A.04 (nominating/corporate governance committee); *id.* § 303A.05 (compensation committee); *id.* § 303A.06-07 (audit committee).

40. Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,129 n.30 (Dec. 8, 2004) (citing Letter from William H. Donaldson, Chairman, Sec. & Exch. Comm’n, to relevant self-regulatory organizations (March 26, 2003)).

41. *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

42. George L. Leffler & Loring C. Farwell, *The Stock Market* 138-43 (3d ed. 1963). For the origins of regulation, see Stuart Banner, *Anglo-American Securities Regulation: Cultural and Political Roots, 1690-1860* (1998). For the New York Stock Exchange’s history, see Francis L. Eames, *The New York Stock Exchange (1894)*, and Charles R. Geisst, *Wall Street: A History, From Its Beginnings to the Fall of Enron* (2004).

marketplace (most importantly for the electronic trading system and regulatory staff), while their income is derived from various sources, the following being the most common:⁴³ (1) the issuers of the stocks that are listed and traded pay listing fees;⁴⁴ (2) depending on whether those listing fees are a flat rate or not, the issuers can also be charged for special services, such as information distribution during tender offers; (3) fees are received from the broker-dealers who are allowed to trade at the stock exchange (known as members or seatholders) and thereby use the stock exchange's facilities, particularly its trading floor and trading system; (4) for each transaction, market participants can be charged transaction fees, as well as fees for clearing, settlement, custodian, and registration services; (5) stock exchanges can impose fines on regulated persons and entities; (6) stock exchanges can, and to an increasing extent do, sell market data; (7) stock exchanges may charge for other ancillary services, such as information technology solutions and support, product licenses, and so forth (for example providing floor brokers with hand-held computers, as it happens at the NYSE). Another field might become general investor relations services.⁴⁵

The funding of stock exchanges raises considerable regulatory concerns. These worries increase when stock exchanges become for-profit companies, which dramatically fosters their focus on reducing expenses and enlarging income. Should Congress and the SEC stay idle when, for instance, stock exchanges slash their regulatory expenses or, in best opposite, tighten enforcement and boost their fines, solely in order to make more profit?

B. Organization of Stock Exchanges

The organizational structure of stock exchanges has two notable landmarks: the Securities Exchange Act of 1934⁴⁶ and the Securities Acts

43. For the stock exchanges' sources of income, see Sebastian Schich & Gert Wehinger, *Prospects for Stock Exchanges*, Fin. Market Trends, Oct. 2003, at 91, 100 (providing a graph showing the allocation between different sources). See generally Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,270-75 (Dec. 8, 2004); IOSCO on Exchange Demutualization, *supra* note 7, at 6. The annual reports of the major stock exchanges provide recent overviews of their incomes. See, e.g., NYSE, Inc., Annual Report (Form 10-K), at 24-27 (2004).

44. See, e.g., NYSE, Inc., *supra* note 34, §§ 701.02, 902; see also Jonathan R. Macey & Maureen O'Hara, *The Economics of Stock Exchange Listing Fees and Listing Requirements*, 11 J. Fin. Intermediation 297, 317 (2002) (closing with the prediction that "either listing fees, or the exchanges, will not survive"); Schich & Wehinger, *supra* note 43, at 94 (presenting an overview of the initial and annual listing fees on twenty-four stock exchanges worldwide).

45. See Press Release, Nasdaq, Nasdaq to Acquire Shareholder.com, Leading Investor Relations Provider (Jan. 10, 2006), available at http://www.nasdaq.com/newsroom/news/pr2006/ne_section06_003.stm.

46. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-kk (2000)).

Amendments of 1975.⁴⁷ Consequently, the following overview is separated into three periods: pre-1934,⁴⁸ 1934 to 1975,⁴⁹ and post-1975.⁵⁰ The overview will conclude with the recent trend of demutualization, which first occurred abroad but has now gained ground on U.S. soil as well.⁵¹

As a general observation one might note that, although stock exchanges were at all times at least partly self-regulated, the trend continuously moves toward centralized federal regulation.

1. Age of Pure Self-Regulation (Until 1934)

The stock exchanges' organizational history differs from that of many other businesses in the financial sector and elsewhere. Most businesses are established by entrepreneurs who believe a promising market exists for their products and services, a demand they can profitably supply. Businessmen applied for bank charters in communities wherein they saw a demand for loans; they offered brokerage services, investment funds, and financial advice in regions and to people they expected would need such services.

In the earlier days of today's major economies, however, no one set up a marketplace for stocks, called it stock exchange, and offered the service to people who wanted to trade. Instead, stock exchanges were established the opposite way: those who wanted to trade in stocks—brokers and dealers—looked for a place and system that guaranteed reliable and permanent trading. As no such organized marketplace yet existed, they launched one—the birth of stock exchanges. Their intention was not to attract traders—they were themselves the traders—but to have a convenient forum to trade securities (with the prospective benefit of commission fees when they acted for others, or direct profits when acting for their own account). So unlike many other businesses, stock exchanges were founded by their customers,⁵² and thus were customer controlled from their very beginning.⁵³

In this traditional structure, known as the mutual or cooperative form, the broker-dealers wear three hats: They are (1) the sole or main customers of the stock exchange; (2) the owners of the stock exchange; and finally, as it is a closely held entity, they are usually also (3) the managers of the stock

47. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. §§ 78a-kk).

48. See *infra* Part I.B.1.

49. See *infra* Part I.B.2.

50. See *infra* Part I.B.3.

51. See *infra* Part I.B.4.

52. We find similar structures only to a limited degree in the history of other branches of the financial industry, most importantly mutual savings banks and mutual life insurance companies. See generally Henry Hansmann, *The Ownership of Enterprise* 246-86 (1996).

53. For the problems of customer-controlled entities, see generally *id.* For stock exchanges, see Carmine Di Noia, *Customer-Controlled Firms: The Case of Financial Exchanges*, in *Capital Markets in the Age of the Euro* 173 (Guido Ferrarini et al. eds., 2002).

exchange. This organizational structure had important implications for the stock exchange's business plan. As the primary customers, the founding traders were less concerned with the stock exchange making money, because the profits mainly derive from transaction fees paid by themselves (from their viewpoint, it is no more than moving money from the own left into the common right pocket). Thus stock exchanges across the world were traditionally organized as not-for-profit organizations. The brokers and dealers that ran the stock exchange did not raise prices higher than necessary to cover the expenses.⁵⁴ Technological advances that reduced the stock exchange's costs did not lead to increased profits but rather to decreased transaction fees.

Another remarkable feature of the history of stock exchanges is the approach to their regulation. Unlike most of the other financial institutions, namely banks and insurance companies, stock exchanges in the United States were for a long time nearly unregulated.⁵⁵ This is surprising considering their economic importance and monopoly power (at least regionally due to the difficulty in trading stocks between the East and West coasts without modern communication). Congress instead relied on the members of the stock exchanges to ensure that the exchanges and their markets were well organized (concept of self-regulation), and maybe to a lesser extent on state laws. Although the stock exchanges' success in regulating their markets is questionable, they clearly made some effort.⁵⁶

2. Inauguration of the Securities and Exchange Commission (1934)

From their inception, stock exchanges have attracted not only good faith entrepreneurs and investors but also fraudsters, impostors, and swindlers seeking easy money. This seamier element could be found among all of the stock exchanges' constituencies: the issuers, the broker-dealers, and the investors. Stock exchanges, through their self-regulation, have always responded to such bad participants—much as a golf club does when members or their patrons damage the clubhouse.

Despite these efforts, eventually the public—and finally Congress—were no longer content just watching how the stock exchanges handled (and sometimes tolerated)⁵⁷ violations. Proposals to regulate stock exchanges

54. See, e.g., Press Release, ASX, ASX Demutualisation—The First Four Months (Feb. 18, 1999) (Address by Richard Humphry, Managing Dir., Austl. Stock Exch., to CEDA, Melbourne (Feb. 18, 1999)) (stating that, organized in the mutual form, “some of our services were substantially underpriced, particularly those directed principally at stockbrokers”), *available at* http://www.asx.com.au/about/shareholder/announcements/AA180299_AS3.htm.

55. Cf. *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 665 (1975) (“The exchanges remained essentially self-regulating and without significant supervision until the adoption of the Securities Exchange Act of 1934.”).

56. For an overview of the New York Stock Exchange's (“NYSE's”) regulation of their market, see Mahoney, *supra* note 33, at 1459-62.

57. See *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 351 (1963). The thesis that the stock exchanges failed to perform their regulatory function is challenged by Mahoney, *supra* note

were made as early as the beginning of the twentieth century, but nothing significant happened.⁵⁸ Public sentiment dramatically changed with the crash in 1929, when investors incurred remarkable losses,⁵⁹ and during the subsequent Great Depression. With the belief that the latter was significantly caused by the crash beforehand, stock exchanges were increasingly identified as public goods with a critical impact on the overall economy.

Within a few years, Congress responded; the Securities Exchange Act of 1934⁶⁰ created the independent and nonpartisan SEC as a federal agency to oversee the securities market and, to a certain degree, the stock exchanges. The result was a two-tiered system: self-regulation by the stock exchanges coupled with governmental oversight.⁶¹ While the stock exchanges' membership was still restricted, they lost part of their autonomy—formerly seen as “private clubs,”⁶² they were now privately organized clubs vested with public responsibilities.

Nonetheless, the inauguration of the SEC did not change the self-regulatory system as such. Unlike most other financial institutions, stock exchanges retained both their status as self-regulatory organizations and their regulatory powers. That may seem surprising, given both the tremendous crash and the alleged reluctance of the stock exchanges to prevent securities fraud. But the tradition of self-regulation, the objections by market participants against significant changes, doubts as to whether government could handle the regulation, and changes in political sentiment helped preserve critical parts of the old system.⁶³

33, at 1464-75. *But see* Coffee & Seligman, *supra* note 21, at 2-4 (noting that regulation was needed for consumer protection, to meet the informational needs of investors, and to cure the inadequate incentives for disclosure).

58. For a brief overview, see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 128 n.9 (1973).

59. A famous note to a 1933 House Report stated that “[f]ully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities.” H.R. Rep. No. 73-152, at 2 (1933).

60. Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(kk) (2000).

61. *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 667 (1975); *Merrill Lynch*, 414 U.S. at 127-28.

62. See William O. Douglas, *Democracy and Finance* 65 (James Allen ed., 1940).

63. For some of the identified reasons, see *Merrill Lynch*, 414 U.S. at 128 n.9. See also Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,256 (Dec. 8, 2004). *But see* Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. Rich. L. Rev. 1069, 1093 (2005) (stating that self regulation was the “result of historical accident and political expediency”).

3. Reinvigoration of the Securities and Exchange Commission (1975)

The second legislative landmark is the Securities Acts Amendments of 1975,⁶⁴ noteworthy in this context for two aspects. First, the amendments reinvigorated the SEC and gave it substantially more power over the stock exchanges. Although the exchanges still remained self-regulatory organizations, they were now subject to extended and tightened oversight by the SEC, which led to a shift toward governmental regulation as important as the 1934 establishment of the Commission. In addition, the amendments imposed new duties on the stock exchanges and strengthened their corporate governance. With these amendments, the exchanges moved further from their status as “private clubs” and grew closer to becoming public agencies. Most remarkably, they were required to submit rule change proposals for public comment,⁶⁵ as federal agencies are required to.⁶⁶

Second, the Securities Acts Amendments of 1975 established the controversial National Market System (“NMS”).⁶⁷ This system connects the various marketplaces that trade stocks in the United States, and is of critical importance for the allocation of orders and therefore for the marketplaces’ competition.

4. Recent Developments (1993-2006)

In roughly the last decade, the world has seen dramatic changes in the organizational structure of stock exchanges. While the major marketplaces in the United States have been unaffected by this development for a long time, they have very recently started to catch up with global trends.

a. *International Trend of Demutualization (Starting 1993)*

Before 1993, all relevant stock exchanges were owned by their members. Starting with the Stockholmsbörsen (Stockholm Stock Exchange) in 1993, stock exchanges worldwide transformed from member-owned companies into publicly held companies, a development known as demutualization. In a publicly traded stock exchange, the members are no longer the sole owners of the exchange. The right to trade at the stock exchange unravels

64. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. § 78(a)-(kk)).

65. Securities Exchange Act § 23(c), 15 U.S.C. § 78w(c).

66. Administrative Procedure Act, 5 U.S.C. § 553 (2000).

67. See Donald L. Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 Va. L. Rev. 785 (1984); Joel Seligman, *The Future of the National Market System*, 10 J. Corp. L. 79 (1984). But see Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. Ill. L. Rev. 315; Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. Rev. 883 (1981).

from the ownership, and the exchange usually becomes a for-profit company.

At the 1999 Annual Meeting of the World Federation of Exchanges,⁶⁸ as many as fifteen out of fifty-two exchanges had demutualized, fourteen exchanges had member approval for demutualization, and another fifteen were thinking about demutualization, which means that only eight exchanges were committed to retaining the mutual form.⁶⁹ In another survey in 2003, forty-two out of eighty-five exchanges were demutualized, sixteen were in the process of demutualization, and twenty-seven had no plans to demutualize.⁷⁰ Eighteen out of the forty-two demutualized exchanges were listed.⁷¹

b. *Failed Attempts in the United States (1999/2000)*

The United States is relatively late in the process of demutualization, and it is not completely clear why domestic exchanges have missed that global trend. Although the legal environment is somewhat hazy, it would probably not have been impossible for stock exchanges to get around it.

The SEC had occasionally claimed that the Securities Exchange Act required stock exchanges to have a “traditional membership structure” and limited “exchange participation to registered broker-dealers.”⁷² Similar language had emerged from the Supreme Court⁷³ and the Seventh Circuit Court of Appeals,⁷⁴ as well as from influential commentators.⁷⁵ In retrospect, such remarks are somewhat surprising because, if they were true, U.S. stock exchanges could not demutualize without an amendment to the Securities Exchange Act, or at least an exemption by the SEC. However, even though the Securities Exchange Act limits membership to registered

68. For general information about the World Federation of Exchanges, see World Federation of Exchanges, <http://www.world-exchanges.org> (last visited Feb. 24, 2006). As of February 24, 2006, the federation had fifty-seven members. See World Federation of Exchanges, [Members Worldwide, http://www.world-exchanges.org/WFE/home.asp?action=document&menu=54](http://www.world-exchanges.org/WFE/home.asp?action=document&menu=54) (last visited Feb. 24, 2006).

69. These numbers were informally reported at the mentioned meeting. See IOSCO on Exchange Demutualization, *supra* note 7, at 3.

70. Carson, *supra* note 8, at 5.

71. *Id.*

72. Regulation of Exchanges, Exchange Act Release No. 34-38672, International Series Release No. IS-1085, 62 Fed. Reg. 30,485, 30,487 (June 4, 1997).

73. See *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 350 (1963) (“The exchanges are by their nature bodies with a limited number of members, each of which plays a certain role in the carrying out of an exchange’s activities.”).

74. *Bd. of Trade v. SEC*, 883 F.2d 525, 528 (7th Cir. 1989) (stating that the Securities Exchange Act treats exchanges as “organizations created and run by broker-members”); *accord Bd. of Trade v. SEC*, 923 F.2d 1270, 1272 (7th Cir. 1991) (stating that “the statute requires that an exchange be controlled by its participants, who must in turn be registered brokers or individuals associated with such brokers”).

75. *Coffee & Seligman*, *supra* note 21, at 630 (“[T]he 1934 Act mandates a governance structure for exchanges based on a conception of them as not-for-profit organizations run for the benefit of participating dealers.”).

broker-dealers,⁷⁶ the Act does not, contrary to what the foregoing authorities might suggest, expressly state that the stock exchange be owned by its members. It is therefore critical to distinguish between membership, which carries the right to trade on the stock exchange and to manage it, and ownership, which gives entitlement to profits and the residual share. The Securities Exchange Act seems not to require that both occur together.

Another important issue is whether the Securities Exchange Act presumes that stock exchanges are not-for-profit organizations; the SEC casually gave the impression that it believed so,⁷⁷ as did some observers.⁷⁸ However, as early as 1998, in its rule on exchanges and alternative trading systems (known as Regulation ATS), the Commission (surprisingly, considering the earlier remarks) stated that it had, under certain conditions, no objections against demutualized for-profit exchanges.⁷⁹

Shortly thereafter, the New York Stock Exchange, at that time described as “die-hard traditionalists”⁸⁰ and as a “potential *Titanic*,”⁸¹ announced plans to demutualize and go public.⁸² In a now well-known testimony, Richard A. Grasso, then chairman and CEO of the New York Stock Exchange, praised this plan as “critically needed to assure the continued competitiveness and position” of the exchange.⁸³ Arthur Levitt, then-chairman of the SEC, several times emphasized the importance of demutualization and warned the domestic stock exchanges not to miss the international trend of demutualization.⁸⁴ However, the demutualization

76. Securities Exchange Act § 6(c)(1), 15 U.S.C. § 78f(c)(1) (2000).

77. See Regulation of Exchanges, 62 Fed. Reg. at 30,487 (stating that there are “exchange requirements that are incompatible with the operation of for-profit, non-membership alternative trading systems”).

78. Coffee & Seligman, *supra* note 21, at 630.

79. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,848 (Dec. 22, 1998).

80. Richard G. Humphry, Managing Dir., Austral. Stock Exch., The Challenge of Financial Globalisation: Address to the CEDA Capital Markets Seminar (Aug. 12, 1999), available at http://www.asx.com.au/about/shareholder/announcements/AA120899_AS3.htm.

81. *A Home-Grown Revolutionary*, Economist, July 31, 1999, at 60.

82. See Press Release, NYSE, NYSE Appoints Committee on Market Structure, Governance and Ownership (Oct. 11, 1999), available at <http://www.nyse.com/Frameset.html?displayPage=/press/1044027445373.html> [hereinafter Press Release, NYSE Appoints Committee]; Press Release, NYSE, NYSE Chairman Richard A. Grasso’s Letter to Members Concerning “Demutualization” (Sept. 2, 1999), available at <http://www.nyse.com/Frameset.html?displayPage=/press/1044027444806.html>; see also *A Home-Grown Revolutionary*, *supra* note 81, at 60; Mike McNamee, *Rethinking Wall Street*, Bus. Wk., Oct. 11, 1999, at 146; *NYSE Unlikely to Go Public Until 2nd Half of 2001*, Wall St. J., May 25, 2000, at 1; Sandra Sugawara, *NYSE May Drop Plans to Take Itself Public*, Wash. Post, Feb. 18, 2000, at E1; Sandra Sugawara, *NYSE Must Change*, Levitt Warns, Wash. Post, Oct. 28, 1999, at E1 [hereinafter Sugawara, *NYSE Must Change*].

83. *Public Ownership of Stock Exchanges: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. (1999) (statement of Richard A. Grasso, Chairman, New York Stock Exchange) [hereinafter *Grasso Statement*].

84. *The Changing Face of Capital Markets and the Impact of ECN’s: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. (1999) [hereinafter *The Changing Face of Capital Markets and the Impact of ECN’s*] (statement of Arthur Levitt, Chairman, Securities and Exchange Commission) (stating that

plan of the New York Stock Exchange soon failed, due partly, it appears, to the larger than expected resistance of the members, who wanted to preserve the traditional structure that had served them so well over a long time,⁸⁵ as well as tax reasons.⁸⁶

c. *Demutualizations in the United States (2004/2005)*

In outsourcing its equity business and establishing PCX Equities, Inc., as a corporate subsidiary in 1999, the Pacific Exchange created the first demutualized for-profit marketplace for stocks in the United States. In the same way, it set up PCX Options, Inc., which demutualized in June 2004. Finally, the Pacific Exchange itself demutualized in August 2004.⁸⁷ In 2000, the Pacific Stock Exchange, together with Archipelago Holdings, created a new national securities exchange, Archipelago Exchange (“ArcaEx”).⁸⁸ Eventually, ArcaEx replaced the equity trading arm of the Pacific Exchange, the above-mentioned PCX Equities, Inc.⁸⁹ Archipelago Holdings went public in 2004.⁹⁰ In January 2005, Archipelago Holdings, Inc., announced that, contingent on SEC approval, it “had entered into a

“today’s global marketplace always stands ready to offer alternatives that are more responsive to investor needs”), available at http://banking.senate.gov/99_10hr/102799/levitt.htm; Arthur Levitt, Chairman, Sec. and Exch. Comm’n, *Dynamic Markets, Timeless Principles*, Address at the Columbia School of Law (Sept. 23, 1999), in 2000 *Colum. Bus. L. Rev.* 1; see also Sugawara, *NYSE Must Change*, *supra* note 82 (quoting Levitt saying that “[i]f they [the New York Stock Exchange] don’t change their method of governance, they won’t be here five years from now”).

85. Mara Der Hovanesian, *Put the Big Board on the Big Board*, *Bus. Wk.*, Sept. 13, 2004, at 90; Sugawara, *NYSE Must Change*, *supra* note 82. The issue is nicely described (before the demutualization plan failed) in *A Home-Grown Revolutionary*, *supra* note 81.

86. Sugawara, *NYSE Must Change*, *supra* note 82.

87. Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto Relating to the Demutualization of the Pacific Exchange, Inc., Exchange Act Release No. 34-49718, 69 Fed. Reg. 29,611 (May 24, 2004).

88. See Press Release, Pac. Exch., Archipelago and the Pacific Exchange Announce Plan to Create a New National Stock Exchange (Mar. 14, 2000), available at http://www.tradearca.com/content/press/releases_03_14_00.pdf; Press Release, Pac. Exch., Archipelago and the Pacific Exchange Close Transaction to Create National Stock Exchange (July 13, 2000), available at http://www.pacificex.com/news/press/press-2000/abt_press_00_arca_close.html; Press Release, Pac. Exch., Archipelago Exchange Approved by SEC (Oct. 25, 2001), available at http://pacificex.com/news/press/press-2001/abt_press_01_sec_arcaex.html.

89. See Press Release, Pac. Exch., Pacific Exchange’s San Francisco Equities Floor Passes into History (Mar. 20, 2002), available at http://www.pacificex.com/news/press/press-2002/press_4-20-2_close.html; Press Release, Pac. Exch., PCX Equities Floors Pass into History (Mar. 19, 2001), available at http://www.pacificex.com/news/press/press-2001/abt_press_01_floors.html.

90. Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Certificate of Incorporation and Bylaws of Archipelago Holdings, Inc., Exchange Act Release No. 34-50170, 69 Fed. Reg. 50,419 (Aug. 16, 2004).

definitive agreement” to acquire PCX Holdings, Inc., the parent company of the Pacific Exchange and PCX Equities, Inc.⁹¹

The Philadelphia Stock Exchange demutualized in 2004;⁹² the Chicago Stock Exchange followed in 2005.⁹³ Neither is publicly traded.

d. *New York Stock Exchange-Archipelago Merger (2005/2006)*

In the spring of 2005, the New York Stock Exchange made its next, and this time successful attempt, to demutualize and go public.⁹⁴ After five years of deadlock, the sentiment about demutualization among the exchange’s members, who have to approve the demutualization of “their” exchange, seemed to have changed. There are at least three events that may explain the altered attitude: investigations against the exchange and the specialist firms for securities fraud;⁹⁵ the corporate governance-related turmoil in the aftermath of Chairman Grasso’s widely noticed ouster; and the falling prices for seats at the exchange, which dropped by more than half since their peak in 2000.⁹⁶

These incidents significantly weakened the exchange’s members: Mr. Grasso, who had spent most of his life at the New York Stock Exchange, had for a long time been the specialists’ guardian angel; with his dismissal the members lost their closest ally against the electronic trading that makes floor specialists unnecessary; the fraud investigations, among the largest in

91. Press Release, Pac. Exch., Archipelago Holdings Inc. to Acquire the Pacific Exchange (Jan. 3, 2005), available at [http://investor.archipelago.com/phoenix.zhtml?c=140290&p=irol-newsArticle&ID=658450&highlight=](http://investor.archipelago.com/phoenix.zhtml?c=140290&p=irol-newsArticle&ID=658450&highlight=;); see also Kate Kelly & Gregory Zuckerman, *Pacific Surf: Archipelago Takes the Ultimate Options Ride*, Wall St. J., Jan. 5, 2005, at C1. For the necessary adjustments, see Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to the Certificate of Incorporation of PCX Holdings, Inc., PCX Rules and Bylaws of Archipelago Holdings, Inc., Exchange Act Release No. 34-52249, 70 Fed. Reg. 48,611, 48,612 (Aug. 18, 2005).

92. Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 3 Thereto Relating to the Demutualization of the Philadelphia Stock Exchange, Inc., Exchange Act Release No. 34-49098, 69 Fed. Reg. 3974 (Jan. 27, 2004). For an assessment of their chances in the new competitive and regulatory landscape, see Meyer Frucher, *Duopoly Alert!*, Wall St. J., June 13, 2005, at A12 (providing the opinion of the Philadelphia Stock Exchange’s Chairman and CEO).

93. Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 by the Chicago Stock Exchange, Inc. Relating to the Demutualization of the Chicago Exchange, Inc., Exchange Act Release No. 34-51149, 70 Fed. Reg. 7531 (Feb. 14, 2005).

94. Gaston F. Ceron, *Big Board, Pondering Transition to For-Profit, Sets Review Panel*, Wall St. J., Feb. 9, 2005, at C3; see also Gaston F. Ceron & Aaron Lucchetti, *NYSE Profit Dropped 50% Last Year*, Wall St. J., Mar. 17, 2005, at C3 (mentioning the appointment of a committee to consider demutualization); Der Hovanesian, *supra* note 85; *The \$1.5 Million Club: NYSE Seats Rebound*, Wall St. J., Feb. 22, 2005, at C3 (same); *With 3 New Directors Nominated, NYSE Members Await April Vote*, Wall St. J., Feb. 22, 2005, at C3 (same).

95. See *infra* Part III.A.3.

96. See *infra* Part I.C tbl.2.

the exchange's history, were the next earthquake; and last but not least, revenues shrank and many firms ended up in the red.

It was no coincidence, then, and not surprising, that in April 2005 the New York Stock Exchange, with its members weakened, announced that it would merge with Archipelago Holdings and subsequently go public.⁹⁷ This landmark deal has drawn much public attention. That Archipelago, the successful start-up marketplace, would finally merge with the old New York Stock Exchange is something few commentators had expected—as the following anecdote may illustrate: In early 2005, Archipelago's CEO spent one week mostly in New York. Analysts asked him whether he had visited the alternative trading system Instinet, a potential takeover target (Instinet ultimately was acquired by Nasdaq).⁹⁸ His answer: "I was absolutely not in Instinet. Right hand in the air, Bible in my left."⁹⁹ Not one of the smart analysts who questioned him stopped to consider the possibility of a merger between Archipelago and the New York Stock Exchange.

After a long series of steps,¹⁰⁰ most importantly approval by its members,¹⁰¹ the Justice Department,¹⁰² and the SEC,¹⁰³ the new NYSE Group, Inc., is now a publicly traded stock exchange, operating the New York Stock Exchange and Archipelago.

97. Press Release, NYSE & Archipelago, New York Stock Exchange and Archipelago Exchange Agree to Merge (Apr. 20, 2005), available at http://www.nyse.com/pdfs/joint_release.pdf; see also *To Tell The Truth*, Wall St. J., Apr. 29, 2005, at C4 (mentioning merger); Jerry Putnam, Chairman & CEO, Archipelago Holdings Inc., Public Statement on Agreement to Merge NYSE and Archipelago (Apr. 20, 2005), available at <http://www.nyse.com/Frameset.html?displayPage=/content/articles/1113993488657.html>.

98. See, e.g., Aaron Lucchetti, *Nasdaq Chief Plays Hardball In Instinet Deal*, Wall St. J., Apr. 25, 2005, at C1; Gregory Zuckerman et al., *Nasdaq Faces Head-On Assault From NYSE Deal*, Wall St. J., Apr. 22, 2005, at A1; Press Release, Nasdaq, Nasdaq Completes Acquisition of INET (Dec. 8, 2005), available at http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_118.stm.

99. *To Tell the Truth*, supra note 97; see also Craig Karmin, *CEO Putnam's Revenge: NYSE Deal*, Wall St. J., Apr. 22, 2005, at C1 (mentioning unsuccessful talks in 2001 to market Archipelago's trading system to the New York Stock Exchange).

100. For an overview of all relevant documents, see the New York Stock Exchange's Website, <http://www.nyse.com/about/newsevents/1114079977834.html> (last visited Feb. 24, 2006).

101. See Aaron Lucchetti, *A Big Exchange: NYSE Members Approve Deal*, Wall St. J., Dec. 7, 2005, at C1.

102. *U.S. Approves Exchange Deals*, Wall St. J., Nov. 17, 2005, at C3.

103. Self-Regulatory Organizations; the New York Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendment Nos. 1, 3, and 5 Thereto and Notice and Filing and Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NYSE's Business Combination with Archipelago Holdings, Inc., Exchange Act Release No. 34-53382, 71 Fed. Reg. 11,251 (Mar. 6, 2006).

C. Overview of the Current Organizational Structure (2006)

The following tables give an overview of the current organizational structure of foreign and domestic stock exchanges, as well as the market value of exchanges whose shares are publicly traded (as of February 17, 2005).

Table 1: Foreign Stock Exchanges¹⁰⁴

	Stock Exchange	Demutualized	Listed	Market Value
1	Australian Stock Exchange	1998 ¹⁰⁵	1998	\$2.5 billion
2	Deutsche Börse	2000 ¹⁰⁶	2001	\$13.3 billion
3	Euronext	1997 ¹⁰⁷	2001	\$7.2 billion
4	HK Exchanges and Clearing	2000 ¹⁰⁸	2000	\$5.3 billion
5	London Stock Exchange	1999	2001	\$3.7 billion
6	OMX Group	1993 ¹⁰⁹	1993 ¹¹⁰	\$2.1 billion
7	Tokyo Stock Exchange	2001	—	—
8	TSX Group	2000 ¹¹¹	2001	\$2.9 billion

104. This is based on publicly available data. For an overview of twenty-six more or less important stock exchanges (the Chicago Mercantile Exchange is mentioned but does not list stocks) that have demutualized, see Schich & Wehinger, *supra* note 43, at 103. For exhaustive data on selected exchanges, see Alfredo Mendiola & Maureen O'Hara, Taking Stock in Stock Markets: The Changing Governance of Exchanges (August 2003) (unpublished manuscript), available at <http://ssrn.com/abstract=431580>.

105. See Frank Donnan, *Self-regulation and the Demutualisation of the Australian Stock Exchange*, 10 Austl. J. Corp. L. 1 (1999).

106. Deutsche Börse itself is not an exchange but rather operates an exchange, the Frankfurter Wertpapierbörse (Frankfurt Stock Exchange). Neither Frankfurter Wertpapierbörse nor Deutsche Börse are demutualized stock exchanges under the normal definition. Together, however, they look like a demutualized and publicly traded stock exchange. Because the regulatory powers are vested with the exchange, which is a public agency under German law, the regulatory challenges that come with demutualization under U.S. law are less important in Germany (provided that both entities, the operator and the exchange, are truly separated).

107. Euronext is the result of a merger of the Amsterdam Exchanges (AEX), the Brussels Exchanges (BXS), the ParisBourse^{SBF} S.A., and later the Bolsa des Valores de Lisboa e Porto (BVL). See Euronext, History, http://www.euronext.com/editorial/wide/0,5371,1732_4427342,00.html (last visited Feb. 22, 2006). The Amsterdam Exchanges (AEX), as a predecessor of today's OMX Group, demutualized in 1997.

108. The Hong Kong Exchanges and Clearing Limited is not an exchange but the parent company of the Stock Exchange of Hong Kong. For the demutualization, see Betty M. Ho, *Demutualization of Organized Securities Exchanges in Hong Kong: The Great Leap Forward*, 33 Law & Pol'y Int'l Bus. 283 (2002).

109. OMX Group owns and operates the exchanges of Copenhagen (Denmark), Helsinki (Finland), Riga (Latvia), Stockholm (Sweden), Tallinn (Estonia), and Vilnius (Lithuania). The Stockholmsbörsen (Stockholm Stock Exchange), as a predecessor of today's OMX Group, demutualized as early as 1993. The Helsingin Pörssi (Helsinki Stock Exchange) demutualized in 1995; the Københavns Fondsbørs (Copenhagen Stock Exchange) in 1996.

110. OMX Group shares themselves have been listed since 2003. The shares of Stockholmsbörsen (Stockholm Stock Exchange), as a predecessor of today's OMX Group, were listed in 1993.

111. TSX Group owns and operates the Toronto Stock Exchange and the TSX Venture Exchange.

Table 2: Domestic Stock Exchanges

	Stock Exchange	Demutualized	Listed	Market Value
1	American Stock Exchange	—	—	—
2	Archipelago Exchange	2004	2004	\$2.8 billion
3	Boston Stock Exchange	—	—	—
4	Chicago Stock Exchange	2005	—	—
5	National Stock Exchange	—	—	—
6	New York Stock Exchange	2006	2006	\$6.4 billion ¹¹²
	—with Archipelago			\$9.2 billion ¹¹³
7	Philadelphia Stock Exchange	2004	—	—
8	Nasdaq Stock Market ¹¹⁴	2002	2002	\$3.8 billion

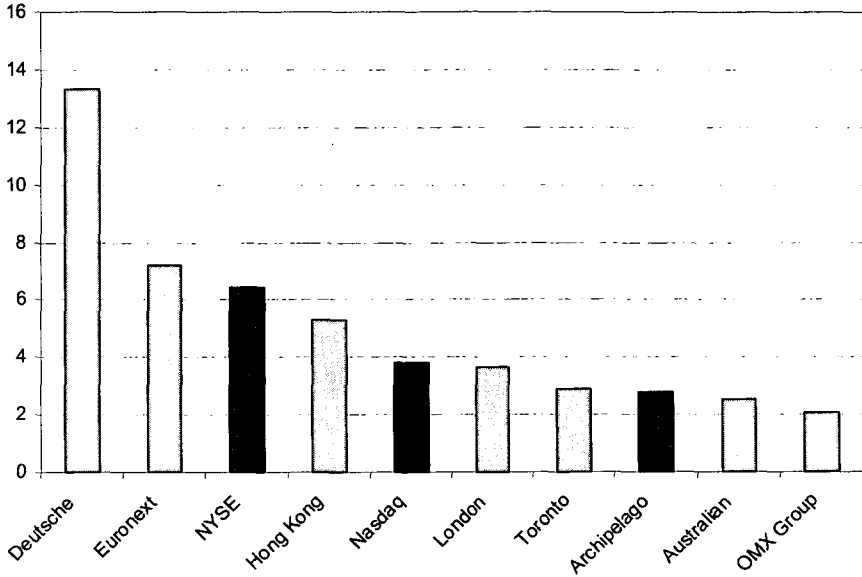
112. The New York Stock Exchange is not yet a publicly traded company (as of February 17, 2006). The market value is therefore an estimation. The former seatholders of the New York Stock Exchange are going to get seventy percent of the new company. *See* Press Release, N.Y. Stock Exch. & Archipelago, *supra* note 97. So the New York Stock Exchange's value, based on the merger agreement, is Archipelago's present value multiplied by 7/3. Another way to calculate the New York Stock Exchange's value was to multiply the number of seats (1366) by the seat price (last trade at \$3.55 million, as of December 30, 2005), which totalled \$4.8 billion. Neither numbers include extra benefits that the members will get as part of the merger.

113. This too is an estimation based on Archipelago's current value and the merger agreement.

114. The Nasdaq Stock Market was not yet registered as a national securities exchange under the Securities Exchange Act of 1934, at the time that it demutualized and went public. *See supra* note 15.

The following chart compares the U.S. marketplaces (dark) with stock exchanges abroad (light):

Chart 1: Market Value of the Stock Market Operators
(in Billions of U.S. Dollars)



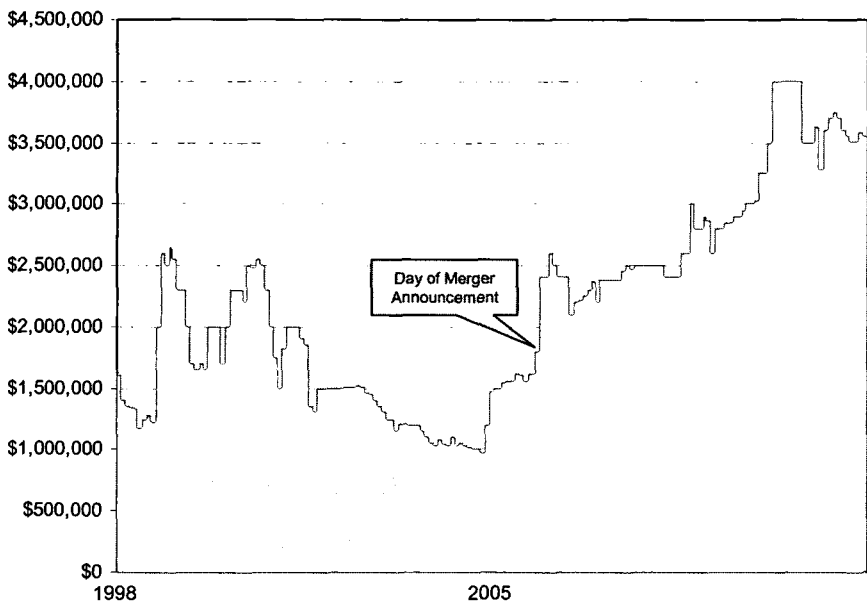
Although much could be said about these figures, one particular comparison shows clearly what is at stake for the United States: Even after taking into account the merger with Archipelago, the New York Stock Exchange would have only sixty-nine percent of Deutsche Börse's market value.¹¹⁵ Before the merger announcement, at the seat price's low in January 2005, the New York Stock Exchange's market value reached only some ten percent of Deutsche Börse's current market capitalization.¹¹⁶ There are many reasons for that discrepancy, most notably that Deutsche Börse is a diversified company offering not only trading in stocks and derivatives but also ancillary services such as clearing (through its subsidiary Clearstream), whereas the New York Stock Exchange still does virtually the same thing it has for the last two centuries: organizing a market solely for stocks.

115. These market values would be \$9.2 billion compared to \$13.3 billion. *See supra* \$120 tbl.1, \$121 tbl.2.

116. These market values were \$1.3 billion (1366 seats multiplied by \$975,000, the low as of January 11, 2005) compared to \$13.3 billion. *See supra* \$120 tbl.1. Earlier estimations for the New York Stock Exchange's market value were even lower. *See Der Hovanesian, supra* note 85 (\$0.9 billion). Concededly, Deutsche Börse's market value on January 11, 2005, was considerably lower than today.

The course of the prices for so-called “seats” at the New York Stock Exchange nicely illustrates the stormy period that the exchange has faced in recent history. Before demutualization, those seats conferred the right to buy and sell stocks at the New York Stock Exchange, both as agent (broker) and as principal (dealer). There were 1366 of those seats.¹¹⁷ Trading in seats ceased on December 30, 2005, after almost 140 years.¹¹⁸ During the last eight years, the period when electronic trading became commonplace and most of its rivals demutualized, seats at the New York Stock Exchange performed according to the following chart.¹¹⁹ (In the chart each column stands for a single trade; the time intervals are therefore not equal.)

Chart 2: Trades in Seats on the New York Stock Exchange



On balance, the trend is clearly toward demutualization. In the short term, the exempting powers of the SEC may be sufficient to deal with demutualization. But for purposes of avoiding any kind of ambiguity, Congress would be well advised to amend the Securities Exchange Act and adjust it to the new organizational reality. When doing so, it might be worth looking at the following discussion of the underlying reasons for the

117. See Certificate of Incorporation of NYSE, Inc. § 13.

118. See Gene Colter, *NYSE Closes Its Books and Folds up Its Seats to Start New Life as a For-Profit Exchange*, Wall St. J., Dec. 31, 2005, at B3; Aaron Lucchetti, *Betting Big on Big Board's Seats*, Wall St. J., Dec. 30, 2005, at C1.

119. Seat sales were reported in *The Wall Street Journal*, usually on the following day, as well as on the New York Stock Exchange's website.

demutualization trend, the conflicts of interest that come with it, and the proposed amendments that might help control them.

II. THE CASE FOR DEMUTUALIZATION AND GOING PUBLIC

Demutualizing and subsequently going public are critical to any stock market's ability to compete with other marketplaces. While commentators sometimes identify distinct factors that drive demutualization, in fact they are all related to one single point: competition.¹²⁰ The stock exchanges themselves regularly emphasize the paramount importance of competition for their reorganization, among them the New York Stock Exchange,¹²¹ the Nasdaq Stock Market,¹²² the Australian Stock Exchange,¹²³ and the London Stock Exchange¹²⁴—as well as neutral observers such as the SEC¹²⁵ and the International Organization of Securities Commissions.¹²⁶

This part explains which forces drive competition,¹²⁷ which markets compete,¹²⁸ what they are competing for,¹²⁹ and most importantly, why

120. The stock exchanges' decision to demutualize and go public may also be influenced by noneconomic reasons, most importantly self-dealing by management, as they will profit from the higher prestige and compensation that they can earn when leading a for-profit company. The members of the stock exchange might benefit by exchanging their illiquid seats for liquid stocks (the latter is a point that Bradley, *supra* note 11, emphasizes throughout her article; it is, however, unclear whether the seat on a stock exchange has enough value to influence the owners' decision to demutualize). These noneconomic factors are not further discussed, as they seem not to be the driving factor behind the global demutualization trend.

121. For this emphasis during the latest move to demutualize, see Press Release, N.Y. Stock Exch. & Archipelago, *supra* note 97. See also Carrick Mollenkamp et al., *Europe May Offer a Glimpse Into Future of U.S. Exchange*, Wall St. J., Apr. 22, 2005, at C1 (mentioning that the New York Stock Exchange's CEO stated that global competitors are all publicly traded companies); *The \$1.5 Million Club: NYSE Seats Rebound*, *supra* note 94 (mentioning that members hope that changing to for-profit business would make the New York Stock Exchange more competitive). For this emphasis during the failed attempt in 1999, see *Grasso Statement*, *supra* note 83, and Press Release, NYSE Appoints Committee, *supra* note 82.

122. Press Release, Nasdaq, Nasdaq to Become a Public Company (Apr. 26, 2001), available at http://www.nasdaq.com/newsroom/news/pr2001/ne_section01_140.html.

123. Richard Humphry, Managing Dir., Austl. Stock Exch., Address to Association of Superannuation Funds of Australia, Sydney, ASX Demutualisation: Cause and Effect Address (December 9, 1998), available at http://www.asx.com.au/about/shareholder/announcements/AA091298_AS3.htm.

124. Cf. Alan Cowell, *Old Exchange In London Tries A New Twist on Ownership*, N.Y. Times, July 31, 1999, at C1 (describing the London Stock Exchange).

125. See Deborah Solomon, *Thrill Bill, 2: Donaldson Has Impact Again*, Wall St. J., May 2, 2005, at C1 (quoting the SEC's Chairman William H. Donaldson in the context of the merger of the New York Stock Exchange and Archipelago as follows: "If you step back and look at what is in the process of happening now—the consolidation, the level playing field—this, I believe, is a prelude to global competition.").

126. IOSCO on Exchange Demutualization, *supra* note 7, at 3 (stating that "certain responses to competition, such as alliances and mergers between exchanges, may be facilitated by demutualization").

127. See *infra* Part II.A.

128. See *infra* Part II.B.

129. See *infra* Part II.C.

demutualized and publicly traded stock exchanges might have competitive advantages over exchanges that are organized in the traditional mutual form.¹³⁰

A. Factors that Foster Competition

This section outlines the factors that foster competition among marketplaces for stocks. The critical determinants are deregulation,¹³¹ technology,¹³² and globalization.¹³³ All three factors correlate with each other, but they can be identified as separate forces.

1. Deregulation

Recent years have seen numerous changes in the regulatory system that helped foster competition in the stock markets. While it is hard to say whether the intensity of regulation overall has declined, there have been some critical acts of deregulation.¹³⁴ The most important in fostering competition have been: (1) the end of fixed commissions;¹³⁵ (2) new order-handling rules;¹³⁶ (3) Regulation ATS, which should lower the entry barriers for new competitors;¹³⁷ and (4) decimalization, that is, trading in decimals instead of eighths or sixteenths.¹³⁸ The most critical influence on competition in the near future will be the new National Market System.¹³⁹

2. Technology

Notwithstanding the regulatory changes, the main reason that competition among stock markets has dramatically increased in the past few years is the astonishing technological progress.¹⁴⁰ New communication and information technologies are driving the changes in the securities markets,

130. See *infra* Part II.D.

131. See *infra* Part II.A.1.

132. See *infra* Part II.A.2.

133. See *infra* Part II.A.3.

134. For an early assessment, see generally Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & Econ. 273 (1984).

135. Securities Exchange Act of 1934 § 6(e), 15 U.S.C. § 78f(e) (2000). Competition was believed to be in the best interest of all participants and the public. See *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 674 (1975).

136. For an overview, see Coffee & Seligman, *supra* note 21, at 652-54.

137. Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,848 (Dec. 22, 1998).

138. For an overview of the move to decimalization, see Karmel, *Turning Seats into Shares*, *supra* note 11, at 373-75. See also Coffee & Seligman, *supra* note 21, at 655-56.

139. For a brief overview of the National Market System, see *infra* Part II.B.

140. See IOSCO on Exchange Demutualization, *supra* note 7, at 3; see also Carson, *supra* note 8, at 5; Press Release, HKEx, Hong Kong Exchanges Starts a New Chapter Following Completion of Merger (Mar. 6, 2000), available at <http://www.hkex.com.hk/news/hkexnews/0306news4.htm> [hereinafter HKEx New Chapter]; Press Release, HKEx, Speech by Mr. Kwong Ki-chi at the HKEx News Conference (Mar. 6, 2000), available at <https://www.hkex.com.hk/news/hkexnews/0306news6.htm> [hereinafter HKEx Kwong Ki-chi Speech].

as the chairman of the Pacific Exchange, which was leading in the domestic demutualization process, observed in 1999, "Technology—the lack of it—was the root of our problem 30 years ago. Today it is the source of both our challenges and our opportunities."¹⁴¹ And yet more significantly, "[t]echnology is a beast with an insatiable appetite for resources—faster processing speeds, greater capacity, bigger bandwidth, and more programmers."¹⁴² New technologies have lowered the entry barriers and made it easier to establish alternative trading systems that compete with the established stock exchanges. The exchanges themselves have also invested heavily in new technology, so that we have seen continuously decreasing trading costs in recent years.¹⁴³ Even the New York Stock Exchange, the "dinosaur"¹⁴⁴ that even in the Internet age relied on humans to discover stock prices, finally hoisted the "white flag in the floor-trading war"¹⁴⁵ and announced creation of a hybrid market, a move that was further supported by the merger with Archipelago, a market leader in electronic trading. Two factors here reinforce each other: Declining trading fees allow more frequent trades; more trades lead to huge economies of scale (once you have built your trading system, it requires few if any additional funds to handle more orders), which in turn lead to further fee cuts and once again to more trades.

3. Globalization

Competition is, to an increasing degree, driven by foreign competitors.¹⁴⁶ Although the globalization of the financial markets is still a relatively new development, it is nowadays one of the strongest forces in competition. Stock markets are no longer national monopolies, given how easy it is today for capital and investors to cross borders, forcing U.S. marketplaces to care about their global competitiveness.

* * *

It is important to note that, notwithstanding the importance of these developments, their effect is mainly an indirect one, in that they lower entry

141. Robert M. Greber, Chairman, Pacific Exchange, Inc., Public Statement Regarding Moving Securities Exchanges into the 21st Century (June 15, 1999).

142. *Id.*

143. See Ian Domowitz & Benn Steil, *Automation, Trading Costs, and the Structure of the Securities Trading Industry*, in Brookings-Wharton Papers on Financial Services 33 (Robert E. Litan & Anthony M. Santomero eds., 1999); Ian Domowitz & Benn Steil, *Securities Trading*, in *Technological Innovation & Economic Performance* 314 (Benn Steil et al. eds., 2002).

144. Alan Murray, *Juvenile Antics Mar Fight Over NYSE Fate*, Wall St. J., Apr. 27, 2005, at A2.

145. *Really Big Board*, Wall St. J., Apr. 22, 2005, at A12; see also Peter A. McKay, *NYSE's Contrasts With Archipelago Need Reconciling*, Wall St. J., Apr. 22, 2005, at C14.

146. Cf. Carson, *supra* note 8, at 5; HKEx New Chapter, *supra* note 140; HKEx Kwong Ki-chi Speech, *supra* note 140.

barriers and foster competition. As such, deregulation, new technologies, and globalization would probably not have an important impact on the organization of stock exchanges, for the latter could enjoy the benefits of their changing environment without any need for organizational changes.

B. Marketplaces that Compete

Many different stock markets compete for issuers and traders in the United States and elsewhere. How these markets are connected to each other (if at all), how orders are routed through them, and how stocks are actually being traded on them are complex concepts that are usually referred to as “market structure.”

The structure of the U.S. stock market has been one of the hottest issues in recent years, driven mainly by the various proposals of the SEC to amend the so-called National Market System, established in 1975 to foster competition in the field of stock trading.¹⁴⁷ Few proposals in the Commission’s history have caused such intense public debate as these amendments,¹⁴⁸ even within the SEC, and the Commission has only recently been able to find a consensus and amend the NMS.¹⁴⁹

For the purposes of this Article, it is sufficient to outline the basic market structure without going into regulatory details.¹⁵⁰ As a simplified model, there are four main categories of marketplaces where stock is traded domestically:

1. Stock Exchanges

Stock exchanges are those marketplaces registered as national securities exchanges under the Securities Exchange Act.¹⁵¹ The number of stock

147. For the goals of the National Market System, see Securities Exchange Act of 1934 § 11A(a)(1), 15 U.S.C. § 78k-1(a)(1) (2000). For an overview of the 1975 Amendments, see *supra* Part I.B.3. For a bibliography on the original system, see *supra* note 67.

148. See, e.g., Craig Pirrong, *Thirty Years War*, Regulation, Summer 2005, at 54.

149. See Regulation NMS, Exchange Act Release No. 34-51808, 70 Fed. Reg. 37,496 (June 29, 2005). *But see* Aaron Lucchetti, *SEC May Delay Implementing New Wall Street Trading Rules*, Wall St. J., Jan. 7, 2006, at B3. For the first proposal, see Regulation NMS, Exchange Act Release No. 34-49325, 69 Fed. Reg. 11,126 (Mar. 9, 2004). The comment period was extended and supplemental comment requested. See Regulation NMS, Exchange Act Release No. 34-49749, 69 Fed. Reg. 30,142 (May 26, 2004). Later, the SEC put forward a new proposal. See Regulation NMS, Exchange Act Release No. 34-50870, 69 Fed. Reg. 77,424 (Dec. 27, 2004), *corrected by* 70 Fed. Reg. 1503 (Jan. 7, 2005). The correction was merely inserting an unintentionally omitted footnote. *Id.*

150. For an overview and comparative analysis, see Stavros Gkantinis, *Regulation and Innovation: Comparing U.S. and European Equity Trading Markets* (February 16, 2006) (unpublished manuscript), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=887645. For recent overviews of the former system, see Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 Colum. Bus. L. Rev. 399, and Marshall E. Blume, *The Structure of the U.S. Equity Markets*, in *Brookings-Wharton Papers on Financial Services*, *supra* note 4, at 35.

151. Securities Exchange Act § 6, 15 U.S.C. § 78f(a).

exchanges has dramatically decreased in the last century. Whereas in 1900 we had more than one hundred stock exchanges in the United States,¹⁵² this figure declined to thirty-four in 1934,¹⁵³ to fourteen exchanges registered with the SEC in 1962,¹⁵⁴ and finally to the current seven, which will increase by one when the Nasdaq Stock Market is finally granted stock exchange status. Compared to the other marketplaces, stock exchanges face a disadvantage insofar as the Securities Exchange Act compels them to regulate the securities markets, while other market organizers can free ride on the stock exchanges' regulatory expenses.

2. Over-the-Counter Markets

Marketplaces that are not registered as national securities exchanges are called "over-the-counter" markets. More than forty years ago, the Supreme Court described such trading as a market "established by traders in the numerous firms all over the country through a process of constant communication to one another of the latest offers to buy and sell."¹⁵⁵ The most important over-the-counter market will be the electronic bulletin board ("OTCBB"),¹⁵⁶ now that Nasdaq itself becomes a stock exchange.

3. Alternative Trading Systems

A third category of marketplaces for stocks emerged in the last decade, usually referred to as alternative trading systems ("ATS"). In its Regulation ATS, the SEC defines such trading systems as "any organization, association, person, group of persons, or system[] [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."¹⁵⁷ This definition is striking insofar as it properly describes what these trading systems offer an "alternative" to: They furnish execution services that traditionally were performed by a stock exchange. Hence, to determine whether a trading system is subject to the SEC's regulation, we have to refer to the term "stock exchange," a term which to date has not been

152. Coffee & Seligman, *supra* note 21, at 23.

153. Mahoney, *supra* note 33, at 1477.

154. Silver v. N.Y. Stock Exch., 373 U.S. 341, 350 (1963).

155. *Id.* at 348.

156. See NASDAQ, <http://www.nasdaq.com> (last visited Feb. 24, 2006); OTCBB, <http://www.otcbb.com> (last visited Feb. 24, 2004); see also Press Release, Nasdaq, Nasdaq to Transfer OTCBB Business to the NASD (July 8, 2005), available at http://www.nasdaq.com/newsroom/news/pr2005/ne_section05_068.stm.

157. See 17 C.F.R. § 242.300(a)-(a)(1) (2005). See generally Regulation of Exchanges and Alternative Trading Systems, Exchange Act Release No. 34-40760, 63 Fed. Reg. 70,844, 70,848 (Dec. 22, 1998). For a critique before the adoption of Regulation ATS, see Polly Nyquist, *Failure to Engage: The Regulation of Proprietary Trading Systems*, 13 Yale L. & Pol'y Rev. 281 (1995).

precisely defined, and will, by its nature, most likely never be so defined.¹⁵⁸ The main category of such alternative trading systems is electronic communication networks (“ECN”),¹⁵⁹ such as INET, a subsidiary of Instinet Group, Inc., which began operations as early as 1969.¹⁶⁰ Another example was Archipelago, which later was combined with two national securities exchanges and recently merged with the New York Stock Exchange.

4. Block Trading

For trades in large blocks of stocks (generally over 10,000 shares or the equivalent of \$200,000), there exist various markets and platforms that allow institutional investors to sell and buy such blocks.¹⁶¹ The main advantage of such facilities is that investors can trade anonymously without attracting the notice of the market.¹⁶² Technological developments might increase such direct trades in the future.

* * *

Due to modern communications, foreign marketplaces of all four kinds, can and increasingly do, attract investors from the United States.¹⁶³

When stocks of the same issuer are traded on different markets, there arise several regulatory concerns. Such market fragmentation leads to a loss of liquidity at each place and might cause the discovery of differing prices. Furthermore, the decision of the brokers about where to execute the customers’ orders can be influenced by selfish motives, such as where the broker gets the highest kickback (often referred to euphemistically as “payment for order-flow”).¹⁶⁴ It is such issues that the National Market System and other regulations address. And it is no coincidence that, considering the far-reaching consequences of the new National Market

158. See Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. § 78c(a)(1) (2000). The definition is further described in 17 C.F.R. § 240.3b-16 (2005). For more details, see *supra* note 20 and accompanying text.

159. For a definition of electronic communication networks (“ECNs”), see 17 C.F.R. § 240.11Ac1-1(a)(8).

160. Coffee & Seligman, *supra* note 21, at 625.

161. James D. Cox et al., Securities Regulation 92 (4th ed. 2004); see also Coffee & Seligman, *supra* note 21, at 33.

162. For an example, see Coffee & Seligman, *supra* note 21, at 38-42.

163. For an overview, see S. Eric Wang, *Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities*, 10 U. Miami Bus. L. Rev. 329 (2002), and Howell E. Jackson, Mark Gurevich & Andreas M. Fleckner, *The Controversy over the Placement of Remote Trading Screens from Foreign Exchanges in the U.S.* (Nov. 2005) (unpublished manuscript, on file with author).

164. See Note, *The Perils of Payment for Order Flow*, 107 Harv. L. Rev. 1675 (1994). These practices are nicely described by Michael Schroeder and Randall Smith, *Sweeping Change in Market Structure Sought*, Wall St. J., Feb. 29, 2000, at C1 (“[O]nline brokers keep control over their customers’ order flow either by executing the orders within their own trading operations, or by shipping them out to firms that pay for such orders.”).

System, only two weeks after its adoption the New York Stock Exchange announced its merger with Archipelago and the Nasdaq Stock Market announced the takeover of Instinet's trading division. Concededly, such transactions were planned long before, but they were planned taking into account the probable new regulatory environment. Having been archrivals in different markets for a long time, in the new regime the New York Stock Exchange and the Nasdaq Stock Market will get closer to each other. It might be the beginning of a long-lasting duopoly.

C. *Subjects of Competition*

The competition among marketplaces has two dimensions: Marketplaces compete for listings and for orders. To get more listings, stock exchanges have to attract issuers. To get more orders, stock exchanges have to attract traders. Both kinds of competition correlate: Marketplaces that have more listings attract more traders, and marketplaces with more traders catch the attention of more issuers. This correlation explains why stock markets tend to become oligopolies or even monopolies: The bigger a market is, the more it draws away the competitors' remaining customers. Liquidity is a magnet for more liquidity—a well-known insight discussed under the heading “network theory.” Not surprisingly, the number of domestic stock exchanges declined over the last century from over one hundred to the current seven.¹⁶⁵

On the other hand, as a factor that reduces the concentration tendency, stock exchanges no longer offer a unique product. Modern technologies reduce entrance barriers to establishing marketplaces for stocks, and provide investors everywhere in the world with services that originally were reserved to stock exchanges. Congress intended to support this development through the introduction of the NMS, which was supposed to ensure “fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.”¹⁶⁶ The last thirty years have certainly brought the desired competition, albeit perhaps different than expected: Competition for traders is strong, while competition for listings has so far been weak. It is difficult to judge whether this is good policy or not. Unlike in other areas, competition for issuers is only to a certain degree desirable in the stock markets, because it leads to fragmented markets and split liquidity. On the other hand, too much concentration hinders economic progress and raises antitrust concerns.

The following representation of the subjects of competition starts with the competition for listings¹⁶⁷ and turns then to the competition for

165. See *supra* Part II.B.1.

166. Securities Exchange Act of 1934 § 11A(a)(1)(C)(ii), 15 U.S.C. § 78k-1(a)(1)(C)(ii) (2000).

167. See *infra* Part II.C.1.

orders.¹⁶⁸ Both subsections distinguish between competition from domestic and from foreign marketplaces.

1. Competition for Listings

The major domestic competitors in the “battle for issuers” are the New York Stock Exchange and the Nasdaq Stock Market. Both compete heavily for new issuers, as was recently seen during the initial public offering of Google.¹⁶⁹ Once an issuer is listed, however, the competition is weak. Typically an issuer will start small, with a listing on Nasdaq, and then as a seasoned company move later to the New York Stock Exchange.¹⁷⁰

Not surprisingly, the Nasdaq Stock Market tries to attack this seemingly natural rule by convincing seasoned issuers to list their stocks exclusively, or at least dually, on the Nasdaq Stock Market. So far, Nasdaq’s efforts have been nearly without effect.¹⁷¹ Dual listings are so rare that the Nasdaq Stock Market even places advertisements when a company decides to dual list on Nasdaq.¹⁷² Another marketplace competing for dual listings is the Archipelago Exchange. It has been more successful, and drawn some notable companies for dual listing.¹⁷³ However, its merger with the New York Stock Exchange eliminates the competition between the two exchanges.

Increasingly, competition for international listings comes from marketplaces abroad.¹⁷⁴ Today, 452 foreign issuers are listed on the New York Stock Exchange, down from a peak of 473 in 2002.¹⁷⁵ In recent years, the U.S. markets seem to have lost their attractiveness to foreign

168. See *infra* Part II.C.2.

169. See Robin Sidel, *Google Plans to List on Nasdaq, Joining Ranks of Tech Notables*, Wall St. J., July 13, 2004, at C5. For a discussion about the competition for listings, see Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 Cornell L. Rev. 1007 (1990).

170. Coffee & Seligman, *supra* note 21, at 26.

171. See Gaston F. Ceron, *Nasdaq Gains Little in NYSE Fight*, Wall St. J., Jan. 18, 2005, at C3.

172. See, e.g., Wall St. J., May 2, 2005, at C7 (advertisement announcing the dual listing of the Chicago Mercantile Exchange Holdings); Wall St. J., Oct. 31, 2005, at A5 (advertisement announcing that “Cadence is now solely listed on Nasdaq”).

173. See, e.g., Theo Francis, *AIG, Long Traded on Big Board, Adds a Listing on Archipelago*, Wall St. J., Jan. 12, 2005, at C3; see also Joseph Weber, *Taking Aim at the Big Board*, Bus. Wk., Nov. 8, 2004, at 102.

174. For an overview of the share of foreign issuers on twenty-six exchanges worldwide, see Schich & Wehinger, *supra* note 43, at 93. See also generally Stijn Claessens et al., *Accessing International Equity Markets: What Firms from Which Countries Go Abroad?* (2003), available at http://www.dise.unisa.it/PDF/Accessing%20International%20Markets_March13.pdf; Sofia B. Ramos, *Competition Between Stock Exchanges: A Survey* (Int’l Center for Fin. Asset Mgmt. & Eng’g, Working Paper No. 77, Feb. 2003), available at <http://ssrn.com/abstract=410727>.

175. See Andreas M. Fleckner, *Foreign Issuers on the New York Stock Exchange* (Feb. 17, 2006) (unpublished manuscript, on file with author) (earlier draft prepared for the EU-US Financial Services Roundtable, Cambridge, United Kingdom, Sept. 30-Oct. 1, 2005).

issuers (for example, only eleven new European offerings since 2001;¹⁷⁶ the number of Latin American issuers listed on the New York Stock Exchange has decreased from 103 in 2001 to the current figure of eighty-eight).¹⁷⁷ There are different explanations for this development. Many observers blame the Sarbanes-Oxley Act¹⁷⁸ and the increased regulatory costs that came with it.¹⁷⁹ Another explanation might be that in today's regulatory environment, issuers need not be listed in the United States when they want to reach U.S. investors.¹⁸⁰

That foreign companies stay at home is only one step. Another would be that U.S. companies start to look abroad—as they did during the heyday of the new economy,¹⁸¹ and as some kinds of businesses still do.¹⁸² Globalization has made financing companies much more flexible, with the result that cross-border capital flows have increased dramatically.¹⁸³ Issuers today are willing and able to cross borders and raise money abroad. That means that in the middle and long term, the main competitors for the New York Stock Exchange and Nasdaq will not be domestic marketplaces, but instead Frankfurt, Hong Kong, London, Paris, and Tokyo. Against this background, it is hardly unreasonable that the conservative New York Stock Exchange is considering breaking taboos and opening earlier to attract European issuers (as well as traders).¹⁸⁴ And even yet more revolutionary, the New York Stock Exchange is considering trading other products such as derivatives, bonds, and exchange-traded funds¹⁸⁵—a clear sign that listing

176. *Id.*

177. *Id.*; see also Amy Guthrie, *Mexican Firms Leave NYSE*, Wall St. J., Jan. 17, 2005, at C14; Aaron Lucchetti & Craig Karmin, *Intensity to Be a 'Global' Stock Has Waned*, Wall St. J., May 10, 2005, at C1.

178. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

179. See *404 Tonnes of Paper*, Economist, Dec. 18, 2004, at 116; see also Daniel Epstein, *Goodbye, Farewell, Auf Wiedersehen, Adieu . . .*, Wall St. J., Feb. 9, 2005, at A10; Lucchetti & Karmin, *supra* note 177.

180. See Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part II (2002)* (unpublished manuscript, on file with author). For Part I, see Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 Bus. Law. 653 (2001). See also Wang, *supra* note 163; Jackson, Gurevich & Fleckner, *supra* note 163.

181. The “new markets” in Europe, such as the *Neuer Markt* in Frankfurt, were able to attract a significant number of high-tech companies that normally would have gone public on the Nasdaq Stock Market, but preferred the European alternatives.

182. Jeff D. Opdyke, *Wall Street North: Listing in Toronto Piques U.S. Interest*, Wall St. J., Mar. 24, 2005, at C1.

183. See Cox et al., *supra* note 161, at 93-94 (reporting impressive figures).

184. Gaston F. Ceron & Aaron Lucchetti, *Big Board May Extend Trading Day*, Wall St. J., Jan. 27, 2005, at C3; *Early Open at NYSE? Not Yet, Thain Says*, Wall St. J., Sept. 23, 2005, at C3.

185. *Big Board Advances ETF Plans*, Wall St. J., Sept. 7, 2005, at A1; Ceron, *supra* note 94; Aaron Lucchetti, *NYSE Seat Price Increases 23%, Largest in 6 Years*, Wall St. J., Jan. 25, 2005, at C3; Aaron Lucchetti et al., *NYSE to Acquire Electronic Trader And Go Public*, Wall St. J., Apr. 21, 2005, at A1; Aaron Lucchetti & David Reilly, *NYSE CEO Thain Wants to Trade More Than Just Stocks*, Wall St. J., June 23, 2005, at C1; Peter A. McKay, *NYSE,*

stocks alone is no longer considered sufficient. Derivatives, especially, offer interesting options, since the stock exchanges themselves “create” these securities, meaning that, unlike the situation with stocks, exchanges do not have to lure issuers but only traders.

On balance, domestic competition for issuers is still weak but increasing in strength, an effect that should yet be intensified by the overhauled National Market System. Meanwhile, developed marketplaces abroad emerge as serious competitors.

2. Competition for Orders

The “battle for orders” is probably more important than the competition for issuers, as it tends to generate more revenue than the listing itself.¹⁸⁶ It is also much more complex, as the battle is fought among all four kinds of markets that trade stocks domestically and abroad.

Competition for orders is driven by various factors, the most important of course being trading costs. Non-cost factors considered by most investors include liquidity, reliability, execution speed, and the quality of price discovery. Particularly for traders of huge blocks, anonymity is also a crucial factor, and one that stock exchanges normally do not offer. Last but not least, kickbacks (also known as payments for order-flow) influence the allocation of orders.

Competition and fragmentation of the market for orders differ significantly among distinct groups of stocks. The New York Stock Exchange could for a long time hold a market share of roughly eighty percent in the trading of stocks of issuers that were primarily listed on the New York Stock Exchange,¹⁸⁷ a number that only recently dropped below seventy-five percent, for the first time since that data has been collected.¹⁸⁸ Conversely, the trade in stocks listed primarily on the Nasdaq Stock Market is much more fragmented. The Archipelago Exchange gives a good impression of this distinction: Archipelago holds a twenty-five percent market share in Nasdaq stocks, but only a two percent share in New York Stock Exchange listed issuers, despite some 230 dual listings.¹⁸⁹ Yet more

Archipelago Plan to Offer a Variety of Financial Products, Wall St. J., Apr. 26, 2005, at C1; Christine Richard, *SEC Gives Big Board Green Light To Finalize Corporate-Bond Plan*, Wall St. J., July 13, 2005, at C4.

186. See Schich & Wehinger, *supra* note 43, at 100 (comparing income sources).

187. Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,131 (Dec. 8, 2004) (providing general information and figures); see also William O. Brown, Jr., et al., *Competing with the NYSE* (August 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=785427.

188. See Aaron Lucchetti, *NYSE's Market Dominance Slips*, Wall St. J., Nov. 29, 2005, at C1 [hereinafter Lucchetti, *NYSE's Market Dominance Slips*]; Aaron Lucchetti, *What Kind of Stock Will the NYSE Itself Be?*, Wall St. J., Dec. 6, 2005, at C1.

189. Lucchetti et al., *supra* note 185; Weber, *supra* note 173; see also Van T. Nguyen et al., *Archipelago's Move Towards Exchange Status: An Analysis of Archipelago Trading in NYSE and NASDAQ Stocks* (May 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=720322>. In 2005, Archipelago's share in stocks listed on the New

threatening for the Nasdaq Stock Market is the competition with alternative trading systems. Although there are different estimations, the consensus is that electronic communication networks now handle roughly half of Nasdaq-listed stock.¹⁹⁰

As for the competition for issuers, domestic marketplaces increasingly feel the squeeze from foreign marketplaces and have to respond. Archipelago Exchange announced that it would start its trading at four o'clock a.m. Eastern Time to attract European investors.¹⁹¹ And, as previously mentioned, even the New York Stock Exchange (which is merging with Archipelago) is considering opening earlier to attract European traders.¹⁹²

D. *Competitive Advantages of Public Stock Exchanges*

Having outlined the elements that foster competition, the markets that compete, and the goals of that competition, the Article turns now to the question of why demutualized and publicly traded stock exchanges will do better than exchanges under the traditional mutual structure: the new structure makes it easier to raise money,¹⁹³ facilitates decision making,¹⁹⁴ and fosters consolidation.¹⁹⁵

1. Raising Money

As already indicated, for decades, even centuries, stock exchanges offered little more than a large room (the exchange floor). Today, however, stock exchanges provide their traders with high-end technology, state-of-the-art information systems, and trade settlement within seconds. Technological advances represent one of the main forces driving competition among stock markets, allowing marketplaces with new technology to cut costs and lower prices without incurring losses.

However, running modern stock exchanges, and having the trading system and other facilities up-to-date, requires large amounts of money. The traditional mutual form cannot fulfill all capital needs because ownership is here restricted to brokers and dealers, which significantly

York Stock Exchange rose from 1.6 percent to 3.7 percent. See Lucchetti, *NYSE's Market Dominance Slips*, *supra* note 188.

190. See Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,131; Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,258 (Dec. 8, 2004).

191. Press Release, Archipelago, Electronic Exchange's Early Opening to Coincide with European Trading Hours, Creating More Open, Transparent Markets (Nov. 23, 2004), available at <http://investor.archipelago.com/phoenix.zhtml?c=140290&p=irol-newsArticle&ID=647127&highlight=>.

192. Ceron & Lucchetti, *supra* note 184; *Early Open at NYSE? Not Yet, Thain Says*, *supra* note 184.

193. See *infra* Part II.D.1.

194. See *infra* Part II.D.2.

195. See *infra* Part II.D.3.

limits the possible capital suppliers and makes it difficult to obtain the funds necessary to maintain modern trading systems. Not surprisingly, then, stock exchanges regularly point to their capital needs when explaining their reasons for demutualization, as stressed for instance by the New York Stock Exchange,¹⁹⁶ the Pacific Exchange,¹⁹⁷ the London Stock Exchange,¹⁹⁸ and the Nasdaq Stock Market.¹⁹⁹

2. Decision Making

Demutualization leads to dramatic changes in the management structure of stock exchanges, a factor that has been somewhat neglected in legal scholarship thus far.²⁰⁰ Under the traditional structure, the broker-dealers are the key decision makers. With demutualization, and a subsequent initial public offering, however, ownership and control separate. Outside stockholders provide nothing more than capital. As in any other public company with dispersed ownership, small stockholders have a rational disinterest in actively contributing to the company's well-being. Thus, the power shifts from the broker-dealers to senior management when stock exchanges go public. This makes it much easier to run a business in a highly competitive environment than under the mutual structure. Said the chairman of the Pacific Exchange when the exchange demutualized:

Membership organizations, especially exchanges, can be frustrating. It is difficult to implement new policies and new strategic decisions. The members, acting through committees or voting en masse on Constitutional amendments, must bless each significant change. Even where reform and enhancement is widely supported, the time necessary to secure committee and member approval can seem interminable.²⁰¹

Moreover, the interests of the members often conflict with the long-term interests of the exchange. For instance, floor brokers oppose electronic trading systems, which make their workplace obsolete, but in the long term the stock exchange may need to invest in such a system to defend its market share. And for the stock exchange to succeed in drawing investors, it may

196. *Grasso Statement*, *supra* note 83.

197. Press Release, Pac. Exch., Pacific Exchange Board Approves Demutualization, Screen-Based Trading Plans (Dec. 13, 2000), available at http://www.pacificex.com/news/press/press-2000/abt_press_00_dec_board.html [hereinafter Pacific Exchange Approves]; Press Release, Pac. Exch., SEC Approves Pacific Exchange Demutualization Plan (May 20, 2004), available at http://www.pacificex.com/news/press/press-2004/press_04_sec_approval.html [hereinafter SEC Approves Pacific Exchange].

198. Cowell, *supra* note 124.

199. See Press Release, Nasdaq, *supra* note 122. But see *supra* notes 15, 116.

200. But see Oliver Hart & John Moore, *The Governance of Exchanges: Members' Cooperatives Versus Outside Ownership*, Oxford Rev. of Econ. Pol'y, Winter 1996, at 53; Steil, *supra* note 11, at 68-71. For an economic analysis of stock exchange governance, see generally Craig Pirrong, *A Theory of Financial Exchange Organization*, 43 J.L. & Econ. 437 (2000).

201. Greber, *supra* note 141.

need to reduce the spreads between ask and bid prices—a change that directly reduces the broker-dealers' income.

Managers of stock exchanges cautiously admit that one of the critical advantages in demutualized exchanges is the greater discretion they have. This has been acknowledged by all demutualized exchanges in the United States—the Chicago Stock Exchange,²⁰² the Pacific Exchange,²⁰³ and the Philadelphia Stock Exchange,²⁰⁴ as well as during the New York Stock Exchange's failed attempt in 1999²⁰⁵—and the demutualization of the Australian Stock Exchange²⁰⁶ and the London Stock Exchange.²⁰⁷ The need for demutualization of the other exchanges grows more pressing with every stock exchange that demutualizes, because more and more competitors will no longer be member organizations and will therefore have more flexibility in decision making.

The impact on the decision making within the stock exchange seems to be at least equally as important as raising money, given that publicly traded stock exchanges have only rarely raised money after demutualization, and many of them have hoarded that cash. That the managers of stock exchanges nonetheless put so much emphasis on raising money might have an easy explanation: It is the members who make the decision to demutualize. Suggesting that the purpose of demutualization is to remove their powers would probably not help win their approval for demutualization.

3. Consolidation

Running a stock exchange is one of the best examples of economies of scale. Once an exchange has set up the trading facilities (such as floors and electronic systems), drafted the rules, formulated the corporate governance standards, and so forth, there are almost no further costs, regardless of the number of transactions performed at the exchange. The managing director of the Australian Stock Exchange has said that

we have a very high proportion of fixed costs, much of it in computer and communications equipment, and a correspondingly low proportion of variable costs. The result is that, above a certain level, increased trading

202. Press Release, Chi. Stock Exch., Chicago Stock Exchange Board of Governors Approves Demutualization Plan (Aug. 5, 2004), available at http://www.chx.com/pressroom/press_article.asp?PR_Date=08/05/04 [hereinafter Chicago Stock Exchange Board of Governors Press Release]; Press Release, Chi. Stock Exch., Chicago Stock Exchange Members Approve Demutualization Plan (Nov. 11, 2004), available at http://www.chx.com/pressroom/press_article.asp?PR_Date=11/11/04.

203. Greber, *supra* note 141.

204. Press Release, Phila. Stock Exch., Philadelphia Stock Exchange Board of Governors Authorizes PHLX Management to Pursue Demutualization Plan for the Exchange (Dec. 12, 2002), available at <http://www.phlx.com/news/pr2002/02pr1212.html>.

205. Grasso Statement, *supra* note 83.

206. Humphry, *supra* note 123.

207. Cowell, *supra* note 124.

volumes in our markets don't just flow through to revenue, they largely flow through to profit.²⁰⁸

And the chairman of the Pacific Exchange stated, "Drive more products over a single platform and you drive down the cost of each transaction."²⁰⁹

If two exchanges merge, they can almost halve most of their fixed expenses, like updating the trading system and reviewing their rules and corporate governance standards. Against this background, it is no wonder that stock exchanges oftentimes praise the advantages of consolidation and strategic partnerships when they demutualize and go public. Examples include the Chicago Stock Exchange,²¹⁰ the New York Stock Exchange,²¹¹ the Pacific Exchange,²¹² the Philadelphia Stock Exchange,²¹³ and abroad, the Stock Exchange of Hong Kong.²¹⁴ And, as in other sectors, stock exchanges increasingly consider their stock as currency during takeovers.²¹⁵ We have already seen such consolidations: in Europe, Euronext (built of four stock exchanges)²¹⁶ and OMX Group (combined from five);²¹⁷ in the United States, Pacific Exchange and Archipelago,²¹⁸ as well as Nasdaq Stock Market, BRUT, and Instinet (most of them were not registered as national securities exchanges when they merged). Nothing seems impossible—even rumors about a merger of the Nasdaq Stock Market and

208. Press Release, ASX, *supra* note 54.

209. Greber, *supra* note 141.

210. Chicago Stock Exchange Board of Governors Press Release, *supra* note 202.

211. *Grasso Statement*, *supra* note 83 (mentioning "strategic alliances" with respect to the failed attempt of 1999).

212. Pacific Exchange Approves, *supra* note 197; Press Release, Pac. Exch., Pacific Exchange Board Unanimously Approves Corporate Restructuring, Demutualization (Sept. 16, 2003), available at http://www.pacificex.com/news/press/press-2003/press_03_demutual.html; Press Release, Pac. Exch., Pacific Exchange Demutualization Effort Advances (Sept. 29, 2000), available at http://www.pacificex.com/news/press/press-2000/abt_press_00_demutual.html; Press Release, Pac. Exch., Pacific Exchange Demutualization Plan Approved (Jan. 22, 2004), available at http://www.pacificex.com/news/press/press-2004/press_04_demutualization.html; SEC Approves Pacific Exchange, *supra* note 197; Press Release, Pac. Exch., SEC Publishes Pacific Exchange Demutualization Proposal (Mar. 29, 2004), available at http://www.pacificex.com/news/press/press-2004/press_04_proposal.html.

213. Press Release, Phila. Stock Exch., *supra* note 204.

214. See Press Release, HKEx, Speech by Mr. Lee Yeh-kwong, Charles at the HKEx News Conference (Mar. 6, 2000), available at <http://www.hkex.com.hk/news/hkexnews/0306news5.htm>; see also HKEx New Chapter, *supra* note 140.

215. *Deutsche Börse Shares Jump*, N.Y. Times, Feb. 6, 2001, at W1 (citing then-Deutsche Börse CEO Werner Seifert); Pacific Exchange Approves, *supra* note 197; see also Press Release, Nasdaq, *supra* note 122.

216. See Euronext, History, http://www.euronext.com/editorial/wide/0,5371,1732_4427342,00.html (last visited Feb. 25, 2005).

217. See OMX, About OMX; Management, <http://www.omxgroup.com/omxcorp/aboutomx/Management/> (last visited Feb. 25, 2005).

218. See Archipelago, Our History, <http://www.archipelago.com/inside/story.asp> (last visited Feb. 25, 2005).

the New York Stock Exchange found their way into the press.²¹⁹ After the CEO of the New York Stock Exchange, John A. Thain, said, “We have too many exchanges,”²²⁰ it took only six weeks until the announcement of the merger with Archipelago and of Nasdaq’s takeover of Instinet.

Consolidation among stock markets is a good example of how technology can prompt a certain market structure. A century ago, it made economic sense to have separate stock exchanges on the West Coast and on the East Coast. Communication, restricted to phone calls, telegrams, and mail, was expensive and time-consuming. Today, in the Internet age, it does not matter where in the United States or the world you are based. The better the means of communication, the less efficient, comparatively, are regional exchanges.

III. CONFLICTS OF INTEREST

Demutualization is far from being free of challenges. Various regulatory problems arise when stock exchanges demutualize, go public, and list their stock. If we are unable to address the challenges that come with this progress, the traditional regulatory system—most importantly the concept of self-regulation—faces an uncertain future. This is why so many observers are worried about the progress of demutualization and the changes it brings.

All regulatory concerns related to demutualization arise from one source: the stock exchanges’ regulatory powers. Without its public mandate, a stock exchange could be treated as any other financial institution. But with the far-reaching regulatory powers that Congress and the SEC have conferred on the stock exchanges, their organizational structure needs our utmost attention, most importantly regarding conflicts of interest that might divert the stock exchanges from fulfilling their regulatory duties and the trust with which they have been invested.

The possibility of conflicts of interest in publicly traded stock exchanges is not an invention of outsiders. The stock exchanges themselves are, though to a lesser degree, aware of these problems.²²¹ The chief regulatory officer of the New York Stock Exchange, for instance, acknowledges that there are “undeniably” conflicts related to self-regulation,²²² and also, as he

219. See Kate Kelly & Susanne Craig, *NASDAQ Chief Approaches NYSE to Explore Merger*, Wall St. J., Dec. 23, 2003, at A1; see also Press Release, Nasdaq, *A Statement From NASDAQ* (Dec. 23, 2003), available at http://www.nasdaq.com/newsroom/news/pr2003/ne_section03_111.html (denying this “unverified story based on rumors and speculation”).

220. *NYSE Seeks Approval for Changes*, Wall St. J., Mar. 9, 2005, at C4 (quoting John A. Thain).

221. See generally Carson, *supra* note 8, *passim* (containing numerous sections about the “exchange view”); see also *id.* at 20 (“Some exchanges acknowledged that under competitive pressure, standards could slip without strong oversight.”).

222. Mara Der Hovanesian, *Big Stick At the Big Board*, Bus. Wk., Nov. 15, 2004, at 84 (citing Richard G. Ketchum).

acknowledged before a House committee recently, the New York Stock Exchange “has not always lived up to our own high standards in ensuring investor protection and market integrity.”²²³ That is a rather nice way to refer to the not so infrequent cases in which self-regulatory organizations have shown enforcement deficits, apparently as a result of influence by business interests.²²⁴ Put in a nutshell, stock exchanges “are not immune from governance missteps”—so says none other than William H. Donaldson, former chairman of both the New York Stock Exchange and the SEC.²²⁵ To the extent that demutualization increases the likelihood of such “missteps,” Congress and the SEC must think about offering more “guidance.”

This part examines the regulatory challenges that demand the proposed changes. The presentation commences with an overview of the regulatory powers of stock exchanges that cause the concerns,²²⁶ and turns then to the various conflicts of interests that arise when stock exchanges demutualize and go public.²²⁷

A. Regulatory Environment

Among the institutions that offer financial services, stock exchanges are out of the ordinary. Concededly, like other financial institutions such as banks, insurance companies, or investment funds, stock exchanges are regulated. But unlike other institutions, stock exchanges are also regulators, insofar as they have regulatory powers over their markets and the market participants, a concept known as “self-regulation.”²²⁸

This section commences with the underlying idea of self-regulation,²²⁹ followed by a discussion of both the governmental powers over stock

223. *Self-Regulatory Organizations: Exploring the Need for Reform: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 8 (2005) (statement of Richard G. Ketchum, Chief Regulatory Officer, NYSE) [hereinafter *Ketchum Statement*].

224. An example of this is the enforcement deficits that led to the separation of the regulatory arm of the National Association of Securities Dealers. See Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 34-37538, 62 SEC Docket 1346 (Aug. 8, 1996). For the recently settled investigations against the New York Stock Exchange and its specialists, see Press Release, Sec. & Exch. Comm'n, SEC Charges the New York Stock Exchange with Failing to Police Specialists (Apr. 12, 2005), available at <http://www.sec.gov/news/press/2005-53.htm>.

225. Donaldson, *supra* note 13.

226. See *infra* Part III.A.

227. See *infra* Part III.B-H.

228. The SEC regularly emphasizes this aspect. See Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,128 (Nov. 18, 2004) (stating in the very first sentence that “[t]he system of regulation for our Nation’s securities markets and market participants is grounded on the principle of self-regulation”).

229. See *infra* Part III.A.1.

exchanges (regulation of stock exchanges),²³⁰ as well as the self-regulatory powers of stock exchanges (regulation by stock exchanges).²³¹

1. Concept of Self-Regulation

The Securities Exchange Act establishes a two-tiered approach for the regulation of the stock markets: self-regulation, coupled with governmental oversight,²³² a concept that is applied to (1) national securities exchanges,²³³ (2) registered securities associations,²³⁴ (3) registered clearing agencies,²³⁵ and (4) various other organizations.²³⁶ This Article is limited to national securities exchanges, which are often referred to simply as “stock exchanges.” The governmental oversight of such exchanges is carried out by the Securities and Exchange Commission, a federal administrative agency that was inaugurated in 1934 by the Securities Exchange Act.²³⁷

What does self-regulation mean? The standard definition describes self-regulation as a regulatory regime under which an organization or industry sector establishes its own rules and regulates itself accordingly.²³⁸ Under the current system, stock exchanges are, to a considerable extent, self-regulators because they set the rules for the markets they organize. This regime is self-regulatory because the market participants are involved in the rulemaking process. In particular, representatives of the distinct constituencies must be on the stock exchange’s boards,²³⁹ namely executives representing member firms that deal with the public, specialists, floor brokers, lessor members, listed companies, institutional investors, and individual investors.²⁴⁰ Therefore, the stock exchange’s constituencies set

230. See *infra* Part III.A.2.

231. See *infra* Part III.A.3.

232. *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 667 (1975); see also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 127-28 (1973). See generally Securities Exchange Act of 1934 § 3(a)(26), 15 U.S.C. § 78c(a)(26) (2000).

233. Securities Exchange Act § 6, 15 U.S.C. § 78f.

234. *Id.* § 15(A), 15 U.S.C. § 78(o-3).

235. *Id.* § 17(A), 15 U.S.C. § 78. For the question of whether a system is an exchange or a clearing agency, see *Board of Trade v. SEC*, 923 F.2d 1270 (7th Cir. 1991), and *Board of Trade v. SEC*, 883 F.2d 525 (7th Cir. 1989).

236. The Municipal Securities Rulemaking Board (“MSRB”), established by Securities Exchange Act § 15B, 15 U.S.C. § 78o-4(b), is treated as a self-regulatory organization solely for purposes of the Securities Exchange Act §§ 19(b), 19(c), and 23(b) (15 U.S.C. §§ 78s(b), 78s(c), and 78w(b)). The Sarbanes-Oxley Act recently added the Public Company Accounting Oversight Board (“PCAOB”). See Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 7211-7219 (Supp. II).

237. Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d. For a general introduction, see *supra* Part I.B.2.

238. Cf. Black’s Law Dictionary 1391 (8th ed. 2004) (defining self-regulation as “[a]n organization’s or industry’s control, oversight, or direction of itself according to rules and standards that it establishes”).

239. Securities Exchange Act § 6(b)(3), 15 U.S.C. § 78f(b)(3); see, e.g., NYSE Constitution art. IV, § 2 (Board of Directors); *id.* art. V, § 2 (Board of Executives).

240. See, e.g., NYSE, Inc., *supra* note 43, at 49.

the rules for themselves, or, to be more precise, through the stock exchange as a separate regulatory body.

The underlying idea of self-regulation is to benefit from the industry's wisdom and superior knowledge compared to the government. If anyone can best understand and identify fraudulent and illegal behavior, so the argument goes, it is the industry itself. Furthermore, rules enacted by the affected persons tend to be accepted and observed sooner than rules set by outsiders.²⁴¹ Another acknowledged advantage of self-regulation is that self-regulatory organizations can rely on the industry's funds, and are therefore better and more efficiently funded than a governmental agency.²⁴²

Needless to say, resting solely on self-regulation bears some risks, because self-regulators are not disinterested but instead biased by their industry affiliation. That is where government comes in, providing, or at least threatening, impartial control. No one said it better than the former chairman of the SEC, Justice William O. Douglas: "[Self-Regulation] is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used."²⁴³

2. Regulation of Stock Exchanges (Governmental Powers)

Governmental oversight of stock exchanges can be divided into two parts: First, there are certain requirements for registration as a self-regulatory organization; second, the SEC continuously monitors and controls the stock exchanges' conduct.

Stock exchanges have to register with the Commission before they can open their market to investors; transactions on unregistered exchanges are, unless an exemption applies, unlawful.²⁴⁴ An exchange will not be registered as a national securities exchange unless it is

so organized and has the capacity to be able to carry out the purposes of [the Securities Exchange Act] and to comply, and . . . to enforce compliance by its members and persons associated with its members, with the provisions of [the Securities Exchange Act], the rules and regulations thereunder, and the rules of the exchange.²⁴⁵

241. IOSCO on Exchange Demutualization, *supra* note 7, at 6. In addition, self-regulatory organizations may be better able to respond to misconduct that falls short of fraud. See Coffee & Seligman, *supra* note 21, at 673-74.

242. Coffee & Seligman, *supra* note 21, at 73, 673. For an overview of the said main advantages of self-regulation, see Dombalagian, *supra* note 63, at 1093-1100.

243. Douglas, *supra* note 62, at 82. Justice William O. Douglas was Chairman of the SEC from September 21, 1937, to April 16, 1939. See SEC, Concise Directory, <http://www.sec.gov/about/concise.shtml#history> (last visited Feb. 25, 2006).

244. Securities Exchange Act § 5, 15 U.S.C. § 78e.

245. *Id.* § 6(b)(1), 15 U.S.C. § 78f(b)(1).

Congress has enacted a detailed catalogue of requirements that must be fulfilled.²⁴⁶ For the SEC, the seven most important are:²⁴⁷

[1] The rules of the [national securities] exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer;²⁴⁸

(2) “The rules of the exchange [or association respectively] provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities [and systems];”²⁴⁹

(3) “rules of the exchange [or association] are designed to prevent fraudulent and manipulative acts and practices;” (4) “to promote just and equitable principles of trade;” (5) “to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general;” (6) “to protect investors and the public interest.”²⁵⁰ And finally

[7] [t]he rules of the exchange provide that . . . its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of [the Securities Exchange Act], the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction. . . .

...

[Such rules must] provide a fair procedure for the disciplining of members and persons associated with members.²⁵¹

When an exchange fulfills these requirements and gets registered, the governmental powers over that exchange are far from exhausted. As explained in earlier parts of this Article, the SEC has acquired increasing power over the stock exchanges in recent decades, making the stock exchanges more like subsidiaries of the Commission than the private clubs that they once were. It is this already existing power of the Commission that argues against much more regulation in the case of demutualization and going public of stock exchanges, as the Article will point out later.

As a general guideline, the Commission has to take action whenever a stock exchange does not sufficiently protect investors.²⁵² While in earlier

246. *See id.* § 6(b)(2)-(9), 15 U.S.C. § 78f(b)(2)-(9).

247. *See* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,128-29 (Dec. 8, 2004); *see also* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 128-29 (1973) (listing these requirements).

248. *See* Securities Exchange Act § 6(b)(3), 15 U.S.C. § 78f(b)(3).

249. *See id.* § 6(b)(4), 15 U.S.C. § 78f(b)(4).

250. *See id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5).

251. *See id.* § 6(b)(6)-(7), 15 U.S.C. § 78f(b)(6)-(7).

days it could be said that the SEC's general function was supervisory,²⁵³ the 1975 Amendments gave the Commission a significantly more active role.²⁵⁴ Out of the broad range of powers that the SEC has over stock exchanges, the most noteworthy are:²⁵⁵

(1) Stock exchanges have to file with the SEC if they want to change their rules. Absent exemptions, changes do not take effect unless the Commission has approved the proposed rule change.²⁵⁶

(2) If the SEC does not like the existing rules of a stock exchange, the Commission is empowered to abrogate, add to, and delete from rules of the stock exchange.²⁵⁷

(3) The SEC can even amend a stock exchange's Constitution and Certificate of Incorporation.²⁵⁸ For instance, as expressly stated, the Commission can increase the number of seats at a stock exchange if the current limit overly hinders competition.²⁵⁹

(4) The SEC can investigate whether persons regulated by the stock exchanges comply with the Securities Exchange Act, the rules or regulations thereunder, and the rules of the national securities exchange.²⁶⁰

(5) If stock exchanges do not fulfill their obligations under the Securities Exchange Act or the rules promulgated thereunder, the SEC is empowered to impose limitations on their business²⁶¹ or remove their officers and directors.²⁶² If such actions are not an adequate response to the misconduct, the Commission is authorized to suspend or revoke the registration of the noncomplying stock exchange.²⁶³

(6) The SEC reviews the disciplinary actions that self-regulatory organizations impose on their members.²⁶⁴

252. *Merrill Lynch*, 414 U.S. at 130; Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,128.

253. *Merrill Lynch*, 414 U.S. at 129.

254. *See supra* Part I.B.3.

255. For the powers that the SEC has identified as the most important, see Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,128-29.

256. Securities Exchange Act § 19(b), 15 U.S.C. § 78s(b). *But see* Proposed Rule Changes of Self-Regulatory Organizations, Exchange Act Release No. 34-49505, 69 Fed. Reg. 17,864 (Apr. 5, 2004).

257. Securities Exchange Act § 19(c), 15 U.S.C. § 78s(c).

258. For the definition of "rules of an exchange," see *id.* § 3(27), 15 U.S.C. § 78c(27).

259. *Id.* § 6(c)(4), 15 U.S.C. § 78f(c)(4). For the number of seats at the New York Stock Exchange, see Certificate of Incorporation of the NYSE, Inc. § 13 (showing that there are 1366 seats).

260. Securities Exchange Act § 21(a), 15 U.S.C. § 78u(a). At any rate, the SEC can discipline brokers and dealers directly when they are, as usually they are, registered with the SEC. *See id.* § 15(b)(4)-(6), 15 U.S.C. § 78o(b)(4)-(6); *cf.* Bd. of Trade v. SEC, 923 F.2d 1270, 1276 (7th Cir. 1991) (Flaum, J., dissenting).

261. Securities Exchange Act § 19(h)(1), 15 U.S.C. § 78s(h)(1).

262. *Id.* § 19(h)(4), 15 U.S.C. § 78s(h)(4).

263. *Id.* § 19(h)(1), 15 U.S.C. § 78s(h)(1).

264. *Id.* § 19(d)(2), 15 U.S.C. § 78s(d)(2).

(7) The SEC can demand all information necessary to fulfill its oversight function. Stock exchanges are required to keep records and to file reports with the Commission.²⁶⁵ The records are subject to examinations by the Commission.²⁶⁶

Despite these broad powers, there remain areas in which stock exchanges have power that the SEC does not have, for the Commission's powers are limited to advancing the goals of the Securities Exchange Act. The best known example of such an area is the set of rules that governs the issuers' corporate governance.²⁶⁷ As held in the seminal *Business Roundtable v. SEC* decision, the Commission lacks authority to initiate corporate governance rules or to intervene against them.²⁶⁸

In addition to the SEC there are two other major players in the governmental oversight of stock exchanges. The first is Congress. The facts of the landmark *Gordon v. New York Stock Exchange* case give a nice illustration of the interplay between the Commission and Congress.²⁶⁹ Dissatisfied with the SEC's progress in banishing fixed commissions at the stock exchanges, Congress intervened and forbade fixed commissions through the Securities Acts Amendments of 1975.²⁷⁰ And there is a second additional player: the courts. However, even though the courts have the final say, they often rely largely on the SEC's judgment.²⁷¹

The powers by the SEC are not a theoretical threat; rather, the Commission is omnipresent in the stock exchange's life. One will hardly find an issue of the Federal Register without proposed stock exchange rule changes, approvals, and so forth. Moreover, the SEC regularly brings actions against stock exchanges. And, as will be discussed in the following section, it does not flinch from taking on the biggest players, such as the New York Stock Exchange or Nasdaq.

3. Regulation by Stock Exchanges (Self-Regulatory Powers)

After the regulatory powers over stock exchanges, this section turns to the regulatory powers of stock exchanges. These powers are critical for the following discussion about demutualization, listing, and self-listing of stock exchanges, because it is the regulatory powers of stock exchanges that create various conflicts of interest if stock exchanges demutualize and go public.

As self-regulatory organizations, stock exchanges bear a "front-line" responsibility for regulation of their markets and for controlling their

265. *Id.* § 17(a)(1), 15 U.S.C. § 78q(a)(1).

266. *Id.* § 17(b), 15 U.S.C. § 78q(b).

267. For the stock exchanges as corporate governance trendsetters, see *supra* Part I.A.4.

268. *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

269. See *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 679-81 (1975).

270. Securities Exchange Act § 6(e), 15 U.S.C. § 78f(e).

271. See, e.g., *Gordon*, 422 U.S. at 686.

members' compliance with the provisions to which they are subject.²⁷² Emphasizing the importance of the self-regulatory organizations to the regulation of our securities markets, the SEC recently stated that the self-regulatory organizations are "charged with an important public trust to carry out their self-regulatory responsibilities effectively and fairly, while fostering free and open markets, protecting investors, and promoting the public trust."²⁷³ In this context, it is important to note that self-regulation is not a right granted to the stock exchanges, but rather a statutorily imposed duty,²⁷⁴ leading to an obligation to regulate themselves.²⁷⁵ This public mandate is not only a privilege, but also an important cost factor for the exchange. For instance, the New York Stock Exchange, as the nation's largest stock exchange, employs more than seven hundred employees for regulatory issues, some forty-five percent of its staff.²⁷⁶ If an entity fails to expend the necessary resources and perform its regulatory function, it will not be registered as a national securities exchange, and any previously granted registration will be revoked.²⁷⁷

The scope of the stock exchange's self-regulation has been somewhat neglected so far, which will presumably change when the conflicts of interest in publicly traded stock exchanges draw more attention. We often read that the stock exchanges' constituencies are subject to its regulatory powers, particularly the stock exchanges' members and the listed issuers. In a simplified way this notion is correct, and is the basis for the following discussion, which distinguishes between powers over members and over issuers. However, as will be discussed in more detail later, the power over issuers is not a regulatory power in a literal sense, because its basis is not the Securities Exchange Act and the rules thereunder, but rather the contract between the stock exchange and the issuer (the so-called listing agreement). This distinction is especially important for demutualized and publicly traded stock exchanges.

a. Regulation of Members

Stock exchanges have both the power and the duty to enforce the compliance of their members (the so-called seat holders) with the Securities Exchange Act, the rules and regulations thereunder, and the stock

272. The term "front-line" is regularly used by the SEC. See Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,128, 71,129 n.30 (Dec. 8, 2004).

273. *Id.* at 71,129 (referring to Securities Exchange Act § 6(b)(5), 15 U.S.C. § 78f(b)(5) (national stock exchanges) and Securities Exchange Act § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (registered securities associations)).

274. See Securities Exchange Act § 6(b), 15 U.S.C. § 78f(b) (cataloging the obligations); see also *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 353 (1963).

275. *Silver*, 373 U.S. at 356.

276. See *NYSE Lays Off About 60 Workers*, Wall St. J., Dec. 15, 2005, at C5 (noting that none of 714 out of the remaining 1577 employees lost their jobs). See generally New York Stock Exchange, <http://www.nyse.com/regulation/> (last visited Feb. 25, 2006).

277. Securities Exchange Act § 19(h)(1), 15 U.S.C. § 78s(h)(1).

exchanges' rules.²⁷⁸ The same rules apply to persons associated with the stock exchanges' members.²⁷⁹ While the stock exchanges' rulemaking powers are limited, most importantly to matters related to the purposes of the Securities Exchange Act and the administration of the stock exchange,²⁸⁰ it is important to note that their surveillance and enforcement powers over members are not. For example, the New York Stock Exchange enforces the prospectus delivery duties that their members have under federal securities law when they sell certain securities.²⁸¹

Within this scope, stock exchanges have the power and the obligation to ensure that their members are reliable, both financially and in regard to their conduct. Concerning the former, the regulation of the stock exchange covers the entire financial and operating compliance of its members, such as financial requirements set by the exchange.²⁸² Concerning the members' conduct, stock exchanges have to enact rules that establish expectations for "training, experience, and competence" on the part of brokers and dealers that trade at the stock exchange.²⁸³

In recent years, trust in the stock exchanges' willingness and ability to regulate their members has seriously suffered. Recently, the SEC charged the New York Stock Exchange for failing to police its specialists for a period of almost four years.²⁸⁴ In addition, the Commission instituted enforcement actions against twenty specialists allegedly involved in the violations,²⁸⁵ after having settled enforcement actions against all seven

278. *Id.* § 6(b)(1), (5), 15 U.S.C. § 78f(b)(1), (5); *id.* § 19(g)(1)(A), 15 U.S.C. § 78s(g)(1)(A); see also Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,259 (Dec. 8, 2004); Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,131; Coffee & Seligman, *supra* note 21, at 674.

279. See Securities Exchange Act § 19(g)(1)(A), 15 U.S.C. § 78s(g)(1)(A). The term "person associated with a member" is defined in Securities Exchange Act § 3(21), 15 U.S.C. § 78c(21).

280. *Id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5).

281. See Ann Davis, *No Prospectus? NYSE Blames Brokerage Firms*, Wall St. J., Nov. 16, 2004, at C1.

282. Securities Exchange Act § 6(c)(3)(A), 15 U.S.C. § 78f(c)(3)(A).

283. *Id.* § 6(c)(3)(B), 15 U.S.C. § 78f(c)(3)(B).

284. Press Release, Sec. & Exch. Comm'n, *supra* note 224 (stating that the New York Stock Exchange violated Securities Exchange Act § 19(g), 15 U.S.C. § 78s(g), Securities Exchange Act § 11(b), 15 U.S.C. § 78k(b), and Rule 11b-1 thereunder (codified at 17 C.F.R. § 240.11b-1 (2005), NYSE Rule 92, and NYSE Rule 104.10); see also Aaron Lucchetti et al., *Current and Former Big Board Regulators Might Face Civil Charges*, Wall St. J., Oct. 4, 2005, at C3; Aaron Lucchetti & Kara Scannell, *Fifteen Indicted in NYSE Case*, Wall St. J., Apr. 13, 2005, at C1; Kara Scannell & Aaron Lucchetti, *Ex-Specialists Face Indictment For NYSE Deals*, Wall St. J., Apr. 12, 2005, at C1; Deborah Solomon et al., *SEC Prepares to Charge the NYSE*, Wall St. J., Jan. 13, 2005, at C3.

285. Press Release, Sec. & Exch. Comm'n, SEC Institutes Enforcement Action Against 20 Former New York Stock Exchange Specialists Alleging Pervasive Course of Fraudulent Trading (Apr. 12, 2005), available at <http://www.sec.gov/news/press/2005-54.htm> (alleging violations of Securities Exchange Act § 17(a), 15 U.S.C. § 77q(a), Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b), Rule 10b-5 thereunder (codified at 17 C.F.R. § 240.10b-5, Securities Exchange Act § 11(b), 15 U.S.C. § 78k(b)), and Rule 11b-1 thereunder (codified

specialist firms one year ago.²⁸⁶ This failure of the New York Stock Exchange in monitoring its members is not the first incident; similar misconduct had occurred as recently as in 1999.²⁸⁷ This time, the New York Stock Exchange agreed to tighten significantly its oversight, for example by videotaping the members' conduct.

b. *Market Surveillance*

Closely related to the regulation of the members is the market surveillance carried on by the stock exchanges, because it is the members who trade on the market. However, whereas the general member regulation is directed toward the members' attributes and characteristics, market surveillance is directed toward the members' behavior. The classic focuses are insider trading and market manipulation, but there are numerous other forms of misconduct that conflict with the mandate to provide fair trading and treatment of investors. For instance, members of stock exchanges must not trade ahead of any order of a nonmember.²⁸⁸

c. *Regulation of Issuers*

Stock exchanges regulate issuers for two purposes: First, they create rules to ensure that the stocks of the issuers can be reliably traded, and second, they create rules to ensure that the stocks are worth trading, namely that the issuers meet corporate governance standards. The first set of rules aims at the quality of the trading, while the second set aims at the quality of the traded stocks. In regard to the former, stock exchanges require minima of stockholders, outstanding publicly traded shares, and market capitalization necessary to have a liquid market in the stocks.²⁸⁹ In regard to the latter, stock exchanges demand minimum corporate governance standards—stock exchanges act thereby as corporate governance trendsetters, a function that was discussed at the beginning of this Article.

at 17 C.F.R. § 240.11b-1, NYSE Rule 92, NYSE Rule 104, NYSE Rule 123B, and NYSE Rule 401).

286. See SIG Specialists, Inc., Exchange Act Release No. 34-50076, 83 SEC Docket 1208 (July 26, 2004); Performance Specialist Group LLC, Exchange Act Release No. 34-50075, 83 SEC Docket 1200 (July 26, 2004); Bear Wagner Specialists LLC, Exchange Act Release No. 34-49498, 82 SEC Docket 1886 (Mar. 30, 2004); Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895 (Mar. 30, 2004); LaBranche & Co. LLC, Exchange Act Release No. 34-49500, 82 SEC Docket 1903 (Mar. 30, 2004); Spear, Leeds & Kellogg Specialists LLC, Exchange Act Release No. 34-49501, 82 SEC Docket 1912 (Mar. 30, 2004); Van der Moolen Specialists USA, LLC, Exchange Act Release No. 34-49502, 82 SEC Docket 1920 (Mar. 30, 2004).

287. N.Y. Stock Exch., Inc., Exchange Act Release No. 34-41574, 70 SEC Docket 106 (June 29, 1999).

288. See Securities Exchange Act § 11(a)(1)(G)(ii), 15 U.S.C. § 78k(a)(1)(G)(ii). For an example of investigations in this field, see Jed Horowitz, *NYSE Bars A Former Specialist For Failure to Cooperate in Probe*, Wall St. J., Dec. 9, 2004, at C6.

289. See, e.g., NYSE, Inc., *supra* note 34, § 102.00.

The problem with the regulation of issuers is that their duties do not depend on the Securities Exchange Act, rules and regulations thereunder, or on the stock exchange's rules, but rather on a contract between the stock exchange and the issuer, the so-called listing agreement.²⁹⁰ Therefore, stock exchanges have no regulatory power (in a literal sense) over noncomplying issuers, but only the powers given in the listing agreement. For instance, if an issuer does not comply with the listing rules, absent special provisions in the listing agreement the stock exchange has no remedy to fine the issuer. Rather, the stock exchange is limited to admonishing and threatening to delist the issuer. This creates problems when demutualized stock exchanges list their stocks on their own market.²⁹¹

* * *

For all kinds of regulation by the stock exchanges, it is important to remember from earlier parts of this Article that the stock exchanges' regulatory powers are often only the first layer of oversight. With respect to many areas, the SEC has the power to intervene, mentioned above. For instance, if issuers of securities fail to file the reports required under the Securities Exchange Act,²⁹² the Commission has powers to suspend trading in such companies or even revoke the registration, which makes future trading unlawful.²⁹³ This prohibition affects the stock exchanges' member, trading, and issuer regulation, or, put differently, all fields that are subject to self-regulation.

In addition to the SEC, important regulatory functions are performed by the National Association of Securities Dealers ("NASD"), the other main self-regulatory organization. For instance, the NASD in 2004 barred 450 individuals from the securities industry and collected a record \$102 million in disciplinary fines,²⁹⁴ increasing to \$125.4 million in 2005,²⁹⁵ up from \$5.3 million one decade earlier.²⁹⁶

With this regulatory system and the stock exchanges' role in mind, the Article now turns to the conflicts of interest that arise when stock exchanges demutualize and go public.

290. For an example of the basic structure of listing agreements, see *id.* §§ 901.01-05.

291. See *infra* Part III.E.2.

292. See Securities Exchange Act § 13, 15 U.S.C. § 78m.

293. The SEC has recently increased the use of such measures. See Judith Burns, *SEC Suspends Trading in Firms That Failed to Make Filings*, Wall St. J., Dec. 2, 2004, at C5; see also Karen Richardson, *Big Board Proposes Crackdown on Late Filers*, Wall St. J., Feb. 11, 2005, at C3.

294. See *NASD Collected Record Fines During 2004*, Wall St. J., Dec. 30, 2004, at C3.

295. See Aaron Lucchetti, *Schapiro to Become NASD's Chief*, Wall St. J., Jan. 13, 2006, at C3.

296. See *NASD Enforcement Chief Plans Return to Private Law Practice*, Wall St. J., Jan. 19, 2006, at C3.

B. *Regulating in General*

The first concern related to the conduct of demutualized and publicly traded stock exchanges is to what extent those companies will focus on regulation in general, with the possibility that it might be either too great an undertaking or fall short of expectations. The reason for that somewhat hazy picture is that stock exchanges have so many constituencies and interests that it might be hard to predict whom they might favor and whom they might not.

After a brief overview of stock exchanges' constituencies,²⁹⁷ the remaining sections will identify incentives both to under-regulate²⁹⁸ and to overregulate,²⁹⁹ which will lead to the insight that the intensity and thoroughness of general regulation is probably indifferent toward the organizational structure of stock exchanges.³⁰⁰

1. Constituencies of Stock Exchanges

As anyone who would serve distinct purposes and therefore different masters, stock exchanges face a vast number of conflicts of interest. Our society, including our law, is normally not very favorable to those conflicts, and tries to develop devices to avoid them in advance rather than to establish rules that help manage them. As the Supreme Court decisively asserts, "[N]o man can serve two masters."³⁰¹ The Court's apodictic language borrows here from the Bible, which says, "No-one can serve two masters. Either he will hate the one and love the other, or he will be devoted to the one and despise the other."³⁰² One might want to add that this is especially true when one of those masters is oneself, so that the choice is between pursuing one's own or another's interest—which leads to the idea that no man shall pass judgment on his own causes, as stated at the Article's beginning.

To what extent those principles will be tested in our context remains to be seen. Demutualized and publicly traded stock exchanges, apart from their critical public function, differ little from other businesses in their daily challenges, because conflicts of interest are inherent to all businesses. There are, as in any other company, four main constituencies that fight for the largest share of the pie—the exchange's assets: stockholders, creditors, employees, and customers. Before demutualization and going public, stock exchanges differ from normal companies only in that the interests of

297. See *infra* Part III.B.1.

298. See *infra* Part III.B.2.

299. See *infra* Part III.B.3.

300. See *infra* Part III.B.4.

301. *NLRB v. Health Care & Ret. Corp. of Am.*, 511 U.S. 571, 595 n.14 (1994); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 196 n.50 (1963); *United States v. Miss. Valley Generating Co.*, 364 U.S. 520, 550 n.14 (1961); *Knights of Pythias v. Withers*, 177 U.S. 260, 269 (1900). Justice Louis Brandeis famously echoed these words. See Brandeis, *supra* note 2, at 56, 69, 198-99, 202.

302. *Matthew* 6:24.

customers and owners are to some extent aligned, as long as the exchanges are owned by their main customers, the broker-dealers. With demutualization and going public, stock exchanges acquire only one other constituency: investor-stockholders, whose sole interest is to get the highest possible return on investment.

These stockholders can expect that the stock exchanges' management does its best to serve the stockholders, rather than other stakeholders. Recall the famous holding in *Dodge v. Ford Motor Co.*, stating that "[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end"303

Admittedly, such stockholder primacy is a source of controversy even today.³⁰⁴ But, at least factually, the constraints by the stock markets let management of publicly traded companies focus primarily on stockholder value,³⁰⁵ a fact that the stock exchanges themselves frankly admit.³⁰⁶ For instance, the Hong Kong Exchange and Clearing Ltd.'s chairman publicly announced from its very beginning that its corporate aim is to operate "in the best interests of its shareholders."³⁰⁷

With ownership separated from the customers, then, we see one new conflict within the exchanges: stockholders versus customers competing for the corporation's profits, with customers demanding low prices, and stockholders the opposite. Stock exchanges will have to please both, because if they overly favor one, the other will be deterred and change to a competitor (by trading on another marketplace or investing in another company). To make things more complicated, the stock exchanges' customers themselves have conflicting interests: Issuers want low listing fees; traders want low trading fees; some customers might want a floor

303. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (1919). Concededly, its precedent is questionable. See *infra* note 304 and accompanying text.

304. For the classic statement for stockholder primacy, see A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931). For a classic statement of the opposite view, see E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932). For a recent, brief overview of the current debate, see Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. Cal. L. Rev. 1189 (2002).

305. See generally Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* 39-40, 43-46 (2003); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 264-66 (1977); Henry Hansmann & Reinier H. Kraakman, *What Is Corporate Law, in The Anatomy of Corporate Law: A Comparative and Functional Approach* 17-19 (Reinier R. Kraakman et al. eds., 2004).

306. Press Release, ASX, *supra* note 54; see also World Org. of Exchs., *The Significance of the Exchange Industry 2* (5th ed. 2004).

307. Press Release, HKEx, *supra* note 214. This statement seems to conflict somewhat with the legally imposed mandate to prefer public goals in a conflict of interests. See Carson, *supra* note 8, at 12, 20.

(particularly those who work on it), while others might prefer an automated trading system.

It is important to note, however, that these conflicts are not limited to publicly traded stock exchanges. Every company with owners different from its customers faces this challenge to the same extent. The reason that we are particularly aware of this conflict in the case of publicly traded stock exchanges is only that, for stock exchanges, it is a new conflict. Although observers should be aware of the initial differences, the conflict is nothing regulators or commentators should be concerned about in the long term. Management will work to find the right approach to handle it, as it does in any other listed company.

Nonetheless, with the regulatory functions that are conferred on the stock exchanges, they have an additional, important constituency: the public. Although the public might have a stake in all companies, for tax, employment, and reputational reasons, in the case of stock exchanges there is considerably more, as marketplaces for stock have a critical macroeconomic function: They match suppliers of capital with companies that demand capital. Without well-organized and efficient markets, companies will have difficulties finding capital to finance their business, which would raise capital costs and impede the entire economy. From the perspective of the capital suppliers, stock exchanges are important because they provide for lucrative investments and simple risk diversification. Last but not least, major parts of our pension system depend on a functioning stock market. For all these reasons, stock exchanges are widely recognized as a public good.³⁰⁸ As Congress wrote into the Securities Exchange Act in 1975, "The securities markets are an important national asset which must be preserved and strengthened."³⁰⁹ To the extent that preserving this national asset creates costs for the exchange without increasing shareholder value, there is a worrisome conflict of interest in the stock exchanges' management. Or, as the Bible says following the last quotation, "You cannot serve both God and mammon."³¹⁰

With that in mind, we turn now to the incentives demutualized and publicly traded stock exchanges might have to under-regulate or overregulate their markets.

308. See, e.g., *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 349 (1963) ("Stock exchanges perform an important function in the economic life of this country."); see also World Org. of Exchs., *supra* note 306, at 6; Carson, *supra* note 8, at 1; IOSCO on Exchange Demutualization, *supra* note 7, at 10.

309. Securities Exchange Act of 1934 § 11A(a)(1)(A), 15 U.S.C. § 78k-1(a)(1)(A) (2000); see also *id.* § 2, 15 U.S.C. § 78b (commencing with, "For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest . . .").

310. *Matthew* 6:24.

2. Incentives for Under-Regulation

There are a couple of reasons why we might expect demutualized for-profit exchanges to under-regulate their markets. All these reasons are related to the obvious notion that such exchanges will try to maximize their profits, as every publicly traded company does.

Under this standard, each expense will be scrutinized in terms of whether it will help increase profits, and our concern is that this scrutiny will include regulatory expenses, which generate little, if any, direct income in the short term. In the world of quarterly reports and short-dated executive compensation, stock exchange managers might forget that they trade not only stocks but also trust, and could be tempted to reduce regulation expenses just to increase profits, an incentive that would include all types of regulation. And the temptation would be significant: as already mentioned, at the New York Stock Exchange, for instance, some forty-five percent of the employees are working for the regulatory arm,³¹¹ i.e., well-paid investigators and lawyers, where cutting workforce would immediately lead to huge savings. In 2004, for instance, the New York Stock Exchange increased its budget for enforcement and market surveillance by \$50 million,³¹² equaling the exchange's profit in the previous year.³¹³ In other words, the New York Stock Exchange could have doubled profits by not spending so much extra on regulation. The unsurprising result was that in the next year, the New York Stock Exchange's profit plummeted to its lowest level since 1991.³¹⁴ As this anecdotal evidence reveals, regulatory expenses are nothing that exchanges would neglect under a pure profit-maximizing standard. The concerns of under-regulation would be further increased in situations where the choice is not between higher or lower profits but between losses and regulation: Would stock exchanges withstand the temptation to cut regulatory expenses when they are under financial pressure and facing bankruptcy?

Another reasonable incentive for general under-regulation might be the attracting of new customers and the pleasing of current ones. Under pressure by the stockholders to turn a profit, stock exchanges may be reluctant to take action against traders who are "good customers" and who generate significant income for the exchange,³¹⁵ a problem that might have increased with the ongoing consolidation in the industry.³¹⁶ Concededly, stock exchanges may be similarly reluctant under the traditional mutual structure, as then those "good customers" are its owners. Related to the last

311. See *supra* note 276 and accompanying text.

312. Der Hovanesian, *supra* note 85. For the tightened oversight and increased regulatory expenses, see Ceron & Lucchetti, *supra* note 94; Davis, *supra* note 281; Jed Horowitz, *NYSE Posts Loss as Legal Costs Rise and Trading Volume Slips*, Wall St. J., Nov. 24, 2004, at C3.

313. NYSE, Inc., *supra* note 43, at 32.

314. Ceron & Lucchetti, *supra* note 94.

315. See generally, IOSCO on Exchange Demutualization, *supra* note 7, at 7.

316. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,259-60, 71,262 (Dec. 8, 2004).

concern is the worry that stock exchanges may be hesitant to suspend trading in heavily traded stocks of noncomplying issuers, issuers that are the “blockbusters” and “cash cows” of the stock exchange, because exchanges charge transaction fees according to the amount of traded stocks; or, earlier in the process of issuer regulation, that stock exchanges may admit securities that they expect to be heavily traded, regardless of whether the issuer fulfills the listing requirements or not. History has already revealed such a habit of leniency toward issuers: The American Stock Exchange traditionally attracted issuers that failed to comply with the New York Stock Exchange’s listing rules. A recent study by the General Accounting Office discovered that more than twenty percent of the new listings at the American Stock Exchange in the examined period did not meet the American Stock Exchange’s own listing standards.³¹⁷ And even the New York Stock Exchange has recently been accused of exempting an issuer just because it is a big player,³¹⁸ in addition to the classic *Business Roundtable* case where the big board eased its requirements so as to allow General Motors to list another class of stocks.³¹⁹

Another, although not-so-plausible fear is that stock exchanges might be reluctant to enforce corporate governance listing standards that the exchanges themselves do not comply with. For instance, stock exchanges might ignore impermissible poison pills, because they have comparable ones of their own.³²⁰ Such conflicts, however, in any case limited to issuer regulation, seem not so likely. Even if the stock exchange does not want to apply certain standards to itself, such an exchange probably will not flinch from applying double standards and enforcing listing standards that the stock exchange itself ignores. The risk that issuers would publicly point fingers at the stock exchange when it applies standards to them that it does not apply to itself is probably not that high, considering the powers of the stock exchange over the issuers and the opportunities to damage the issuer’s reputation.

3. Incentives for Overregulation

There are also incentives for over-regulation. Under the traditional framework, stock exchanges have powers to levy fines against persons and entities that do not comply with the law, including rules set by the stock

317. U.S. Gen. Accounting Office, *Securities Regulation: Improvements Needed in the Amex Listing Program 3* (2001).

318. See Jesse Eisinger, *Santander-Sovereign Deal Gives NYSE A Shot at Proving Its Policing Prowess*, Wall St. J., Nov. 16, 2005, at C1; see also Phyllis Plitch, *NYSE Deadline Stance Softens With Proposal*, Wall St. J., Nov. 29, 2005, at C3 (discussing a controversial rule change that would exempt Fannie Mae from the New York Stock Exchange’s normal delisting procedures).

319. *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

320. Karmel, *Turning Seats into Shares*, *supra* note 11, at 422. Defensive tactics for takeovers (“poison pills”) are governed by the exchanges. See, e.g., NYSE, Inc., *supra* note 34, §§ 308, 312.03. For an overview of demutualized markets’ poison pills, see Bradley, *supra* note 11, at 698-99.

exchanges. As the fines and other kinds of payments go directly into the stock exchange's pockets, for-profit stock exchanges might be tempted to overregulate and increase the number as well as the amount of the fines, as long as the additional revenue outweighs the regulatory expenses. Although there may be a positive effect from seeing regulation as an income source, as it might provide stock exchanges with an incentive to thoroughly regulate, it would seem problematic to give entities regulatory powers to impose fines that are to the benefit of the entity's stockholders, because enforcement action would no longer be driven by regulatory purposes but rather by financial goals. The effect would be increased further if the compensation of management and particularly of the regulatory staff is linked to the stock exchange's performance.³²¹ Such a link, which is an important and usually reasonable corporate governance tool to constrain management,³²² increases the incentives of the responsible personnel to overregulate, regardless of the stock exchange's general policy.

At least this is the theory; in practice, fines are anything but a reliable source of income, as fined persons can and probably will challenge the stock exchange's decision, which creates enormous costs for the stock exchange, for legal advice and opinions, that offset any profit gained from the fines. One might argue that fined persons might not dare to challenge the fine, as this creates bad publicity and the challenging person risks being even more intensively regulated in the future. However, both arguments are weak. First, a person already fined has little reputation to lose, if there is any good reputation left at all. Second, the risk of being more intensively regulated is most likely negligible in this context. As the stock exchange will in most cases not make any profits with challenged fines, due to the expenditures, the exchange is unlikely to overregulate again.

4. The Organizational Structures' Indifference Toward Regulation

Until this point, we could identify incentives both for under-regulation and over-regulation, though the latter being not as promising as a source of income, which would suggest that our main concern would be whether demutualized for-profit exchanges will be tempted to under-regulate, either the overall market or good customers.

In the short term, that might seem promising, whereas in the long term, trust will be the core asset of any marketplace to attract traders and issuers, a classical problem that calls to mind the discussion of whether state competition for corporate charters leads to a "race to the bottom" or a "race

321. For this concern, see Carson, *supra* note 8, at 14.

322. See generally Roe, *supra* note 305, at 41-43; Henry Hansmann & Reinier H. Kraakman, *Agency Problems and Legal Strategy*, in *The Anatomy of Corporate Law: A Comparative and Functional Approach*, *supra* note 305, at 26-27, 51-52.

to the top," if there is a race at all.³²³ Though the issues derive from two different contexts, the basic argumentation might be similar, with the following distinction: There is a considerable risk that the first corporate scandal might occur as early as the next quarter, with the not so unlikely threat of ousting the current management that decided to under-regulate. It is like an airline saving money by cutting costs for airplane maintenance and security. You can be lucky for a couple of years, but in any case, the first crashed airplane costs the entire business, including management, as no one will ever fly with that airline again, at least not under the same name (remember ValuJet).³²⁴

It is pretty much the same for stock markets: As soon as investors realize that issuer regulation is lenient and fair price discovery no longer guaranteed, they will switch to another marketplace, which stands ready to fill the gap. Demutualization does not change anything in that regard, as evidenced by a statement by the chairman of the Board of the Pacific Exchange: "Lose [investors'] confidence and it matters little whether you're trading on a floor or in front of a screen, through a member organization or a private or public corporation."³²⁵ Pacific Exchange's Chairman went on to say that "[n]othing—nothing—is as essential to our ongoing viability—as an industry or an exchange—as public confidence."³²⁶

In addition, stock exchanges are a heavily regulated industry. Demutualization and listing does not lessen any of the numerous obligations of the Securities Exchange Act and the rules thereunder. It is the stock exchanges that demutualize and start working for-profit, not the SEC, which will enforce the law as vigorously as before, maybe with even more attention to publicly traded stock exchanges.

And finally, the incentive to under-regulate is not necessarily greater for publicly traded stock exchanges than for the traditionally organized exchanges.³²⁷ The underlying idea for that assumption is that, to the extent that the stock exchanges' profits depend on properly regulated markets, the interests of the stock exchanges' shareholders might be more aligned with macroeconomic goals than under the current system. For instance, broker-

323. For the view that the competition among the states is a race to the bottom, see William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L. J. 663 (1974), and more recently, see Lucian Arye Bebhuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1437 (1992). For the opposite view (race to the top), see Roberta Romano, *The Genius of American Corporate Law* (1993), and Winter, *supra* note 305, at 254-62. However, some commentators question whether there is a race at all. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679 (2002).

324. After the crash of one of its airplanes into the Everglades in 1996, ValuJet merged with the much smaller AirTran, under which it still operates.

325. Greber, *supra* note 141.

326. *Id.*

327. See Steil, *supra* note 11, at 72-77 (arguing that demutualization might reduce conflicts of interest).

dealers as the traditional owners of stock exchanges may profit from a loosely supervised market, because it enables them to defraud investors. Those fraud profits can easily outweigh the proportional loss they incur because of the decline of the stock exchange's value.

On balance, there do exist incentives for stock exchanges to overregulate and (perhaps more often) to under-regulate. Nevertheless, there are good reasons to believe that stock exchanges will, in general, not change their regulatory policy if they demutualize and go public. Instead, the organizational structure seems to be largely indifferent toward the general quality of regulation. In this light, there is no need to impose an additional duty on the stock exchange's management to favor the public's interests over the stockholders' interests.³²⁸ Apart from the lack of enforceability of such a rule, it is neither necessary nor desirable. On the contrary, such a rule would give management a good excuse for any misconduct³²⁹—the contention that they acted in the public interest is hard to reject, as the public interest is subject to different interpretations.

Therefore, although there might be some tensions between for-profit stock exchanges and their public mandate, which the SEC may be all too aware of,³³⁰ these tensions are nothing that needs regulatory or legislative action.

C. Regulating Stockholders

Noteworthy and worrisome conflicts of interest arise when stock exchanges regulate their stockholders. That scenario is likely, since many investors that are expected to buy into stock exchanges are subject to regulation by stock exchanges.

To begin with, the former members as the owners of the stock exchange will get the first shares when the stock exchange demutualizes,³³¹ and thereby keep their control over the stock exchange's management. Even if additional shares are being offered to the public, either as part of the going public or in a second offering, broker-dealers will retain a significant share

328. Such provisions were enacted in Hong Kong and in Singapore. See Carson, *supra* note 8, at 12, 20.

329. See generally Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 38 (1991); Paul Davies & Klaus J. Hopt, *Control Transactions, in The Anatomy of Corporate Law: A Comparative and Functional Approach*, *supra* note 305, at 188; Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2065 (2001).

330. Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,132 (Dec. 8, 2004). See generally Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256 (Dec. 8, 2004).

331. In the case of the New York Stock Exchange, see Aaron Lucchetti, *NYSE Deal Treats Insiders Unequally*, Wall St. J., May 11, 2005, at C3; Aaron Lucchetti, *NYSE to Ease Restrictions On Members' Sales of Shares*, Wall St. J., May 12, 2005, at C6. For the Stock Exchange of Hong Kong, see Press Release, HKEx, *The Merger Proposals for the Stock and Futures Exchanges and the Clearing Houses Take Effect* (Mar. 6, 2000), available at <http://www.hkex.com.hk/news/hkexnews/0306news.htm>.

in the stock exchange that could allow them to influence the stock exchange's policies, theoretically to make management be lenient toward them. But this concern should not loom too large: First, with many of them in financial need and looking for capital to invest in new technologies, the share of members in the exchange will probably sink over time, as mainly non-broker-dealers will buy the offered shares. Second, and this is probably the most important reason, their position as stockholders is much weaker than as members, so demutualization reduces the threat of undue member influence rather than increasing it. And last but not least, as for all conflicts, demutualization and listing do not affect the stock exchange's obligations under the Securities Exchange Act and the oversight by the SEC thereunder. It is therefore not likely that publicly traded stock exchanges generally will under-regulate their members. (The arguments of the previous section against general under-regulation also apply.)

Matters change if the issue is not about the regulation of the broker-dealers in general, but about one or a few broker-dealers with a huge share. We can extend this to regulated issuers that hold large shares, such as listed financial holding companies. Let us assume that such a regulated broker-dealer or issuer holds thirty percent of the stock exchange. Now, management is in a significant personal conflict of interest, because if management displeases this major stockholder, its days are numbered. This leads to a material conflict of interest, one whose dimension is entirely different from a conflict over whether the stock exchange could be tempted to under-regulate good customers: First of all, customers are unlikely to have a share in revenues as large as stockholders have in the exchange's equity. Second, displeasing customers threatens management only indirectly, if at all. Displeasing controlling stockholders, on the other hand, creates a direct threat to management, as this shareholder might use the very next chance to oust them.

In this constellation, the watchful eyes of the SEC and the market (both of which know of the large stockholder due to reporting requirements) would not be sufficient to mitigate the conflict, that is to avoid the risk of under-regulation of large stockholders, as outsiders can only see what is presented to them. But whether the stockholders get special treatment such as extended deadlines or favorable surveillance is not always visible to someone who is not on-site.

One of the proposals to mitigate conflicts of that type is to set forth restrictions and limits for ownership in stock exchanges.³³² As explained later, such strict ownership rules would not be good policy, because they might prevent ownership structures that are desirable both from a regulatory and a competitive standpoint.³³³ Under the regime that this Article proposes, there would not be such a conflict of interest at all, because the

332. See Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,143-46.

333. See *infra* Part IV.C.

regulatory arm of the stock exchanges would report to the SEC and not to management.³³⁴ Management would have no influence over the regulation of stockholders, with the consequence that large stockholders would not have a reason to threaten and to oust them, as a new management could not do anything about it either.

D. *Regulating Competitors*

Significant conflicts of interest arise whenever stock exchanges regulate competitors and thereby, as stated at the outset of this Article, pass judgment on a competitor's cause, the constellation that we should probably be most worried about. Although the conflicts that arise with regulating competitors also occur in cases of mutual stock exchanges (because such exchanges also want to maintain or improve their competitive position), the pressure of stockholders to deliver profits may boost the incentive to treat rivals unfairly, and the tendency of for-profit exchanges to expand their businesses may create more opportunities for discrimination than would exist in a traditional stock exchange.

Stock exchanges have plenty of ways to treat competitors unfairly, such as by delaying regulatory decisions, imposing unjustified sanctions, excessive fees and fines, and, generally, by exaggerating surveillance. Especially in the case of competing issuers, halting the trading in stocks of a competitor for an unreasonable period of time or without reasons may be quite damaging.³³⁵ That the competitors can appeal such actions and sue the stock exchange is no adequate remedy, as it will often be very difficult to prove the stock exchange's bad motivations, especially in the many cases where stock exchanges have broad discretion. Moreover, it is probably not a good idea to sue the exchange, considering the bad publicity that comes with the lawsuit regardless of its outcome. Last, but not least, threatening to leave the exchange will only be an option in a few cases, as there often will be no adequate, alternative marketplace. Consequently, in most cases, competitors will be almost unprotected against the stock exchange's conduct. Opportunities to discriminate against competitors can be observed both in the context of trading regulation,³³⁶ as well as for issuer regulation.³³⁷

1. Trading Regulation

Any broker-dealer that competes for listings or transactions will bring the stock exchange that regulates the broker-dealer into significant conflicts of interest. One of the most common areas for such conflicts may be broker-dealers that engage in in-house crossing, i.e., that match orders without

334. See *infra* Part IV.B.2.

335. For the power to halt trading, see, e.g., NYSE, Inc., *supra* note 34, § 202.07.

336. See *infra* Part III.D.1.

337. See *infra* Part III.D.2.

routing them through the national market system, or organize other markets that compete with the stock exchange. Stock exchanges have considerable incentives here for unfair regulation, and the SEC has already been faced with such a case.³³⁸

Aside from stock exchange members that happen to organize a competing market, there might be conflicts with organizers that normally would not be interested in being a member of a stock exchange, but that are nonetheless driven into the stock exchange's hands as a consequence of the regulatory environment. Under the SEC's Regulation ATS, organizers of alternative marketplaces can choose whether they want to be regulated as national securities exchanges or as broker-dealers.³³⁹ The rationale behind this requirement is to provide for an oversight of alternative trading systems within the traditional regulatory framework, without the need to establish a regulatory framework just for that type of market organizer. If they opt to become regulated as broker-dealers, alternative trading systems are required to become members of a self-regulatory organization,³⁴⁰ which means in practice either the NASD or a national securities exchange. If an alternative trading system—for whatever reason—does not want to be subject to NASD regulation, its only option is to become a member of a national securities exchange, which creates the opportunities for unfair treatment that are the subject of this section.

Recent history gives us a good example (although the story finally ended in a different way): Nasdaq was, at least temporarily, thinking about leasing a seat at the New York Stock Exchange,³⁴¹ as the SEC saw insurmountable conflicts of interest if the NASD, Nasdaq's former parent company, continued supervising Nasdaq.³⁴² As a lessee at the New York Stock Exchange, however, Nasdaq would have been subject to the New York Stock Exchange's broker-dealer regulation, which would have allowed Nasdaq to cut all ties with the NASD. Changing from the NASD, however, to the New York Stock Exchange might have been like jumping out of the frying pan and into the fire. From a regulatory standpoint, the Nasdaq Stock Market probably would have been better regulated by the New York Stock Exchange than by the then-partisan NASD; from a competitive standpoint, however, such a move would have been quite questionable.

338. Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,262 (Dec. 8, 2004).

339. Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,130-31 (Dec. 8, 2004).

340. See Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2000).

341. See Aaron Lucchetti, *Nasdaq, Snapping Up a Bargain, Leases NYSE Seat For Brut Unit*, Wall St. J., Feb. 9, 2005, at C3.

342. See *id.*

2. Issuer Regulation

The potential conflicts of interest caused by the regulation of competitors are even greater with respect to issuers. Whereas the number and the business scope of broker-dealers is naturally and by law limited, issuers that are listed on a stock exchange can be engaged in any type of business. This means that there can be issuers competing in all the businesses that the stock exchange itself is engaged in.

To the extent that demutualized U.S. stock exchanges expand their business (e.g., into derivatives trading, clearing, settlement, index services) the opportunities for unfair issuer regulation will increase dramatically. Europe might offer here a glimpse into the future, with Deutsche Börse probably being the best example. According to its investor relations website,

Deutsche Börse AG is far more than a German stock exchange—it is a transaction service provider which affords companies and investors access to the global capital markets by means of advanced technology. With its product and service portfolio, covering the entire process chain from front to back office of its customers, Deutsche Börse has a far wider basis than all its competitors.³⁴³

With each additional business sector, there will be more competitors, and more conflicts of interests.

Nasdaq listed on the New York Stock Exchange is only the easiest and most obvious example in this category. Australia has seen a more complex constellation in the takeover battle for the Sydney Futures Exchange,³⁴⁴ a case that nicely illustrates the potential conflicts. The Australian Stock Exchange, then already a demutualized and self-listed stock exchange, made a bid for the Sydney Futures Exchange, a derivatives market.³⁴⁵ So

343. Deutsche Börse Group, Investor Relations, http://deutscheboerse.com/dbag/dispatch/en/kir/gdb_navigation/investor_relations? (last visited Feb. 25, 2006).

344. See IOSCO on Exchange Demutualization, *supra* note 7, at 16-17. For general information about the Sydney Futures Exchange, see Sydney Futures Exchange, <http://www.sfe.com.au> (last visited Feb. 25, 2006).

345. Press Release, ASX, ASX and SFE (Dec. 22, 1998), *available at* http://www.asx.com.au/about/shareholder/announcements/AA221298b_AS3.htm; Press Release, ASX, ASX & SFE Merger (Aug. 3, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA030899_AS3.htm [hereinafter Press Release, ASX & SFE Merger]; Press Release, ASX, ASX & SFE Merger (July 29, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA290799_AS3.htm; Press Release, ASX, ASX and SFE Merger (June 17, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA170699a_AS3.htm; Press Release, ASX, ASX & SFE Merger (May 19, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA190599_AS3.htm [hereinafter Press Release, ASX & SFE Merger 2]; Press Release, ASX, ASX & SFE Merger—Progress Report (Feb. 19, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA190299_AS3.htm; Press Release, ASX, ASX and SFE Merger Proposal (Apr. 27, 1999), *available at*

did Computershare Ltd., a company that offers share registry and provides financial market services.³⁴⁶ A problem arose because Computershare Ltd. was (and still is) listed on the Australian Stock Exchange and therefore was subject to its regulatory powers. In other words, a stock exchange was competing with one of its regulated issuers for the takeover of a third company, a conflict of interest that the affected parties took very seriously. Finally, the Australian Securities and Investments Commission (the Australian Stock Exchange's regulator), the Australian Stock Exchange, and Computershare Ltd. entered into an agreement that addressed the conflict of interest.³⁴⁷ Under this arrangement, the Australian Stock Exchange was, for the period of the takeover battle, forced to consult with the Australian Securities and Investments Commission before making any regulatory decision as to the listing of Computershare.³⁴⁸ Eventually, for reasons that are not relevant here, neither acquired the Sydney Futures Exchange.³⁴⁹

However, the story gives us a further example of the possible conflicts: The Sydney Futures Exchange itself subsequently went public, and has been listed on the Australian Stock Exchange since April 2002. The problem here is that the Australian Stock Exchange, notwithstanding its failed takeover, also organizes a market for derivatives, and in this regard competes with the Sydney Futures Exchange. To avoid conflicts of interest with regard to Computershare and other competitors, the Australian Securities and Investments Commission was empowered to step in and perform the functions that are normally conferred upon the Australian Stock Exchange.³⁵⁰

Although the United States is late in the process of demutualization and listing of stock exchanges, there are already some early problems. For instance, the Pacific Exchange, then part of Archipelago, traded options on

http://www.asx.com.au/about/shareholder/announcements/AA270499_AS3.htm; Press Release, ASX, ASX Announces Revised \$260 Million SFE Merger Proposal (June 11, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA110699_AS3.htm; Press Release, ASX, Merger Proposal (June 3, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA030699_AS3.htm [hereinafter Press Release, Merger Proposal]; Press Release, ASX, Merger Proposal (May 25, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA250599_AS3.htm.

346. For general information, see Computershare, <http://www.computershare.com.au> (last visited Feb. 25, 2006). For the responses of the Australian Stock Exchange to Computershare's bid, see Press Release, ASX & SFE Merger 2, *supra* note 345; Press Release, Merger Proposal, *supra* note 345; Press Release, ASX & SFE Merger, *supra* note 345.

347. Press Release, ASX, ASIC/ASX/Computershare Agreement (May 28, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA280599_AS3.htm.

348. *See id.*

349. For the withdrawal of the Australian Stock Exchange, see Press Release, ASX, ASX & SFE Merger (Aug. 13, 1999), *available at* http://www.asx.com.au/about/shareholder/announcements/AA130899_AS3.htm.

350. Carson, *supra* note 8, at 16.

Instinet,³⁵¹ the alternative trading system that was competing with the Pacific Exchange's and Archipelago's stock market. Admittedly, the possible conflicts of interest in the supervision of the trade in options are smaller than in the case of stocks, but there are some possibilities for unfair influence. Furthermore, Instinet was traded on the Nasdaq Stock Market, again a competitor, which ultimately bought Instinet.

Under the regime that this Article proposes, such conflicts would be mitigated by separating the stock exchange's regulatory arm from its business operations, so that management has no opportunity to discriminate against competitors.

E. *Regulating Oneself*

When stock exchanges demutualize and go public, they have to make another fundamental decision: Where should the exchange's own stocks be traded, i.e., on which market should the exchange itself be listed? Consider the New York Stock Exchange as an example: Now that it has become a publicly traded company, called NYSE Group Inc., where should its stocks be traded?

The answer seems obvious—predominantly on its own market. Just as auto producers use their own cars on their premises, airline employees their own flight connections, and computer producers their own laptops, so can stock exchanges use their own markets to list their shares. And—not surprisingly—all demutualized stock exchanges have listed their stock or the stock of their holding companies on their own markets, usually referred to as self-listing.³⁵² Examples of self-listing include Archipelago and Nasdaq (although before it became a stock exchange) as well as the Australian Stock Exchange, the Frankfurt Stock Exchange (Deutsche Börse), Euronext N.V., the London Stock Exchange, OMX Group, and the Stock Exchange of Hong Kong (Hong Kong Exchanges and Clearing Limited).

Self-listing raises questions as to whether the stock exchange will be impartial enough to apply the regulatory framework to itself the same way it does to others. This question leads back to the notion expressed in the first paragraph of this Article: No one shall judge in her own cause.

Like previous parts, the following discussion distinguishes between conflicts that arise in the context of trading regulation³⁵³ and issuer regulation.³⁵⁴

351. The trading began in 2001. See Press Release, Pac. Exch., Pacific Exchange to Trade Options on Instinet Group Incorporated and USEC, Inc. (May 30, 2001), available at http://www.pacificex.com/news/press/press-2001/opt_press_01_instinet_usec.html.

352. IOSCO on Exchange Demutualization, *supra* note 7, at 8; Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,132, 71,151 (Dec. 8, 2004).

353. See *infra* Part III.E.1.

354. See *infra* Part III.E.2.

1. Trading Regulation

The first set of conflicts of interest arises in the regulation of the trading in the stock exchange's stock. These conflicts are related to two separate regulatory powers of stock exchanges: the power over the broker-dealers and the power over the trading as a whole, known as market surveillance.

Stock exchanges might misuse their broad powers over broker-dealers in order to influence positively the trade in their own stocks, e.g., by apparently increasing the trading volume through "wash sales,"³⁵⁵ by measures to artificially stabilize the price, or by discouraging trading practices that are presumed to have negative impacts on the stock price, such as short sales. Most susceptible to undue influence by the stock exchange is probably the specialist that oversees the trading in the stock exchange's stocks, because this particular broker-dealer is not only subject to the stock exchange's regulation, but can also be influenced by the stock exchange's management if the latter threatens to choose another specialist (an option, concededly, that is open to any issuer).³⁵⁶

Among the general powers of stock exchanges over the market, one might think that the stock exchanges' authority to halt, delay, and resume the trading in stocks might be troublesome, especially with regard to companies that have material news pending.³⁵⁷ These powers seem to give opportunities for self-preferential treatment, for example if the stock exchange's management delays a halt in the trading of their stocks so that they can sell (bad news) or buy (good news) in advance of the news release. Such conduct, however, is not limited to publicly traded stock exchanges; any member of management can commit such securities fraud (to give it a proper name) by not disclosing the information to the stock exchange, and trading to its own advantage.

More worrisome is probably the authority to decide on delistings,³⁵⁸ an area where the stock exchange's power can be based on both the listing rules³⁵⁹ and the trading rules.³⁶⁰ Limiting the discussion here on the latter, stock exchanges may refrain from delisting their shares even though their trading rules require it, most importantly because the trading volume is too low. The risk of unfair decision is increased in this area by the wide discretion that stock exchanges have in delisting decisions.³⁶¹

355. Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,151.

356. For the New York Stock Exchange's specialist, see *NYSE Chooses Bear Wagner as Its Specialist*, Wall St. J., Jan. 7, 2006, at B13.

357. See, e.g., NYSE, Inc., *supra* note 34, § 202.07.

358. For a comprehensive overview, see Jonathan Macey et al., *Down and Out in the Stock Market: The Law and Economics of the Delisting Process* (Apr. 2005) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=583401.

359. See, e.g., NYSE, Inc., *supra* note 34, § 801.00.

360. See, e.g., NYSE, Inc., Rule 499 (removed and rescinded as of May 5, 2005).

361. See, e.g., *id.* Rule 499.10 (removed and rescinded as of May 5, 2005).

None of the conflicts discussed in this subsection arise when the stock exchanges' regulatory arm is separated and reports to the SEC, as proposed later herein.

2. Issuer Regulation

Conflicts related to the issuer regulation of self-listed stock exchanges are the core problem of self-listing, and they will not be solved just by separating the regulatory arm.

As explained earlier, issuer regulation is based on listing agreements into which the stock exchanges enter with the issuers.³⁶² Such agreements lay down the whole set of listing requirements with which issuers have to comply when they are listed on the stock exchange, not only for the initial listing process but on an ongoing basis (even though the powers of stock exchanges to enforce the listing rules are not regulatory powers in a literal meaning, but based solely on the contract with the issuer).

For several reasons, listing requirements for self-listed stock exchanges cannot be governed by traditional listing agreements. So far, commentators have questioned whether stock exchanges will "negotiate listing agreements with themselves and then supervise continuing compliance with such agreements."³⁶³ Those concerns that the stock exchanges will not honor the listing agreements are probably warranted, but perhaps on slightly different grounds. Stock exchanges cannot enter into listing agreements with themselves, because no one can make a contract with oneself. It does not work. You cannot establish a claim against yourself. Of course, that is a very technical aspect, a problem that might be easy to solve. For example, stock exchanges might publicly announce that they are bound to their listing rules, so that they will be constrained by public scrutiny to follow those rules, instead of following a contractual obligation. But there remain a couple of problems that are not so easy to overcome. To begin with, a considerable number of listing rules are subject to individual negotiation. That is why parties normally enter into individual listing agreements instead of using the same set of rules for all issuers. Who is going to "negotiate" them? While we sometimes engage in spirited debates over transactions that might or might not be entered into at arm's length, this is a situation here where only one arm is involved, so to speak.

Even if we overcome all those procedural problems, there remains one substantive point, the core problem: Most of the normal listing rules would, literally applied to stock exchanges, not make any sense. Why should the stock exchange, as an issuer, submit annual and interim reports to itself, the stock exchange as the regulator?³⁶⁴ Why should the stock exchange, as issuer, give notice about important developments to itself, as the

362. For an example of the basic structure of listing agreements, see NYSE, Inc., *supra* note 34, § 901.01-.05. For an overview of issuer regulation, see *supra* Part III.A.3.

363. Karmel, *Turning Seats into Shares*, *supra* note 11, at 421.

364. For this obligation, see, e.g., NYSE, Inc., *supra* note 34, § 203.00.

regulator?³⁶⁵ There are dozens of such notice obligations, particularly for charter and by-laws amendments³⁶⁶ and various material changes, such as with regard to directors and officers,³⁶⁷ the auditor,³⁶⁸ or the business purpose.³⁶⁹ All these reporting requirements make sense if the issuer is not the stock exchange. But reporting to oneself is like a soliloquy, even if there is some sort of separation. Is there any sense in reporting a change of directors within the same company? Is there any benefit in delivering the annual report from one department to another?

It is important to note that, unlike in other contexts, the question here is not whether we can trust the stock exchanges to examine their own reports as thoroughly as the reports of the other issuers. Much of the benefit gained from reporting requirements is connected to the fact that material information gets from inside the company to outsiders, people who are not in any way affiliated with the company, so that an outsider puts a watchful eye on the information. All that is lost if a stock exchange reports to itself.

Not so important are the problems that arise with respect to listing fees, which are normally part of the listing agreement.³⁷⁰ At first view, it might raise competitive concerns if the stock exchange charges its competitors higher fees than it charges itself. But at a closer look, it does not matter what fees the stock exchange itself pays because they are merely transferred from the left pocket into the right pocket. From a regulatory and a competitive viewpoint, self-listing fees do not matter (although they might from an accounting and tax viewpoint).

Last but not least, regulatory concerns arise in the context of the termination of the listing. Stock exchanges have the power at any time to suspend listed stocks from dealing ("delisting"). As already mentioned, this power has two foundations: It can be based on both the listing rules³⁷¹ and the trading rules.³⁷² Stock exchanges may be tempted to allow themselves an easy way to delist that is not available for other issuers.³⁷³

On balance, the usual listing agreement regime does not work for self-listed stock exchanges. Since the main reason for that is the lack of outside control, any proposal to tighten the requirements placed on stock exchanges when regulating themselves misses the point. Instead, later parts of this Article put forward the idea of mandatory dual listing for stock exchanges. Implementing this would allow a competent outsider, another stock exchange, to have a closer look at the exchange. And there is no concern

365. See, e.g., *id.* §§ 204.00-33.

366. See, e.g., *id.* § 204.03.

367. See, e.g., *id.* § 204.14.

368. See, e.g., *id.* § 204.05.

369. See, e.g., *id.* § 204.06.

370. See, e.g., *id.* §§ 701.02, 902.00.

371. See, e.g., *id.* § 801.00.

372. See, e.g., NYSE, Inc., Rule 499 (removed and rescinded as of May 5, 2005).

373. Cf. Fleckner, *supra* note 175, at 16-17 (discussing the problems of foreign issuers leaving the U.S. securities markets, which requires not only delisting but also deregistration).

about bias—under the proposed regime, the regulatory arm of the other stock exchange would report to the SEC if it is itself a publicly traded stock exchange.

F. *Regulating Affiliates*

A variant of the foregoing problems is the regulation of affiliates of the stock exchange, most importantly parent companies or subsidiaries, which the exchange might be tempted to favor over other entities. By nature, the incentive for the stock exchange's management to under-regulate such affiliates is greater in the case of the regulation of the parent company, because the managers are personally affected insofar as their days as managers of the subsidiary are numbered if they fail to please the parent company's management.

The problems that arise in this context are similar to those concerning regulation of the stock exchange itself, and inverse to those concerning regulation of competitors. If the affiliate is listed on the stock exchange, both parties—the stock exchange and its affiliate—can formally enter into listing agreements. Such a contract between “friends,” however, is probably not of much worth. The proposed solution to conflicts arising from listing affiliates is the same as for those arising from self-listing: mandatory dual listing for the affiliates on another market and establishment of a separate regulatory arm that reports to the SEC.

The same is true with respect to the regulation of members and trading (needless to say, dual listing does not help in this regard). The recent mergers and acquisitions give a nice illustration of the problems involved. Archipelago Holdings, the parent company of the Archipelago Exchange, wholly owned a brokerage firm, Wave Securities.³⁷⁴ This raised regulatory concerns for two reasons: Wave Securities would have been subject to the regulation by the regulatory arm of the Pacific Exchange, which became a subsidiary of Archipelago last year, with the result that Wave would have been regulated by an affiliated body. When Archipelago merged with the New York Stock Exchange, the same problem would have happened at an additional venue: Wave Securities would also have been subject to regulation by the New York Stock Exchange, its direct or indirect parent company. Both constellations would have created tensions from a regulatory point of view. Accordingly, it is not surprising that one of the first things announced concerning the merger was the plan to sell Wave Securities.³⁷⁵ At any rate, this might be a wise decision to avoid critiques of the merger, regardless of whether it is also a wise business decision. Under the proposed regulatory regime, however, such a move would not

374. For general information, see Wave Securities, <http://www.wavesecurities.com> (last visited Feb. 25, 2006).

375. See Aaron Lucchetti, *NYSE, Archipelago Face Hurdles On Road to Combined Company*, Wall St. J., May 2, 2005, at C3; see also *Merrill to Buy Archipelago Unit*, Wall St. J., Jan. 24, 2006, at C5.

have been necessary, for the regulatory arm of the New York Stock Exchange would be separated anyway and report to the SEC.

G. *Nonregulation (Anticompetitive Behavior)*

“Congress in effecting a scheme of self-regulation designed to insure fair dealing cannot be thought to have sanctioned and protected self-regulative activity when carried out in a fundamentally unfair manner.”³⁷⁶ Thus said the U.S. Supreme Court when dealing with anticompetitive behavior by the New York Stock Exchange. Compare that statement with the following:

The Exchange has broad discretion regarding the listing of a company. . . . [T]he Exchange may deny listing or apply additional or more stringent criteria based on any event, condition, or circumstance that makes the listing of the company inadvisable or unwarranted in the opinion of the Exchange. Such determination can be made even if the company meets the standards set forth below.³⁷⁷

This excerpt is an official statement of the New York Stock Exchange, made in the introduction to the New York Stock Exchange's Listed Company Manual. The Exchange states that it has broad discretion and that it may deny listing even if the applicant company meets the requirements of the listing rules.³⁷⁸

That creates significant problems. So far, the Article has dealt with conflicts of interest in the regulation of stockholders, competitors, the exchange itself, affiliates, and in general. In contrast to those cases, the problem discussed in this section is not that the stock exchange may unfairly regulate, but that it may, by rejecting the listing application, refuse to regulate at all. This is not a regulatory problem but a competitive and macroeconomic one. Let us assume Nasdaq files an application for a listing on the New York Stock Exchange. Let us, to dramatize matters, assume that Nasdaq together with its listing promotes new shares with the outlook of investing in a new trading system that will poach the issuers and traders on the New York Stock Exchange. Is the New York Stock Exchange free of conflicts of interest when it decides on the Nasdaq Stock Market's listing application? Can the New York Stock Exchange reject the application without cause? Or would the competitive threat even be a reasonable cause? Similar problems arise in regard to a delisting; the stock exchange has broad discretion in either case.³⁷⁹ And finally, with the traders no longer the owners of the marketplace, stock exchanges might use their

376. *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 364 (1963).

377. *NYSE, Inc.*, *supra* note 34, § 101.00.

378. For the listing application procedure, see *id.* § 701, for the listing agreements, see *id.* § 901, and for the application forms, see *id.* § 903.

379. See, e.g., *id.* § 801.00.

oligopoly or even monopoly powers to seek extra rents from its main customers and former owners, the brokers and dealers.³⁸⁰

These are all considerable problems that, however, must be solved by antitrust law.³⁸¹ They are not so much regulatory problems, because the issue is not unfair regulation but unfair denial of regulation or misuse of economic power. Consequently, the regulatory proposal that is put forward in the next part does not address these problems. Interestingly, the European Union recently partly solved the problem by transferring all listing decisions to agencies independent from the stock exchanges and other market participants.³⁸²

H. Other Conflicts of Interest

While the previous sections have mentioned various conflicts of interest in the world of demutualized for-profit stock exchanges, there are many more conflicts that could and should be addressed. So far, this Article has been limited to stock exchanges and the listing of stock (or equity). Exchanges, however, can list several other types of securities, such as bonds or derivatives, with the latter being a more common example.³⁸³ As mentioned earlier, worldwide stock exchanges, in increasing numbers, list derivatives or are affiliated with derivatives exchanges. Even the New York Stock Exchange has considered trading bonds, exchange-traded funds, and derivatives.³⁸⁴ In all these cases, the conflicts related to self-listing and regulating competitors arise in a similar manner, although generally to a lesser extent, considering the fewer regulatory powers in this area. We have already seen a prominent example in the United States of a case of this type: The Pacific Exchange (part of Archipelago) trades options on Instinet,³⁸⁵ the alternative trading system that competes with Archipelago's stock market (and has recently become part of Nasdaq). Aside from its influence on the trading in these options, it is completely up to the Pacific Exchange to determine what kind of options it offers, such as puts or calls, so that the exchange could favor options for trading strategies that cause problems for the trading in Instinet's equity shares.

380. For an early contribution to the widely neglected discussion, see Lee, *The Future of Securities Exchanges*, *supra* note 4, at 21-23.

381. Antitrust cases are not unfamiliar in this field, considering the New York Stock Exchange's monopoly power. See, e.g., *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659 (1975); *Silver v. N.Y. Stock Exch.*, 373 U.S. 341 (1963).

382. Council Directive 2003/71, art. 21, 2003 O.J. (L 345) 64, 79 (EC). Sentence 3 of subsection (1) of article 21 reads as follows: "These competent authorities shall be completely independent from all market participants." *Id.*

383. Bonds are usually traded on unregulated markets. See Coffee & Seligman, *supra* note 21, at 15. But there is no reason why liquid bonds should not be traded on stock exchanges, and indeed to some extent they are, particularly in Europe. As the following remarks in the text reveal, U.S. stock markets are also about to expand their trading into the bond market.

384. See *supra* note 185 and accompanying text.

385. Press Release, Pac. Exch., *supra* note 351.

Many other conflicts of interest may also arise if, as is likely, the stock exchanges diversify and engage in other businesses. Such expansion has already been identified as conflict-increasing, because it leads to more competitors that may be unfairly treated. There is a second dimension. Stock exchanges may use their powers over issuers and broker-dealers to compel them to use the exchange's other services, such as clearing and settlement.³⁸⁶ Again, however, this is less a regulatory problem than an antitrust issue, and is therefore beyond the scope of this Article.³⁸⁷

Worrisome from a regulatory standpoint, however, are cases in which stock exchanges abuse their powers over regulated entities and force them to further the stock exchange's policy interests. The recent conflict about the new National Market System nicely illustrates the concern. The New York Stock Exchange through mass emails contacted the listed issuers to ask them to support the New York Stock Exchange's position.³⁸⁸

IV. AMENDMENTS TO THE REGULATORY REGIME

Demutualization and subsequent listing of stock exchanges requires our greatest attention. The progress alone does not, however, require greater changes to the regulatory system, as the challenges that come with the new organizational structure of stock exchanges are manageable. (Whether an overhaul of the traditional system might be advisable for other reasons is out of this Article's scope.)

This Article puts forward a simple proposal that seems sufficient to address the emerging problems without overly hindering stock exchanges or throwing overboard the traditional regulatory system: First, the regulatory arm of the stock exchanges should be separated from the other business units. Second, this separated regulatory arm should not report to the board of directors of the stock exchange, but rather to the SEC. Third, self-listed stock exchanges and their affiliates should be required to have a second listing at another stock exchange.

The argument commences with introductory remarks on the desirability and extent of regulation,³⁸⁹ then introduces the proposed regulatory

386. See generally Group of Thirty, *Global Clearing and Settlement: A Plan of Action* (2003).

387. Such anticompetitive behavior, however, is not so unlikely. For instance, the New York Stock Exchange forbade their members to trade at other marketplaces entirely until 1975, and to a lesser degree until 2000. See NYSE, Inc., Rule 390 (removed and rescinded May 5, 2000). Interestingly, then-Chairman of the SEC Arthur Levitt doubted that "such an anticompetitive rule" could be sustained when the New York Stock Exchange demutualizes. See Levitt, *supra* note 84, at 10; see also *The Changing Face of Capital Markets and the Impact of ECN's*, *supra* note 84.

388. See Aaron Lucchetti, *Big Board Still Carries a Big Stick*, Wall St. J., Apr. 5, 2005, at C1.

389. See *infra* Part IV.A.

regime,³⁹⁰ and finally discusses why this proposal is superior to other approaches.³⁹¹

A. Introductory Remarks

Any proposal of a regulatory framework for demutualized and publicly traded stock exchanges touches upon the general question of how much regulation of stock exchanges is desirable. The chief regulatory officer of the New York Stock Exchange perhaps captured best what we must be able to expect: "If self-regulation is going to work, it must show that our decisions are irrelevant to whether it helps or hurts the [New York Stock Exchange] as a business."³⁹²

The offered proposal aims at nothing more than mitigating the conflicts of interest so that the impartiality of stock exchanges remains above doubt, without overly hindering the management of the stock exchanges. Demutualization and subsequent public listing are critical to help stock exchanges compete with other marketplaces, but overly regulating publicly traded stock exchanges, which would be the result of some institutions' and commentators' proposals, would erase the intended positive effects, cause the entire restructuring to be questioned, and cement the U.S. stock exchange's passive role in the worldwide consolidation, a result that by no means would be good policy. Therefore, when discussing the new regulatory environment for demutualized for-profit exchanges, we should be careful with regard to the regulatory intensity that we want to employ.

In a general remark in favor of deregulation, Alan Greenspan, until recently the chairman of the Board of Governors of the Federal Reserve System, said some forty years ago in one of his early works, "[I]t is in the self-interest of every businessman to have a reputation for honest dealings and a quality product. . . . Reputation, in an unregulated economy, is thus a major competitive tool."³⁹³

The "quality product" that stock exchanges (the "businessman" in Greenspan's words) offer is organizing and regulating a market for stocks. Is selling this product like selling bread?³⁹⁴ Is the incentive to sell the best bread to the investing customers big enough to abandon or at least reduce the regulation of stock exchanges by the SEC? Some commentators think so³⁹⁵—and not surprisingly the stock exchanges share this view.³⁹⁶ They believe, as Greenspan suggested in his early work, that the competition for investors will constrain the stock exchange's management and let management focus on the stock exchange's most valuable asset: integrity.

390. See *infra* Part IV.B.

391. See *infra* Part IV.C.

392. Der Hovanesian, *supra* note 222, at 84 (quoting Richard G. Ketchum).

393. Alan Greenspan, *The Assault on Integrity*, Objectivist Newsletter, Aug. 1963, at 31, 32.

394. The bread example is taken from Mahoney, *supra* note 33, at 1459.

395. See *generally id.* (significantly titled "The Exchange as Regulator").

396. World Org. of Exchs., *supra* note 306, at 7; see also Carson, *supra* note 8, at 11.

In this belief, these commentators argue in favor of more regulatory powers for stock exchanges and less governmental involvement. But there are also opponents of more regulatory power on the stock exchange level.³⁹⁷ One such opposing argument is that local stock exchanges are hardly able to regulate the market in the age of globalization, with issuers and traders based all over the world.³⁹⁸ Another, also not entirely unwarranted, concern is that stock exchanges may abuse their regulatory powers for anticompetitive behavior.³⁹⁹ And finally, perhaps the strongest point, the stock exchange's track record is not above doubt.⁴⁰⁰ For stock exchanges that have already lost their reputation, there is no reputation at stake, a point that is sometimes neglected.

For the purposes of this Article, however, that discussion is somewhat outdated and therefore only briefly summarized. Contributions so far have mainly been based on the assumption that stock exchanges are organized in the mutual form, with many commentators not (yet) having considered that stock exchanges may demutualize and go public. Moreover, it is beyond the purpose of this Article to discuss whether the current system as a whole—most importantly the concept of self-regulation—is good policy, and if so, to what extent.⁴⁰¹ Rather, the amendments put forward in this Article go only so far as necessary to address the challenges that come with demutualization.

Before the Article turns to these proposed amendments, it might be advisable to recapitulate and to emphasize that the current system of mutual stock exchanges is all but free of the conflicts associated with demutualized exchanges (except for self-listing, which is a new conflict).⁴⁰² And in addition, there are considerable conflicts of interest under the current

397. See generally Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *Fordham L. Rev.* 1855 (1997); Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 *Va. L. Rev.* 1509 (1997) (arguing against more power on the stock exchange level); Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 *Wash. & Lee L. Rev.* 853 (1985) (providing an earlier example of an argument against more power on the stock exchange level).

398. *But see* Karmel, *Turning Seats into Shares*, *supra* note 11, at 370, 427 (coming to the contrary conclusion). However, if the national authorities, such as the SEC, cannot accurately regulate in the age of globalization, as she argues, how can the stock exchanges? Put differently, if a governmental agency—the SEC—cannot collaborate with foreign financial market authorities, why should the private stock exchange be able to do so?

399. See, e.g., *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659 (1975); *Silver v. N.Y. Stock Exch.*, 373 U.S. 341 (1963).

400. See *supra* Part III.A.3.

401. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 *Fed. Reg.* 71,256 (Dec. 8, 2004); *Sec. & Exch. Comm'n, Market 2000: An Examination of Current Equity Market Developments* (1994); see also Securities Industry Association, *supra* note 32. For a discussion in a broader context, see Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 *Theoretical Inquiries in L.* 649 (2001) (discussing the allocation of regulatory power in the area of corporate law, securities regulation, and the regulation of financial institutions).

402. See Concept Release Concerning Self-Regulation, 69 *Fed. Reg.* at 71,259-75.

system that would be solved under the new structure, particularly between the exchange and its members, and among the members themselves.⁴⁰³ Congress knew of these conflicts of interest when it enacted the regulatory system in 1934. They seemed inevitable but outweighed by the benefits of vesting regulatory power with the stock exchanges.⁴⁰⁴ Of course, we should not be indifferent toward conflicts of interest only because they have always existed; but with the legislative and regulatory history in mind, we should be confident that we can handle the challenges that come with demutualization without questioning the whole system, and without trying to mitigate all possible conflicts.

B. Elements of the Proposed Regime

The proposed regulatory regime for publicly traded stock exchanges has three prongs: segregation of the regulatory arm from the business operations,⁴⁰⁵ reporting to the SEC,⁴⁰⁶ and mandatory dual listing for stock exchanges and affiliates.⁴⁰⁷

1. Segregation of the Regulatory Arm

Publicly traded stock exchanges should separate their regulatory arm from the other business units. Though details differ, there seems to be a broad consensus for such segregation,⁴⁰⁸ and there is already some experience with such a move. The Stock Exchange of Hong Kong, for instance, spun off its regulatory arm with demutualization,⁴⁰⁹ and the New York Stock Exchange had taken steps in that direction as part of its corporate governance overhaul, and again announced that it would further separate its regulatory arm as part of the merger of Archipelago and the subsequent going public.⁴¹⁰

The proposed separation mitigates all incentives and conflicts that are related to the regulatory intensity in general, the regulation of stockholders, of competitors, of oneself, and of affiliates. It also precludes hidden cross-

403. These conflicts are nicely described by *Grasso Statement*, *supra* note 83. See Schroeder & Smith, *supra* note 164.

404. See Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,132 n.69 (Dec. 8, 2004).

405. See *infra* Part IV.B.1.

406. See *infra* Part IV.B.2.

407. See *infra* Part IV.B.3.

408. Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,141-43; Carson, *supra* note 8, at 17; Levitt, *supra* note 84.

409. See Press Release, HKEx, A Transcript of the Address by HKEx Chairman Charles Lee at the Legislative Council's Financial Affairs Panel (July 31, 2002), available at <http://www.hkex.com.hk/news/hkexnews/0207312news.htm> (describing the spin off).

410. *Keitchum Statement*, *supra* note 223, at 5-6; see also Aaron Lucchetti, *NYSE to Boost Independence Of Regulatory Unit's Board*, Wall St. J., Jan. 21, 2006, at B3; Lucchetti et al., *supra* note 185; Press Release, NYSE & Archipelago, *supra* note 97.

subsidization, which some commentators and organizations are concerned about.⁴¹¹

2. Reporting to the Securities and Exchange Commission

The second prong supplements the segregation of the regulatory arm: The head of the regulatory arm should not report to senior management or the board of directors of the stock exchange, but to the SEC.

The rationale behind this amendment is that separation itself does not change much if the head of the regulatory arm is still responsible to the general management of the stock exchange. Under such a system, the regulatory arm is only one division among others. The conflicts of interest that require the separation are hardly mitigated if the regulatory arm continues to report to senior management. The latter, for instance, could require the regulatory arm to meet the company's income targets, which would make the regulatory arm focus on fines and neglect areas that create little income, regardless of whether this is good policy from a regulatory standpoint.

The stock exchanges themselves are aware of this problem. For instance, as a consequence of its corporate governance problems, the New York Stock Exchange changed its regulatory structure so that the chief regulator now reports to a committee of independent directors instead of the chairman⁴¹²—concededly, a significant improvement over reporting to senior management. If one believes that independent directors are the long-sought-after panacea for various corporate governance issues, one will probably say that reporting to them is sufficient to ensure a proper separation of the regulatory arm from the other business units.⁴¹³ However, if one believes that independent directors are to some degree dependent on management and tend to fraternize with management, reporting to independent directors does not adequately mitigate the conflicts of interest. Particularly in this context, it is questionable whether independent directors will have the necessary regulatory knowledge and understanding of the stock exchange's daily business to qualify as contact persons for reporting abuses of regulatory power.

It seems, therefore, worth considering a requirement that the head of the regulatory arm report to the SEC. This reporting requirement would not give the Commission the power to make any decisions within the stock exchange, concerning, for instance, their hiring of additional regulatory staff. Such decisions should be left to the stock exchange, because there is

411. IOSCO on Exchange Demutualization, *supra* note 7, at 13.

412. Der Hovanesian, *supra* note 85. The New York Stock Exchange wants to keep this structure after its merger with Archipelago. See Press Release, NYSE & Archipelago, *supra* note 97.

413. Fair Administration and Governance of Self-Regulatory Organizations, 69 Fed. Reg. at 71,134-38 (relying on independent directors and committees solely composed of independent directors).

no reason to believe, as explained in earlier sections, that the stock exchange generally will under-regulate or overregulate. The requirement of reporting to the SEC will ensure only that the regulatory staff has someone impartial to whom to report single abuses of regulatory powers, particularly overregulation of competitors and underregulation of oneself and affiliates. The WorldCom case shows us how important it is that employees be able to report to someone who is not part of the corrupt system.⁴¹⁴

To be sure, implementing such governmental intervention requires good reasons. The conflicts of interest that are outlined in Part III are such good reasons. Particularly the conflicts of interest that arise in regard to the regulation of competitors, oneself, and affiliates require a clear separation of business interests and regulatory functions. And it might be advisable to consider that the proposed reporting will not change much, but rather will codify what virtually already exists: If stock exchanges fail to perform their regulatory functions, the SEC can step in under the current system anyway.⁴¹⁵ Taking into account the numerous other powers of the Commission, the reporting requirement is relatively modest. That is particularly true if compared with the frequently supported proposal to entirely outsource the regulatory functions, a proposal that will be considered and questioned later.

3. Mandatory Dual Listing for Stock Exchanges and Affiliates

The first and the second prongs of the regulatory proposal do not entirely address the challenges that come with self-listing. As explained above, the problem here is that stock exchanges cannot enter into a listing agreement with themselves, and even if we find substitutes for surveillance and enforcement, most of the listing requirements would miss their underlying purpose.

To overcome this problem, we should require stock exchanges, along with their affiliates, to choose another market for a second listing (a concept which will be referred to as mandatory dual listing hereinafter). The rule would not apply to stock exchanges and affiliates that do not want to list the stocks on their own market and therefore not rely on self-listing. So for example, if the New York Stock Exchange goes public and also wants to list its stock on its own market, under the proposal put forward it will have to apply for listing at another stock exchange, such as Nasdaq. In the age of globalization, dual listing at a well-organized foreign stock exchange should also fulfill the dual listing requirement, and the SEC could make a list of such eligible foreign exchanges (at least Frankfurt, London, and Paris/Euronext).

414. WorldCom's business "culture" almost entirely suppressed control by employees. See Special Investigative Comm. of the Bd. of Dirs. of WorldCom, Inc., Report of Investigation 18-24 (2003).

415. Securities Exchange Act of 1934 § 21, 15 U.S.C. § 78u (2000); see *id.* § 21(f), 15 U.S.C. § 78u(f).

At first blush, one could counterargue that listing at competing marketplaces is not better than self-listing. To be sure, the second stock exchange faces conflicts of interest when it regulates competitors, particularly if the second stock exchange itself is demutualized and publicly traded, as discussed in earlier parts.⁴¹⁶ Such competitor-regulating stock exchanges, however, would be subject to the first two prongs of the proposed regulatory system: Their regulatory arm would be separated and would report to the SEC, procedures that the Commission could require by foreign stock exchanges if they want to qualify for dual listing.

Concededly, dual listing creates downsides for the stock exchange. First of all, there are listing fees that the stock exchange has to pay to the second exchange. Secondly, the listing on two exchanges might lead to market fragmentation and reduce liquidity. However, there are also benefits of dual listing; otherwise companies would not voluntarily dual list, as some do.⁴¹⁷ Even without such benefits, the downsides of dual listing constitute no basis for rejecting the proposal of mandatory dual listing. If the costs of dual listing are too high, the stock exchange can avoid them by forgoing self-listing and listing solely at another stock exchange—as all companies do that are not stock exchanges. It would be just a cost-benefit analysis of whether the costs of self-listing outweigh the benefits.

Trickier is the problem of fragmentation. It depends on the market structure and the linkages between the stock exchanges whether dual listing will lead to fragmentation at all. If there is evidence that dual listing of stock exchanges indeed leads to fragmented and illiquid markets, the proposed regime would need a slight amendment: It would be sufficient to make dual listing mandatory, rather than dual trading. The rationale behind that distinction is that the regulatory concerns with respect to the regulation of the trading in the stock exchange's own stocks are mitigated by the separation of the regulatory arm and the reporting to the SEC. Therefore, the new regime could allow the stock exchange to be listed at another marketplace but not actually traded there. Based on its dual listing, the stock exchange would be subject to the other marketplace's issuer regulation. But without trading at this marketplace, there would be no fragmentation in the trading of the stock exchange's shares. Put simply, mandatory listing would mean that the shares of stock exchanges are dual listed without being dual traded.⁴¹⁸

416. Bradley sees a problem of listing on a competing market insofar as it might look like a lack of confidence of the market to list its own shares. Bradley, *supra* note 11, at 685, 701. She does not raise any regulatory concerns connected to regulating competitors.

417. Investors profit from dual listing, at least insofar as it increases the competition among stock exchanges, which might lead to better service at lower prices.

418. Interestingly, the temporary but exceedingly successful Neuer Markt of the Deutsche Börse rested exactly on this model: Issuers were listed on the officially regulated market ("Geregelter Markt"), but not traded. Rather, the trading took place on the Neuer Markt. See Andreas M. Fleckner, *Die Lücke im Recht des Devisenterminhandels*, 57 *Zeitschrift für Wirtschafts- und Bankrecht* 168, 171 (2003).

In conclusion, mandatory dual listing for publicly traded stock exchanges and their affiliates is an effective, efficient, and quite simple way to ensure that they are as thoroughly regulated as any issuer.

C. *Argument for the Proposed Regime*

The regulatory system that this Article puts forward amends the current regulatory regime only to the extent that is necessary to address the regulatory challenges that come with demutualization.

A couple of arguments lead this Article to conclude that regulation as such will not suffer from demutualization and listing of stock exchanges, as stock exchanges will have no strong incentive to under-regulate their markets. Therefore, the challenges that need to be addressed are limited to the conflicts of interest that have been identified in Part III as being material: that stock exchanges might abuse their regulatory powers in certain fields to promote their own business and that they might be too soft on themselves and too hard on competitors. Naturally, such specific abuses are harder to detect and prevent than general regulation deficits, particularly if they offset each other, so that the overall regulatory figures like personnel, actions, and fines remain unchanged. But these problems are manageable without overhauling the traditional regulatory system with stock exchanges as frontline regulators.

Under the proposed system, market and issuer regulation would remain in the hands of the stock exchanges. The advantages of self-regulation, particularly the closeness and the expertise of the stock exchanges, would not be lost. Furthermore, leaving the stock exchanges their regulatory powers would allow them to use regulation to place themselves in the competition. Regulation, reputation, and integrity are values that a stock exchange can emphasize, strengthen, and promote—something for which stock exchanges can compete, upon which they can build a brand name. Richard Grasso, the former chairman of the New York Stock Exchange, once said, “The money we spend on regulatory oversight . . . builds equity in our brand . . .”⁴¹⁹ Such statements are found all over the world.⁴²⁰ A critical part of competition would be lost if we outsourced regulation to a single regulator or the SEC.⁴²¹

Another advantage of the proposed regulatory system is that we would not have to be worried if persons that are regulated by the stock exchange

419. *Grasso Statement*, *supra* note 83; see also Greg Ip, *Grasso, Zarb Differ on Self-Regulation of Stock Markets Once They Go Public*, Wall St. J., Sept. 29, 1999, at C17.

420. See, e.g., Humphry, *supra* note 123; see also Press Release, ASX, *World's Stock Exchanges Map Out Action Plan* (Oct. 5, 2000), available at <http://www.asx.com.au/about/pdf/FIBV051000.pdf>.

421. Commentators have proposed partially or completely outsourcing regulation to a new regulatory organization or the SEC. See Der Hovanesian, *supra* note 85 (arguing that merging the regulatory arms of the NASD and the New York Stock Exchange would save \$100 million a year); Dombalagian, *supra* note 63, at 1146-53; Schroeder & Smith, *supra* note 164.

hold a significant share in the stock exchange. Without any amendments one might be worried that the stock exchange may be unwilling to enforce independently and effectively the broker-dealers' and issuers' obligations, if both are the stock exchange's major stockholders.⁴²² Under the proposed regime, however, there would not be such a risk because the regulatory arm would report to the SEC and not to management. This approach is much smoother than the arbitrary ownership restrictions that some commentators and organizations propose, most notably the Commission.⁴²³ Such restrictions are nothing other than poison pills that protect a stock exchange's management against takeovers. They are not in the interest of the stock exchange and its stockholders, because they will increase its capital costs. And they are not in the interest of the economy, because they may prevent efficient ownership structures.⁴²⁴

The smartest move seems to be the mandatory dual listing (which does not necessarily require dual trading). That would be much less onerous than the reporting requirements that the SEC has proposed and those Nasdaq has implemented,⁴²⁵ and it would allow much more flexibility than generally preventing exchanges from listing their shares on their own market. Under the proposed regime, it will be the market that decides whether there is enough trust to trade the shares at the exchange's own market or, if there is reason to question the exchange's impartiality, to trade somewhere else.

CONCLUSION

More than forty years ago, the U.S. Supreme Court held in the widely recognized *Silver* case,

It requires but little appreciation of the extent of the Exchange's economic power and of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail as to every aspect of the Exchange's activities. What is basically at issue here is whether the type of partnership between government and private enterprise that marks the design of the Securities Exchange Act of 1934

422. See *supra* Part III.C.

423. See Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50699, 69 Fed. Reg. 71,126, 71,143-46 (Dec. 8, 2004); see also Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700, 69 Fed. Reg. 71,256, 71,264 n.130 (Dec. 8, 2004) (referring to several marketplaces in the United States where the SEC has allowed rules that limit ownership).

424. Possible antitrust issues, again, are not to be solved by securities law.

425. See NASD, Manual, Rule 4370 (2006) available at <http://nasd.complinet.com/nasd/display/index.html>. Rule 4370, titled "Additional Requirements for Nasdaq-Listed Securities Issued by Nasdaq or its Affiliates," most importantly requires Nasdaq to file a monthly report with the SEC and to engage an independent accounting firm every year to review and prepare a report. *Id.* For the SEC's proposed rules, see Self-Regulatory Organizations; National Association of Securities Dealers, Inc., Exchange Act Release No. 34-51123, 70 Fed. Reg. 6743 (Feb. 8, 2005).

can operate effectively to insure the maintenance of such standards in the long run.⁴²⁶

Demutualization and subsequent public listing once again challenge the partnership to which the Court refers, known as the concept of self-regulation.

With the proposals made in this Article, the regulatory challenges that come with demutualization, listing, and self-listing of stock exchanges are manageable without jeopardizing the benefits of this process. The modest amendments put forward here would help preserve the stock exchanges' integrity without overly hindering their management in responding to increasing competition. Congress and the SEC would be well advised to not go further. At the cusp of a new era, adhering to regulatory restraint is a wise decision.

There is much at stake. While marketplaces abroad went through demutualization a couple of years ago and have since benefited from that transformation, U.S. stock exchanges were forced to watch the global development from afar. Still organized in the mutual form, they played no role in the global consolidation, for most of them were neither acquirable nor had the money to acquire others. Nothing less was—and probably still is—in danger, than the long U.S. predominance in the stock markets. Its lead in futures trading has already been lost, and competition does not halt at the derivatives markets.⁴²⁷ As an example, at the apex of the internet boom, markets for start-up companies such as the German *Neuer Markt* were able to win over U.S. issuers from the “new economy” that normally would have gone public on the Nasdaq Stock Market.

Arthur Levitt, then-chairman of the SEC, as early as 1999 pointed out that the United States could fall behind overseas markets if it missed the trend toward demutualization and going public.⁴²⁸ Mr. Levitt aptly noted that “today’s global marketplace always stands ready to offer alternatives that are more responsive to investor needs.”⁴²⁹ Mr. Levitt, in dramatic fashion, warned that if the people at the New York Stock Exchange did not change “their method of governance, they won’t be here five years from now.”⁴³⁰ At the same time, observers described the New York Stock

426. *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 366 (1963).

427. The leading derivatives exchange is now Eurex, which is jointly owned and operated by Deutsche Börse and the SWX Swiss Exchange. Most importantly, no other exchange trades more contracts: On Eurex, 1.014 billion contracts were traded in 2003. See *The Handbook of World Stock, Derivative & Commodity Exchanges* 37 (Herbie Skeete ed., 2004). None of the various U.S. derivatives exchanges reaches this volume: 640.2 million at the Chicago Mercantile Exchange, *id.* at 744, 454.2 million at the Chicago Board of Trade, *id.* at 728, 283.9 million at the Chicago Board Options Exchange, *id.* at 701, 244.9 million at the International Securities Exchange, *id.* at 780, and 180.1 million at the American Stock Exchange, *id.* at 685.

428. See Levitt, *supra* note 84.

429. *The Changing Face of Capital Markets and the Impact of ECN's*, *supra* note 84.

430. Sugawara, *NYSE Must Change*, *supra* note 82 (quoting Arthur Levitt).

Exchange as being led by “die-hard traditionalists”⁴³¹ and as a “potential *Titanic*.”⁴³²

That was more than six years ago. Not much has changed since, until recently. The Wall Street Journal, disinclined to defame a U.S. icon without reason, still in 2005 characterized the New York Stock Exchange as a “rinky-dink” company,⁴³³ a “dinosaur,”⁴³⁴ an “anachronism,”⁴³⁵ and the “queen of slow markets.”⁴³⁶

It is probably not too late to catch up with global competition—but it will require prompt action to defend the long-enjoyed U.S. preeminence in stock trading. Recent mergers are an important step, but it is only the very first.

431. Humphry, *supra* note 80.

432. *A Home-Grown Revolutionary*, *supra* note 81.

433. Holman W. Jenkins, *Antique for Sale*, Wall St. J., Apr. 27, 2005, at A15.

434. Murray, *supra* note 144; *see also Donaldson's Dinosaur*, Wall St. J., Apr. 4, 2005, at A14.

435. Murray, *supra* note 144.

436. *SEC Loves NYSE*, Wall St. J., Dec. 6, 2004, at A14.