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# Relational Enforcement of Stock Exchange Rules

Geeyoung Min

Kwon-Yong Jin

# Relational Enforcement of Stock Exchange Rules

*Geeyoung Min & Kwon-Yong Jin**

*Stock exchanges, as regulating entities supervised by the Securities and Exchange Commission (SEC), have wielded their rulemaking power on various corporate governance issues, ranging from the independent board committee requirement adopted in 2003 to the board diversity requirement approved in 2021. Simultaneously, as for-profit corporate entities, major stock exchanges have been competing against each other to attract and retain more companies. This dual status of stock exchanges—as regulators and as profit-driven entities—brings into question the stock exchanges' incentive to enforce their own rules against listed companies. What happens if a listed company violates stock exchange rules?*

*As the first study that offers an analysis of original hand-collected data on 838 enforcement actions by stock exchanges in 2019, this Article finds that (1) stock exchanges' detection of noncompliance is mostly on the failure to meet mechanical*

* Geeyoung Min is an Assistant Professor of Law at the Michigan State University College of Law. Kwon-Yong Jin is an Associate in the Corporate Department of Wachtell, Lipton, Rosen & Katz. This Article represents the authors' views only and does not represent the views of Wachtell, Lipton, Rosen & Katz. The authors would like to thank Scott Altman, Miriam Baer, Jonathan Barnett, Daniel Barnhizer, Jordan Barry, Christine Chabot, Eric Chaffee, Albert Choi, Stephen Choi, Patrick Corrigan, Mihailis Diamantis, Kevin Douglas, Jill Fisch, Matthew Fletcher, Dov Fox, George Georgiev, Nadelle Grossman, Joan Heminway, Nathan Hammons, Virginia Harper Ho, Adam Hirsch, Felipe Jimenez, Ariel Jurow Kleiman, Daniel Klerman, Naomi Lamoreaux, Herbert Lazerow, Alexander Lemann, Ann Lipton, Dorothy Lund, Jonathan Macey, Gregory Mark, Francine McKenna, Amelia Miazad, Noga Morag-Levine, Yaron Nili, James Park, Alex Platt, Adam Pritchard, Gabriel Rauterberg, Peter Robau, Daria Roithmayr, Sarath Sanga, Michael Sant'Ambrogio, Veronica Santarosa, Ryan Scoville, Justin Simard, Thomas Smith, Glen Staszewski, James Tierney, Andrew Verstein, Andrew Winden, Emily Winston, Chris Wonnell, David Zaring, and the participants at the 2021 AALS Annual Meeting, the 2021 American Law and Economics Association Annual Meeting, the 2020 National Business Law Scholars Conference, the Chicagoland Junior Scholars Conference, the 2020 Corporate & Securities Litigation Summer Workshop, Marquette University Law School Faculty Workshop, Michigan State University College of Law Faculty Workshop, University of San Diego School of Law Faculty Workshop, USC Gould School of Law Faculty Workshop, and University of Michigan Law and Economics Workshop for their insightful comments.

*criteria, such as the $1.00 minimum stock price requirement; (2) listed companies tend to self-report violations of corporate governance requirements before the stock exchanges detect them; and (3) even after noncompliance is detected, stock exchanges tend to extend cure periods and rarely impose the only substantive sanction for stock exchange rule violations: delisting. Focusing on stock exchanges' corporate governance requirements for listed companies, our analysis of S&P 1500 companies' board composition data shows that most companies diligently comply with the stock exchanges' requirements despite this low likelihood of detection and enforcement.*

*This Article argues that this curious coexistence of lax enforcement and diligent compliance can be explained as an extension of the relational contract theory to the relationship between a regulator and a regulated. Competition among stock exchanges makes a long-term, interactive relationship between stock exchanges and their listed companies valuable to both sides. The fact that the stock exchanges' enforcement mechanism relies on a single, drastic measure of terminating the relationship (i.e., delisting) and that listed companies' noncompliance rarely triggers delisting incentivize cooperative compliance between the regulator and the regulated. Such "relational enforcement" of stock exchange rules indicates that where there is an extended regulatory relationship that offers a substantial benefit to the regulated entity, diligent compliance can be expected even in the absence of rigorous, formal policing.*

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## INTRODUCTION

Picture a stretch of highway with a speed limit of fifty miles per hour. Occasionally, police are on the side of the highway to check for speeding cars and ensure compliance with the speed limit. But what is remarkable about this stretch of highway is how the police act. The police rarely catch a speeding driver, and even when the

police do catch a speeding driver, the officer typically lets off the driver with a warning—no ticket; no fines.

What is even more remarkable about this highway, however, is how the drivers act—even when they know of the police's lenient enforcement. Despite lax police enforcement, the likelihood of getting caught for speeding is low. Even when caught, the monetary penalties are nonexistent—the drivers are extremely diligent in driving under the speed limit; it is practically impossible to find a speeding driver. In the rare case they inadvertently drive above the speed limit, they self-report their speeding to the police.

This Article explores this curious coexistence of lax enforcement and rigorous compliance in one major area of American securities regulation: regulation of listed companies by stock exchanges. U.S. stock exchanges, most notably the New York Stock Exchange (NYSE) and Nasdaq, set a number of rules that their listed companies must abide by, ranging from quantitative criteria (e.g., minimum trading price) to disclosure (e.g., timely filing of periodic reports) to corporate governance (e.g., majority independent board, mandatory board committees, and board diversity).[1] Particularly for corporate governance rules, the data on stock exchange enforcement disclosures reveals that exchanges rarely enforce their rules, and when they enforce, the punishments are light at worst. Yet, separate data on board composition shows that the listed companies diligently comply with the exchanges' corporate governance rules, with virtually no violations among more than one thousand companies in our sample.

1. Moreover, in more recent years, the stock exchanges have taken greater roles in affecting the corporate governance of their listed companies; for example, with the proposal and adoption of the board diversity requirement, Nasdaq has made a foray into diversity composition—not just independence—of board members by requiring that Nasdaq-listed companies disclose the gender, racial, and LGBTQ+ status of their directors and have (or disclose/explain why it does not have) two directors who are "diverse." Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt Listing Rules Related to Board Diversity and to Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service, Exchange Act Release No. 34-92590 (Aug. 6, 2021); Nasdaq Stock Market, *Nasdaq's Board Diversity Rule: What Nasdaq-Listed Companies Should Know* (Aug. 17, 2021), https://listingcenter.nasdaq.com/assets/Board%20Diversity%20Disclosure%20Five%20Things.pdf. Similarly, in the depths of the COVID-19 pandemic, both Nasdaq and the NYSE relaxed their rules on shareholder approval for equity issuances. Notice of Filing and Immediate Effectiveness of Proposed Rule Change, Exchange Act Release No. 34-88572 (Apr. 6, 2020); Notice of Filing and Immediate Effectiveness of Proposed Rule Change, Exchange Act Release No. 34-88805 (May 4, 2020).

A complicating factor in this puzzle is the dual status of the stock exchanges in the United States. As a regulating entity designated by the Securities and Exchange Commission (SEC), on the one hand, they act as regulators and enforcers, setting rules for their listed companies and enforcing them.[2] On the other hand, as a corporate entity, they are publicly traded for-profit corporations[3] in a competitive market for more listed companies.[4] This Article examines how the stock exchanges' for-profit corporate entity status, combined with competition between the exchanges, affects the exchanges' regulatory enforcement, and in turn, influences the listed companies' compliance.

The dual status of stock exchanges creates a balance of push-pull factors for stock exchange rule enforcement.[5] At first glance, as asserted by critics of industry self-regulation, the stock exchanges' pursuit of profits and the presence of a competitor can potentially lead to lax enforcement, as they may lower their standards to attract

2. Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1455 (1997); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 977 (1999) [hereinafter Pritchard, *Markets as Monitors*]; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2399–2401 (1998); Adam C. Pritchard, *Self-Regulation and Securities Markets*, REGUL. (Spring 2003), at 32, 33–34 (2003) [hereinafter Pritchard, *Self-Regulation and Securities Markets*].

3. Nasdaq began trading on its own platform in 2005 after a spin-off from National Association of Securities Dealers (NASD), and NYSE became a publicly traded company the following year through a merger with Archipelago Holdings. *See* Jerry Knight, *Stock Markets on the Open Market: Exchanges Go Public, Generate Windfalls*, WASH. POST. (Feb. 20, 2006), https://www.washingtonpost.com/archive/business/2006/02/20/stock-markets-on-the-open-market-exchanges-go-public-generate-windfalls/41e4af29-66a0-4446-92a4-147f11e97fb1. Intercontinental Exchange, Inc., a for-profit publicly traded company, acquired NYSE in 2013.

4. *See* John McCrank, *U.S. Stock Exchange Competition to Heat Up in 2020 with New Entrants*, REUTERS (Sept. 19, 2019, 2:57 PM), https://www.reuters.com/article/us-usa-exchanges/u-s-stock-exchange-competition-to-heat-up-in-2020-with-new-entrants-idUSKBN1W42Y6 ("There are currently 13 U.S. stock exchanges, 12 of which are run by Intercontinental Exchange Inc.'s NYSE, Nasdaq Inc., and Cboe Global Markets Group runs the only independent exchange."). As of July 23, 2020, there are twenty-four U.S. stock exchanges registered with the SEC under Section 6 of the Securities Exchange Act of 1934. *See National Securities Exchanges*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/fast-answers/divisionsmarketregmrexchangesshtml.html (last visited Oct. 8, 2021).

5. The stock exchanges recognize the difficulties in balancing the conflicting obligations as a dual status entity as a risk factor. *See* Intercontinental Exch., Annual Report (Form 10-K) 28 (Feb. 6, 2020) ("The for-profit exchanges' goal of maximizing stockholder value might contradict the exchanges' regulatory and self-regulatory responsibilities."); Nasdaq, Annual Report (Form 10-K) 21 (Feb. 25, 2020) ("We have self-regulatory obligations and also operate for-profit business, and these two roles may create conflicts of interest).

more issuers.[6] Simultaneously, such collusion concerns may be counterbalanced by the exchanges' reputational concerns and the SEC oversight.[7] Relaxing their enforcement level too much risks destroying the reputational capital of the major exchanges, and conspicuous collusion may also invite SEC intervention. Furthermore, the fact that enforcement options available to exchanges are practically all or nothing makes the stock exchanges' enforcement not a viable option against most of the violations.[8] Given this background, this Article explores the following questions. What happens if a listed company violates stock exchange rules?[9] If stock exchanges do not enforce their rules rigorously, how well do listed companies comply with the rules? Is it desirable for stock exchanges to enforce the rules and delist companies proactively?

The existing literature on stock exchange rules largely falls into two categories: theoretical examinations of stock exchanges' incentive structure and how such incentive structure affects their

6. *See* Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963, 975 (2012).

7. *See* Nasdaq, *supra* note 5, at 21 ("We . . . bear regulatory responsibility related to our listed companies and our markets. Any failure by us to diligently and fairly regulate our markets or to otherwise fulfill our regulatory obligations could significantly harm our reputation, prompt SEC scrutiny and adversely affect our business and reputation."). It is worth noting that the SEC does sometimes encourage "collusion" between exchanges by encouraging them to adopt similar rules, but such "collusion" is more closely characterized as "coordination." What we refer to as "collusion" (in the problematic sense) is between the exchange and the listed issuer. *See* Pritchard, *Markets as Monitors*, *supra* note 2, at 977–78.

8. For both NYSE and Nasdaq, the only formal sanction available against a noncompliant company is a delisting, or a suspension as a pre-stage of the delisting. *See infra* Section I.B.2.

9. A recent legal memorandum highlights the possibility that a listed company may analyze the costs and benefits of violating stock exchange rules, taking into account the probability of detection and severity of sanctions, and decide that violation is justified. *See* Victor Lewkow, Christopher E. Austin & Paul M. Tiger, *CBS-NAI Dispute, Part III: Can Stockholders Rely on Stock Exchange Rules to Prevent Dilution of Their Voting and Economic Interests?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 24, 2018), https://corpgov.law.harvard.edu/2018/10/24/cbs-nai-dispute-part-iii-can-stockholders-rely-on-stock-exchange-rules-to-prevent-dilution-of-their-voting-and-economic-interests/ ("[S]tockholders of an NYSE-listed (or NASDAQ-listed) company should not blindly assume that an issuer will comply with the applicable exchange's rules in every situation. There may be instances where directors of a board are willing to bear the risk of delisting—and in fact, feel justified (rightly or wrongly) in doing so—to achieve some other aim that they believe is paramount."). For companies' deviation from the law and regulations for the value-enhancing innovations, see Elizabeth Pollman, *Corporate Disobedience*, 68 DUKE L.J. 709 (2019); Elizabeth Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013 (2019).

regulatory and supervisory capacity or willingness;[10] and empirical studies of voluntary and/or involuntary delistings and their effects.[11] The former generally does not address how such incentives actually shape stock exchange enforcement, and the latter largely focuses on the aftereffects of corporate delisting instead of the factors that lead to the delisting decision by the stock exchanges. To bridge that gap, we examine firm-level data on enforcement of and compliance with stock exchange rules in the United States, focusing on disclosures made in 2019. In addition, we complement our data with practitioner interviews regarding their perception of stock exchange enforcement efforts. Pairing the enforcement disclosure data with the practitioner interviews provides both quantitative and qualitative pictures of stock exchange rule enforcement patterns.

The Article's contributions to literature are fourfold. First, we present a comprehensive examination of the enforcement pattern of stock exchange rules. Given that rules without enforcement are mere guidelines, understanding the enforcement of stock exchange rules is just as important as understanding the structure of the rules themselves. Based on Form 8-K disclosures filed by issuers that have been subject to exchange sanctions and industry interviews, we show that stock exchange enforcement strategy largely relies on conversation and negotiation with issuers to remedy violations instead of formal enforcement actions, and delisting is rare. While the formal sanctions available to exchanges are limited to delisting, the exchanges have created a de facto informal system of sanctions by relying more heavily on negotiations and conversations to achieve their goal of remedying noncompliance.

Second, as a flipside to enforcement, focusing on corporate governance listing standards, we also present an overview of the status quo of stock exchange rule compliance. Contrary to our prediction—that the rate of compliance would be low given that

10. *See, e.g.*, Mahoney, *supra* note 2; Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1518 (1997); Pritchard, *Markets as Monitors*, *supra* note 2; Pritchard, *Self-Regulation and Securities Markets*, *supra* note 2, at 32; Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435 (2008).

11. *See* Jonathan Macey, Maureen O'Hara & David Pompilio, *Down and Out in the Stock Market: The Law and Economics of the Delisting Process*, 51 J.L. & ECON. 683 (2008); Jeffrey H. Harris, Venkatesh Panchapagesan & Ingrid M. Werner, *Off But Not Gone: A Study of Nasdaq Delistings* (Ohio State Univ. Fisher Coll. Of Bus. Working Paper No. 2008-03-005, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=628203.

there is no substantial risk of delisting for noncompliance—a separate dataset on S&P 1500 companies' board composition shows that listed companies comply and voluntarily report their violations, if any, to the exchanges. Particularly, for corporate governance violations, the delisting sanction is rarely, if ever, imposed, so the repercussions for noncompliance are minor at best, but violations are rare. Given that stock exchanges detect noncompliance mostly based on listed companies' self-reporting and, more importantly, rarely delist companies based on noncompliance with the corporate governance requirements, this indicates a puzzling mix of lax enforcement and rigorous compliance.

Third, we draw upon the relational contract literature to examine and understand the enforcement and compliance pattern found in stock exchange rules. When we view stock exchange regulation as a "relational" contract, the ostensibly lax enforcement strategy nonetheless can be effective as long as there is a threat of termination of a relationship, i.e., delisting, based on issuer noncompliance. On the flip side, even if current enforcement is lax, listed companies' strong compliance with the exchange rules can be explained as signaling the issuer's future value to the exchange, discouraging the exchange from terminating the relationship should the listed company's violations become more serious; in a way, past compliance can be seen as insurance against future delisting. Returning to the highway analogy above, when the same police officer is on the highway day after day, and the drivers form a relationship with that officer, the drivers would be inclined to remain on the officer's good side, lest they need the officer's leniency later.

Lastly, we note a number of complexities and departures from the traditional relational contract model, including the potential divergence of the exchanges' private incentives with their public role and the conflict between present and future shareholders in delisting decisions. These complexities introduce another layer of interested groups—most notably, the current shareholders and the public investors—that can influence the decisions of stock exchanges. Taken together, this Article sheds light on the unique dynamics of enforcement and compliance in a repeated game (a relational model).

Our research is particularly timely in today's securities regulation environment, given the expanding role of stock

exchanges in the corporate governance landscape.[12] In the aftermath of the Enron and WorldCom scandals, stock exchange rules were amended to impose a number of corporate governance requirements to strengthen internal controls, such as an executive compensation committee and a nominating/governance committee comprised entirely of independent directors (or a close substitute of such requirement). In 2020, with the increasing focus on boardroom diversity, Nasdaq proposed a rule amendment that would mandate at least two diverse directors and public disclosure of a board diversity score, which was finally adopted in 2021 after SEC approval.[13] These initiatives by stock exchanges would have no teeth without enforcement and compliance, making our research questions particularly relevant.

The rest of this Article proceeds as follows. Part I lays out the legal framework governing securities exchanges, both as regulating entities and for-profit corporate entities, and the peculiarities of regulation by stock exchanges, including how the stock exchange regulation differs from other securities regulation. Part II examines the enforcement and compliance landscape of stock exchange rules and presents relevant data. Part III explains this enforcement and compliance landscape based on the characterization of stock exchange regulation as a relational contract, followed by the conclusion.[14]

12. *See, e.g.*, Hans Christiansen & Alissa Koldertsova, *The Role of Stock Exchanges in Corporate Governance* 4 (OECD Fin. Mkt. Trends, Working Paper No. 2009/1, 2008) ("[S]tock exchanges have often enlarged their regulatory role to embrace a wider palette of corporate governance concerns. They have contributed to the development of corporate governance recommendations and encouraged their application to listed companies."); Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583, 626 (2001) ("The stiffening competition among stock exchanges, however, may help change this situation by imposing corporate governance requirements as part of their listing conditions, thereby creating corporate governance regimes that are disconnected from particular national laws.").

13. *See supra* note 1.

14. A stock exchange can act as a regulator of both its broker-dealer members and its listed companies. In this Article, our focus is exclusively on the stock exchange's regulation of its listed companies.

## I. LEGAL FRAMEWORK GOVERNING STOCK EXCHANGE RULE ENFORCEMENT

### *A. Dual Status of Stock Exchanges*

National securities exchanges in the United States, by virtue of their corporate and regulatory structure, embody multiple characteristics at once. As a regulating entity, they are self-regulatory organizations governing their broker-dealer members and standard-setters for their listed companies. As a corporate entity, they are for-profit business organizations, with commensurate fiduciary obligations to their shareholders. As a regulated entity, they are subject to the SEC's oversight as national securities exchanges. This Part I thus lays out the multiple legal frameworks governing securities exchanges and how they affect the securities exchanges' regulatory role.

#### *1. Exchanges as a regulating entity*

*a. Exchanges' delegated authority*. As noted above, pursuant to the Securities Exchange Act (hereinafter "Exchange Act"), the national securities exchanges act as—and are required to act as—regulators of their broker-dealer members. In furtherance of this mandate, the exchanges have adopted a number of rules governing their broker-dealer members including those relating to organizational qualifications, communications with the public, and trading conduct. Exchanges can impose a number of sanctions on violating broker-dealer members, including censure, monetary fine, cease-and-desist order, suspension, and expulsion.[15] In fact, in sanctioning a member (including associated persons), both the NYSE and Nasdaq have incredibly wide latitude—even if a sanction does not fall under the enumerated list above, both exchanges can impose "any other fitting sanction."[16]

In addition to their role as a regulator of broker-dealer members, securities exchanges also serve as regulators of their

15. NYSE Rule 8310 (2020); Nasdaq Stock Market Rule 8310 (2020).

16. NYSE Rule 8310(a)(7) (2020); Nasdaq Stock Market Rule 8310(a)(7) (2020). It is worth noting that the stock exchanges' authority to levy sanctions on their members is not unlimited. If the SEC finds that the sanction "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act] or is excessive or oppressive," the SEC may set aside or reduce such sanction. 15 U.S.C. § 78s(e)(2) (2018).

listed companies through their listing standards. Originating as marketing devices to attract investors,[17] and/or a way to earn exemption from state blue sky laws,[18] listing standards straddle the boundary between contractual obligations and public law regulations. In the early days of securities exchanges, the listing standards began as obligations pursuant to listing agreements between the exchanges and the listing issuers. But with the amendment of the Exchange Act in 1975, the SEC's new authority to approve or disapprove exchange rules (or even add, amend, or delete rules itself) brought the listing standards within the purview of the SEC's oversight.[19] Historically, the SEC has relied more on its Section 19(b) authority to approve or disapprove rule amendments proposed by exchanges (rather than adding new rules itself pursuant to its Section 19(c) authority), likely because exchanges have more flexibility in adopting rules (and having them approved by the SEC) than the SEC has in adopting exchange rules itself.[20]

17. Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act*, 47 BUS. L. 1461, 1462 (1991).

18. Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 332 (2001).

19. While most of the Exchange Act's provisions concerning national securities exchanges focus on exchanges' regulation of their broker-dealer members, rules applicable to listed companies are nonetheless exchange rules subject to Section 19 of the Exchange Act and the corresponding SEC oversight and approval.

20. This difference in scope was clearly demonstrated in the adoption and subsequent invalidation of SEC's Rule 19c-4. In 1988, pursuant to its Section 19(c) authority, the SEC adopted Rule 19c-4 barring national securities exchanges from listing shares of issuers that violate the one-share, one-vote principle. However, the rule was invalidated by the D.C. Circuit, which held that the rule is not "in furtherance of the purposes of the Exchange Act." In contrast, the D.C. Circuit noted that when exchanges regulate listed companies by threat of delisting, they are not relying on any governmental authority and thus have greater flexibility in adopting rules governing listed companies. *See* Business Roundtable v. SEC, 905 F.2d 406, 414 (D.C. Cir. 1990) ("The government regulatory authority conferred by the [Exchange Act] is an exchange's power to expel, fine, bar from associating with members, and otherwise sanction 'its members and persons associated with its members.' . . . Of course an exchange may delist an issuer and thus in some sense 'enforce' its listing standards, but it still does not exercise any governmental authority to 'regulate' the issuer. Thus Congress appears to have contemplated exchanges' taking (1) some measures that regulate members with delegated governmental authority and that are required to be, at a minimum, related to the purposes of the [Exchange Act], and (2) others, that do not regulate members and do not rely on government regulatory authority, for which there is no such requirement. As we read the [Exchange Act], both categories are subject to Commission review under § 19(b) and to amendment under § 19(c), but for some rules in the second category—those which do not regulate members and are not related to the purposes of the Act—the Commission's § 19 powers will be quite limited.") (internal citation omitted) (emphasis omitted).

For example, when the SEC sought to adopt audit committee requirements for listed companies, it "suggested" the requirement's adoption to the NYSE, which in turn proposed the rule and adopted it with the SEC's blessing.[21] Therefore, listing standards can be considered private law obligations subject to the SEC's oversight, but whether they draw on governmental regulatory authority in their enforcement is debatable.

Currently, the NYSE and Nasdaq's listing standards can be broadly classified into three categories. First, there are quantitative—or technical—standards. These include minimum criteria for distribution of shares, market capitalization, and per share price. In particular, minimum market capitalization and minimum per share price are often limiting criteria for financially troubled issuers that see their share price (and therefore the market capitalization) plummet as a result of the financial distress. While some quantitative standards may be defensible to ensure a liquid trading market (e.g., distribution of shares), price-based requirements have also come under criticism for their arbitrariness.

The second set of standards include disclosure-related requirements. Listed companies are required to provide periodic financial information to their shareholders, disclose material information promptly to the public, and provide advance notice to the exchange of certain information.[22] Given the federal securities laws' focus on disclosure of accurate material information, these disclosure-related standards overlap with the requirements of federal securities laws to a substantial degree. Since federal securities laws already impose penalties for failure to disclose material information in accordance with the applicable laws and regulations, the penalties imposed by the stock exchanges for violation of disclosure-related requirements play a supplemental role.

Lastly, there are corporate governance standards. These include the requirement that listed companies' boards of directors have a majority of independent directors, the requirement that listed companies have a nominating/corporate governance committee,

21. Karmel, *supra* note 18, at 340. During this rule proposal process, the stock exchanges typically submit the draft rule proposal to the SEC for comments and incorporate those comments before filing the proposal officially. Thus, the SEC can de facto shape the stock exchange rules through the 19(b) process.

22. NYSE Listed Company Manual §§ 202–04 (2020); Nasdaq Stock Market Rule 5250 (2020) [hereinafter Nasdaq Rules].

compensation committee, and audit committee—in each case composed entirely of independent directors —and the requirement that shareholder approval be obtained for certain transactions (e.g., issuance of common stock with voting power equal to or in excess of 20% of voting power currently outstanding).[23] Since these provisions govern the internal corporate affairs of issuers, some of these requirements overlap with the provisions of state corporate law—such as the annual shareholder meeting requirement—but others are standalone requirements, essentially creating a corporate law system independent of state corporate law.

Although many of these standards are rooted neither in the federal regulatory powers nor in the state corporate law, their practical importance cannot be overemphasized. Quantitative listing standards, such as the minimum per share price, drive a number of corporate actions like reverse stock splits. Many corporate governance standards set the norm for listed companies, including a majority independent board, and shape the manner in which corporate transactions are implemented. For example, the shareholder approval requirement for issuance of common stock with a voting power of 20% or more effectively creates an acquirer-side vote requirement for stock acquisitions. As such, the enforcement of these listing standards should be considered no less important than enforcement of federal securities laws or of state corporate law.

*b. SEC's supervision.* Among other things, the Exchange Act has set up a regulatory system of stock exchanges whereby the SEC monitors and regulates (and imposes certain obligations upon) stock exchanges, and the stock exchanges, in turn, regulate their members and listed companies.[24] Under Section 5 of the Exchange Act, brokers, dealers, and exchanges are prohibited from transacting in securities unless such exchange is registered as a "national securities exchange" (or is granted an exemption by the SEC), and Section 6 of the Exchange Act sets up the registration system for such national securities exchanges.[25] Under the statute, the SEC may not approve registration for national securities exchange status unless it makes a

23. NYSE Listed Company Manual § 312.03; Nasdaq Rule 5635(a).

24. *See* Verity Winship, *Enforcement Networks*, 37 YALE J. ON REG. 274, 278 (2020).

25. 15 U.S.C. §§ 78e, 78f (2018).

number of findings.[26] Most notably, the SEC must find that the exchange is capable of complying with the Exchange Act (including rules under the Exchange Act) and the exchange's own rules, and that the exchange is capable of *enforcing similar compliance of the Exchange Act and the exchange's rules by its members*. In addition, the SEC must also find, among other things, that the exchange's rules are designed to "prevent fraudulent and manipulative acts and practices" and "to promote just and equitable principles of trade" and that they provide for appropriate discipline of violating members.[27]

After registration of an exchange as a national securities exchange, the SEC has a further role in regulating the exchanges' rules and their enforcement. Before the adoption, change, addition, or deletion of any exchange rule, the exchange must submit such proposed rule (including deletions thereto) to the SEC for approval.[28] After public comment and hearing (in certain cases), the SEC is to approve such rule if and only if such proposed rule is consistent with the requirements of [the Exchange Act] and the rules applicable to such exchange.[29] Furthermore, in addition to this power to review proposed rules, the SEC has the power to abrogate, add to, or delete from the rules of an exchange,[30] review member disciplinary actions,[31] and censure, suspend, or deregister an exchange for failure to comply with the Exchange Act or for failure to enforce member compliance therewith.[32] Thus, the initial registration and subsequent regulation of national securities exchanges require that such exchanges serve a dual role as regulated entities and regulating entities.

When the stock exchanges impose sanctions on their members or on their issuers, the sanctions are subject to SEC review and supervision as well. Disciplinary sanctions imposed by stock

26. It is worth noting that while Section 6 of the Securities Exchange Act sets forth the substantive requirements for registration of a national securities exchange, Section 19(a) sets forth the procedural requirements.

27. 15 U.S.C. § 78f(b).

28. Strictly speaking, this requirement applies to all self-regulatory organizations, but as our focus is on the national securities exchanges, we focus on exchange rules here.

29. 15 U.S.C. § 78s(b)(2)(C).

30. *Id*. § 78s(c).

31. *Id*. § 78s(d).

32. *Id*. § 78s(h).

exchanges on their members can be appealed to the SEC, where it is reviewed under an "unnecessary or inappropriate burden on competition" or "excessive or oppressive" standard; if the SEC finds either criterion is satisfied, then the SEC can cancel or reduce the sanction.[33] For sanctions that involve the denial of membership or of service—e.g., expulsion for a member, delisting for an issuer—the SEC can review the sanction upon penalized entity's appeal. Upon such appeal, the SEC is to uphold the sanction if it finds that (1) the facts forming the basis for the sanction exist, (2) the sanction is in accordance with the rules of the exchange, and (3) such rules were applied in a manner consistent with the purposes of the Exchange Act;[34] in practice, this means that the appeal is rarely, if ever, successful.

*2. Exchanges as a corporate entity*

The two dominant securities exchanges in the United States both underwent a series of corporate structure changes in recent years. Starting with the Buttonwood Agreement in 1792, through which twenty-four brokers began organized securities trading in New York, for more than two centuries the NYSE had been a nonprofit organization with its broker-dealers as members.[35] In fact, this mutual organization model was the norm for securities exchanges around the world as late as the 1990s.[36] Under the mutual association model, the exchanges were owned by the broker-dealers who traded securities on the exchange. Membership carried with it the privilege of trading on the exchange, and members also shared in the profits of the exchange.[37] Reflecting their partially public character,

33. *Id*. § 78s(e)(2).

34. *Id*.

35. Stephen F. Diamond & Jennifer W. Kuan, *Ringing on the Bell on the NYSE: Might a Nonprofit Stock Exchange Have Been Efficient?*, 9 DUQ. BUS. L.J. 1, 1 (2007).

36. John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1800 (2002) ("Historically, securities exchanges in the U.S. and generally elsewhere have operated as non-profit mutual or membership organizations. . . . The first exchange to demutualized was the Stockholm Stock Exchange in 1993."); Licht, *supra* note 12, at 589.

37. Coffee, *supra* note 36, at 1801. ("With demutualization comes a more specified governance structure in which the interests of the new shareholders are likely to dominate over those of the constituent groups within the exchange who formerly exercised veto power. Shareholders in turn will predictably wish to maximize the share value of their

however, their governance did reflect some public involvement. For example, until 2003, one-half of NYSE's directors were public directors and the other half were directors associated with and representing the NYSE's industry members.[38]

As a result of increasing pressures on the existing dominant exchanges to adopt new technologies and the attendant need for capital—as well as a number of other factors, including intra-membership conflict in decision-making—a number of exchanges have demutualized and transformed into for-profit corporations in recent years.[39] The NYSE, being no exception, was demutualized in 2006 as part of its merger with electronic trading platform operator Archipelago Holdings, forming the NYSE Group, a Delaware for-profit corporation, and listed itself on the NYSE. Subsequently, the NYSE Group merged with Euronext in 2007 to form NYSE Euronext, which was in turn acquired by Intercontinental Exchange in 2013. As a result, the NYSE now exists as a for-profit subsidiary of Intercontinental Exchange, a publicly-traded Delaware corporation. Given this corporate structure, the NYSE is indirectly subject to the obligations that come with being a publicly-traded corporation, including periodic reporting (on a consolidated basis with the Intercontinental Exchange's other subsidiaries) and maximization of shareholder value.[40]

The Nasdaq followed a similar, albeit slightly different, path to its current status as a publicly-traded for-profit corporation. It originally began in 1971 as a quotation system operated by the National Association of Securities Dealers (NASD), a self-regulatory organization of broker-dealer firms and registered brokers. As such,

investment . . . ."); Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 369 (2002).

38. Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355, 386 (2007).

39. The first exchange to demutualize was the Stockholm Stock Exchange in 1993. It was followed by Borsa Italiana in 1997, Australian Stock Exchange in 1998, Singapore Stock Exchange in 1999, the Hong Kong Stock Exchange, London Stock Exchange, Deutsche Borse, and Nasdaq in 2000, and the NYSE in 2006. These are only examples of many more exchanges that have demutualized in the past quarter century. *See* FRANCIS A. LEES, FINANCIAL EXCHANGES: A COMPARATIVE APPROACH 30 (2012).

40. Whether maximization of shareholder value should be the be-all and end-all of corporate purpose has been subject to significant debate, and we make no normative judgment, as it is outside the scope of this Article.

during its initial years, NASD's nonprofit, member association corporate governance structure also governed Nasdaq.[41]

During the wave of exchange demutualization in the late 1990s and early 2000s, Nasdaq, like the NYSE, also underwent a change in corporate form. In 2000, the NASD spun off Nasdaq as a separate Delaware for-profit corporation (along with registering it as a national securities exchange), and Nasdaq began trading on the OTC market in 2002 and on Nasdaq itself in 2005. Following a number of acquisitions, including Scandinavian exchange operator OMX, Nasdaq, Inc. is now the publicly traded Delaware holding company of a number of exchange operators, including Nasdaq Stock Market LLC, which operates the Nasdaq exchange. Thus, just like the NYSE, Nasdaq's operator is subject to the various obligations and pressures that accompany its status as a publicly traded corporation.

### *B. Peculiarities of Stock Exchange Enforcement*

Partly as a result of the legal framework governing them, stock exchange regulation is characterized by a number of peculiarities that are in contrast to regulation by the SEC or regulation by other Self-Regulatory Organizations (SROs), including the Financial Industry Regulatory Authority (FINRA). In particular, these characteristics significantly affect the incentive structures for stock exchanges in enforcing their regulations governing issuer conduct and governance.

#### *1. Competitive stock exchange market*

Stock exchanges' regulatory framework faces an issue well-known in the regulatory world: regulatory competition and arbitrage. Particularly in the United States, the oligopolistic nature of the stock exchange industry—as opposed to monopolistic—makes regulatory competition a more probable outcome, since

41. In fact, because it was owned and operated by NASD, a self-regulatory organization, it was not even required to register as a national securities exchange until it was spun off. *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 (June 7, 2001) ("Nasdaq currently is exempt from the definition of 'exchange' under Rule 3a1-1 because it is operated by the NASD.").

issuers can transfer their listing domestically. An unsatisfied issuer can move from the NYSE to Nasdaq and vice versa.

The competitive nature of the stock exchange regulatory scheme is further compounded by the fact that the exchanges themselves are publicly traded companies answerable to their shareholders. Regulatory arbitrage is not a welcome phenomenon for any regulatory body, but for stock exchanges, regulatory arbitrage—and subsequent decrease in the number of listed companies—has a direct, negative impact on their revenue and profit. Thus, the increasing incidence of regulatory arbitrage can be particularly sensitive for stock exchanges.

At the same time, to assume that this competitive dynamic would lead to a race to the bottom, in which exchanges increasingly turn a blind eye to violations lest listed companies leave for other exchanges, would be too strong, as there are a number of countervailing factors. For one, the exchanges themselves are subject to SEC oversight, and persistent failure to enforce their regulations may lead to SEC sanctions.[42] Even in the absence of specific SEC sanctions, the persistent failure of stock exchanges to enforce their rules may result in calls for regulatory reform (and potential re-shoring of regulatory authority to the SEC).[43]

Moreover, reputational concerns can temper this potential race to the bottom. The two major exchanges in the United States enjoy a substantial premium precisely because they have reputational capital they can offer to listed companies.[44] This reputational capital, in turn, is based on the perception that the major exchanges offer a gold standard of quality and that securities listed on those exchanges meet such quality standards. Persistent failure to enforce

42. *See, e.g.*, 15 U.S.C. § 78s(g), (h) (2018); Pritchard, *Markets as Monitors*, *supra* note 2, at 977. It is worth noting, however, that the statutory language only notes failure to enforce compliance "by [a stock exchange's] members and persons associated with its members[.]" 15 U.S.C. § 78s(g). This narrow language may mean that the SEC does not have express oversight authority over exchanges' persistent failure to enforce their own rules against *issuers* (as opposed to *members*), but such analysis is beyond the scope of this Article.

43. Nan S. Ellis, Lisa M. Fairchild & Harold D. Fletcher, *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 128 (2010).

44. *See* Coffee, *supra* note 36, at 1828 (The NYSE "recognized that to develop a 'reputational brand,' it had to exclude those unwilling or unable to comply with its high quality standards."); *id.* at 1829 ("[O]nly those markets that have developed such a brand name have developed into major international market centers with deep liquidity."); Robert Battalio, Andrew Ellul & Robert Jennings, *Reputation Effects in Trading on the New York Stock Exchange*, 62 J. FIN. 1243 (2007).

their regulations can erode this reputational capital, and the premium that investors place on NYSE or Nasdaq-listed companies.[45] In the short run, this loss of reputational capital can lead to lower trading volume (as some investors drop out), and in the longer run, this loss of prestige associated with listing on NYSE or Nasdaq can lead to lower demand for exchange listing, as private companies see a lower benefit to listing (as opposed to remaining a private company).

Thus, the fact that stock exchanges are dual status entities—(1) private, profit-seeking entities in a competitive market and (2) regulator of the listed companies—creates a balance of countervailing factors. At first glance, their pursuit of profits and the presence of a competitor can lead to lax enforcement but may be counterbalanced by reputational concerns and SEC oversight. In later sections, we will empirically address the actual status of their enforcement patterns and how this competitive market shapes such enforcement patterns.

*2. Limited enforcement option*

Both the SEC and FINRA are authorized to levy a wide range of sanctions on industry participants and/or issuers that are in violation of their respective regulations. For instance, for violations of the Exchange Act or rules thereunder (including those of the self-regulatory organizations), the SEC is expressly authorized to

45. Professor Marcel Kahan does note that exchanges may seek to "protect" their reputational capital not by enforcement but by forbearance, because conveying an image that no violation has occurred (as opposed to actively enforcing their regulations and conveying an image that numerous violations have occurred on the exchanges) is more beneficial to their reputation. Kahan, *supra* note 10, at 1518 ("From the perspective of an exchange, the optimal image to convey to the public is that no violations of its rules occur, an image that is blunted by the discovery of violations, even if the violator is found and punished."). In response, Professor Adam C. Pritchard noted that it would be difficult to suppress such evidence of wrongdoing and that SEC oversight of exchange enforcement can mitigate such "head in the sand" concerns. Pritchard, *Markets as Monitors*, *supra* note 2, at 980. We also note that this "head in the sand" approach may not pass the cost-benefit test from the perspective of the exchanges, because potential loss of reputation is not a linear function of number of and degree of disclosed violations. Instead, loss of reputation is affected disproportionately by disclosure of major violations and scandals; disclosure of one major scandal can do more damage to an exchange's reputation than disclosure of a hundred minor violations, as seen in the uproar in the aftermath of the Enron scandal. Thus, from the perspective of an exchange, turning a blind eye to potential red flags to convey an image that no violation of its rules has occurred is a ticking time bomb.

sue for injunctive relief, civil penalties, or other equitable relief, to institute a cease-and-desist order, and/or to impose collateral bars.[46] In addition, for violations of the rules against manipulative and deceptive devices, the SEC's authority—through a court proceeding—extends to prohibiting a violator from serving as a director or officer of a public company.[47] Likewise, FINRA's authority to levy sanctions includes censure, fine, suspension, expulsion, cease-and-desist order, and/or "any other fitting sanction."[48] Thus, in response to violations of their rules, the SEC and FINRA can take a graduated approach, levying appropriate sanctions based on the nature and severity of the violation.

In contrast, NYSE and Nasdaq's enforcement options against noncompliant issuers are relatively limited.[49] For example, under its regulations governing issuer noncompliance, NYSE is authorized to suspend or delist securities of a company that falls below its quantitative or qualitative listing standards.[50] However, suspension and/or delisting are draconian sanctions, particularly for minor violations of the listing standards; they are akin to imposing a death sentence for any criminal infractions, however minor. Furthermore, while exchange listing standards are designed to protect market participants—including public shareholders—it is precisely those public shareholders who are hurt the most by suspension and/or delisting of securities of issuers that violate exchange listing standards.

Recognizing this limitation, the NYSE Listed Company Manual also authorizes the exchange to issue public reprimand letters to listed companies that violate its listing standards, and under SEC regulations, these public reprimand letters would have to be disclosed by the issuer as well (in a Form 8-K), but aside from this option, which relies entirely on public shaming to be effective, the NYSE Listed Company Manual does not expressly authorize

46. 15 U.S.C. §§ 78u, 78u-3, 78o(b)(6). Criminal penalties are also authorized. *Id*. § 78ff.

47. *Id*. § 78u(d)(2).

48. 8310 Sanction for Violation of the Rules, FINRA, https://www.finra.org/rules-guidance/rulebooks/finra-rules/8310 (last visited Oct. 10, 2021).

49. NYSE's enforcement options against broker-dealer members are similar to FINRA's and are quite flexible.

50. NYSE Listed Company Manual § 801.00 et seq.

any other form of intermediate sanctions.[51] Thus, in enforcing their regulations applicable to issuers, the exchanges are left with only three options: forbearance, public reprimand, or suspension/delisting. To the extent that there is a big jump in severity from a public reprimand to suspension/delisting, when the appropriate sanction falls in the intermediate zone, this dearth of options can sway the exchanges in favor of less severe sanctions.[52]

In addition to potentially swaying exchanges in favor of forbearance, the fact that enforcement options available to exchanges are essentially binary makes the appropriate timing of sanctions against issuers difficult to ascertain. Take, for example, the recent case of the Chinese coffee chain Luckin Coffee, Inc., which was embroiled in a fraudulent accounting scandal after it was revealed in early April 2020 that it had fabricated around $310 million in sales.[53] Five days after this revelation, Nasdaq suspended trading (which suspension lasted until mid-May) in Luckin's stock pending request for additional information from the company.[54] Six weeks later, on May 19, Nasdaq began delisting procedure for the company's stock, citing "public interest concerns as raised by the fabricated transactions" and "[Luckin's] past failure to publicly disclose material information."[55] When the news of the delisting notice broke and trading resumed, investors rushed to the exit, further triggering a collapse in the company's stock price.[56]

51. *Id*. § 303A.13. ("Suspending trading in or delisting a listed company can be harmful to the very shareholders that the NYSE listing standards seek to protect; the NYSE must therefore use these measures sparingly and judiciously.").

52. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 36 (1992).

53. Press Release, Luckin Coffee, Luckin Coffee Announces Formation of Independent Special Committee and Provides Certain Information Related to Ongoing Internal Investigation (Apr. 2, 2020), http://investor.luckincoffee.com/news-releases/news-release-details/luckin-coffee-announces-formation-independent-special-committee.

54. Press Release, Nasdaq Stock Market, Nasdaq Halts Luckin Coffee Inc. (Apr. 9, 2020), https://www.nasdaq.com/press-release/nasdaq-halts-luckin-coffee-inc.-2020-04-09.

55. Press Release, Luckin Coffee, Luckin Coffee Receives Delisting Notice from Nasdaq and Plans to Request Hearing (May 19, 2020), http://investor.luckincoffee.com/news-releases/news-release-details/luckin-coffee-receives-delisting-notice-nasdaq-and-plans-request.

56. *Luckin Stock Faces Wipeout in Rush to Sell Before Delisting*, BLOOMBERG (May 20, 2020), https://www.bloomberg.com/news/articles/2020-05-20/luckin-s-stock-faces-wipeout-in-rush-to-sell-before-delisting.

Such a situation raises a troubling dilemma for the exchange's regulatory team charged with maintaining the integrity of the trading system and protecting investors. Particularly when the depth of and/or repercussions from an issuer's violation is uncertain, delisting a security too early can risk imposing a premature death penalty on the company's financing and severely penalize the very investors that the exchanges should protect. On the other hand, waiting for all the details regarding the depth of and/or repercussions from an issuer's violation to emerge and delisting the violator's security too late risks creating additional victims of an issuer's wrongdoing.

*3. Lack of a private right of action*

The ability of private investors—either individually or (more commonly) as a class—to pursue legal action against violators of securities laws and recover damages independently of public enforcement is a key defining feature of American securities regulation. Each year, over 400 securities class actions are filed in federal courts, and even excluding lawsuits (that have recently become very common) related to mergers and acquisitions, over 200 federal securities class actions are filed every year.[57] While the SEC and the Justice Department, for a number of reasons (including resource constraints), cannot investigate and pursue every violation of federal securities laws, the private securities bar has played a significant supplemental role in enforcing securities regulations, and the importance of private enforcement cannot be overstated.

Federal securities laws provide for a number of express private rights of action. The Securities Act of 1933 (the Securities Act) provides for, among others, an express private right of action against signers (and other involved parties) of false or misleading registration statements and against sellers of securities who violate the applicable registration requirements.[58] Likewise, the Exchange Act provides for private rights of action against those who manipulate security prices and those who file false or

57. CORNERSTONE RSCH., SECURITIES CLASS ACTION FILINGS: 2019 MIDYEAR ASSESSMENT (2019). Although slightly dated, one study notes that securities class actions account for nearly half of all class actions filed in federal courts. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

58. 15 U.S.C. §§ 77k, 77l (2018).

misleading statements.[59] In addition, courts have interpreted extensive *implied* private rights of action under federal securities laws.[60]

59. *Id*. §§ 78i, 78r.

60. For instance, neither Section 10(b) of the Securities Exchange Act nor Rule 10b-5, the most prominent securities anti-fraud provisions, provides for express private right of action against the violators of such rules. Despite this lack of express recognition of private right of action, in 1946, the U.S. District Court for the Eastern District of Pennsylvania held that private right of action exists for violations of Section 10 of the Exchange Act and Rule 10b-5 thereunder, noting that "disregard of the command of a statute is a wrongful act and a tort." Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946). A number of subsequent district and circuit court cases acknowledged a private right of action for securities law violations—even in the absence of express statutory language—and the Supreme Court validated such implied private right of action in *J. I Case v. Borak* in 1964. *See* J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Amanda Marie Rose, *The Shifting Raison d'Etre of the Rule 10b-5 Private Right of Action*, *in* RESEARCH HANDBOOK ON REPRESENTATIVE SHAREHOLDER LITIGATION (Sean Griffith et al. eds., 2017).

In deciding *Borak*, instead of the *Kardon* court's tort approach, the Supreme Court focused on Congressional purpose, holding that the judiciary would recognize a private right of action to further the Congressional purpose in enacting the securities laws. *Borak*, 377 U.S. at 432–33 ("While [the statutory language] makes no specific reference to a private right of action, among [the Securities Exchange Act's] chief purposes is 'the protection of investors,' which certainly implied the availability of judicial relief where necessary to achieve that result. . . . We, therefore, believe that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."). Although the rationale for implying a private right of action under the securities laws evolved, widespread recognition of such a right would firmly take hold. *See also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under § 10(b).").

But the *Borak* approach was troublesome in that its application could expand extremely broadly and indefinitely. *See* William F. Schneider, *Implying Private Rights and Remedies Under the Federal Securities Act*, 62 N.C. L. REV. 853, 873 (1984) ("*[B]orak* and its progeny prompted the lower federal courts to expansively imply causes of action, not only from the securities laws, but also from many other federal statutes. It was therefore inevitable that the pendulum would swing too far."). In response, in 1975, the Supreme Court tempered the *Borak* decision's focus on Congressional purpose, setting forth a four-part test to determine whether a private right of action should be inferred:

1. "[I]s the plaintiff 'one of the class for whose *especial* benefit the statute was enacted"?
2. "[I]s there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one?"
3. "[I]s it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff?"
4. "[I]s the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

Cort v. Ash, 422 U.S. 66, 78 (1975). Subsequent cases have confirmed this narrower approach to implied private right of action. *See*, *e.g.*, Touche Ross & Co. v. Reddington, 442 U.S. 560, 578 (1979) ("To the extent our analysis in today's decision differs from that of the Court in

However, despite extensive implied private rights of action under securities laws inferred by federal courts, the current prevailing view is that violations of stock exchange rules generally do not give rise to a private right of action.[61] Some relatively older decisions have inferred or at least hinted at the possibility of inferring private right of action for exchange rule violations, but they are either pre-*Cort* cases decided under a more expansive framework or have narrowly defined the rules whose violations would give rise to a private right of action.[62]

*Borak*, it suffices to say that, in a series of cases since *Borak* we have adhered to a stricter standard for the implication of private causes of action, and we follow that stricter standard today. . . . The ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law.").

While the *Cort* test does not place one factor ahead of another, in practice courts have focused largely on the second element—legislative intent—in their inference of (or refusal to infer) private right of action.

61. *See, e.g.*, Jablon v. Dean Witter, 614 F.2d 677, 680 (9th Cir. 1980) ("Congressional intent to provide a private cause of action [for stock exchange rule violations] must therefore be found in § 6(b) [of the Securities Exchange Act] alone. We find no such intent."); State Tchrs. Ret. Bd. v. Fluor Corp., 654 F.2d 843, 853 (2d Cir. 1981) ("[A] legislative intent to permit a federal claim for violation of the Exchange's Company Manual rules regarding disclosure of corporate news cannot be inferred."); Colman v. DH Blair & Co., 521 F. Supp. 646, 651 (S.D.N.Y. 1981) ("[T]hose courts which have addressed the issue have generally ruled that no implied private right of action may be premised upon violations of NYSE or NASD Rules."). *See generally* MARC I. STEINBERG, SECURITIES REGULATION: LIABILITIES AND REMEDIES § 9.03[2] (2019) ("In view of recent case law . . . it appears that such implication" of private right of action for violation of a stock exchange rule is improbable.); John M. Bloxom IV, Note, *Implied Private Rights of Action Under Section 6(b) of the Securities Exchange Act of 1934*, 39 WASH. & LEE L. REV. 1047, 1070–71 (1982) ("[I]n the case of section 6 [of the Securities Exchange Act], a more restricted approach is consistent with the role of exchange rules in the securities laws. As Congress deemed it wise not to undertake direct regulation of stock exchange transactions and broker-client relationships, courts should be hesitant to undertake direct regulation themselves."); Note, *Private Actions as a Remedy for Violations of Stock Exchange Rules*, 83 HARV. L. REV. 825, 831 (1970) ("But there does not appear to be a general statutory or regulatory duty upon members to obey exchange rules.").

62. *See, e.g.*, Colonial Realty Corp. v. Bache Co., 358 F.2d 178, 182 (2d Cir. 1966) ("What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."); Van Gemert v. Boeing Co., 520 F.2d 1373, 1381 (2d Cir. 1975) ("[W]e do not now take the position . . . that violation of an exchange rule cannot under any circumstances give rise to civil liability under the federal acts.").

This general non-recognition of a private right of action for violations of stock exchange rules has two major implications for the structure of stock exchange rule enforcement. First, while the private securities bar can supplement public enforcement of securities laws, stock exchanges cannot expect such a supplemental role from the private sector. For securities law violations—at least for those provisions whose violations give rise to a private right of action—the resource constraints that public enforcers face are somewhat alleviated by the private sector's role in enforcing those same regulations.[63] For violations of stock exchange rules, on the other hand, lack of private right of action means that the stock exchanges' regulatory teams are alone in uncovering, investigating, and sanctioning such violations.

Second—and ironically—the fact that there is no "competition" from the private bar for enforcement of stock exchange rules can give exchanges more freedom in addressing issuers violating their listing standards. If private litigation for violation of stock exchange rules were possible, issuers would be fearful of massive liability to private investors and inclined not to self-report their violations.[64] For example, in the context of securities litigation, companies resist admitting guilt in SEC settlements, lest such admission be used

Moreover, particularly in the case of corporate governance standards (which form an important subset of listing standards set by the NYSE and Nasdaq), the fact that corporate governance is typically regulated by state law and that SEC plays a relatively smaller role in this area also weigh against recognition of a private right of action. Inferring private right of action for violations of corporate governance listing standards risks federalizing corporate governance, beyond that intended by Congress.

63. *See* Elisse B. Walter, Comm'r, Sec. & Exch. Comm'n, Remarks Before the FINRA Institute: The Interrelationship Between Public and Private Securities Enforcement (Nov. 8, 2011) (transcript available at https://www.sec.gov/news/speech/2011/spch110811ebw.htm). *See also* Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 106–13 (2005) (noting the advantages of private enforcement of regulations, including complementing limited government resources and innovation); John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215, 218 (1982) ("The conventional theory of the private attorney general stresses that the role of private litigation is not simply to secure compensation for victims, but is at least equally to generate deterrence, principally by multiplying the total resources committed to the detection and prosecution of the prohibited behavior.").

64. Amanda M. Rose, *Better Bounty Hunting: How the SEC's New Whistleblower Program Changes the Securities Fraud Class Action Debate*, 108 NW. L. REV. 1235, 1250 (2014) (citing Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 707(1997)).

against them in subsequent or concurrent private litigation.[65] Even if the stock exchange offers a carrot—for instance, leniency for self-reported violations—issuers would not be willing to self-report and cooperate in exchange for that carrot, if they face a much larger stick in the form of private litigation later on. As a result, private litigation can hinder the regulator's efforts to induce cooperation from the regulated entities.[66]

65. David Rosenfeld, *Admissions in SEC Enforcement Cases: The Revolution That Wasn't*, 103 IOWA L. REV. 113, 125 (2017).

66. An example of this phenomenon can be found in the antitrust context, where self-reporting is crucial in detecting and investigating cartel activity. Daniel J. Bennett, Note, *Killing One Bird with Two Stones: The Effect of Empagran and the Antitrust Criminal Penalty Enhancement and Reform Act of 2004 on Detecting and Deterring International Cartels*, 93 GEO. L.J. 1421, 1423 (2005). In the United States, antitrust law violations are subject to both public and private enforcement. In particular, in private litigation, antitrust victims can recover treble damages, encouraging the private bar to step in and enforce the antitrust laws. 15 U.S.C. § 15 (2018). However, the award of treble damages in private litigation was seen as undermining the effectiveness of the Department of Justice's amnesty program, which protects companies voluntarily reporting antitrust violations from *public* enforcement. Jaynie Randall, Comment, *Does De-Trebling Sacrifice Recoverability of Antitrust Awards?*, 23 YALE J. ON REG. 311, 315 (2006); Glenn Harrison & Matthew Bell, *Recent Enhancements in Antitrust Criminal Enforcement: Bigger Sticks and Sweeter Carrots*, 6 HOUS. BUS. & TAX L.J. 206, 213–18, 223 (2006) ("[A]ny corporation contemplating applying for amnesty had to be aware of the fact that any immunity from criminal prosecution did not mean immunity from civil sanctions. . . . [T]he risk of treble damages under the Clayton Act appeared to be the greatest deterrent to applying for amnesty . . . ."); Thomas Mueller & Gregory Evans, *ACPERA and the Value of Uncertainty*, WILMERHALE, Feb. 12, 2010, https://www.wilmerhale.com/en/insights/publications/acpera-and-the-value-of-uncertainty-february-12-2010. Thus, while the DOJ had set up incentives vis-à-vis public enforcement to induce cooperation, such a "carrot" was negated by the "stick" of private enforcement.

Recognizing this limitation, Congress enacted the Antitrust Criminal Penalty Enforcement and Reform Act (ACPERA) in 2004. Antitrust Criminal Penalty Enhancement and Reform Act of 2004, Pub. L. No. 108-237, 118 Stat. 661, 665–69. Among others, ACPERA de-trebled the civil damage that leniency applicants are subject to in a civil proceeding, provided that the applicant provides "satisfactory cooperation" to the plaintiff in the civil action. *Id.* § 213. Therefore, if a cartel participant cooperates with the public authorities and with the civil action plaintiff, it is not only protected from public enforcement but also faces only actual—as opposed to treble—damages in private litigation. At the time of ACPERA's passage, it was contemplated that this additional carrot in the private enforcement context would further promote voluntary cooperation by cartel participants.

As with any law, it is difficult to determine for certain whether ACPERA was fully successful in its stated goal. However, one GAO study, examining the six years before and the six years after ACPERA's enactment, found that while the total number of amnesty applications remained similar, the amnesty applicants in cartels of which the Justice Department had no prior knowledge (so-called "Type A applicants") increased nearly twofold, concluding that ACPERA had "slight positive effect" on amnesty applications. Amy B. Manning, *ACPERA - Eight Years Later, "Satisfactory Cooperation" Lacks a "Satisfactory" Definition*, MCGUIREWOODS 9–

In the absence of a private right of action for stock exchange violations, exchanges can engage in one-on-one cooperation with the issuers they regulate, without fear of the private bar short-circuiting such cooperation. In order to remain in the exchanges' good graces, issuers would be inclined to self-report violations, enhancing exchanges' enforcement efforts. On the flip side, exchanges can offer incentives—such as informal forbearance—particularly to issuers that cooperate with exchanges' regulatory teams. This voluntary cooperation is especially important in the context of stock exchange rules, since exchanges have limited resources that cannot be supplemented by private enforcement.

In short, a lack of private right of action for stock exchange rule violations leads to effects that feed back into one another. Because exchanges cannot rely on the private bar to enforce their rules, they are subject to resource and information restraints, making voluntary cooperation important. On the other hand, for stock exchange rule violations, the absence of private bar involvement helps the formation of a one-on-one cycle of cooperation between the exchange and the issuer and helps the exchange induce issuers' voluntary cooperation.

## II. CURRENT PRACTICE OF STOCK EXCHANGE RULE ENFORCEMENT AND COMPLIANCE

These peculiarities of stock exchange regulation noted above create a mix of opposing factors in stock exchange rule enforcement. Critics of industry self-regulation may expect collusion, conflict of interest, lax enforcement, and therefore lax compliance. Those who are more optimistic about the industry's ability to self-regulate may expect the exchanges to vigorously enforce their regulations to protect their reputation. In order to determine which of these factors are most relevant, we now examine the *status quo* of stock exchange enforcement and compliance, based on firm-level disclosures of listing standard noncompliance and of their board composition, in each case from 2019, supplemented by interviews with industry insiders.

10 (2012), https://www.mcguirewoods.com/news-resources/publications/antitrust/ACPERA-Eight-Years-Later.pdf. Moreover, the positive effect of ACPERA may have been tempered by ambiguity in the definition of "satisfactory cooperation," making it uncertain whether an amnesty applicant would indeed receive the benefit of ACPERA's de-trebling. *Id.*

### *A. Lax Enforcement of Stock Exchange Rules*

As noted in Part I, stock exchanges' continued listing standards applicable to issuers can be broadly classified into three categories: quantitative criteria; disclosure-related rules; and corporate governance rules. Upon detection of violation of a listing rule—whether it be through voluntary disclosure by the listed company or through stock exchange's monitoring—the enforcement process typically begins informally; the exchange's regulatory team may engage in informal conversations with the violating issuer to encourage remedial action and compliance.[67]

#### *1. Formal Enforcement of Stock Exchange Rules*

When noncompliance with a rule warrants action beyond informal negotiation and conversation with an issuer, formal enforcement of an exchange's rules generally involves multiple escalating steps, from initial noncompliance notice (or public reprimand letter) to ultimate delisting. In the case of the NYSE, within ten business days of identification of noncompliance, the exchange is to notify the listed company, in writing, of its noncompliance.[68] Within 45 days of the notification letter's receipt, the listed company must submit a plan of compliance to the NYSE, which is subject to exchange review.[69] If the NYSE accepts such a plan of compliance, it provides an 18-month cure period within which the listed company can regain compliance.[70]

If the NYSE does not accept such a plan of compliance or the listed company fails to regain compliance during the cure period,

67. Macey, O'Hara & Pompilio, *supra* note 11, at 688. A number of practitioners noted that exchanges may sometimes provide advance guidance as well, particularly when an issuer is uncertain about compliance with a rule. For example, an issuer may inquire whether a particular transaction or conduct complies with a listing rule, and the exchange may provide guidance on how to achieve compliance. In cases where a noncompliant transaction has already occurred, exchanges may sometimes "forgive" such noncompliance and guide the issuer toward compliance in the next iteration.

68. NYSE Listed Company Manual § 802.02.

69. *Id.*

70. *Id.* In some cases, the cure period differs from the default 18 months. For example, for delinquency in filing SEC-required periodic reports, a listed company initially has six months to file delinquent reports, subject to an additional six months that can be granted at NYSE's discretion. *Id.* § 802.01E. Likewise, for noncompliance with $1.00 minimum price requirement, a listed company has a six-month cure period. *Id.* § 802.01C. In some cases, NYSE also has discretion to initiate suspension and delisting procedures immediately. *Id.* § 802.02.

the NYSE can initiate delisting procedures by notifying the listed company of the delisting determination and issuing a public press release.[71] Within ten business days of the NYSE staff's notification, the subject issuer can appeal the staff's determination to a committee of the Board of Directors of the NYSE.[72] Generally, the company's stock would continue trading during the appeal period. If the company does not appeal the staff's delisting determination or the NYSE Board of Directors upholds the staff's determination, the company's securities will be suspended and delisted.[73]

Nasdaq provides a similar escalating enforcement process, with a few notable differences. First, under Nasdaq regulations, rule violations are classified into four categories: (1) those that result in immediate delisting; (2) those for which the cure period is subject to Nasdaq staff review of compliance plan; (3) those for which the listed company is automatically granted a cure period; and (4) those for which a public reprimand letter is issued.[74] If the Nasdaq staff determines that continued listing raises "a public interest concern" (among other grounds), the security is subject to immediate delisting. For noncompliance with certain corporate governance standards (e.g., shareholder meeting, shareholder approval), a requirement to file periodic reports, and certain quantitative criteria (e.g., minimum equity, number of stockholders), the staff can grant a cure period of up to 180 days, subject to its review and approval of the listed company's compliance plan.[75] For a number of other continued listing standards—including minimum bid price, majority independent board, and audit committee composition—the listed company is automatically granted a specified cure period (typically 180 days, but varies depending on the type of violation).[76]

Second, unlike the NYSE, Nasdaq has a multi-step appeal process. Upon Nasdaq staff's delisting determination, the subject company can appeal to the Nasdaq Hearing Panel. If the Nasdaq Hearing Panel upholds the delisting determination, it can then

71. *Id*. § 804.00

72. *Id*.

73. *Id*.

74. Nasdaq Rule § 5810(c). As noted above, the NYSE also has the power to issue public reprimand letters.

75. *Id*. § 5810-1(c)(1).

76. *Id*. § 5810-2(B)(i).

appeal to the Nasdaq Listing and Hearing Review Council. The Listing and Hearing Review Council's decision is further subject to discretionary review by the Board of Directors of Nasdaq.[77] Thus, Nasdaq provides a much longer appeal process than NYSE does.

In both cases, under Section 19(f) of the Exchange Act, the SEC can review the delisting decision by the NYSE or Nasdaq, as such a decision constitutes a denial of access to services by a self-regulatory organization. However, as noted previously, the SEC's review is limited to whether the factual basis for the decision exists, whether the decision was made in accordance with the rules of the exchange, and whether the rules were applied in a manner consistent with the goals of the Exchange Act, and exchange delisting determinations are rarely overturned at the SEC appeal stage.

*2. Federal Disclosure Data on Stock Exchange Enforcements*

Once a stock exchange initiates enforcement for noncompliance with a continued listing standard, the federal securities laws impose a disclosure obligation on the listed company. In an Exchange Act Form 8-K (Item 3.01), an Exchange Act registrant is required to disclose: (1) notice of noncompliance with the continued listing standards of the exchange on which the registrant's common equity is principally listed; (2) notice of exchange-initiated delisting from such exchange; (3) registrant's voluntary notice to its stock exchange of noncompliance with applicable continued listing standards; (4) public reprimand or similar communication from a registrant's stock exchange for violation of continued listing standards; and (5) voluntary delisting decisions.[78] As a result, Form 8-K Item 3.01 disclosures provide a complete picture of enforcement actions taken by stock exchanges in the United States against issuers for noncompliance with continued listing standards, including notice of noncompliance, suspension, and/or delisting.[79]

Thus, in order to examine the status quo of stock exchange rule enforcement against issuers, we collected data on enforcement

77. *Id*. § 5825.

78. Form 8-K for Current Reports, 17 C.F.R. § 249.308 (2019).

79. Item 3.01 triggering events include listed companies' voluntary delisting decisions (including as a result of merger) that are unrelated to stock exchange rule violations, so Item 3.01 disclosures are actually overinclusive.

actions from all Form 8-Ks filed in 2019 that made a disclosure under Item 3.01. Table 1 below shows the breakdown of Item 3.01 disclosures by type of disclosure and exchange, excluding duplicate items.[80]

TABLE 1: ITEM 3.01 DISCLOSURES BY TYPE OF DISCLOSURE AND EXCHANGE

| Type | NYSE | Nasdaq | Other (e.g., OTC) | Total |
|---|---|---|---|---|
| Voluntary Delisting or Transfer (including as a result of merger) | 112 | 115 | 12 | 239 |
| Noncompliance Notice | 91 | 317 | 1 | 409 |
| Involuntary Delisting | 26 | 91 | 0 | 117 |
| Other (e.g., compliance, extension of cure period) | 8 | 65 | 0 | 73 |
| Total | 237 | 588 | 13 | 838 |

Of the 838 Item 3.01 disclosures (excluding duplicates), approximately 29% (239) relate to voluntary delisting or transfer, which may be as a result of a merger, board decision to save listing costs, or transfer to another exchange. The remainder relates to noncompliance with a continued listing standard. Approximately half of Item 3.01 disclosures in 2019 disclose a notice of noncompliance, while 14% disclose a notice of delisting. Some of the notices of delisting are as a result of failure to cure noncompliance during the grace period, while others are as a result of exchange decision to immediately suspend and delist the subject security. Slightly less than 9% disclose other items related to noncompliance

80. The exchanges' websites also disclose the issuers that are noncompliant with a listing standard. However, the websites only contain the issuers that remain noncompliant as of that particular moment and does not include whether a certain issuer was noncompliant at a past moment. *See, e.g.*, *Noncompliant Issuers*, NYSE REGULATION, https://www.nyse.com/regulation/noncompliant-issuers (Last visited Oct. 20, 2021); *Noncompliant Companies*, NASDAQ, https://listingcenter.nasdaq.com/noncompliantcompanylist.aspx (Last visited Oct. 20, 2021).

with a rule, including that the listed company has regained compliance or that the cure period has been granted or extended.[81]

As noted above, the stock exchanges have two potential sanctions at their disposal: public reprimand or delisting. Other "sanctions"—such as suspension—are not independent sanctions *per se* but preludes to public reprimand or (most often) delisting. Likewise, although notice of noncompliance is publicly disclosed pursuant to SEC rules and such disclosure can have negative effects on the violating company, the notice itself is not a sanction but preliminary steps toward a formal sanction.

Between these two potential sanctions, we note an extremely rare use of the public reprimand sanction compared to the delisting sanction. In 2019, only three public reprimand letters from stock exchanges were disclosed in Form 8-K filings, all of which related to failure to obtain stockholder approval for offering of shares representing 20% or more of the voting power of the issuer. In these cases, since the offering has already taken place, it appears that the stock exchanges rely on public reprimand letters to deter future violations. In the vast majority of other cases, while the notice of noncompliance does have some shaming function, the exchanges retain the flexibility to escalate to the delisting sanction, depending on the cooperation and remediation by the noncompliant issuer.

We also classified the noncompliance notices and involuntary delisting actions by the type of noncompliance that gave rise to such notice/delisting action, and the result is presented in Table 2. A significant majority—nearly three-quarter—of the noncompliance and delisting notices are based on failure to meet quantitative criteria for continued listing, such as the $1.00 price minimum or market capitalization minimum. Delinquent periodic reports account for 12% of the total, and corporate governance violations, including failure to constitute the board and board committees in accordance with exchange regulations, failure to hold an annual meeting, or failure to obtain shareholder approval as required, account for another 12%. Other violations, such as failure to pay listing fees, bankruptcy, and listing contrary to the public interest, account for the remainder; given the severity of

81. While these items are not required to be disclosed (since they relate to *compliance*, rather than *noncompliance*), a substantial number of companies voluntarily report them.

these "other" violations, as expected, all of them involve direct delisting notices.

TABLE 2: NONCOMPLIANCE/DELISTING NOTICES BY TYPE OF VIOLATION

| Violation Type | Noncompliance Notice | Delisting | Subtotal | Percentage of Total |
|---|---|---|---|---|
| Quantitative Criteria | 295 | 84 | 379 | 72% |
| Delinquent Periodic Report | 54 | 10 | 64 | 12% |
| Corporate Governance | 60 | 1 | 61 | 12% |
| Other | 0 | 22 | 22 | 4% |
| Total | 409 | 117 | 526 | 100% |

A few items are worth noting from these data. First, stock exchanges' formal enforcement is focused largely on continued listing standards that are easily observable. Failure to comply with the quantitative criteria for continued listing is easily observable based on listed companies' market data and financial reports, and delinquency in filing periodic reports is also observable, particularly since periodic report deadlines are mostly synchronized. The fact that violations of these criteria are easily observable also means that they give rise to much less discretion in enforcement, which may explain their accounting for a vast majority of formal enforcement actions. Another potential explanation for this concentration of enforcement actions is that stock exchanges may view the failure to meet quantitative criteria as affecting the liquidity in the trading markets, directly and immediately undermining the quality of the product they offer. An implication of the exchanges' apparent emphasis on quantitative listing criteria and financial reports is that exchanges' enforcement is ironically concentrated on violations for which the listed companies are arguably less culpable. Noncompliance with quantitative continued listing standards can arise due to a number of factors—including market factors—many of which are beyond

the listed company's control, but these standards are precisely the ones that the exchanges focus the most on.

Second, among enforcement actions for corporate governance violations, more than half stem from listed companies' voluntary reporting. For example, upon death or departure of an independent director that leads to breach of majority independent board requirement or *ex post* revelation that a transaction that did not receive shareholder approval was indeed subject to the shareholder vote requirement, a listed company would voluntarily report such violation to the exchange, which in turn would provide the cure period as prescribed in the exchange regulations. Of the 61 noncompliance/delisting notices based on a violation of corporate governance standards, 37 arose out of the listed company's self-reporting. Thus, formal enforcement for violations of corporate governance standards that have been detected by exchanges without the issuer's self-reporting appears to be rare.

Third, only a fraction of issuers that receive a noncompliance notice end up in the delisting process.[82] Given extended cure periods, most companies are able to cure their deficiencies before delisting procedures commence. This is particularly pronounced for corporate governance violations, as only one company faced delisting in 2019 for noncompliance with a corporate governance standard. Moreover, even after the delisting process begins, as a result of issuers' ability to appeal the delisting decision, only two-thirds of the issuers initially subject to delisting actually end up delisted; of 117 companies whose delisting process began in 2019, 41, or 35% of the total, still remain listed. Even after formal enforcement for stock exchange rule violation is initiated, there are a number of "escape hatches" that allow a listed company to remain listed, and actual delisting only occurs for a small fraction of the noncompliant issuers.

One recent delisting illustrates the long leash afforded to listed companies by exchanges. On October 2, 2018, USA Technologies,

82. Our dataset is a snapshot of disclosures made in 2019, and the delisting notices that were disclosed in 2019 often stem from noncompliance that occurred in 2018 or earlier. However, in the absence of drastic policy change between 2018 and 2019, it is reasonable to assume that comparing delisting notices from 2019 with the noncompliance notices from the same year gives an approximation of the likelihood that a noncompliant issuer ends up facing the delisting process. Based on this assumption, only about one-quarter of companies that receive a noncompliance notice end up in the delisting stage.

Inc., then a Nasdaq-listed company, received initial notice of noncompliance due to its failure to file its annual report (Form 10-K) on time.[83] A month later, on November 14, the company again received notice of noncompliance for failure to file its quarterly report on time.[84] At that time, pursuant to Nasdaq's decision to accept the company's plan of compliance, Nasdaq granted the company until March 12, 2019, to file its delinquent reports.

On February 26, 2019, however, Nasdaq determined that the company would not be in a position to file its delinquent reports by the March 12 deadline and commenced delisting procedures.[85] In response to Nasdaq's determination, the company appealed to the Nasdaq Hearings Panel, which granted an extension until September 9, 2019, to regain compliance. In the meantime, however, the company received two additional noncompliance notices, one for failure to file a quarterly report on time (May 14) and one for failure to hold an annual meeting (July 10), and failed to regain compliance with its periodic filing obligations by the September 9 extended deadline.[86] As a result, the delisting procedure resumed, but the company again appealed the delisting determination to the Nasdaq Listing and Hearing Review Council, which affirmed the delisting decision. The company was finally delisted on February 4, 2020.[87] Thus, from the initial noncompliance to delisting, with multiple compliance cure periods and two appeals, it took more than sixteen months.

Taken together, the Form 8-K disclosures we collected indicate that exchanges infrequently rely on their "big stick," particularly for corporate governance standard violations. Exchanges often rely on "informal enforcement"—starting with conversations and negotiations with the noncompliant issuer—to prod the listed

83. USA Technologies, Inc., Current Report (Form 8-K) (Oct. 1, 2018)

84. USA Technologies, Inc., Current Report (Form 8-K) (Nov. 20, 2018).

85. USA Technologies, Inc., Current Report (Form 8-K) (Mar. 4, 2019).

86. USA Technologies, Inc., Current Report (Form 8-K) (May 20, 2019); USA Technologies, Inc., Current Report (Form 8-K) (July 16, 2019).

87. USA Technologies, Inc., Notification of Removal from Listing and/or Registration (Form 25) (Feb. 5, 2020). The company's stock is still traded on the OTC market after delisting from Nasdaq. When a company fails to file a Form 10-K, SEC Rule 12b-25 requires that the company file a Form NT and the timely filing of the form gives the company a one-time grace period. If the company fails to file its Form 10-K within the grace period—at least in theory—the company's stock can be subject to the SEC's administrative proceedings. 17 C.F.R. § 240.12b-25 (2019).

company into complying. When the exchanges do engage in formal enforcement actions, they focus largely on the failure to meet quantitative criteria for continued listing and the failure to file SEC-mandated periodic reports, and enforcement actions for violations of corporate governance listing standards are rare. Combined with lengthy cure periods and multi-step appeal process prescribed by the exchange regulations, such a pattern of formal enforcement means that a listed company would rarely face suspension and delisting for their noncompliance.

### *B. Rigorous Compliance with Stock Exchange Rules*

In the previous section, we showed that the stock exchanges' formal disciplinary sanctions are rare, especially for corporate governance standard violations. While the analysis of Form 8-K Item 3.01 captures the full picture of stock exchanges' *enforcement* activities against listed companies in 2019, it does not necessarily describe how well companies are in *compliance* with the exchange rules. After all, a low level of enforcement activities may indicate a low level of detection of noncompliance. To better understand the implications of a low level of enforcement and focusing on the corporate governance requirements (with which exchanges' enforcement appears to be most lax), we examined a separate set of data on corporate board compositions of S&P 1500 companies to see the current status of compliance with the corporate governance requirements in stock exchange rules. The results indicate that compliance with stock exchange rules is robust despite the low level of enforcement.

#### *1. Stock exchanges' corporate governance requirements*

In the aftermath of the Enron and WorldCom scandals and revelations of lax internal controls of public companies, calls for reform led to an overhaul of stock exchanges' corporate governance listing standards, and on November 4, 2003, the SEC approved the NYSE and Nasdaq's proposed rule changes on corporate governance requirements "to ensure the independence of directors of listed companies and to strengthen corporate governance

practices."[88] Most notably, the exchanges required listed companies to have a board of directors with a majority of independent directors ("majority independent board")[89] and to have board committees (e.g., audit, compensation, and nominating committee) comprised exclusively of independent directors ("independent committees").[90] Listed companies must also affirmatively determine whether each director is qualified as an independent director under the definitions offered by stock exchange rules.[91]

An affirmative determination of independence is either made by a mechanical application of the bright-line disqualification criteria of stock exchange rules,[92] or by the assessment of potential impairment of each director's independent judgment.[93] Courts distinguish the two types of independence determination and protect a board's evaluation beyond the application of the bright-line rule as "the product of the board's business judgment."[94] The determination is made by the nominating committee, the members of which are independent directors themselves.[95] For large companies, it is not uncommon that

88. NASD and NYSE Rulemaking: Relating to Corporate Governance, SEC Rel. No. 34-48745, 68 Fed. Reg. 64, 154 (Nov. 4, 2003), https://www.sec.gov/rules/sro/34-48745.htm. The NYSE and Nasdaq submitted a proposal and its amendments respectively in 2002 and the SEC approved both exchanges' proposals on November 4, 2003. For the role of monitoring boards, see Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268–72 (1997). For the adoption of stock exchange rules emphasizing board independence, see Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1818 (2010); Miriam H. Baer, *Confronting the Two Faces of Corporate Fraud*, 66 FLA. L. REV. 87, 151–52 (2014).

89. NYSE Listed Company Manual § 303A.01; Nasdaq Rule § 4350(c)(1).

90. NYSE Listed Company Manual § 303A.01; Nasdaq Rule § 4350(c)(1). Unlike NYSE, Nasdaq does not mandate an independent nominating committee, and director nomination can be done by majority of the independent directors. Also, only NYSE requires its listed company to post the company's three mandatory (audit, compensation, and nominating) committee charters on the company's website. NYSE Listed Company Manual §§ 303A.04-06. For a comprehensive analysis of corporate governance documents published through S&P 1500 companies' websites, see Yaron Nili & Cathy Hwang, *Shadow Governance*, 108 CALIF. L. REV. 1097 (2020).

91. NYSE Listed Company Manual § 303A.02; Nasdaq Rule § 4200(a)(15).

92. *E.g.*, NYSE Listed Company Manual § 303A.02(b).

93. *E.g.*, *id.* § 303A.02(a) Commentary ("[I]t is best that boards making 'independence' determinations broadly consider all relevant facts and circumstances.").

94. Forestal v. Caldwell, 739 Fed. App'x 895, 899 (9th Cir. 2018).

95. *See, e.g.*, *Nominating and Corporate Governance Committee Charter*, APPLE INC., ("Purpose: To consider and report periodically to the Board of Directors on matters relating

their independent directors are executives of other companies or directors sitting on multiple boards simultaneously, and both due to time constraints and limited access to inside information, the nominating committee members' determinations largely rely on the information self-reported by the subject directors.[96] Nominating committees evaluate directors' self-reported conflicts of interest along with the bright-line disqualifying factors for independence, and self-report its independence determination to stock exchanges. Such a double-self-reporting mechanism makes it harder for stock exchanges to validate a listed company's independence determination.

*2. Self-reporting compliance: corporate governance affirmation*

Unlike the quantitative listing standards, corporate governance requirements of stock exchange rules demand *qualitative* assessment of director independence, and it is more difficult to detect noncompliance without the listed company's cooperation. Thus, solely for the corporate governance requirements, the NYSE requires self-reporting of noncompliance, and the enforcement of stock exchange rules heavily relies on self-reporting.

Companies listed on the NYSE and Nasdaq have an obligation to self-report compliance with corporate governance requirements, but the level of rigor differs. First, the NYSE expressly requires that a listed company submit an annual and interim written affirmation in addition to the disclosure requirements of Section 303A.[97] The affirmation should be accompanied by the certification of the

to the identification, selection and qualification of the Board of Directors and candidates nominated to the Board of Directors[.]"). Regulation S-K mandates companies to disclose whether the determination has been made that a director is independent. 17 C.F.R. § 229.407(a)(1)(i) (2019). *See also* NYSE Listed Company Manual § 303A.6; Nasdaq Rule § 5605(c)(2).

96. *See, e.g.*, *Guidelines Regarding Director Conflicts of Interest*, APPLE INC. (Feb. 12, 2018), https://s2.q4cdn.com/470004039/files/doc_downloads/gov_docs/2018.02.12_Director_Conflicts_Guidelines.pdf ("The Corporation's General Counsel will survey each director annually to determine if the director has any actual or potential conflicts of interest with the Corporation. In addition, any director who becomes aware of an actual or potential conflict of interest with the Corporation at any time during the year shall notify the Corporation's General Counsel promptly in writing of the material facts of the actual or potential conflict of interest. The Corporation's General Counsel shall notify the Chair of the Nominating and Corporate Governance Committee of such facts.").

97. NYSE Listed Company Manual § 303A.12(c).

company's CEO.[98] By contrast, Nasdaq does not expressly require equivalent corporate governance certification, and a Nasdaq-listed company needs to submit a corporate governance certification upon its initial listing,[99] and needs to modify the certification only when there is a change from the initial certification.[100]

When listed companies notify noncompliance, stock exchanges are likely to start an enforcement process, but as we discussed in the earlier section, stock exchanges mostly guide companies to comply with the requirements during the cure period. In the next section, we examine whether scarce enforcement is due to the poor detection rate associated with the low quality of self-reporting, or due to the high compliance rate of the corporate governance requirements.

*3. Current practice of compliance*

In order to examine the current status of compliance, we use the S&P 1500 companies' data on board compositions.[101] The main dataset is from BoardEx,[102] and we cross-checked the BoardEx data with information disclosed in companies' proxy statements. Corresponding to stock exchanges' enforcement activities in 2019, we collected data from proxy statements prepared for annual meetings in 2020, which summarizes board activities in the 2019 fiscal year and also shows board nominees for the 2020 fiscal year.

*a. Majority independent board.* Looking at the board composition for the fiscal year 2019, all but ten companies had the majority of independent directors on the board as required. Not many companies stood on the borderline of the 50% threshold, and most companies surpassed the required threshold easily. About 10% of the companies had a board comprised of more than 90% of

98. *Id.* § 303A.12(a), (b).

99. *Corporate Governance Certification Form*, NASDAQ LISTING CENTER https://listingcenter.nasdaq.com/ViewPDF.aspx?CGCertForm.aspx?Preview=CGC&Print=N&filenm=Corporate%20Governance%20Certification%20Form (last visited Oct. 10, 2021).

100. Nasdaq Rule § 5625 (Notification of Noncompliance).

101. Although S&P 1500 does not fully demonstrate the current compliance of all U.S. listed companies, the index is still a representative sample covering about 90% of the market capitalization of the U.S. stock market. It contains large-sized (S&P 500), medium-sized (S&P 400), and small-sized (S&P 600) companies. Because funds and trusts' corporate governance is significantly different from traditional listed companies', we excluded them from our analysis.

102. BoardEx database is constructed with information on company websites, annual reports, and public filings. *Data Quality*, BOARDEX, https://corp.boardex.com/data-quality/ (last visited Oct. 8, 2021).

independent directors. All ten companies that do not have the majority independent board are controlled companies, which are exempted from the requirements.[103] That is, all companies are in compliance with the requirement.

However, the practice of the supermajority independent board was already in trend before the adoption of the majority independent board requirement in 2003.[104] While the stock exchanges' majority independent board requirement confirmed the monitoring function of independent directors and extended the requirement to all listed companies, it did not initiate the trend for most companies. Nonetheless, the zero-noncompliance rate illustrates strong adherence to the requirements imposed by stock exchanges.

*b. Independent board committees.* The stock exchanges' corporate governance requirements adopted in 2003 more profoundly influenced the structure of board committees. NYSE Listed Company Manual requires three mandatory board committees: Audit, Compensation, and Nominating/Corporate Governance Committees.[105] For Nasdaq-listed companies, a stand-alone nominating committee is optional, and the independent directors constituting the majority of all independent directors on the board can select director nominees instead.[106] The members of each of these board committees should be independent directors.[107]

All S&P 1500 companies had an audit committee with at least three independent directors. Besides controlled companies utilizing exemptions from the requirements,[108] all but seven companies had an independent committee with a title that included the word "compensation." The seven deviating companies had a

103. *See infra* Section II.C.4.

104. *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1475 (2007) (documenting the proportion of independent directors surpassed 50% prior to 1995 and reached approximately 75% in 2005).

105. NYSE Listed Company Manual §§ 303A.04–06.

106. Nasdaq Rule § 5605(e)(1).

107. A more stringent independence standard applies to audit and compensation committee members. NYSE Listed Company Manual §§ 303A.04–06; Nasdaq Rule § 5605(c)-(e).

108. Although Coty Inc. (NYSE: COTY) claims that the company has "decided not to take advantage of these [controlled company] exemptions," the company has two board committees (Audit and Finance Committee & Remuneration and Nomination Committee), and the same committee reviews executive compensation and director nomination, which does not comply with the NYSE's board committee requirements. Coty Inc., Proxy Statement (Form DEF14A) (Sept. 25, 2019).

committee with different names but functionally equivalent to a compensation committee.[109] As for nominating committees, all S&P 1500 companies either had a standalone nominating committee (sometimes with variations in name as permitted by Nasdaq) or had director nominees selected by the independent directors constituting the majority of all independent directors on the board instead of a standalone nominating committee (as permitted by Nasdaq).[110] Also illustrating this strong compliance pattern, Expedia formed a nominating committee on the exact day (without taking advantage of the phase-in period it was entitled to) it ceased to be a controlled company and was no longer exempt.[111] Thus, we were unable to find a single S&P 1500 company not in compliance with board committee requirements imposed by the stock exchanges.

### *C. Curious Case of Rigorous Compliance with Lax Enforcement*

One limitation of using proxy statement disclosures to measure the current practice of compliance is that information in proxy statements only captures a "snapshot" of compliance around the time of an annual shareholder meeting and does not show whether the company complied during the time between shareholder meetings. The stock exchanges' enforcement activities described in the earlier section mostly occurred between the shareholder meetings. While noncompliance between shareholder meetings is possible and does happen, at minimum, having to file proxy statements offers a strong incentive for the companies to comply with the stock exchange rules at least once a year. In that sense, a question remains: Why do companies comply with stock exchange rules despite the seemingly lax enforcement?

109. The variations of a compensation committee name include: People Resources Committee (CIGNA Corp.), Personal and Organization Committee (Colgate-Palmolive Co.), Personnel Committee (Entergy Corp.), Executive Resources Committee (RLI Corp.), Salary and Employee Benefits Committee (Selective Insurance Group Inc.), and Management Planning and Development Committee (CVS Health Corp. & Yum! Brands Inc.).

110. Nasdaq Rule § 5605(e). In our sample, fifty-eight (approximately 10.5%) Nasdaq listed companies do not have a standalone nominating committee.

111. Expedia Group, Inc. ceased to be a controlled company following the closing of the Liberty Expedia Transaction and formed a nominating committee with two independent directors on July 26, 2019. *See* Expedia Grp., Inc., Proxy Statement 12-14 (Form DEF14A) (May 7, 2020).

*1. SEC disclosure requirements*

One possible explanation can be the SEC's disclosure requirements. The SEC Regulation S-K Item 407(a) requires each company to identify and list all independent directors in its proxy statement, and identify any audit, compensation, and nominating committee member who is not independent under each committee's independence standard.[112] Accordingly, if a company does not disclose whether each director is independent, both the SEC and the company's shareholders can claim a violation of the SEC rules, since, at least in theory, such non-disclosure can constitute a material *omission*.

On the other hand, whether the SEC or shareholders can challenge a company's disclosure of director independence based on the claim of material *misstatement* is questionable. One recent case demonstrates the difficulty of carrying such a claim. In *Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera*, the plaintiff claimed direct injury allegedly caused by material misstatements in the company's (Orbitz) 2014 proxy statement. The company, using the proxy statement, sought stockholder votes in connection with the election of directors. However, the proxy statement, according to the plaintiff, falsely identified three directors as being independent.[113] The Delaware Chancery Court dismissed the case for failure to state a claim because the plaintiff failed to argue that the proxy statement "failed to accurately disclose all material facts relevant to assessing the independence of any of Orbitz's directors under Delaware law[.]"[114] The court stated that the "[p]laintiff's challenge to the propriety of an independence determination under the NYSE Rules does not undermine the sufficiency of the disclosures in the 2014 proxy statement."[115] According to the court, since the plaintiff challenged the substance of the board's independence determination for the three directors under the NYSE listing standard, the plaintiff should have established that

112. 17 C.F.R. § 229.407 (2020). For an analysis of disclosure practices associated with independent directors, see Geeyoung Min, *The SEC and the Courts' Cooperative Policing of Related Party Transactions*, 2014 COLUM. BUS. L. REV. 663 (2014); Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 52 (2017).

113. Teamsters Union 25 Health Servs. & Ins. Plan v. Baiera, 119 A. 3d 44, 68. (Del. Ch. 2015).

114. *Id.* at 48, 69 (footnote omitted).

115. *Id.* at 69.

the board violated the NYSE rules.[116] Most importantly, according to the court, the plaintiff, "fail[ed] to allege *any indication from the NYSE* that Orbitz has done anything wrong under the NYSE Rules"[117] (emphasis added). The court's reasoning suggests that whether a company complies with the stock exchange rules cannot be determined by the shareholders but can only be determined by the relevant exchange.

Furthermore, with respect to the board composition requirements, the SEC disclosure rules focus on making information about director independence publicly available and do not impose substantive requirements on stock exchange rules.[118] Thus, as long as companies disclose which director is qualified as an independent director in compliance with the stock exchanges' criteria, and disclose the composition of the board committees, not having a majority independent board or independent committees does not constitute a violation of the SEC rule.[119] In that sense, the SEC disclosure requirements are limited in their ability to enforce compliance with the stock exchange rules.

*2. Supplemental role of stock exchange corporate governance requirements*

One could also argue that stock exchanges are not inclined to enforce their corporate governance requirements and instead focus their attention on quantitative requirements because the failure to meet quantitative requirements directly affects the liquidity and external perception of the stock exchanges, whereas corporate

116. *Id.* at 69–70.

117. *Id.* at 70.

118. *See* 17 C.F.R. § 229.407(b)(3) (2020) ("State whether or not the registrant has standing audit, nominating and compensation committees of the board of directors, or committees performing similar functions. If the registrant has such committees, however designated, identify each committee member . . . ."); *id.* at (a) (when a company does not have a "separately designated audit, nominating or compensation committee or committee performing similar functions," the company must disclose all non-independent directors applying such committee independence standards that stock exchanges provide); *id.* at (c)(1) ("If the registrant does not have a standing nominating committee or committee performing similar functions, state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a committee and identify each director who participates in the consideration of director nominees."); *id.* at (e)(1) ("If the registrant does not have a standing compensation committee . . . .").

119. *Id.*

governance requirements do not have such a direct impact on the stock exchanges' reputational capital. Moreover, given that corporate governance has traditionally been in the purview of state corporate law, stock exchanges may not emphasize their role in enforcing corporate governance requirements as much as their role in enforcing quantitative requirements.

This explanation for stock exchanges' lax enforcement of their own corporate governance rules overemphasizes the degree of overlap between state corporate law and stock exchanges' corporate governance requirements. In fact, among the stock exchange corporate governance requirements, the most notable ones—e.g., shareholder vote upon issuance of stock with 20% or more in voting power, majority independent board, mandatory board committees—have no equivalent in state corporate law. If stock exchange corporate governance requirements did not exist, state corporate law would not impose any similar requirements. Furthermore, this explanation does not account for the fact that stock exchanges often impose sanctions for failure to file periodic reports as mandated by the SEC; if the "supplemental role" explanation held, then one would expect the stock exchanges to also defer to the SEC in enforcing periodic disclosure rules.

Even if we assume, arguendo, that stock exchanges do not view corporate governance as their main regulatory area, this does not explain issuers' rigorous compliance with corporate governance rules imposed by stock exchanges. After all, one would actually expect the opposite; if stock exchanges view their role as merely supplemental to state corporate law, such a view will downplay the importance of compliance to the issuers, which runs against the pattern of rigorous compliance we see.

*3. Proxy advisors' voting guidelines*

Another possible explanation for the compliance can be proxy advisors' voting guidelines prepared for institutional investors. Institutional Shareholder Services ("ISS"), a dominant proxy advisor, has a voting guideline that recommends voting against non-independent directors when a company (1) does not have a majority independent board, (2) has a non-independent director as a member of the audit, compensation, or nominating committees, (3) lacks an audit, compensation, or nominating committee, or (4) lacks a formal stand-alone nominating committee,

"even if the board attests that the independent directors fulfill the functions of such a committee."[120]

The ISS's influence on director elections, however, does not fully explain why more than 10% of companies on Nasdaq do not have a standalone nominating or governance committee, despite the ISS voting guidelines.[121] Although these companies are in compliance with Nasdaq listing standards, their lack of a standalone nominating or governance committee runs against ISS voting guidelines. This indicates that in many cases, companies will step outside proxy advisors' voting guidelines, as long as they stay within the limits of stock exchange regulations, and that therefore, proxy advisors' influence cannot fully account for the compliance pattern we noted above.[122] Furthermore, ISS's actual voting recommendation for each company is not always identical to its general voting guideline.[123]

*4. Voluntary compliance as "best practice"*

Lastly, one could posit that listed issuers may comply with stock exchanges' corporate governance requirements because they represent the "best practice" in corporate governance, and thus there is an independent reason for the issuers' compliance. Under this argument, the curious coexistence of lax enforcement and rigorous compliance is not a puzzle, because the stock exchanges'

120. ISS voting guidelines list the triggering events corresponding to the NYSE Listing Manual's independence requirements, which incentivizes Nasdaq-listed companies to follow the more stringent NYSE requirements. For instance, even if a Nasdaq-listed company decides not to have a standalone nominating committee, although it does not violate the Nasdaq rule as long as its independent board members carry out director nominations, the lack of a nominating committee itself directly triggers the ISS's objections to the election of non-independent directors or the entire board members. ISS, U.S. PROXY VOTING GUIDELINES, BENCHMARK POLICY RECOMMENDATIONS 8 (Nov. 19, 2020), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

121. *See supra* note 110.

122. *Id.*

123. On a more generalized note, an empirical study found that an actual ISS recommendation shifts only 6%–10% of shareholder votes on specific issues that ISS recommended, considering the underlying factors, which shows that the impact of ISS's voting guideline may not be as significant as to shape the compliance practice across companies. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth Or Reality?*, 59 EMORY L.J. 869, 903 (2010). It is worth noting, however, that the study is not on the governance changes deviating from ISS recommendations, which may trigger bigger shift of vote against in director elections.

corporate governance requirements are not the limiting factor; companies adopt the majority independent board and three board committees not because the stock exchanges require them to but because they believe it is the best thing to do for themselves.

There may be some validity to this argument. The rationale for the stock exchanges to adopt the corporate governance requirements—to strengthen internal control—applies to the companies themselves as well, and to the extent that the listed issuers are well-intentioned and want strong internal controls, they would be incentivized to adopt the practices delineated in the stock exchanges' corporate governance requirements. Thus, a substantial portion of the S&P 1500 companies' "compliance" with the stock exchange corporate governance requirements can be explained with this "voluntary adoption" argument.

But whether the internal incentives are so strong that not a single S&P 1500 company violates the stock exchange corporate governance requirements is doubtful. First, adoption of the "best practices" is not costless. General counsels we interviewed noted various costs of such adoption, including costs associated with setting up and maintaining separate committees of the board. In the presence of these costs, it is questionable whether the benefits are so substantial *for all S&P 1500 companies* that they outweigh the costs.

Second, to examine how "voluntary" the compliance by listed issuers is, we can compare with a subset of companies that are not subject to the stock exchanges' corporate governance requirements: controlled companies. Under both NYSE and Nasdaq rules, "controlled companies" are exempted from certain corporate governance requirements.[124] More specifically, while controlled companies are required to have an audit committee comprised of independent directors, they are not obligated to have a majority independent board, a compensation committee, or a nominating committee.[125] If the compliance by listed issuers is indeed truly

124. NYSE Listed Company Manual § 303A.00 ("Controlled Companies. A listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company is not required to comply with the requirements of Sections 303A.01, 303A.04 or 303A.05."); Nasdaq Rule § 5615(c)(1) ("A Controlled Company is a Company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company.").

125. *See* NYSE Listed Company Manual § 303A.00 (exempting controlled companies from Section 303A.01 (majority independent director requirement), Section 303A.04

voluntary and is entirely motivated by the companies' desire to adopt best practices in corporate governance, we would expect that controlled companies, in the absence of any limiting requirements, to comply with the rules rigorously as well.

To test this hypothesis, we hand-collected board and committee composition data of all controlled companies listed on the NYSE and Nasdaq. As shown below in Table 3, among 232 controlled companies examined, 88 (38%) lacked a majority independent board, 96 (41%) lacked a fully independent compensation committee, and 152 (66%) lacked a fully independent nominating committee. Taken together, more than 70% of controlled companies took advantage of at least one exemption from the corporate governance requirements (i.e., a majority independent board, a compensation committee comprised entirely of independent directors, and a nominating committee comprised entirely of independent directors). This divergence of compliance between companies that are subject to the corporate governance requirements and those that are not, confirms our view that the "voluntary adoption" hypothesis explains some, but not all, of the rigorous compliance with stock exchange corporate governance requirements by listed companies.

TABLE 3: CONTROLLED COMPANIES' BOARD COMPOSITION

| Characteristic | Number of Companies | Percentage of Total |
|---|---|---|
| Lacking Majority Independent Board | 88 | 38% |
| Lacking Independent Compensation Committee | 96 | 41% |
| Lacking Independent Nominating Committee | 152 | 66% |
| Lacking At Least One Feature Above | 164 | 71% |

Furthermore, while stock exchange rules require a controller with more than 50% of voting control for the controlled company

(nominating and corporate governance committee), and 303A.05 (compensation committee)); Nasdaq Rule § 5615(c)(2) (exempting controlled companies from Rule 5605(b) (majority independent director requirement), Rule 5605(d) (compensation committee), and Rule 5605(e) (independent director oversight of director nominations)).

exemption, in practice, companies can also be controlled by shareholders with less than 50% of the voting power.[126] They are both in effect controlled companies that share similar internal dynamics, but their compliance rates vary significantly depending on whether companies are subject to the exemption based on the 50% threshold. Thus, the lower compliance rate of controlled companies shown in Table 3 cannot solely be explained by the unique dynamic in companies with controlled shareholders.

## III. RELATIONAL ENFORCEMENT: STOCK EXCHANGE RULE AS A RELATIONAL CONTRACT

In Part II, we illustrated the current status of enforcement and compliance of stock exchange rules: despite lax enforcement, listed companies rigorously comply with the stock exchange rules. While one may argue that the low frequency of enforcement is due to a high level of compliance, we also note that enforcement actions infrequently move beyond noncompliance notification to the delisting stage. Given this quantitatively and qualitatively low level of enforcement, we would generally expect noncompliance to be common, but we actually find the opposite. In addition, in Section II.C, we showed that while there are a number of alternative explanations for robust compliance by listed companies, these, standing alone, do not sufficiently explain the level of compliance that we observe. Hence, in this Part III, we introduce a new perspective that can explain the dynamic between a listed company and a stock exchange: stock exchange rule as a relational contract.

### *A. Conceptualizing Stock Exchange Rule as a Relational Contract*

#### *1. Relational contract*

Transactions between multiple parties—and the contracts that govern such transactions—can be characterized along a spectrum. At one end of this spectrum lies a discrete, one-shot

126. *See generally* Ann M. Lipton, *After Corwin: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977 (2019); Note, *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards*, 133 HARV. L. REV. 1706, 1707 (2020) ("[I]n recent years, a proliferation of Delaware cases has muddled the inquiry, de-emphasizing substantiality of share ownership and holding that stockholders with as little as 15% ownership and no effective voting power are controlling stockholders despite the presence of a controlled board.").

transaction. Such transactions are typically (although not always) short-term exchanges, and the identity of the counterparty is, more or less, irrelevant.[127] A contract governing such a discrete, one-shot transaction tends to be more complete, in that the contract contemplates most, if not all, possible contingencies and the consequences of each contingency.[128] As such, any nonperformance is dealt with in accordance with the "four corners" of the contract and through legal sanctions, such as contract law-based remedies.[129] Buying a commoditized good in a foreign land would qualify as such a discrete, one-shot transaction; since the good is commoditized and there is no prospect of a repeat transaction, the identity of the counterparty does not matter, and the remedy for any nonperformance is predictable.[130]

At the other end of this spectrum lies an extended, long-term relationship governed by a relational contract. Long-term relationships that require cooperation and resource pooling between the parties fall closer to this end of the spectrum. Because the parties must maintain their relationship over an extended period of time and their fates are interconnected, the identity of the counterparty carries significant weight. In many of these relationships, the parties make investments that are specific to the relationship, further cementing their interconnectedness.[131] Partly because of the extended duration and complexity of the relationship, it is impossible to state well-defined performance obligations and delineate in advance every possible contingent outcome, so there is uncertainty and (explicit and implicit)

127. *See* Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 856 (1978); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981); Paul J. Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 BUFF. L. REV. 763, 764 (1998); Robert C. Bird, *Employment as a Relational Contract*, 8 U. PA. J. LAB. & EMP. L. 149, 152 (2005); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 236 (1979).

128. *See* Macneil, *supra* note 127, at 859; Gudel, *supra* note 127, at 764; Goetz & Scott, *supra* note 127, at 1092.

129. The focus on the "four corners" in contract interpretation is one of the ways in which traditional contract law is more aligned with the discrete transaction model. Macneil, *supra* note 127, at 864.

130. Scholars note that a genuinely discrete transaction is exceedingly rare. Macneil, *supra* note 127, at 856; Gudel, *supra* note 127, at 764.

131. Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823, 830 (2000).

discretion regarding the future of the relationship.[132] A long-term joint venture between two commercial entities, in which both parties invest substantial resources, would be an example of such a relational contract. As a corollary to this unpredictability and discretion, parties to a relational contract often rely on nonlegal sanctions (including the threat thereof) to control opportunism.[133] Such nonlegal sanctions can range from reputational damage to terminating the relationship.

*2. Listing agreements between stock exchanges and listed companies*

To get a better sense of how this relationship works, in this subsection, we briefly introduce the agreement entered into between the NYSE and a listing company. After a company chooses which stock exchange to be listed on, a company enters into a "listing agreement" with the stock exchange. Both the NYSE and Nasdaq have a template listing agreement, with pre-determined terms and conditions.

Figure 1 below captures the first part of the NYSE listing agreement. As the figure shows, items 1 and 2 of the agreement stipulate that a listed company has an obligation to comply with and notify the NYSE of any noncompliance with stock exchange rules. The agreement itself does not expressly stipulate the rules that a listed company has to comply with, and the rules are subject to the NYSE's subsequent, unilateral modification. To make it even more interesting, the agreement is silent on the NYSE's contractual obligations to the listing companies or potential sanctions, nor is there an explicit duration.

132. Goetz & Scott, *supra* note 127, at 1091; Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 847 (2000).

133. *See, e.g.*, Keith A. Palzer, *Relational Contract Theory and Sovereign Debt*, 8 NW. J. INT'L L. & BUS. 727, 730 (1988); Robert C. Ellickson, *A Hypothesis of Wealth-Maximizing Norms: Evidence from the Whaling Industry*, 5 J.L. ECON. & ORG. 83 (1989); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992); Scott Baker & Albert Choi, *Contract's Role in Relational Contract*, 101 VA. L. REV. 559, 566 (2015); Cathy Hwang, *Deal Momentum*, 65 UCLA L. REV. 376, 413–14 (2018).

FIGURE 1: NYSE LISTING AGREEMENT TEMPLATE

**NEW YORK STOCK EXCHANGE**
**LISTING AGREEMENT FOR DOMESTIC COMPANY**
**EQUITY SECURITIES**

The undersigned, being a duly authorized officer of:

_____

Full Legal Corporate Name of the Applicant Issuer

does hereby certify that this agreement is made pursuant to a resolution(s) adopted by the Applicant Issuer's governing body to list on the New York Stock Exchange (the "Exchange"),

_____

(Title of Security) (Par Value)

1. The Applicant Issuer certifies that it understands and agrees to comply with all current and future rules, listing standards, procedures and policies of the Exchange as they may be amended from time to time.

2. The Applicant Issuer agrees to promptly notify the Exchange in writing of any corporate action or other event which will cause the Applicant Issuer to cease to be in compliance with Exchange listing requirements.

Since there is no express duration of the agreement, the contract can be deemed an "at-will" contract, at least from the listed company's perspective. At the same time, the agreement grants substantial latitude to the NYSE to terminate the relationship if it deems appropriate. Item 11 of the listing agreement expressly states that the exchange "may . . . suspend [a listed company's] securities and commence delisting proceedings with or without prior notice . . . upon failure . . . to comply with any one or more sections of the listing agreement . . . ."[134] Thus, express and implied contractual obligations and sanctions between a stock exchange and a listed company could be summarized as in Table 4.

134. *Listing Agreement for Domestic Company Equity Securities*, NYSE, https://www.nyse.com/publicdocs/nyse/listing/Domestic_Co_Listing_Agreement.pdf.

TABLE 4: EXPRESS AND IMPLIED OBLIGATIONS AND SANCTIONS ON LISTING AGREEMENTS

| | Listed Companies | Stock Exchanges |
|---|---|---|
| Obligations | Compliance with the stock exchange rules<br>Payment of fees | Provide a high-quality trading platform<br>"Licensing" the exchange's reputational capital |
| Sanctions | Unilateral termination of relationship without penalty | Termination of relationship<br>Reputational sanction (e.g., public reprimand) |

*3. Listing agreements as relational contracts*

Given the spectrum of contracts introduced in prior sections, when we examine stock exchanges' regulation of their listed companies and view it from the perspective of a contract (as opposed to top-down regulation), we see that it resembles a relational contract rather than a one-shot exchange relying on a complete contract. First, upon an issuer's listing, the two parties—the exchange and the listed company—begin an extended, interconnected relationship that is expected to last indefinitely. As part of that relationship, they make certain relationship-specific investments. For instance, the exchange shares its reputational capital with the listed company, and the listed company incurs the initial cost of establishing a relationship with the exchange.[135] Relationship-specific investments could also include compliance with specific rules of the exchange or establishment of a cooperative relationship with the exchange staff assigned to each listed company. In the process of making such investments, they become interdependent on one another. Since the continued existence and productivity of the relationship depends on the counterparty's behavior, the identity of the counterparty is certainly a relevant factor to each party.

As a corollary to this extended relationship, the listed issuer and the exchange engage in a repeated game, in which one party's

135. For example, after the initial listing—and the listed company incurs such initial costs—listing of additional securities becomes much less burdensome, as the amount of paperwork is reduced considerably.

action affects the other party's choices in the next period and beyond. In a one-period game, if one party engages in opportunistic behavior, the other party does not have ex post means of retaliation, since the game has already ended. In this repeated game, however, the other party that was the victim of opportunism can retaliate to punish the opportunistic player. In the relationship between a listed issuer and an exchange, if the listed issuer engages in opportunism (e.g., by engaging in unscrupulous behavior while riding on the coattails of the exchange), the exchange can act to cut off the listed issuer from taking advantage of the exchange's resources; thus, the listed issuer's past bad behavior results in the exchange's retaliation in future periods. On the other hand, if the exchange fails to uphold its end of the bargain (e.g., by failing to ensure liquid trading), the listed issuer can "retaliate" by, for example, terminating its relationship. As we will examine, this repeated game nature of the issuer-exchange relationship fundamentally enables the exchange's regulation of its issuers.

Second, their contract is an incomplete one, and much discretion is reserved. The extended relationship between the stock exchange and the listed company can evolve in a number of ways, depending on the factors internal and external to the relationship. For example, as a result of changes in the capital market conditions or the listed company's financial condition, listing may no longer be an attractive option for the issuer, and the issuer reserves the right to withdraw from listing. On the other hand, should the listed company's financial condition or regulatory compliance deteriorate, the exchange also reserves discretion in the manner in which it deals with the listed company.[136] Even if an issuer's conduct does not violate a particular rule, if the exchange views the issuer's continued listing as significantly detrimental, it can rely on

136. In dealing with noncompliant issuers, the exchanges' rules provide for baseline sanction procedures, but the exchanges have substantial discretion as well. *See, e.g.*, NYSE Listed Company Manual § 802.01D ("The Exchange is not limited by the criteria set forth above. Rather, it may make an appraisal of, and determine on an individual basis, the suitability for continued listing of an issue in the light of all pertinent facts whenever it deems such action appropriate, even though a security meets or fails to meet any enumerated criteria."); Nasdaq Rule § 5810(c) (providing that the Nasdaq staff may delist a security if it determines under its discretionary authority that continued listing raises a public interest concern).

the "public interest concern" standard to delist an issuer.[137] Furthermore, the listing standards themselves may evolve over time, whether due to the parties' conduct or because of external factors, and the parties therefore anticipate that the baseline rules governing their relationship will evolve as well.[138]

Lastly, in resolving disagreements between the parties, they rely mostly on nonlegal sanctions, rather than legal sanctions with the involvement of third parties. Instead of fines or court orders, the exchanges rely on informal sanctions, such as an expression of disapproval (whether in a conversation with the listed company or in a public reprimand letter) or the termination of the relationship. Likewise, the listed company's way of sanctioning the stock exchange is "voting with its feet" and transferring its listing to another stock exchange. The parties resolve their disputes internally with informal sanctions, as is typically the case with relational contracts.

Thus, a listing relationship between a stock exchange and a listed company resembles a relational contract. Within this framework, we see how the above-noted pattern of little formal enforcement and rigorous compliance is rational from the perspective of both the stock exchange and the listed company.

137. Nasdaq Rule § 5101 ("Nasdaq may use such discretion to deny initial listing, apply additional or more stringent criteria for the initial or continued listing of particular securities, or suspend or delist particular securities based on any event, condition, or circumstance that exists or occurs that makes initial or continued listing of the securities on Nasdaq inadvisable or unwarranted in the opinion of Nasdaq, even though the securities meet all enumerated criteria for initial or continued listing on Nasdaq."). As a comparison, SEC also retains significant discretion in its manner of enforcement, particularly through the Administrative Law Judge process. *See, e.g.*, David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155 (2016).

138. The New York Stock Exchange's listing agreement provides that the listed company agrees to comply with "all current and future rules, listing standards, procedures and policies of the Exchange as they may be amended from time to time." *Listing Agreement for Domestic Company Equity Securities*, NYSE, https://www.nyse.com/publicdocs/nyse/listing/Domestic_Co_Listing_Agreement.pdf. Historically speaking, this was not the case in the early days of the NYSE—issuers could only be held against the agreements they had signed—but the restrictions on exchanges' ability to compel compliance with new rules led to the adoption of an open-ended listing agreement. Michael, *supra* note 17, at 1466 n.22 (citing RICHARD J. TEWELES & EDWARD S. BRADLEY, THE STOCK MARKET 109 (4th ed. 1982)) ("Companies could be held only to agreements that they had signed, some of which had been entered into very many years before. If new and additional agreements were formulated by the Exchange, old listed companies could not be compelled to comply . . . .").

### *B. Relational Enforcement of Stock Exchange Rules*

When viewed from the traditional perspective of enforcement and compliance as one-off interactions in which both the enforcer and the enforcement target conduct cost-benefit analyses of their actions, the mix of little formal enforcement and strict compliance does not make sense. Under this traditional framework, when the exchange selects a low enforcement regime—and the listed companies know that—there is a low expected penalty for violating a stock exchange rule, incentivizing unscrupulous issuers to play fast and loose. Therefore, based on the conceptualization of a stock exchange rule as a relational contract, we now seek to explain the enforcement and compliance pattern of stock exchange rules, in what we call "relational enforcement."

#### *1. Reliance on informal sanctions and infrequent delisting*

The most striking feature of the stock exchange enforcement strategy is the reliance on conversation and negotiation with issuers to remedy violations, instead of formal enforcement actions, and infrequent use of the delisting option. While the formal sanctions available to exchanges are limited to delisting, the exchanges have created a de facto graduated system of sanctions by relying more heavily on informal negotiations and conversations to achieve their goal of remedying noncompliance.

Exchanges' heavy reliance on informal sanctions mirrors the regulatory pyramid concept of Professors Ian Ayres and John Braithwaite, in which a system of graduated punishments, along with the use of a tit-for-tat strategy, induces compliance effectively.[139] Signaling the willingness to escalate the sanction for continued noncompliance encourages compliance at an earlier stage, with the most severe sanction being used only sparingly.[140]

Thus, we see that the "relational" nature of stock exchange regulation is central to the effective use of informal sanctions. The ability of the stock exchange to engage in tit-for-tat escalation of sanctions depends on the prospect of a continued relationship

139. AYRES & BRAITHWAITE, *supra* note 52, at 40 (noting three predictive elements of a successful cooperative regulatory regime: use of tit-for-tat strategy, hierarchical range of sanctions, punitiveness of the most severe sanction).

140. *Id.* at 39.

between the stock exchange and the listed company. Moreover, the exchange's discretion in selecting the most appropriate sanction for noncompliance means that tit-for-tat escalation (or de-escalation, as the case may be) is a real possibility; in a case where the exchange is limited in its course of action—for example, because the rules prescribe certain automatic courses of action for certain violations—the exchange's relationship with the listed company begins to resemble that of a one-period game, particularly because the exchange's response depends solely on the current period violation and not on past period conduct of the listed company.

Additionally, the relational enforcement of stock exchange regulation is notable in that the most severe sanction available, delisting, severs the tie between the exchange and the listed company. As such, the exchange is free to engage in tit-for-tat de-escalation in its regulatory pyramid, but *only until* it imposes the delisting sanction; once it imposes the delisting sanction, the decision is practically irreversible. From the perspective of cost-benefit analysis, while the future benefits of the relationship are maintained as the exchange's sanctions escalate, it is cut off when the exchange imposes delisting sanction. Therefore, the marginal cost of imposing the delisting sanction is substantial, foreclosing it as a realistic option for minor violations.

*2. Rigorous compliance and voluntary reporting of violations*

Another striking feature of stock exchange rule enforcement and compliance is the listed companies' rigorous compliance and voluntary reporting of violations. Particularly for corporate governance violations, the delisting sanction is rarely, if ever, imposed, so the repercussions for noncompliance are minor at best, but as we noted in Part II, violations are practically nonexistent.

One possible explanation is that since noncompliance with corporate governance violations, although rarely leading to delisting, nonetheless must be disclosed to the public investors, the "shaming" effect of such disclosures keeps the firms in check.[141] Although not subject to the delisting sanction, if the shareholders punish issuers for noncompliance with stock exchange rules, perhaps by voting with

141. *See, e.g.*, Sharon Yadin, *Regulatory Shaming*, 49 ENV'T. L. 407 (2019); Matthew Johnson, *Regulation by Shaming: Deterrence Effects of Publicizing Violations of Workplace Safety and Health Laws*, 110 AM. ECON. REV. 1866 (2020).

their feet or by applying shareholder pressure, the fear of shareholder punishment would induce compliance.

However, this explanation does not fully explain the ironic coexistence of two phenomena: rigorous compliance *and* voluntary reporting. If the listed companies remain fearful of punishment from shareholders, rigorous compliance is indeed expected. At the same time, since noncompliance must be publicly disclosed regardless of whether it was self-reported to the exchange, the optimal strategy from the listed company's perspective is to keep silent about noncompliance and remedy it internally. This is particularly so if the violation arises out of the issuer's intentional misconduct or negligence or if the violation can be cured quickly (i.e., before it can be discovered by others).[142] If, on the other hand, the reputational damage from the disclosure of noncompliance with stock exchange rules is not significant, the "reputational sanction explanation" does not explain the listed company's rigorous compliance with the exchange rules, as the expected punishments from noncompliance are nonexistent.

In light of this seeming incongruence, we offer an alternative explanation: signaling future value. In the exchange-issuer relationship, in addition to a platform for liquid trading, the exchange offers to the listed company its reputational capital. In turn, the listed company offers to the exchange a commitment to maintaining the reputational capital of the exchange and network externality (in addition to tangible contributions, such as listing fees).[143] From the exchange's perspective, the future value of the relationship with the listed company is the combination of the stream of tangible benefits, increase in market liquidity (network externality), and the listed company's future contribution to the exchange's reputational capital. Thus, the exchange's perception

142. One such example would be an overdue realization that an independent director does not satisfy the applicable independence standard. Not only is such a disclosure embarrassing for the issuer, such a violation can be cured quickly. However, such failures to satisfy applicable independence standards are routinely self-reported to the exchanges.

143. *See* Jonathan R. Macey & Maureen O'Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 22 (1999); Jonathan R. 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, 1009–10 (1990) ("[O]rganized exchanges provide listing companies with: (1) liquidity, (2) monitoring of exchange trading, (3) standard form, off-the-rack rules to reduce transactions costs, and (4) a signaling function that serves to inform investors that the issuing companies' stock is of high quality.").

of the future value of the relationship depends partly on its estimate of how much the listed company can contribute to the exchange's reputation.

In this framework, the issuer's rigorous compliance and voluntary reporting serve to signal that it is willing to continue to contribute to the reputational capital of the exchange. In the future, when, as a result of deteriorating financial conditions or otherwise, the issuer falls short of the exchange's listing standards, the issuer's past signal of its commitment to contribute to the reputational capital of the exchange serves to increase the value of the relationship to the exchange, making the exchange more likely to take a second chance on the listed company (particularly since the exchange retains substantial discretion in its delisting determination). Thus, the issuer's current compliance and voluntary reporting are ways to establish bonds of trust with the exchange and to signal the issuer's commitment to maintain and contribute to the exchange's reputational capital, such that the exchange sees continued value in maintaining the relationship.

*3. Potential for hidden violations*

It is indeed possible that this signaling may not overlap completely with listed issuers' actual compliance with stock exchange rules; that is, listed issuers may comply only with those rules whose violations are visible (signaling) but ignore the rules whose violations are less easily detected. For example, whether a board consists of a majority of independent directors or whether certain board committees consist only of independent directors are readily disclosed. However, whether a director who is ostensibly independent is actually independent (e.g., whether there are side transactions that render such director non-independent) is less easily verifiable.

We acknowledge this possibility and how it may limit our empirical analysis; by virtue of the fact that such violations are "invisible," we cannot verify this possibility in our empirical analysis. But we note that our relational analysis is even more important with the possibility of invisible violations. As these violations are less visible—to investors, to regulators, and to third parties—stock exchanges need the cooperation of the issuers to detect and deter these violations. Therefore, it is in the exchanges' interest to apply the regulatory pyramid to these invisible

violations, incentivizing issuers to refrain from hidden opportunism but signaling its willingness to escalate up the regulatory pyramid rapidly and punish those issuers that engage in duplicitous behavior.

A related explanation for listed issuers' compliance with stock exchange rules comes from the genesis of the corporate governance standards themselves. As noted above, stock exchanges' corporate governance standards were adopted in the aftermath of the WorldCom and Enron scandals, with pressure from the SEC.[144] Companies may be more inclined to abide by the corporate governance standards, even in the absence of stock exchange enforcement, because they expect the SEC and the public to monitor and punish them for violations.

This explanation, however, does not account for the longevity of listed issuers' strict adherence to stock exchange corporate governance standards. It has been nearly two decades since the stock exchange corporate governance standards were adopted, and there have been a number of regulatory initiatives since then that have overtaken the SEC's and the public's attention. Yet, the fact that strict adherence to stock exchange corporate governance standards remains lends credence to the idea of a more fundamental driver behind listed issuers' compliance patterns.

*4. Distinction from the literature on self-reporting and self-policing*

At first glance, our characterization of the exchange-issuer relationship as a relational contract and application of the framework to explain the puzzling coexistence of lax enforcement and rigorous compliance may appear similar to the existing administrative law literature on self-reporting and self-policing. For example, Professors Toffel and Short found that in the context of Environmental Protection Agency (EPA) enforcement, the regulatory agency shifts inspection resources away from companies that self-report their violations and that self-reporting is a reliable indicator of efforts invested in self-policing (and is therefore correlated with better compliance).[145] In some ways, there is indeed some overlap between our analysis and the

144. *See supra* note 88 and accompanying text.

145. Michael W. Toffel & Jodi L. Short, *Coming Clean and Cleaning Up: Does Voluntary Self-Reporting Indicate Effective Self-Policing?*, 54 J.L. & ECON. 609 (2011).

existing literature: that compliance and self-reporting serve as signals, and that future regulatory response depends on such signals.

At the same time, our analysis extends the literature in a number of other ways. First, in our analysis, given the opt-in nature of stock exchanges, the key driver of signaling behavior is the possibility of severance of the relationship (i.e., delisting); in contrast, in a traditional regulatory model, while a number of regulatory punishments can be levied, severance of the regulatory relationship is typically not an option. A number of factors, such as the length of the relationship, the level of investment into that relationship by both parties, and the presence (and possibility) of alternative relationships, all affect the value of the relationship. Thus, the level of benefit that the regulated entity can expect from maintaining the relationship plays a significant role in how willing such entity is to maintain strict compliance. Second, our analysis introduces a number of complexities, which will be addressed below in Section III.C, that affect the regulatory relationship between the stock exchange and the listed companies. These include: the dual status of the regulatory agency (which is unique to self-regulatory organizations),[146] the reputational spillover from one regulated entity to another,[147] and the effect of the regulatory response on third parties.[148] Thus, our analysis refines the existing literature on self-reporting and self-policing by extending it to the context of an opt-in self-regulatory organization.

### *C. Implications of Stock Exchange Rule as a Relational Contract*

#### *1. Dual status of stock exchanges and stimulating compliance*

The conceptualization of stock exchange regulation as a relational contract, in which the exchange weighs the future value and cost of maintaining the relationship in determining whether to delist a listed company, may be objectionable, particularly to critics of self-regulation. Indeed, self-regulation has been under significant criticism in recent years, mostly on the grounds that self-regulation

146. *See infra* Section III.C.1.

147. *Id.*

148. *See infra* Sections III.C.3., III.C.4.

can be undermined by conflicts of interest and a lack of incentives.[149] To its critics, self-regulation evokes the image of collusion, forbearance, and regulatory capture. The fact that stock exchanges are publicly traded entities, subject to profit pressures from their own shareholders, accentuates this perception; particularly given that delisting reduces the fee income (and profit) for the exchange, it may be suspected that the exchanges would be reluctant to delist listed companies. In the United States in particular, the competitive nature of the stock exchange market—with the NYSE and Nasdaq competing for listings—may also mean that the exchanges would lower their enforcement standards lest the issuers transfer their listing to the competitor exchange.

This concern for the "race to the bottom" in stock exchange enforcement and potential conflicts of interest between profit and regulatory motives of the exchanges assumes, however, two things: first, that a listed company that falls short of an exchange's listing standards still presents positive future relational value to the exchange; and second, that the two major exchanges in the United States have (potentially) substantially different listing standards such that a company that is subject to regulatory pressure from one exchange is still welcome at another.

These assumptions are challengeable. First, in the stock exchange context, the future value of the relationship is not symmetric between the exchange and a listed company. As noted above, from the exchange's perspective, the future value of maintaining the relationship with a listed company is the sum of direct, tangible benefits (e.g., fees), network externalities, and contribution to the reputational capital of the exchange. From the listed company's perspective, the future value of maintaining the relationship is the sum of the reputational and liquidity benefits from being listed on an exchange, offset by the regulatory burden and the listing costs. Since the reputational value of stock exchange listing is subject to the asymmetric information problem—if there is a mix of high- and low-quality issuers in the exchange, the investors do not know from listing alone which are high- and which are low-quality issuers—a low-quality issuer (from a regulatory

149. *See, e.g.*, Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 415 (2011) (describing the hostility toward industry self-regulation); Macey & Novogrod, *supra* note 6, at 975.

perspective) contributes less to (or may even worsen) an exchange's reputational capital, while it benefits the most from the contributions of other higher-quality issuers. As a result, the higher the reputational benefit of listing to an issuer, the lower the reputational benefit of keeping an issuer to an exchange. As such, a lower-quality issuer may see substantial value in remaining listed, but the desire to maintain the relationship may not be reciprocated by the exchange.

Second, while there is a competition between exchanges in the United States—and indeed, industry participants have noted to us the perennial fear of the exchanges of losing a listed company to another exchange—this competition does not target all listed companies. Related to the first point, exchanges' expectation of relational benefit vis-à-vis low-quality issuers is low, so competition for listing would be limited to higher-quality issuers. Moreover, the exchanges' listing standards are substantially similar, such that lower-quality issuers cannot arbitrage the difference between the listing standards and jump from one exchange to another.

Thus, in the presence of reputational spillover from the individual issuer to the exchange and vice versa, we would expect competition for issuers, but *only* for high-quality issuers. This competition is much less troubling, if at all, given that a conflict between the profit motives of the exchange and its regulatory mission is most problematic when exchanges lower their standards to keep *low-quality* issuers.[150]

In this area, we note the relationship between competition and the long-term stability of this "race to the top." When there is a stock exchange monopoly, there is a lower incentive to maintain the reputational capital of the exchange to "compete" on the quality of the issuers. After all, the only option for dissatisfied investors and traders is to drop out of the market altogether. As competition intensifies, however, there is a need to build a competitive edge in the form of reputational capital. This competition can be internal (for example, between the NYSE and Nasdaq) or external (threat of new entrants into the stock exchange business). For example, as the

150. Mahoney, *supra* note 2, at 1457. ("As a provider of liquidity, an exchange competes with other exchanges and over-the-counter markets, both to attract companies to list and to induce investors to purchase listed securities.").

cost of entry into the business of providing a trading venue has fallen as trading has become electronic, if the NYSE and Nasdaq lose their reputational capital, that could spur new entrants into the market for exchanges at any time.[151]

Accordingly, delisting a low-quality company that represents positive revenue to the exchange but that poses longer-term reputational risk is a tradeoff between the short-term and the long-term; while delisting sacrifices current period revenue, it ensures that over the long run, the exchange is able to maintain its reputational capital.[152]

*2. Relational sanction and severance of regulatory relationship*

Another point of conflict between the regulatory mission of a stock exchange and the relational nature of stock exchange regulation is that upon exercise of the relational sanction (i.e., delisting), the regulatory relationship between the exchange and the listed company is severed. This stands in contrast to a traditional regulatory relationship, in which the regulator does not "kick out" a regulated entity, or to a traditional relational contract, in which there is no regulatory overlay. As a result, when a stock exchange delists an issuer, the penalized issuer is free from the compliance obligations imposed by the stock exchange.

Particularly since the relational sanction would already be imposed on a lower-quality issuer, the cessation of oversight and compliance obligation can be problematic. This problem mainly arises because the exchange's expectation of the future private benefit of the relationship does not necessarily include its regulatory mission. From the exchange's perspective, the optimal decision may be to cut loose an issuer that is detrimental to its

151. Brummer, *supra* note 10, at 1464 ("[T]he emergence of fast, low-cost, and increasingly commoditized trading services has rendered the trading industry much more contestable than at any time in the past.").

152. However, as stock exchange competition further intensifies and there is less and less leeway for exchanges to sacrifice their current period income, there can be a temptation to prioritize short-term revenue over long-term reputational capital. In such a scenario, excessive competition could mean that stock exchanges may engage in a "race to the bottom" to maximize their short-term profits.

reputational capital, but the public may benefit from continued enforcement and compliance.[153]

One possible way to reconcile this gap is to make the "tiers" of stock exchanges more explicit, such that within a particular exchange, investors can treat different tiers of exchanges differently. Currently, the New York Stock Exchange also has a companion exchange, NYSE American, focused on small cap companies, while Nasdaq operates three tiers, Global Select Market, Global Market, and Capital Market. However, these tiers are mostly used to classify firms based on size, and they are not noted in many reporting services.[154] But tiering the various exchanges based on regulatory burden can also reduce the need to entirely expel a listed company but at the same time maintain regulatory control over that entity. Thus, this approach would essentially create multiple levels of "delisting" (or "down-listing"), each carrying some punitiveness for the issuer but only the most severe one (delisting from the exchange altogether) leading to full severance of the listing (and therefore regulatory) relationship.

*3. Relational sanction's impact on third parties*

The presence and interests of third parties can further complicate the relationship between an exchange and its listed companies. In particular, the severity of the delisting sanction means that the shareholders are the primary victims of a listed company's noncompliance and subsequent delisting; as expected, delisting generally has a significant negative impact on share price and liquidity.[155] Like the divergence between the exchange's private incentives to preserve its reputational capital and the public's interests in maintaining oversight over the listed companies, there can be a divergence between the shareholders' interests and the interests of the exchange and, indirectly, between the current shareholders' interests and the future shareholders' interests.

As noted above, from the exchange's perspective, delisting is optimal if the future benefits of maintaining the relationship are

153. The OTC Market does have a set of listing standards, but they are generally laxer than the major stock exchanges'.

154. For example, price information from Nasdaq's own website does not show which of the three tiers a listed company belongs to.

155. *See* Macey, O'Hara & Pompilio, *supra* note 11, at 701*; see also supra* Section I.B.2.

outweighed by the reputational drain of the applicable listed company. On the other hand, the listed company's shareholders have a strong preference to keep the company listed to avoid the liquidity and value penalties of delisting. Given that the benefits of delisting a low-quality issuer accrue to a diverse spectrum of investors—few of whom have serious interest in the decision—while the negative effects accrue to a small group of shareholders of that particular issuer who have concentrated interests, the issuer's shareholders may exert substantial pressure on the exchange to maintain the listing, and the shareholders' pressures may not be offset by the potential benefits to the public investors at large.[156] This may also have the effect of changing the reputational calculation for the exchange, which may view delisting as more detrimental to its reputation, even when there are signs of trouble. Lack of a private right of action for violation of stock exchange rules may further exacerbate the shareholders' resistance since they may be left without any recourse.[157]

Thus, given the presence of and pressures from third parties, an exchange may be pressured to err on the side of forbearance. As noted above, the timing of relational sanction is important because it is both effectively irrevocable and critical to ensuring that the number of victims of corporate malfeasance is minimized.[158]

In this area, the SEC's regulatory overlay also plays an important role. As noted in Section II.A.1, the SEC has the authority to review stock exchanges' delisting decisions upon appeal by the penalized issuer under Section 19(f) of the Exchange Act. In conducting such a review, however, the SEC's three-prong standard of review—whether the facts underlying the delisting exist, whether the delisting is in accordance with the rules of the exchange, and whether the rules of the exchange are consistent with the purposes of the Exchange Act—means that only rarely will a stock exchange's delisting decision be reversed.

156. *See, e.g.*, James Park, *Reassessing the Distinction Between Corporate and Securities Law*, 64 UCLA L. REV. 116, 141–43 (2017); Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 57 ARIZ. L. REV. 85, 104 (2015); Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006).

157. *See supra* Section I.B.3.

158. *See supra* Section I.B.2.

Furthermore, regarding the apparent conflict of interest between current shareholders (who will be harmed by a delisting decision) and prospective shareholders, the SEC has clearly articulated that the interests of the prospective investors must come first.[159] Thus, the SEC is not sympathetic to the arguments of delisted issuers that such a sanction hurts current investors.

On the other hand, while the SEC's standard of review and doctrine are not favorable to the current shareholders of delisted companies, in practice, there is also a disparity between current and future shareholders in their ability to exert pressure. A company facing delisting—and the shareholders who stand to be hurt by such delisting—have a number of remedies, including appeals within the stock exchange and appeal to the SEC. On the other hand, if a stock exchange errs on the side of forbearance, the future investors have little recourse except public pressure, and given that the "benefits" of delisting a noncompliant issuer accrue to a diverse set of investors, the incentives for future investors to "fight" a stock exchange's forbearance decision are low as well.

Based on this statutory and practical framework, we note a divergence between the two. While an appealing issuer is unlikely to succeed at the SEC appeal stage, there can still be considerable investor pressure exerted on the stock exchanges to turn a blind eye to noncompliance with its rules. Knowing that once the delisting decision is made it is practically irreversible, the current investors are likely to fight the delisting decision at the stock exchange stage, and there is little countervailing effort on the side of the future investors. To reduce this disparity and to alleviate shareholder pressure to maintain an issuer's listing, we propose that a private right of action for violations of stock exchange rules be recognized. At the same time, to prevent such private rights of action from ballooning to strike suits and preventing companies from cooperating with exchanges, shareholder-plaintiffs may be entitled to recover damages only when an exchange has taken tangible action against an issuer, such as suspension or delisting.

159. Midland Res., Inc., 46 SEC 861, 864 (1977); Navistar Int'l Corp., Exchange Act Release No. 56769, at 14 ("[W]hile exclusion from a quotation system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors.").

*4. Double-edged sword of informality*

A key element of the relational contract between a listed issuer and an exchange is the *informality* of the relationship. As noted above, formally speaking, the exchanges only have a limited number of sanctions available to them: forbearance (i.e., lack of a sanction), public reprimand, or suspension/delisting. But the exchanges have created a de facto system of informal sanctions, culminating in its most draconian formal sanction, delisting. This informality pervades not only the form of the sanctions themselves but also the processes by which and standards against which sanctions are applied. For example, exchanges engage in informal negotiations and conversations with listed companies to prod them into compliance. Likewise, the level of sanction to be applied depends heavily on the exchange's discretion.

This informality can affect the exchange's regulation of its listed companies in multiple ways. First, the informality of the exchange's regulation of its listed companies can preserve the intrinsic motivation of listed companies to comply with the exchange standards and moderate the exchanges' opposition. A rigid, formalistic system of regulation can breed resentment from the perspective of the regulated entities and turn what is a moral norm into a mere regulatory requirement.[160] Such a rigid approach can "crowd out" moral norms and turn "we should comply because it is the right thing to do" (a cooperative approach) into "we have no choice but to comply—and will not comply if we do not have to" (a cat-and-mouse chase).[161] In contrast, a more textured approach from the exchange can preserve the intrinsic incentives for listed companies to comply with the exchange listing rules. Thus, in this sense, the informality of the exchange's regulatory relationship with the listed companies can reduce regulatory costs and improve issuer

160. *See, e.g.*, Sidney A. Shapiro & Randy S. Rabinowitz, *Punishment Versus Cooperation in Regulatory Enforcement: A Case Study of OSHA*, 49 ADMIN. L. REV. 713, 718 (1997) ("A business's long-term incentives might induce it to comply with agency regulations even when there are short-term incentives to disobey, but government enforcement policies determine whether managers will comply. If the government punishes companies in circumstances where managers believe there has been good faith compliance, corporate officers may react by being less cooperative with regulatory agencies.").

161. *See, e.g.*, Kristen Underhill, *Money That Costs Too Much: Regulating Financial Incentives*, 94 IND. L.J. 1109 (2019).

compliance by maintaining the cooperative nature of the relationship.

On the flip side, the informality of the relationship between a listed issuer and an exchange can lead to criticism that the exchanges are underenforcing their listing standards. This criticism may be accentuated for two reasons. First, the exchanges are self-regulatory organizations, and critics may see them as more conflicted than purely public agencies. Second, while explicit, written rules are subject to public comment and input, informal enforcement decisions are less transparent and therefore more susceptible to charges of underenforcement. Moreover, the exchanges' graduated approach to issuer regulation may *appear* to be underenforcement, even if the leniency offered to the listed companies may be intentional. Reputational concerns, the potential private right of action suggested in the previous subsection, and SEC oversight can mitigate underenforcement concerns, but the perception of underenforcement may independently erode the public's confidence in the exchanges, potentially undermining the stability of the exchange's regulatory approach.

## CONCLUSION

Regulation by stock exchanges offers a mix of characteristics. In that they impose obligations on listed companies and public investors expect compliance with such obligations, they are akin to other types of regulations. In that the exchanges are private, profit-seeking entities, the regulatory and enforcement framework also creates an incentive structure that is not identical to a government regulator's. As noted above, stock exchange regulation is also subject to a number of peculiarities, including a lack of a private right of action, limited enforcement options, and a competitive market for listings.

With this backdrop, we find a puzzling coexistence of enforcement that often lacks teeth and compliance that is nearly perfect. Using the highway analogy previously presented, what we find is a stretch of highway in which there is very little police presence. The police do not have a well-functioning radar gun, so they rely largely on individuals' self-reporting of their speeding violations. And when the police do catch an offender, the offender is often let go with a warning. Yet, on this highway, we see very few cars, if at all, speeding.

To explain this curious coexistence, we apply the concept of a relational contract to stock exchange rules. Both the exchange and the listed company establish a long-term relationship with each other, and discretion, particularly given the changing nature of the stock market, is reserved for both parties. In this dynamic, issuers' strong compliance can be considered a signal of their commitment to preserving and increasing the exchange's reputational capital. The exchange's discretion, although rarely used, in imposing a draconian penalty further serves to deter opportunistic behavior; if the police have the discretion to permanently revoke a driver's license for speeding, such discretion would significantly deter speeding, even if such penalty is rarely, if ever, imposed. To those concerned about conflict of interest in this relational contract, we also present why a race to the bottom has not occurred in stock market regulation.

In the era of sharing regulatory authority with private entities—with decreasing emphasis on command-and-control regulation by the government—stock exchange rules present an interesting case study. As we saw in the case of stock exchange rules, a rigid, formal approach is not the only answer to inducing rigorous compliance. Even when it appears to be lax, an appropriately designed regulatory regime can nonetheless induce strong compliance, even without heavy intervention and sanctions.