

STOCK TRANSFER RESTRICTIONS AND ISSUER CHOICE IN TRADING VENUES

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INTRODUCTION

The recent spate of corporate scandals (Enron, Tyco, etc.) opened a “policy window” through which Congress and the executive were able to overcome the strong interest group pressures resisting federal usurpation of the states’ traditional autonomy over the regulation of the internal affairs of corporate firms. Congress’s response to Enron and its successors was the Sarbanes-Oxley Act (“SOX”), which is designed to improve corporate accountability and to assert the Securities and Exchange Commission as a major force in competition with the states in the production of corporate law rules.¹

The Securities and Exchange Commission also responded to its new role by proposing rules to enhance the role of shareholders in electing directors. Much of corporate America observes, correctly, that SOX has increased costs with little or no benefit² and that the SEC’s proposals will diminish the effectiveness of corporate boards by provoking friction.

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¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). The Sarbanes-Oxley Act, *inter alia*, makes corporate officers responsible for earnings reports, forbids accounting firms from acting as consultants to accounting clients, and stiffens penalties for fraud. The Sarbanes-Oxley Act was signed into law in July, 2002.

² Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. (forthcoming 2005).

This article starts with the premise that, while the proper role of corporate law is to reduce transaction costs by providing efficiently configured “off-the-rack” legal rules, the proper role of corporate governance is to promote transparency and to create an efficient contracting space in which investors can configure rules that reduce agency costs by aligning the interests of managers with their own interests.

Much attention has been paid of late to the relative merits of the states versus the federal government as the optimal locus for generating laws related to corporate governance of U.S. corporations. Less attention has been paid to the continued relevance, if any, of the joint production of corporate governance rules by public companies and stock exchanges. This is odd because the stock exchanges, in rivalrous competition with other trading venues for listings and trading volume, long have taken the view that producing efficient, investor-friendly corporate law rules is an important component of the bundle of liquidity services they must offer. Thus, one must consider the relevance of the production of corporate law rules by stock exchanges to the perceived crisis in American corporate governance revealed in the Enron-era scandals and the passage of Sarbanes-Oxley in order to be able fully to evaluate the range of policy options available to confront the ostensible problem.

Further, it seems clear that issuers have, or should have, an intense interest in the venue where their securities trade, if for no other reason than to ensure a robust, liquid, high-quality market for their firms’ shares. Firms traditionally have considered trading venues important, and are concerned about the quality of the corporate governance rules on the exchanges on which they list. This article explains why this may no longer be the case, and what the implications are for corporate governance.

This article continues our exploration of the law and economics of trading venues. Building on our organizing framework that describes the economic development of stock exchanges,³ the article then ana-

³ See Jonathan R. Macey & Maureen O’Hara, *The Economics of Stock Exchange Listing Fees and Listing Requirements*, 11 J. FIN. INTERMEDIATION 297, 298 (2002) [hereinafter *Stock Exchange Listing Fees*] (investigating “the once and future role of listing fees”); Jonathan R. Macey & Maureen O’Hara, *Globalization, Exchange Governance, and the Future of Exchanges*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 1999 1, 1 (R. Litan and A. Santomero eds., 1999) [hereinafter *Future of Exchanges*] (identifying “three ways in which the competitive environment has changed”); Jonathan R. Macey & Maureen O’Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 19 (1999) [hereinafter *Regulating Exchanges*] (providing “a law and economic perspective on the regulation of [alternative trading systems]”); see also, Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes For the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1008 (1990) [hereinafter *The Stock*

lyzes the three critical issues that relate to the production of corporate law by stock exchanges. These issues are the modern emergence of multi-market trading venues, the ability of exchanges to grant unlisted trading privileges to companies' stocks, and the renewed involvement of stock exchanges in corporate governance.

The basic business of being a stock exchange has evolved over time as a result of competitive pressures. Like many other businesses, the business of being a stock exchange has become "commodified." The result of this commodification is that the business of being a stock exchange has transformed from its historical role as a quasi-governmental entity that had highly complex, multi-dimensional relationships with listed firms, into far more simple firms that focus on the marketing of a single service: the provision of liquidity to traders, investors, and, ultimately, to listed firms. Because different investors have radically different needs for and preferences about liquidity, a number of different trading venues have arisen to serve the needs of these investors. A single exchange or trading venue is, therefore, unlikely to be able to satisfy the needs of all investors. As a result, we have observed the emergence of multi-market trading.⁴ In other words, just as the range of services historically offered by exchanges has begun to narrow to a single service—the provision of liquidity—the competition to provide that single service has increased.

Three related policy questions emerge from this analysis. The first question, a legal question, is whether issuers of securities should be able to select the venue where their securities trade and to thereby restrict, if they so choose, the trading in their securities to a particular venue. To this question we offer a qualified "yes." That is, issuers should, as a normative matter, have the authority to determine the venue or venues where their securities trade, so long as they do so when the conflicts of interest between insiders and investors are low, i.e., at the time when the securities initially are offered to the public.

The second question that this article addresses is the extent to which current U.S. law addresses the issues raised by such choice. Specifically, we ask whether U.S. companies could, if they so wished,

Exchange as a Firm] (articulating "the economic underpinnings of organized stock exchanges").

⁴ Securities listed on an organized stock exchange can trade simultaneously on other stock exchanges, and on the NASDAQ (NASDAQ is an acronym for the National Association of Securities Dealers Automated Quotation System) and the National Market System (the National Market System is comprised of the most liquid securities traded on NASDAQ or reported on the consolidated tape by NASDAQ). In addition, securities traded on an exchange, or on NASDAQ, may be traded simultaneously on private trading systems (Automated Traded Systems (ATs)) and Electronic Communications Networks (ECNs)) and on the "Pink Sheets."

effectively restrict the venues on which their firms' securities could legally trade. We argue that firms probably could, if they wanted to, restrict the venues on which their securities trade through the use of stock transfer restrictions. Specifically, the Uniform Commercial Code empowers issuing companies and investors to agree to restrict future share transfers, subject to certain limitations on unreasonable or undisclosed restrictions. Thus, for example, a restriction to limit the trading in a company's security to a particular trading venue, such as the New York Stock Exchange, would, in our view, be reasonable, provided that the company issuing the security could articulate a reasonable justification for imposing this restriction.

Finally, we observe that, as an empirical matter, issuers do not, in fact, attempt to limit the venues on which their securities trade. We argue that this is because the costs to issuers and investors of such a limitation outweigh any potential benefits. Multi-venue securities trading is, in other words, beneficial to both issuers and investors. Issues that attempted to impose or enforce such restrictions would find themselves at a competitive disadvantage in the capital markets.

A further, more general assumption embedded in this analysis is that stock exchanges are not particularly useful venues for the production of certain kinds of corporate law rules. While the production of corporate law rules has been one of the traditional functions of stock exchanges, as we have observed elsewhere stock exchanges have been replaced by a variety of other entities and institutions. As a purely positive matter, it is somewhat misleading to describe stock exchanges as firms that generate corporate governance rules in an environment of jurisdictional competition for corporate charters. Rather, the exchanges simply generate rules on behalf of the Securities and Exchange Commission that the Commission could not generate itself due to the legal restrictions that courts have imposed on its administrative authority.⁵ From a normative perspective, it probably would be better to leave the production of corporate governance rules to the individual states. Barring that, however, if the SEC is going to continue to take the leading role in generating corporate governance rules, it would be more desirable to have them do so directly, rather than by using the exchanges as subterfuges.

This article is organized as follows: In Part I, we describe the gradual evolution that has taken place in the economic function of stock exchanges over the past few decades. Part II addresses the legal issue of whether U.S. firms could, if they wished, restrict the venues on

⁵ *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

which their securities trade. Part III examines the implications of the above analysis for today's work of multi-venue trading.

While U.S. firms may no longer be interested in selecting a particular trading venue in order to improve their perception among investors, or in order to distinguish their corporate governance from other firms, they may wish to select a particular trading venue in order to improve the liquidity with which their shares trade, or for other, more nefarious reasons, such as to make hostile takeovers more difficult and expensive. We argue that, although restrictions on multi-venue trading may harm shareholders by making takeovers more difficult, they are highly unlikely to help shareholders. Thus, the current system of multi-market trading in the U.S. is efficient. Finally, Part IV examines the ongoing role of stock exchanges in the production of corporate governance rules for listed firms. We find that this role has become severely limited as a result of multi-market trading.

I. THE COMMODIFICATION OF STOCK EXCHANGES

Our understanding of the nature of stock exchanges has evolved dramatically.⁶ We now have come to understand that, while exchanges have many of the characteristics of markets, the conception of exchanges that conforms best to economic reality is that they "are firms that generate revenues by sponsoring trading in financial instruments."⁷ Exchanges, like other firms, compete for market share.

Stock exchanges pre-date the securities laws. From their inception, they offered investors a complex array of services that included, among other things, listing standards and corporate governance rules that were a substitute for government regulation.⁸ More specifically, stock exchanges such as the New York Stock Exchange historically offered its listing-firm clients a bundle of services with the following five components: (1) monitoring of exchange trading against manipu-

⁶ See Macey & O'Hara, *Stock Exchange Listing Fees*, *supra* note 3, at 298 (investigating "the once and future role of listing fees"); Macey & O'Hara, *Future of Exchanges*, *supra* note 3, at 1 (identifying "three ways in which the competitive environment has changed"); Macey & O'Hara, *Regulating Exchanges*, *supra* note 3, at 19 (providing "a law and economic perspective on the regulation of [alternative trading systems]"); *see also*, Macey & Kanda, *The Stock Exchange as a Firm*, *supra* note 3, at 1008 (articulating "the economic underpinnings of organized stock exchanges").

⁷ Jonathan Macey & Maureen O'Hara, *From Markets to Venues: Security Regulation in an Evolving World*, 58 STAN. L. REV. (forthcoming 2005) [hereinafter *From Markets to Venues*]; Macey & O'Hara, *Stock Exchange Listing Fees*, *supra* note 3, at 1008; Guido Ferrarini, *Exchange Governance and Regulation: An Overview*, 27 *Annali Della Facoltà di Giurisprudenza di Genova* 3 (1995).

⁸ Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 327 (2001).

lation and insider trading; (2) the provision of standard-form, off-the-rack legal rules to reduce transaction costs for investors; (3) a signaling function to inform investors that the issuing company's stock is of high quality; (4) clearing services to ensure that secondary participants receive timely payment for securities sold and timely delivery of securities purchased; and (5) the promise of liquidity, often, but not always, backed by an affirmative obligation on the part of exchange specialists to "maintain fair and orderly markets" in the stocks in which they specialize.⁹

The complex array of products and services traditionally offered by the exchange gradually has become "unbundled." Each of these component parts—except for liquidity—is now offered by other, more specialized, and often superior, providers. And often these other providers offer these services to traders for free because the costs associated with delivering these services either are subsidized by the government or are paid for by the listing firms themselves.

In a nutshell, the contract between the NYSE and listing firms was:

highly contextual and relational. The complex bundle of services provided by exchanges to listing firms resulted in a relationship characterized by long-term mutual dependency. Each side had asset-specific relations with the other that raised the specter of exploitation through opportunistic behavior. But the fact that such specific investments were reciprocal reduced the incentives for one-shot opportunism.¹⁰

Put differently, in the past, a core feature of the economic relationship between listing firms and stock exchanges was that each side depended heavily on the maintenance of the listing.¹¹ The Exchange depended on the listing for fees and trading revenues; the listing firm depended on the Exchange as a source of liquidity in its shares. Such interdependence was not typically found in other types of exchange markets. For example, futures exchanges, trade commodities, and listing fees were never part of their revenue structure. Similarly, option markets, which also do not charge listing fees, have no relationship with the underlying companies whose options they trade. Thus,

⁹ These economic characteristics are identified and discussed at length in *Future of Exchanges*, *supra* note 3; and in Macey & O'Hara, *Regulating Exchanges*, *supra* note 3. See also RUBEN LEE, *WHAT IS AN EXCHANGE?* (1999) (discussing four themes of exchanges).

¹⁰ See Macey & O'Hara, *Future of Exchanges*, *supra* note 3, at 10.

¹¹ Johannes Köndgen, *Ownership and Corporate Governance of Stock Exchanges*, 154 J. INSTITUTIONAL & THEORETICAL ECON. 224, 235 (1998).

futures and options exchanges' entire focus was on the production of liquidity; stock exchanges traditionally did much more.

The competitive environment under which stock exchanges operate is different now.¹² While stock exchanges need revenue to survive, the proliferation of unlisted and multi-venue trading shows that maintaining a stock exchange membership is not required to survive and even prosper. Instead, trading venues can, and often do, survive on trading volume alone.¹³

While these points have been developed elsewhere, we think that it would be useful to describe the features of the exchange relationship that were, at one time, the exclusive domain of exchanges in order to show how close, and generally superior, substitutes have arisen for all these services. This analysis is reinforced by looking at changes in the nature of the exchange's clientele, which has evolved from a customer base dominated by individual investors trading for their own accounts to institutional customers, which now represent 70 percent of the Exchange's transaction volume.¹⁴

This change is relevant because when those purchasing NYSE shares were largely individuals, the value of the NYSE's function as monitor, as reputational intermediary, and as supplier of liquidity was much greater than it is now. By contrast, in today's markets, sophisticated institutional investors use their own analysis, including direct contact with management, to monitor and evaluate issuers' performance.

If, for example, listing on the NYSE serves as a successful mechanism for signaling, bonding and otherwise "opting into" honest corporate reporting and good corporate governance, then firms listed on the NYSE should have a lower incidence of corporate scandals than other firms. However, the opposite is true.

A. Monitoring

Investors clearly value the ability to monitor the trading in the shares they own in order to ensure that their trades are executed at market prices, and that insiders and market professionals do not engage in insider trading, front-running or market manipulation. Here

¹² See Macey & O'Hara, *From Markets to Venues*, *supra* note 7.

¹³ For example, in 2001, the NASDAQ, which is not technically an exchange, garnered 55% of total trading volume. Many of the best known and most heavily traded U.S. stocks, such as Intel, Microsoft, MCI, Dell Computer, Nestle, and Cisco Systems, have elected to eschew exchange listings entirely. Trading venues (including exchanges) can earn money on the basis of the sale of trade data, and by charging fees for trading volume.

¹⁴ *NYSE Launches Competitive Initiatives*, EXCHANGE (NYSE, New York, N.Y.), Oct. 1999, at 1.

the competitive problem for exchanges has arisen because of changes in technology. At one time the fixed-site locations of exchanges gave exchanges an unrivaled ability to monitor trading on behalf of investors. Now that off-exchange trading takes place via computer rather than via telephone, it is possible to monitor off-exchange trading very effectively. As long ago as 1976, the Securities and Exchange Commission recognized that over-the-counter trades were not “intrinsically more difficult to monitor than exchange transactions.”¹⁵

B. Standard-form Legal Rules

The NYSE once served as an independent source of corporate governance rules for listed firms. Rules regarding disclosure, capital structure, audit committees, and other aspects of corporate governance were supplied by the NYSE before the SEC even existed.¹⁶ However, the NYSE’s role as an independent source of legal rules for listed firms has all but disappeared.¹⁷

In February, 2002, Harvey Pitt, then Chairman of the SEC, sent his now-famous “Dick and Wick” letter to Richard (Dick) Grasso, CEO of the NYSE, and Wick Simmons, Chairman of NASDAQ, which called upon these securities markets to strengthen their corporate gov-

¹⁵ Exchange Act Release No. 34,11942, 41 Fed. Reg. 4507, 4512 (Jan. 30, 1976). Nor has the NYSE been immune from complaints about the quality of its own monitoring services. The recent scandal on the NYSE involving front-running by floor brokers shows that the NYSE cannot promise listing firms an infraction-free trading environment. The point here, however, is not that the NYSE is not committed to careful and effective monitoring of listed stocks. Rather, the argument is merely that the NYSE no longer enjoys a unique ability to monitor that cannot be matched by the NASD or even by proprietary trading systems like Instinet. Perhaps most importantly, regardless of where a firm’s shares trade, traders are bound by the SEC’s rules barring manipulation and insider trading, and mandating that customers receive the best execution of orders placed with brokers. These SEC rules have eroded the NYSE’s dominant position by creating a trading environment in which investors have the same protections both on the NYSE and in alternative trading venues. The SEC’s ability to monitor and enforce its rules further diminishes the NYSE’s historical position as providing the country’s most honest and open market. Now the NYSE is simply one of many honest and open American equity markets.

¹⁶ George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Act of 1934*, 63 AM. ECON. REV. 132, 133 (1973); see also George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964) (observing past public policies and new public policies created by the regulation of the securities markets).

¹⁷ Cf., Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997) (arguing that stock exchanges remain, even in modern times, the best institution to regulate the trading markets). Mahoney’s analysis focuses on regulation of the securities markets and not corporate governance rules, and is therefore of limited relevance here. However, while Mahoney’s argument that exchanges have strong incentives to provide rules of market structure that investors want and to compel adherence by their members to contractual and fiduciary obligations has considerable appeal, he does not come to grips with the fact that the exchanges may no longer have the power to compel firms to comply with the regulations they promulgate. One way of measuring the effectiveness of organized exchanges in dealing with aberrant corporate conduct is to examine the correlation between exchange affiliation and accounting scandals. See also Macey & O’Hara, *From Markets to Venues*, *supra* note 7 at manuscript p. 17-20.

ernance rules.¹⁸ However, the current rule-making initiatives, though impressive, should not be confused with earlier generations of private rule-making by the New York Stock Exchange and other securities market-based Self-Regulatory Organizations (“SROs”). The difference is that the SROs are currently promulgating rules not independently, but rather at the behest, and under the guidance and control of, the SEC.

Consistent with this analysis, there are no sharp differences the structure and content of the proposed new NYSE and the NASDAQ corporate governance rules.¹⁹ There are no sharp differences. Both plans call for increasing board independence and increasing the role and authority of independent directors.²⁰ The point is that, unlike in the past, rival markets now coordinate their listing standards so that listing decisions will not be made on the basis of these provisions. Rather, listing decisions are now made on the basis of whether the market on which the firm is listing provides liquidity for the shareholders of the listing firms.

Historically, exchanges and other SROs engaged in self-governance in order to attract new listings. Self-governance in that era was characterized by an effort at product differentiation. Rules reflected an effort by exchanges to attract a particular clientele of firms. This is no longer the case.

In that earlier era, the relationship between issuers and stock exchanges was purely contractual, and the SEC’s authority was virtually non-existent. Exchanges were interested in promulgating investor-protection rules as a means of attracting listing firms that wanted to make a credible commitment to investors that they had permanently “opted-in” to a legal regime featuring significant investor protections.

Over time, the nature of the exchanges’ rule-making function has changed from being an independent promulgator of rules to being a surrogate of the SEC. The changes occurred in three stages. First, competitive pressures deprived the exchanges of both the willingness and the ability to initiate corporate governance standards for listed

¹⁸ See Press Release, Chairman Harvey L. Pitt of the SEC, Pitt Seeks Review of Corporate Governance, Conduct Codes (Feb. 13, 2002) (on file with the Case Western Reserve Law Review), available at <http://www.sec.gov/news/press/2002-23.txt> (last visited Jun. 1, 2005).

¹⁹ See listing of rule change proposals and amendments of the NYSE, available at <http://www.nyse.com/listed/p1020656067970.html?displayPage=%2Fabout%2F1045516490394.html> (last visited Jun. 1, 2005); listing of NASD’s proposed rules, available at <http://www.nasdaq.com/about/ProposedRuleChanges.stm> (last visited Jun. 1, 2005).

²⁰ There are minor differences. For example, the NYSE proposes a five-year “cooling-off” period before former employees of a listed company can become board members. The NASDAQ’s proposed cooling off period is only three years. But in important areas, such as directors’ compensation and prohibitions on audit committees from receiving any payment other than for board services, the rules are identical.

firms. Second, the National Market System legislation of 1975 gave the SEC broad power not only to oversee, but actually to control, any changes to corporate governance rules being made under the auspices of an exchange. Finally, SOX largely displaced the states from their traditional role in regulating corporate governance, and gave the SEC even more leverage to impose its will on the exchanges.

1. Competitive Pressures

The stock exchanges' ability to serve as effective self-regulatory organizations depends on their ability to sanction listed firms that break their rules. The ability of exchanges to sanction listed firms depends, in turn, on the market power of the exchange. Historically, an exchange such as the New York Stock Exchange was a very effective self-regulatory organization because it could enforce its rules—and thereby enable listing firms to make credible commitments to obey the exchange's rules—by threatening to de-list firms that disobeyed their rules.

As technology and rival markets developed, the threat of de-listing has subsided. Firms that were de-listed would simply move to rival trading venues with similar liquidity characteristics, and more congenial rules.²¹

The paradigmatic illustration of this phenomenon is the one-share, one-vote listing requirement. During the 1980s, the senior management teams of several firms that were listed on the New York Stock Exchange were concerned about the possibility of a hostile takeover, and wanted to adopt a particularly potent defensive strategy, which involved recapitalizing the firm with additional classes of voting stock, to be held by management, which would have significantly greater voting rights than the shares held by other shareholders. The problem with this recapitalization strategy was that it clearly violated an unambiguous NYSE rule providing that all shares of common stock of listed companies could have one, and only one, vote.

Significantly, several venerable listed firms, notably General Motors Corporation and Dow Jones, Inc., that wanted to engage in these so-called “dual-class recapitalizations” elected to proceed with their plans and risk de-listing. The consequences for these firms would simply have been that their shares would have migrated to a rival trading venue, such as the American Stock Exchange or the NASDAQ, both of which permitted dual-class recapitalizations. The result was that the NYSE was forced to relax its listing requirements,

²¹ See Macey & O'Hara, *From Markets to Venues*, *supra* note 7.

and to petition the SEC to impose a uniform voting rights standard for all publicly traded firms.

The U.S. Court of Appeals for the District of Columbia, in *Business Roundtable v. SEC*,²² ultimately held that the SEC did not have the authority to adopt a uniform voting rights standard.²³ However, by the time the Court had ruled, the NASD, the AMEX, and the NYSE had adopted the SEC's proposed rule, and none was willing to risk its ongoing relationship with the SEC by returning to its previous rule.²⁴ Moreover, the ruling in *Business Roundtable* that the SEC lacked the authority to promulgate rules of corporate governance has been weakened considerably, if not eviscerated entirely, by the Sarbanes-Oxley Act of 2002, which gave a significant amount of new power to the SEC in the realm of corporate governance.²⁵

2. The National Market System Legislation

Another significant break with the past occurred in 1975, when Congress passed its National Market System legislation,²⁶ which "vested the SEC with broad flexible authority to design, implement, and regulate the trading markets."²⁷ Of particular relevance to the instant inquiry was the fact that the new rules gave the SEC the authority to approve, to disapprove, and even to add to or delete any rules that the exchanges proposed to adopt.²⁸

The 1975 National Market System legislation was "intended to harmonize SEC authority over various SROs by expanding the Ex-

²² 905 F.2d 406 (D.C. Cir. 1990).

²³ *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

²⁴ With SEC involvement, the NYSE, AMEX and NASDAQ adopted a uniform listing standard resembling SEC Rule 19c-4. See ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIP AND LIMITED LIABILITY COMPANIES* 727 (8th ed. 2003); see also RONALD J. GILSON & BERNARD S. BLACK, *THE LAW & FINANCE OF CORPORATE ACQUISITIONS* 748-51 (2d ed. 1995).

²⁵ Sarbanes-Oxley Act of 2002, 15 U.S.C.A. §7201, §§ 7211-7219 (West 2005).

²⁶ Securities Exchange Act of 1934, Pub. L. No. 94-29, § 249, 89 Stat. 97 (codified as amended at 5 U.S.C. § 78k-1 (1975)) (adding section 11A to the Exchange Act).

²⁷ Karmel, *supra* note 8, at 339.

²⁸ Securities Exchange Act of 1934, 15 U.S.C.A. § 78s (West 2005) (amended 1975). Section 19(b) of the Act requires SROs such as the NASD and the NYSE to file proposed rule changes with the SEC, and to get the Commission's approval for rule changes. 19(b) requires the SEC to approve an Exchange's proposed rule change "if it finds that such proposed rule change is consistent with the requirements of the [Securities Exchange Act of 1934.]" Under Section 19(c) of the Securities Exchange Act of 1934, the SEC is given the power to "abrogate, add to, and delete . . . the rules of a self-regulatory organization" such as the NYSE or the NASD, but only "to conform its rules to the requirements of [the Act,] or otherwise in furtherance of the purposes of the Act." *Id.* Under 19(c), the SEC has authority to impose new SRO rules or to amend or delete existing ones: (1) whenever it "deems [it] necessary or appropriate to insure the fair administration of the [SRO]"; or (2) "to conform [the SRO's] rules to requirements of [the Exchange Act applicable to SROs]"; or (3) "otherwise in furtherance of the purposes of the Exchange Act." *Id.*

change Act to cover Nasdaq.”²⁹ While the National Market System legislation, as interpreted by the D.C. Circuit in the *Business Roundtable* decision, does not give the SEC the power unilaterally to impose corporate governance listing standards, there is no question that the exchanges can impose such standards on themselves. And there is no question that the SEC can, and does, take an active role in shaping these standards during the approval process. The exchanges’ ongoing relationships with the SEC gives these markets significant incentives to cooperate with the SEC’s views on corporate governance issues.

3. *Sarbanes-Oxley*

With the passage of Sarbanes-Oxley in the wake of the Enron-era corporate governance scandals, it is at least arguable that “federal law now occupies the largest part of the legal corporate governance structure in the twenty-first century.”³⁰ Sarbanes-Oxley contains provisions requiring CEOs and CFOs to certify financial statements, barring loans to executive officers and directors, and requiring the creation and maintenance of adequate internal controls by corporations, among many other provisions related directly to corporate governance.

The implications of Sarbanes-Oxley on the current analysis are two-fold. First, the increased role of federal law in corporate governance further displaces any residual role that the exchanges might have in the formation of corporate governance rules. Second, as noted above, Sarbanes-Oxley has dramatically eroded the court’s decision in *Business Roundtable*. In that opinion, the court held that the SEC had authority to make stock exchange rules only in furtherance of the purposes of the Exchange Act, and lacked the power to promulgate general rules of corporate governance. However, Sarbanes-Oxley clearly has moved corporate governance into the Exchange Act, particularly the conduct of audit committees, and monitoring and control by directors and senior officers. Thus, it seems clear that the SEC now can promulgate exchange rules in furtherance of these purposes. These sorts of rules clearly involve corporate governance.

While the securities laws and the SEC are the most important alternative providers of legal rules for public firms, they are by no means the only sources of such rules. State legislatures, particularly

²⁹ Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1517 (2002).

³⁰ Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV., 859, 861-62 (2003).

Delaware, and a wide range of independent legal organizations including the American Law Institute (which promulgated the ALI's Principles of Corporate Governance), the American Bar Association's Committee on Corporate Laws (which promulgated the Model Business Corporation Act), and the Financial Accounting Standards Board, all provide rules of corporate governance and practice that are more significant than the rules provided by the NYSE. Historically, Delaware has been the most significant source of corporate governance rules for companies. As Roberta Romano has observed, "[s]tate regulation does, moreover, offer some decided benefits over stock exchange regulation: a more effective mechanism of private dispute resolution for securities suits against issuers, and a public enforcement system, should the deterrent effect of criminal prosecution for securities law violations be a necessary complement to civil liability."³¹

In sum, it is clear that the NYSE and other trading venues are no longer the primary or even a particularly significant arbiter of corporate governance rules for listing firms. Rather the corporate governance rules promulgated by the exchanges and other trading venues actually reflect: (a) an effort by the exchanges to "cartelize" the production of their regulatory activities, and (b) an effort by the SEC to use the exchanges' rule-making process to inject themselves into corporate governance in a way prohibited directly by the D.C. Circuit's decision in *Business Roundtable*.

C. Signaling

Historically, in exchange for listing fees, the NYSE lent its own substantial reputation to listing firms. The idea was that many of the firms traded in secondary capital markets may be well known regionally, but they may not enjoy a national or international reputation. For such firms, the international reputation of the NYSE as a forum where the shares of high quality, high liquidity firms were traded was, and is, a valuable resource. For less well-known firms, the NYSE served as a reputational intermediary. Investors who knew nothing about a particular firm listed on the NYSE derived information about the firm from the very fact that the NYSE had agreed to list it for trading. For example when Canandaigua Brands, Inc. listed on the NYSE, Richard Sands, its chairman and CEO, defended the decision

³¹ ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 145 (2002).

on the grounds that “[t]he move to the NYSE will support our growth by enhancing our visibility throughout the world.”³²

Just as a NYSE listing is no longer a guarantee that listing firms will agree to abide by the NYSE’s rules and regulations regarding corporate governance,³³ exchange listings in general no longer convey any signal that trading in the firm’s shares will be conducted with greater probity. The SEC, rather than the exchanges, now promulgates and enforces the rules regarding trading practices. Thus, rival trading venues no longer have any claim to providing a more fair or investor-friendly trading environment than their competitors.

There are a plethora of other, more effective information intermediaries that provide signals about the quality of firms whose shares trade in secondary markets. These rival information intermediaries include investment banks, law firms, accounting firms, rating agencies, and the SEC (which approves registration statements and enforces rules against false and misleading statements in connection with the purchase and sale of securities). Finally, as technology, particularly the use of the Internet as a research tool, has lowered the cost of research about traded companies, the demand for this aspect of the exchanges’ traditional bundle of services has declined. It is simply no longer reasonable to assume that a firm whose shares trade on venues such as the NYSE is of higher quality than a firm that trades on rival venues.

Firms that trade in markets with severely under-developed legal systems and with weak reputational intermediaries will still value the reputational capital associated with an exchange listing. Such a listing illustrates that the listing firm has agreed to comply with local (U.S.) accounting laws.

D. Clearing Services

For much of the NYSE’s history there were no substitutes for the Exchange’s role in ensuring the reliability of counter-parties contractual obligations. Obviously, it is important that traders be able to rely on the fact that they will receive timely payment for securities sold and timely delivery of securities purchased. The NYSE’s ability to provide such assurances gave it a strong competitive advantage. The NYSE still provides clearing services. But investment banks and commercial banks also provide such services. The success of the huge foreign exchange and U.S. government securities markets demon-

³² *NYSE Listings: New Listings September 20 – October 15*, EXCHANGE (NYSE, New York, N.Y.), Nov. 1999, at 6.

³³ See the discussion of the one-share, one-vote controversy, *supra* Part I.B.1.

strates that the Exchange is no longer the sole provider of reliable, large-scale clearing services.

Moreover, markets have developed to the point at which clearing services can be separated (unbundled) from trading services. Specialized firms like Bear Stearns Securities Corp. provide clearing services for other broker-dealer firms who do not want to invest in creating and maintaining their own clearing services. The Exchanges are no longer essential for clearing.

E. Liquidity

The advantages of listing on a particular exchange such as the New York Stock Exchange in order to achieve better monitoring, better signaling, superior legal rules, and more reliable clearing have been eroded. For the reasons specified above, it is no longer plausible to defend a decision to list on a particular exchange on the grounds that it provides these sorts of advantages. Instead, trading venues compete for trading volume, regardless of whether they are exchanges, like the NYSE, or “markets” like the NASDAQ, or Automated Trading Systems like Instinet or an Electronic Trading Network, like Datek.

When it comes to providing liquidity for listing firms, however, there appears to be significantly more product differentiation. Here the critical questions are: (1) whether one trading venue is superior to another; and (2) whether a strategy of isolating trading on a particular venue is superior to simultaneous trading on multiple venues for any issuers.

Investors value the ability to buy and to sell their shares quickly and cheaply at prices closely approximating to the present value of the future income to investors associated with those shares. Because the bid-asked spread represents a transaction cost to investors, investors value a narrow bid-asked spread. In other words, investors value low trading costs and fair and orderly markets. They value liquidity.

In the over-the-counter markets, liquidity is provided via competition among dealers and other market professionals. On alternative trading systems, liquidity arises from the interaction of customer orders. Because liquidity arises endogenously (which is to say that there is no other source of liquidity other than customer orders), liquidity may vanish when market conditions turn adverse.

On the New York Stock Exchange, the listing fee paid by listed firms buys the bundle of services provided by an exchange specialist. The NYSE’s Allocation Committee assigns a specialist to each listed firm. In turn, each specialist has an affirmative obligation to “main-

tain fair and orderly markets” in the stocks in which they specialize. According to the Exchange’s rules:

The maintenance of a fair and orderly market implies the maintenance of price continuity with reasonable depth, and the minimizing of the effects of temporary disparity between supply and demand.

In connection with the maintenance of a fair and orderly market, it is commonly desirable that a member acting as a specialist engage to a reasonable degree under existing circumstances in dealings for his own account when lack of price continuity, lack of depth, or disparity between supply and demand exists or is reasonably to be anticipated.³⁴

Recent research has argued, however, that this affirmative obligation does not benefit investors.³⁵ It does not appear to reduce share volatility or make markets more efficient.³⁶

Although in the past exchange specialists may have had the ability to have a marginal impact on the maintenance of fair and orderly markets, it is clear that they are no longer able to do so. Now that NYSE-listed stocks trade on multiple venues, specialists must enjoy a monopoly position in order to be able to carry out this obligation. The specialists’ ability to maintain fair and orderly markets depends upon their ability to reap sufficient profits during the easy times when volatility is low and trading volume is high (so that the specialists are “earning” the bid-asked spread), so that they can afford to take the losses associated with maintaining fair and orderly markets when market conditions become more uncertain, and their regulatory obligation becomes costly.

However, when trading on multiple venues is possible, as it is today, the affirmative obligation of market-makers makes no sense. Specialists who attempt to make sufficient profits during times of low-volatility and/or high trading volume to compensate for expected losses during times of high volatility and times of low trading volume will find themselves losing market share to rival venues. This market share will only return when market conditions change and the specialists must incur the costs of maintaining a fair and orderly market.

³⁴ NYSE Guide, (CCH) ¶ 2104.10 at 2705.

³⁵ See Hans R. Stoll, *Reconsidering the Affirmative Obligations of Market Makers*, 54 FIN. ANALYSTS J. 72 (Sept. 1, 1998).

³⁶ *Id.*

Finally, it is important to note that the affirmative obligation of market makers to provide liquidity is needed the least for large firms with heavy trading volumes. Firms with large numbers of shares outstanding and heavy trading provide the greatest number of trading opportunities and the largest number of profit-making opportunities for market professionals. Thus, it is not plausible that firms like Coca-Cola or IBM would lose liquidity if they ceased being traded on the NYSE. Likewise, it is not plausible that shares in Intel or Apple would become more liquid if they started trading on the NYSE.

A more interesting question is whether the benefits of multi-venue trading outweigh the costs. The benefits of multi-market trading come in the form of increased competition for “order flow” among rival trading venues. The costs come in the form of fragmentation: where trading occurs simultaneously on a variety of trading venues, it not only may be difficult to identify the best price, but low-cost competitors may be able to “free-ride” on the costly price-setting activities of high-quality rivals. This free-riding manifests itself in the form of “cream-skimming” of the most profitable trading by low-price trading venues.

Part III of this Article evaluates these issues. For now, the only point that needs to be made is that listing fees make it possible, at least in theory, for a particular trading venue to specialize in the promulgation of corporate governance rules for listed firms. Even if securities trade in multiple venues, issuing firms that wanted to “opt into” the particular corporate governance regime created by a specific stock exchange could do so listing on that exchange. The listing fees paid by the firm would compensate the exchange for any costs it incurred establishing and maintaining the corporate governance regime. The problem is that the act of “opting into” a particular corporate governance regime is only a valuable signal to investors (and thus useful to issuers as a method for lowering capital costs) to the extent that firms cannot suddenly decide that they no longer wish to maintain their commitment to the exchange’s corporate governance regime, and then de-list in order to rid themselves of their prior obligations.

This is precisely the problem today: acting unilaterally, stock exchanges and other trading venues are no longer in a position to act as effective self-governance organizations because the act of listing serves as a commitment committed to that trading venue’s corporate governance regime only as long as the firm decides to remain voluntarily listed. A problem exists because, as we saw in the case of the one-share, one-vote controversy, firms that choose to flaunt exchange

rules “mid-stream” (after their shares are issued and outstanding), can do so with impunity. The following section deals with the legal issue of whether issuers and exchanges can deal with this issue contractually.

A remaining critical issue raised by the existence of multi-jurisdictional trading venues is whether such trading affects liquidity, irrespective of corporate governance issues. It could be that committing a company to the corporate governance rules of a particular exchange or trading venue is optimal from a corporate governance perspective, but sub-optimal from a liquidity perspective. The critical issue here is the trade-off between the salutary effects of competition that multi-venue trading brings as contrasted with the potential harms of fragmentation associated with multi-venue trading. Part III discusses these issues.

II. CONTROL OF TRADING VENUE: THE FORGOTTEN ROLE OF SHARE TRANSFER RESTRICTIONS

From the above discussion it seems conceivable that firms might find it in their interests to limit trading in the securities they have issued to a single trading venue. This section explores why we do not observe firms putting such restrictions in place.

At the outset, we wish to note that firms rarely make an effort to do this. One explanation, of course, is that firms are unable to limit where their securities trade. This explanation posits that there are legal and regulatory restrictions that make it impossible for firms to effectuate restrictions regarding the venue on which their securities trade. An alternative explanation is that firms do not attempt to place restrictions on the venue where their securities trade because such restrictions would harm shareholders. A final explanation is that, while firms have the power to implement restrictions, agency costs prevent them from doing so. According to this hypothesis, restrictions on trading venues would benefit investors but harm managers. The presence of agency costs (the costs associated with investors’ efforts to monitor and control managers), however, creates a situation in which firms do not adopt trading restrictions, despite the benefits such restrictions might have for shareholders.

The pre-existing legal scholarship on the role played by issuers in determining where shares trade asserts that “[t]he issuer’s role in determining how and where its securities are traded is severely limited

under current U.S. regulatory policy.”³⁷ This scholarship is, in our view, both analytically and descriptively flawed.

The scholarship is flawed analytically because it fails to distinguish between *ex ante* efforts to control trading venue and *ex post* efforts to control trading venue. Specifically, there is a crucial difference between issuers’ efforts to control trading venue at the time of a firm’s initial public offering (*ex ante*), and subsequent efforts to control trading venue (*ex post*) after investors have purchased the securities and are trading in secondary markets.

The scholarship is flawed descriptively because it looks only at federal law, and only at issuers’ efforts to control trading venue in secondary markets after securities have been sold. It ignores issuers’ ability to control trading venue by inserting valid share transfer restrictions at the time the securities are first sold.

A. Unlisted Trading Privileges

As Amihud and Mendelson have observed, the Securities and Exchange Commission has taken a dim view of issuers’ efforts to restrict the trading venue of their securities, once those securities have been issued and already are being traded.³⁸ In particular, the SEC routinely grants so-called “unlisted trading privileges” to securities exchanges. Unlisted trading privileges, as the name implies, give a particular trading venue the privilege of trading a security in situations in which the issuer of the securities has not asked permission for its securities to be traded in (listed on) that venue.

Under the Unlisted Trading Privileges Act of 1994,³⁹ regional stock exchanges were actually encouraged to extend unlisted trading privileges to stocks listed on other trading venues. That statute simply codified a long-standing SEC policy of acquiescing in requests by regional exchanges for unlisted trading privileges.⁴⁰

Occasionally, issuers have tried to control trading in their securities after their securities already have been issued, but these efforts have been uniformly unsuccessful.⁴¹ Two points about these efforts by issuers to control trading venue are worth making.

³⁷ Yakov Amihud & Haim Mendelson, *A New Approach to the Regulation of Trading Across Securities Markets*, 71 N.Y.U. L. REV. 1411, 1416 (1996).

³⁸ See *id.* at 1416-26 (describing the issuer’s role under current U.S. regulatory policy).

³⁹ See 15 U.S.C.A. § 78l(f) (West 1994) (providing that unlisted trading privileges for securities originally listed on another national exchange may be granted to “any security that is listed and registered on a national securities exchange”).

⁴⁰ 140 CONG. REC. H6508 (daily ed. Aug. 1, 1994) (statement of Rep. Markey).

⁴¹ See, e.g., *In re Edison Elec. Illuminating Co.*, Exchange Act Release No. 986, 1 S.E.C. 909 (Dec. 16, 1936) (rejecting effort by company to block the granting of unlisted trading privileges in its bonds by the New York Curb Exchange); *In re Providence Gas Co.*, Exchange Act

First, it appears that the SEC's reluctance to block the grant of unlisted trading privileges, at least in some cases, has furthered shareholder interests by blocking managers' efforts to entrench themselves in office. For example, in *In re Providence Gas Company*,⁴² managers of a public utility wanted to limit ownership in the stock of the company to customers of the company. The managers sought to effectuate this policy by limiting trading in the firm's securities to the local over-the-counter market. This policy was upset when the New York Curb Exchange (now the American Stock Exchange) granted unlisted trading privileges to the company's stock. The company then unsuccessfully tried to litigate to block the New York Curb Exchange's move to extend unlisted trading privileges to the company's stock. Here it seems clear that the interests of management in restricting trading were unlikely to have been shared by the company's shareholders, whose interests were in expanding the investor base to improve liquidity in the company's shares. Management, on the other hand, would care less about liquidity and more about limiting outsiders' access in the company's shares in order to reduce the possibility of a hostile takeover attempt.

Thus, in this context at least, it appears that the liberal use of unlisted trading privileges serves shareholder interests and reduces agency costs.

Second, as the following section of this article explains, even if unlisted trading privileges are liberally granted, issuers are not necessarily helpless to effectuate restrictions on the venues on which their securities trade. Because they require unanimous shareholder approval, and thus cannot be used by managers as easily to exploit shareholders, share transfer restrictions are a far more attractive strategy for restricting trading venue than the refusal to grant unlisted trading privileges.

B. Share Transfer Restrictions

A share transfer restriction is a provision in the articles of incorporation of a company that restricts, in some way or other, the ability of shareholders to transfer their shares to other investors. Those writing

Release No. 1992, 4 S.E.C. 395 (January 19, 1939) (rejecting issuer's attempt to terminate the granting of unlisted trading privileges in the company's common stock by the New York Curb Exchange); *In re Chicago Rivet & Mach. Co.*, Exchange Act Release No. 3395, Fed. Sec. L. Rep. (CCH) ¶ 75,369 (March 16, 1943) (same); *Ludlow Corp. v. SEC*, 604 F.2d 704 (D.C. Cir. 1979) (permitting, over the issuer's objection, the Boston Stock Exchange to grant unlisted trading privileges to stock already trading on the New York Stock Exchange).

⁴² Exchange Act Release No. 1992, 4 S.E.C. 395 (Jan. 19, 1939).

about control of trading venue by issuers have considered only the relevance of unlisted trading privileges in their analysis. They have ignored the fact that it may be possible for firms that want to limit trading in their shares to a particular venue to use share transfer restrictions to accomplish this objective. This strategy is more likely to be successful than efforts to block the extension of unlisted trading privileges.

In general, stock certificates (and other, more modern indicia of share ownership) are regarded as personal property, and are subject to the traditional, common law rule that there be no unreasonable restraint on alienation.⁴³ Share transfer restrictions, however, are widely used by corporations and serve a number of valid purposes. For example, they ensure that a corporation will continue to satisfy certain regulatory requirements, such as Subchapter S of the Internal Revenue Code, which grants preferred (pass-through) tax treatment to corporations but requires them to have no more than 100 shareholders;⁴⁴ ensure that the company retains exemptions from the registration requirements of the Securities Act of 1933 that prohibit the public offering of unregistered securities.⁴⁵ In addition, share transfer restrictions are commonly used to maintain a family's control over a particular corporation, to maintain the *status quo* ownership structure among shareholders, or to permit shareholders in closely held corporations to control the identity of new investors.⁴⁶

While the general rule is that shares of stock are freely transferable, share transfer restrictions are valid in the vast majority of states as long as the restrictions they impose are reasonable under the circumstance.⁴⁷ The modern rule of share transfer restrictions, in other

⁴³ See *Rafe v. Hinden*, 288 N.Y.S.2d 662, 665 (N.Y. App. Div. 1968), *aff'd* 244 N.E.2d 469 (N.Y. 1968); *Allen v. Biltmore Tissue Corp.*, 141 N.E.2d 812, 814 (N.Y. 1957); *Penthouse Properties v. 1158 Fifth Ave.*, 11 N.Y.S.2d 417 (N.Y. App. Div. 1939).

⁴⁴ 26 U.S.C.A. § 1361 (West Supp. 2005).

⁴⁵ 15 U.S.C.A. §77e (West 2002).

⁴⁶ This latter restriction is valuable in circumstances where, for example, state law limits share ownership in a professional medical corporation to doctors, or ownership in a professional legal corporation to licensed attorneys. These restrictions similarly allow shareholders to choose their business associates, to restrict ownership to family members, and to ensure congenial and knowledgeable associates. Share transfer restrictions also can prevent business competitors from purchasing shares. There are also important tax planning reasons for the restrictions.

⁴⁷ See, e.g., MODEL BUS. CORP. ACT §6.27 (1999); CAL. CORP. CODE §418 (West 2004); Del. Code Ann. tit. 8, § 202 (2004). In addition to the requirement that share transfer restrictions be reasonable, in order for such restrictions to be valid (except as to transferees with actual knowledge of the restrictions), the existence of the restrictions must be noted conspicuously on the share certificates that are subject to the restrictions. The Model Business Corporation Act, for example, provides that the stock legend giving notice of the existence of share transfer restrictions must be printed in italics, boldface, contrasting color, typed in capital letters, or underlined. MODEL BUS. CORP. ACT §1.40(3) (1999).

words, “balances two conflicting corporate tenets: free alienability of corporate ownership interests and private corporate structuring to meet the participants’ needs.”⁴⁸

If it is truly the case, as some have argued,⁴⁹ that issuers may be able to improve the quality of secondary market trading in their shares by limiting trading in their shares to a particular trading venue, then a share transfer restriction containing such a limitation would be valid. Suppose, for example, an issuer was concerned that multi-venue trading would increase investors’ trading costs by increasing the bid-asked spread in the issuers’ securities. When making its initial public offering, a genuinely-concerned issuer could impose a share transfer restriction limiting trading in the company’s shares to, say, the New York Stock Exchange.

Such a restriction seems valid, since it serves a legitimate purpose and is not “unreasonable” in any way. More importantly, the use of share transfer restrictions appears to be categorically superior as a means for controlling trading venue than the traditional method of issuers bringing lawsuits against trading venues on which they would prefer not to have their shares trade. For one thing, where restrictions on trading venue are effectuated through share-transfer restrictions, investors would have *notice* of the imposition of such restrictions. By contrast, when restrictions on trading venue are effectuated through lawsuits, shareholders have no notice and, therefore, no input into whether the restriction should be put into place.

Second, share transfer restrictions efficiently control trading venue because they impose a unanimity requirement on restrictions on trading venue at very low cost. Where share transfer restrictions are utilized to restrict trading venues, potential investors who would prefer a wider range of choices about trading venue, or who otherwise disapprove of such restrictions, can simply decide not to purchase the shares. As the discussion of *In re Providence Gas* illustrated, it is highly likely that restrictions on trading venue will benefit some shareholders (incumbent managers) but harm others (outside shareholders). The use of share transfer restrictions permits the shareholders who are harmed by the imposition of such restrictions to respond, either by declining to invest in the first place, or by adjusting the price they pay for their shares by an amount sufficient to make up for the losses resulting from of the restrictions.

⁴⁸ LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS § 26.6.3 (3d ed. 1999).

⁴⁹ See Amihud & Mendelson, *supra* note 37, at 1433-42 (discussing how multi-market trading may be harmful by decreasing value through reduced liquidity in the firm).

Thus, share transfer restrictions are a more legally-defensible and economically-efficient mechanism for restricting trading venue than the historically unsuccessful strategy of having incumbent management commence litigation in order to prevent undesired venues from trading a company's shares. Nevertheless, we do not generally observe issuers attempting to impose restrictions on a firm's trading venue. As the next section makes clear, the most plausible explanation for the lack of interest by issuers in restricting trading venue is that such restrictions are not in the interest of either issuers or investors. The costs of restricting trading venue appear to be higher than the benefits, resulting in a general lack of demand for imposing such restrictions.

III. THE COSTS AND BENEFITS OF RESTRICTING TRADING VENUE

Thus far, multi-market trading has been viewed as involving a simple trade-off between the virtue of competition and the vices of fragmentation. Competition is good because it leads to lower transaction costs for investors, lower capital costs for issuers, and ultimately to higher securities prices on a risk-adjusted basis.⁵⁰ Fragmentation occurs when orders that could be executed in a single market are executed in multiple markets. Fragmentation is bad, in theory, because it reduces the number of traders in a particular market and therefore may reduce the probability of a particular trader finding the optimal counter-party in that market. Single-venue trading has the virtue of eliminating the specter of fragmentation. Multi-venue trading has the virtue of fostering competition. As Amihud and Mendelson observe:

The effect of multimarket trading on liquidity is ambiguous because of the conflicting effects of competition and fragmentation. On one hand, multimarket trading may generate liquidity improvements due to enhanced intermarket competition. On the other hand, it may hurt liquidity because it induces fragmentation of the order flow between markets⁵¹

An economy's decision about how to balance the costs and benefits of fragmentation and competition will determine the answer to one of the most enduring questions in finance: how to construct the most efficient national market system for a particular economy.

⁵⁰ See Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223 (1986).

⁵¹ Amihud & Mendelson, *supra* note 37, at 1433.

Because of the large variety of factors involved in determining whether a particular trading structure is efficient, The goal of constructing an efficient securities transaction system is elusive. In particular, “[e]fficient execution clearly involves a transactional component in the sense of minimizing execution costs for traders, but it must also surely involve the notion of price discovery or of prices being efficient in the sense of impounding information.”⁵²

Further complicating the analysis is the fact that investors are a very heterogeneous group. Institutional customers who want to effectuate large block trades have very different concerns than small retail investors who want to execute smaller trades. Large block traders will be concerned about the impact of his trade on the bid price of the security, and therefore will very likely be interested in retaining their anonymity until their entire trading strategy has been completed. The small, retail trader will be concerned with the gap between the bid and the asked sides of the spread, and with the commission charged by her broker.⁵³

Another important issue is the relationship between securities trading and stock market efficiency. Some trades contribute more than others to the efficiency of the marketplace: some trades contain more information than others. In addition, it is clear that all trading venues do not contribute equally to the process of “price discovery,” which is the process by which market-trading moves the price of a security to reflect new information.

Those most concerned about the problems of fragmentation point out that the vast majority of price discovery occurs on the exchange for stocks listed on an organized securities exchange such as the NYSE.⁵⁴ Other trading venues play a minimal role, if any, in price discovery. Worse, market fragmentation in the form of trading on other venues may well result in “cream-skimming,” which, in turn, reduces the efficacy of the price-setting mechanisms on the primary market.⁵⁵ While cream-skimming is a concern, “it does not appear that the underlying price discovery process requires every order to participate, nor does it appear to matter if some traders prefer to trade

⁵² Macey & O’Hara, *Regulating Exchanges*, *supra* note 3, at 29.

⁵³ *Id.*

⁵⁴ See Joel Hasbrouck, *One Security, Many Markets: Determining the Contribution to Price Discovery*, 50 J. FIN. 1175 (1995) (discussing the importance of price information and price discovery in period of increased fragmentation).

⁵⁵ See David Easley, Nicholas M. Kiefer, & Maureen O’Hara, *Cream-Skimming or Profit Sharing? The Curious Role of Purchased Order Flow*, 51 J. FIN. 811 (1996); Robert H. Battalio, *Third Market Broker-Dealers: Cost Competitors or Cream Skimmers?*, 52 J. FIN. 341 (1997).

off the potential for price improvement for the promise of lower trading commissions.”⁵⁶

Empirical studies of the effects of multi-market trading on liquidity obtain results consistent with the theoretical discussion above: multi-market trading appears to help some firms’ investors and harm others. Khan and Baker studied the multi-market trading in NYSE and AMEX stocks that occurred when stocks listed on these venues were granted unlisted trading privileges on regional stock exchanges.⁵⁷ Consistent with the view that pro-competitive benefits of multi-market trading outweigh the anti-competitive costs of fragmentation, they found that, on average, share prices of listed firms rose by a statistically significant amount when the extension of unlisted trading privileges was announced.⁵⁸ While the results were generally positive, however a sizeable minority of the sample of the companies studied experienced declines in share prices and increased bid-asked spreads.⁵⁹

The sort of empirical study just described does not reflect all of the benefits from competition that occur when multi-market trading is allowed. Specifically, multi-market trading provides competitive incentives for exchanges and other trading venues to invest in new trading technologies and to adopt more efficient internal trading rules in order to prevent order flow from migrating to other trading venues.⁶⁰ In addition, the mere threat of multi-market competition causes trading venues to tighten bid-asked spreads and generally to offer better terms to traders in order to discourage entry by new competitors. It is probably not coincidental that the advent of modern, fully automated trading systems and procedures over the past two decades corresponds with the rise of multi-market competition.⁶¹

It seems clear that, at least for some firms, multi-market trading is a good idea. In particular, multi-market trading appears like a good idea for large firms: share prices of firms with low liquidity suffer more from multi-market listing than the share prices of larger firms with better liquidity.⁶² This makes sense. Large firms, whose securi-

⁵⁶ Macey & O’Hara, *Regulating Exchanges*, *supra* note 3, at 30.

⁵⁷ Walayet A. Khan & H. Kent Baker, *Unlisted Trading Privileges, Liquidity and Stock Returns*, 16 J. FIN. RES. 221 (1993).

⁵⁸ *Id.* at 229.

⁵⁹ *Id.* at 229-234.

⁶⁰ KALMAN J. COHEN, ET AL., *THE MICROSTRUCTURE OF SECURITIES MARKETS* 163 (1986); ROBERT A. SCHWARTZ, *RESHAPING THE EQUITIES MARKETS: A GUIDE FOR THE 1990S* 175-80 (1991).

⁶¹ COHEN, *supra* note 60, at 163; SCHWARTZ, *supra* note 60, at 172.

⁶² See Amihud & Mendelson, *supra* note 37, at 1440, n.151 (discussing empirical results in unpublished manuscript by Walayet A. Kahn et al., *Competition Versus Consolidation of Order Flow: Common Stock Listing on Dual Domestic Exchanges* (1994) (on file with au-

ties exhibit higher trading volume, can more easily support the trading on multiple venues that is the hallmark of a fragmented market.

Smaller firms, with large numbers of retail traders, may find it in their interest to eliminate fragmentation by restricting trading to a single venue. Moreover, the benefits of New York Stock Exchange practice assigning a single specialist to listing firms, and charging that specialist with the responsibility to provide liquidity for investors by maintaining a high quality continuous two-sided market is likely to be of much greater value to smaller firms than to larger firms.⁶³ Larger firms have no need for this service, because big firms are followed by multiple analysts, traded by multiple market-makers, and enjoy large daily trading volumes that create their own inherent liquidity.

Since some firms seem to benefit and some firms appear to be harmed by multi-market trading, firms should be able to decide for themselves what venue is best for their securities. Despite the advantage of venue choice, no firm has even attempted to utilize share transfer restrictions to restrict the trading venue for their shares. However, an explanation emerges from the previous discussion. Small firms, rather than large firms, are the most likely candidates for banning multi-venue trading. But unlike large firms, which are eligible to list their shares for trading on venues like the New York Stock Exchange or the American Stock Exchange, smaller firms must initially list their shares for trading on other venues and wait until they become large enough and profitable enough to qualify for listing on the NYSE or NASDAQ.⁶⁴ Thus, it would be irrational for small firms to limit, *ex ante* the venue where their securities trade, because doing so would bar them from being able to migrate to larger, superior trading venues when they mature.

Large firms, on the other hand, have less incentive to adopt multi-venue trading restrictions since the greater trading volume in their shares suggests that they would benefit from trading on multiple markets.

Another reason why firms are likely to be reluctant to adopt internal corporate governance rules that prohibit multi-venue trading is that technological advances have lowered the costs of fragmentation and increased the benefits of multi-venue trading, and this is a trend that we can expect to continue. For example, the Internet, intranets, e-mail, and other electronic communications linkages, have made it

thors)).

⁶³ Macey & O'Hara, *Stock Exchange Listing Fees*, *supra* note 3.

⁶⁴ *Id.*

far easier for rival markets to observe in real-time transactions in other markets. This, in turn, has reduced the costs of fragmentation because orders can migrate to the markets with the best quotes more quickly and at lower cost as technology develops. Similarly, Liquidity can migrate away from traditional trading locales with ever-growing ease and speed, because these technological changes have forced various trading venues to compete. Indeed, while securities markets may appear to be fragmented from the perspective of the trading venues themselves, technology increasingly has made the markets functionally unified from the perspective of the traders who are transacting on those markets.

IV. THE ONCE AND FUTURE ROLE OF STOCK EXCHANGES IN CORPORATE GOVERNANCE

Small firms are unlikely to desire trading rules that restrict multi-venue trading, even if such rules are the best sorts of rules for them in the near-term, because such restrictions would permanently lock them out of the most desirable trading venues (the NYSE and NASDAQ), and would prevent them from taking advantage of advances in technology that make multi-venue trading less problematic.

Large firms are unlikely to desire trading rules that restrict the venues on which their securities can trade since multi-venue trading is likely to reduce capital costs by increasing share prices and improving liquidity for large firms.

From a corporate governance perspective, it seems clear that the “issuer choice” rule proposed by Amihud and Mendelson to regulate multi-venue trading is inefficient. Their proposed rule is as follows: “The security’s issuer has the exclusive right to decide where its security will be traded. Trading the security in any securities market or trading system requires the issuer’s consent.”⁶⁵

The problem with this rule is that it ignores the agency costs (conflicts of interest) between issuers and shareholders on the question of trading venue. Under the rule proposed by Amihud and Mendelson, management concerned about a takeover could decide to reallocate trading to trading venues that make hostile takeovers more difficult and unlikely, despite the fact that such takeovers are likely to be in the best interests of the shareholders.

In other words, Amihud and Mendelson are wrong to assert that there is a constant and continuous alignment of interests between the interests of the issuers and their securities holders.⁶⁶ In fact, agency

⁶⁵ Amihud & Mendelson, *supra* note 37, at 1443.

⁶⁶ *Id.*

costs are ubiquitous. A far better rule would be to permit issuer choice, but to require that the issuer's choice be reflected in share transfer restrictions. As a practical matter for publicly traded companies, this would require any trading venue restrictions to be put into place at the time of a firm's initial public offering of the securities,⁶⁷ and it would prevent opportunistic mid-stream changes by managers that are contrary to the interests of the shareholders.

The cost of the approach recommended here is its intractability: Once restrictions are put into place, they are difficult to remove. Removal of existing share transfer restrictions generally requires the permission of all of the shareholders. This may explain why firms do not attempt to control trading venue through the use of share transfer restrictions.

Thus, as a practical matter, we are unlikely to observe issuers attempting to avail themselves of the ability to control trading venue through the use of share transfer restrictions. And, as discussed above, the proliferation of trading venues has deprived the stock exchanges of their incentives to promulgate general rules of corporate governance for listed firms that safeguard investors' interests. The problem is that shareholders face collective action problems. When managers find it inconvenient to abide by the rules of a particular exchange, they feel free to migrate to rival trading venues with less-restrictive rules. For widely disbursed shareholders, expulsion from a particular trading venue is no longer a salient issue, because the rival trading venues to which a large firm is likely to migrate will have liquidity characteristics that are, from the shareholders' perspective, identical to the liquidity characteristics of the original venue.

The SEC has stepped in and filled this gap by providing "administrative guidance" for the stock exchanges. This guidance permits the stock exchanges to continue to involve themselves in corporate governance. But the coordinating role now played by the SEC ensures that no trading venue will lose market share to another venue because of the content of its corporate governance rule. The cost of this new regulatory paradigm manifests itself in terms of lower levels of innovation and product differentiation. Where formerly the stock exchanges, particularly the New York Stock Exchange, attempted to

⁶⁷ Technically speaking, share transfer restrictions may be imposed by a company's certificate of incorporation, or by the bylaws of the company, or by an agreement among any number of shareholders. See DEL. CODE ANN. tit. 8, § 202(b); MODEL BUS. CORP. ACT §6.27(a) (1999). However, a share transfer restriction binding less than 100% of shareholders would present the problems of fragmentation that the share transfer restrictions are trying to avoid. Share transfer restrictions binding one hundred percent (or close to one hundred percent of shareholders) would be difficult to implement after the initial public offering because hold-out and other collective action problems would make it difficult to achieve unanimity *ex post*.

distinguish themselves from their rivals by offering superior corporate governance rules, the emergence of close substitutes for the NYSE has made that sort of competition impossible.

CONCLUSION

In this article, we have argued that a company issuing stock is free to restrict trading in that stock to a particular trading forum, such as the NYSE, if they do so through share transfer restrictions and if those restrictions are reasonable. In our view, a restriction to limit trading in a security to the NYSE would be reasonable. In order to restrict trading in this way, the company would have to reasonably conclude that imposing this restriction would result in net benefits such as a lower cost of capital and improved liquidity for shareholders. In addition, the company issuing the securities would have to comply with certain minimum state law restrictions, such as the requirement that the restriction on transfers outside of the floor of the NYSE be disclosed and conspicuously noted on share certificates.

Having argued that companies not only can and should be able to impose reasonable restrictions on the venues in which their securities trade, we observe that they generally do not. Instead, companies permit their securities to be traded in multiple venues, including exchanges, the NASDAQ system, and ECNs.

This multiple-venue trading has implications for both the internal rules of corporate governance of the firms whose shares are traded in multiple markets as well as for the trading rules. With regard to the former, we argue that stock exchanges are no longer a viable source of internal rules of corporate governance because they can no longer enforce the rules of corporate governance that they promulgate. States, the SEC, and the federal government are all superior substitutes for rules of internal corporate governance for firms. Consistent with this analysis, we observe that the exchanges essentially have abdicated to the SEC their role as creators of corporate governance rules. In other words, although the exchanges at one point promulgated corporate governance rules as a means for attracting listings by differentiating their products from rival exchanges, they currently use the SEC to coordinate their corporate governance rules with other exchanges.

With regard to trading rules, we find that for most firms, and certainly for large firms, the optimal trading rule is to permit multi-market trading in order to take advantage competing sources of liquidity. This argument applies with particular force to firms with heterogeneous groups of shareholders, some of whom might be better

served by a different trading venue than others. Moreover, as technology changes, the benefits of multi-venue trading are likely to increase, while the costs are likely to diminish. Consequently, it appears to be undesirable for firms to limit themselves to a single venue through the use of share-transfer restrictions, since doing so would interfere with the firms' ability to take advantage of changes in technology that make multi-venue trading increasingly more desirable.

For some small firms, it might make sense to limit trading to a particular high-quality venue, such as the NYSE. Unfortunately, the NYSE's listing standards prohibit these smaller firms from listing their shares. Thus, share transfer restrictions limiting a particular security's trading to the NYSE are not a viable option for these firms, either.