REVISTA SEMESTRAL DE DIREITO EMPRESARIAL

Nº 21

Publicação do Departamento de Direito Comercial e do Trabalho
da Faculdade de Direito da Universidade do Estado do Rio de Janeiro

Rio de Janeiro
julho / dezembro de 2017

REVISTA SEMESTRAL DE DIREITO EMPRESARIAL

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Publicação do Departamento de Direito Comercial e do Trabalho da Faculdade de Direito da Universidade do Estado do Rio de Janeiro (Prof. Alexandre Ferreira de Assumpção Alves, Prof. Eduardo Henrique Raymundo Von Adamovich, Prof. Eduardo Takemi Dutra dos Santos Kataoka, Prof. Enzo Baiocchi, Prof. Ivan Garcia, Prof. João Batista Berthier Leite Soares, Prof. José Carlos Vaz e Dias, Prof. José Gabriel Assis de Almeida, Prof. Leonardo da Silva Sant'Anna, Prof. Marcelo Leonardo Tavares, Prof. Mauricio Moreira Menezes, Prof. Rodrigo Lychowski e Prof. Sérgio Campinho).

ISSN 1983-5264

CIP-Brasil. Catalogação-na-fonte
Sindicato Nacional dos Editores de Livros, RJ.

Revista semestral de direito empresarial. — nº 21 (julho/dezembro 2017)
. — Rio de Janeiro: Processo, 2007-.
v.
UERJ
Campinho Advogados
Moreira Menezes, Martins, Advogados
Semestral
1. Direito — Periódicos brasileiros e estrangeiros.

94-1416. CDU — 236(104)

* Publicada no segundo semestre de 2018.

INCREASED COMPETITION BETWEEN STOCK EXCHANGES AND THEIR CURRENT ROLE IN CORPORATE GOVERNANCE[1]

O AUMENTO DA COMPETIÇÃO ENTRE AS BOLSAS DE VALORES E O SEU ATUAL PAPEL NA GOVERNANÇA CORPORATIVA

Mariana Campinho

Abstract: This paper theoretically aims to discuss (1) to what extent do stock exchanges substantially interfere in corporate governance; (2) whether the increase in competition between stock exchanges due to technological advances, globalization and their demutualization will undermine their ability to substantially interfere in corporate governance; and (3) what is the best possible way to surmount the increased competition between stock exchanges. In order to address these questions, this paper is divided into three parts. Part I describes how stock exchanges have been influencing corporate governance over the years. Part II identifies the existence of an increased international competition between stock exchanges and addresses whether and how this affects the role they have been playing in corporate governance. Part II.A addresses the "race towards the top" theory. Part II.B addresses the "race towards the bottom" explanation. Part II.C presents our opinion that the increased competition between stock exchanges will produce neither a race towards the top nor a race towards the bottom, but rather it will amount to a point

1 Artigo recebido em 01.12.2018 e aceito em 13.12.2018.

in-between these races. Due to the different issuers' and investors' preferences, there is a trade-off between increasing and decreasing corporate governance standards. Therefore, stock exchanges may follow two different paths in order to overcome the effects of the increased competition: either try to find the optimum corporate governance standards balance or develop listing segments with different levels of corporate governance standards to attract companies with different profiles. We hold the latter is the most appropriate one. Finally, Part III presents our conclusion.

Keywords: Stock Exchanges. Corporate Governance. Competition. Race towards the top. Race towards the bottom.

Resumo: Esse artigo tem por objetivo examinar (1) até que ponto as bolsas de valores interferem substancialmente na governança corporativa; (2) se o aumento da competição entre as bolsas de valores decorrente de avanços tecnológicos, globalização e desmutualização prejudicará a sua capacidade de interferir na governança corporativa; e (3) qual é a melhor solução para superação dos efeitos do aumento da concorrência entre as bolsas de valores. A fim de enfrentar essas questões, esse artigo se divide em três partes. Parte I descreve como as bolsas de valores têm influenciado a governança corporativa ao longo dos anos. Parte II identifica a existência do aumento da concorrência internacional entre as bolsas de valores e aborda se e como isso afeta o papel que as bolsas de valores vinham desempenhando na governança corporativa. Parte II.A apresenta a teoria da "corrida em direção ao topo". Parte II.B expõe a teoria da "corrida em direção ao fundo". Parte II.C expõe a nossa opinião de que a intensificada competição entre as bolsas de valores não produzirá uma corrida em direção ao topo nem uma corrida em direção ao fundo, mas sim levará ao meio termo. Devido às diferentes preferências de investidores e companhias emissoras, há um equilíbrio entre o endurecimento e o enfraquecimento do nível de governança corporativa. Portanto, para superar os efeitos da intensificação da concorrência, dois diferentes caminhos poderão ser seguidos pelas bolsas de valores: encontrar o equilíbrio ideal no que se refere ao nível de governança corporativa ou desenvolver listagens de diferentes níveis de governança corporativa para atrair companhias com diferentes perfis. Sustentamos que a segunda proposta é a mais adequada. Por fim, Parte III apresenta a nossa conclusão.

Palavras-chave: Bolsa de Valores. Governança Corporativa. Competição. Corrida em direção ao topo. Corrida em direção ao fundo.

Introduction.

This paper addresses the challenging question of to what extent do stock exchanges substantially interfere in corporate governance and until when they will be doing so. The study of corporate governance, i.e. the study of how corporations are structured and managed, matters because it affects firm value and firm's performance, which affects the market and society's welfare as a whole.

Stock exchanges have been playing a noteworthy role in establishing rules and standards in order to enhance corporate governance. By developing requirements that must be met by their listed companies, stock exchanges can effectively govern aspects of companies' internal affairs. Nonetheless, we should inquire whether the increase in competition among stock exchanges due to technological advances, globalization and their demutualization will undermine their ability to substantially interfere in corporate governance. Thus, whether stock exchanges' influence on corporate governance will soon come to an end and what is the best possible way to surmount the increased competition between stock exchanges are the relevant questions this paper theoretically aims to discuss.

This paper first describes how stock exchanges have been interfering in corporate governance over the years. In order to do that, it examines stock listing requirements as well as other governance incentives created by stocks exchanges by addressing concrete examples of it. It presents how the New York Stock Exchange, Inc. (NYSE), the American Stock Exchange (AMEX) and the Nasdaq Stock Market LLC (Nasdaq) have been dealing in their listing requirements with the issues of requirements for independent directors, audit committee procedures, one share, one vote rule, proxy solicitation requirement, disclosure rules etc. Moreover, it addresses the adoption of a premium corporate governance listing known as "Novo Mercado" by the Brazilian stock exchange, another possible stock exchanges mechanism to enhance corporate governance. Thus, the first part of the paper shows that stock exchanges do influence the development of corporate governance by establishing a set of corporate governance rules and standards that must be followed by their listed companies.

Subsequently, the paper sheds light on the competition between stock exchanges that have substantially increased since the early 1990s and expanded to an international level due to advances in technology, globalization and stock exchange demutualization. We discuss whether this increased competition will affect the relevant role stock exchanges have been playing in enhancing corporate governance. In order to do that, we analyze whether the competition between stock exchanges will lead to a "race towards the top", to a "race towards the bottom" or to somewhere in-between.

A “race towards the top” would be established if the competition among stock exchanges resulted in the adoption of higher and more restrictive corporate governance standards. In order to illustrate that competition may favor the adoption of higher corporate governance standards by stock exchanges, the paper describes the Brazilian stock exchange attempt to increase their corporate governance standards by creating a new listing segment called “Novo Mercado”, providing stronger shareholders’ rights and higher disclosure requirements, due to increased competition with the U.S. capital market in the 1990s, a period when there was an expressive migration of Brazilian firms to the U.S. stock market.

Conversely, a “race towards the bottom” would be generated if competition between stock exchanges led to a decrease in the level of transparency and corporate governance as a whole. As examples of this, the paper (i) analyzes the evolution of the dual-class structure in the U.S. from the stock exchange perspective, in which NYSE modified its longstanding one share, one vote rule in order to allow dual-class recapitalizations in a response to competitive pressure from Nasdaq and AMEX, and (ii) briefly discusses the case of the Alibaba Group Holding Ltd. (Alibaba) group’s IPO, in which they decided to list themselves on the NYSE in 2014 instead of on the Hong Kong or Shanghai exchanges since they wanted to consolidate control in the hands of their founders and Hong Kong and Shanghai exchanges did not allow dual-class structure.

Nonetheless, we uphold that the increased competition between stock exchanges will produce neither of these effects (a race towards the top nor a race towards the bottom). In fact, this paper shows that when it comes to attracting different types of issuers and investors, there is a trade-off between increasing and decreasing corporate governance standards. When a stock exchange decides to increase their corporate governance standards listing requirements, it will be losing a significant number of possible listed companies (especially companies with concentrated ownership), whereas when it decides to decrease its corporate governance standards listing requirement, it will be losing the majority of the investors and other potential listed companies (especially companies with dispersed ownership). Therefore, we hold that the increased competition will neither cause an exclusive race to the top nor an exclusive race to the bottom.

Indeed, in order to overcome the increased (and international) competition, stock exchanges will try to either (i) find the optimum balance between divergent investors' and issuers' interests that will cover the biggest market share and use this balance when setting up their corporate governance listing requirements or (ii) increase consumers' possible options by offering a range of different lists with distinct levels of corporate governance standards to attract companies with different profiles.

We hold that the second path would be the most appropriate one. Firstly, instead of offering only one list with one possible corporate governance arrangement that was considered to be the optimum one in terms of getting the biggest possible market share, the second path will attract the highest number of potential listed companies covering all possible market shares by offering different lists. Secondly, providing a range of different lists with distinct levels of corporate governance standards will also increase liquidity, since it will attract many types of investors with different preferences and characteristics. Finally, this path is in line with the idea that corporate governance should be firm-specific, i.e., that companies should be free to tailor their corporate governance structure according to their own particularities (e.g. industry, life-time-cycle, ownership structure, business strategy, personal characteristics of controlling shareholders and investors etc.). We believe that determining the same corporate governance arrangement for all companies is harmful to many of them – corporate governance arrangements should be set at each company's discretion[2].

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2 Considering the existence of a *minimum* state or federal regulation to set *minimum* socially acceptable parameters when and where there is a specific market failure. The need and the

We conclude by addressing that the increased competition among stock exchanges around the world is affecting the way they have been dealing with corporate governance standards. However, this competition will neither undermine their willingness to set effective corporate governance standards nor taint the relevant role they have been playing in enhancing corporate governance. By competing more actively between themselves, stock exchanges are trying to find the optimum corporate governance standards and/or developing new listing segments with different options of corporate governance standards. Therefore, they are still contributing to the development of corporate governance through their regulatory approach and there is no reason to fear this will come to an end.

This paper is divided into three parts. Part I describes how stock exchanges act to enhance corporate governance and gives examples of how they have been doing this over the years. Part II identifies the existence of an increased competition between stock exchanges and addresses whether and how this affects the role they have been playing in corporate governance. Part III presents our conclusion.

I. Stock exchanges historical role in corporate governance: how stock exchanges have been influencing corporate governance over the years?

In the U.S., the NYSE has been playing a relevant role in enhancing best governance practices through its listing requirements. From the earliest days of the NYSE, the stock exchange has been fighting against traditional corporate management secrecy by imposing disclosure requirements for its listed companies[3]. As early as 1869,

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extent of this regulation will vary according to how the capital market is developed and how strong the institutions are.

3 PRITCHARD, Adam C. Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers. *Virginia Law Review*, v. 85, nº 6, 1999, p. 1007.

listed companies were required to disclose information related to the nature of their business, management, capitalization structure, stock provisions, business financials and accounting policies[4]. The first corporate governance standard imposed within the listing agreements was the mandatory annual shareholders' meeting[5]. NYSE's listing agreements also started to demand listed companies distribute annual reports to its stockholders in 1900 and started to demand that this distribution occurs prior to the shareholder's annual meeting in 1909[6]. But was only after the end of the NYSE's "Unlisted Department" in 1910 that NYSE was able to make agreements with its listed companies that provided for substantial financial disclosure[7]. In 1926, the NYSE adopted the one share, one vote listing requirement[8-9] and, in 1932, independent audits became mandatory for newly listed companies[10], which became federal law with the enactment of the 1933 Securities Act[11]. These are examples of how NYSE attempted to increase the quality of corporate governance over the years.

Historically, stock exchange listings requirements to improve corporate governance were so relevant that they were seen as a substitute for governmental regulation[12]. NYSE's listing requirements were so important to the development of disclosure practice and

4 KARMEL, Roberta S. The Future of Corporate Governance Listing Requirements. *SMU Law Review*, v. 54, 2001, p. 327.

5 Ibid. p. 328.

6 Loc. cit.

7 Ibid. p. 327.

8 *See* SELIGMAN, Joel. Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy. *George Washington Law Review*, v. 54, 1985, p. 687.

9 The one share, one vote listing requirement was officially abandoned by NYSE in 1986.

10 KARMEL, Roberta S. Op. cit. p. 328.

11 Securities Act of 1933, schedule A, items (25) and (26).

12 KARMEL, Roberta S. Op. cit. p. 327.

other corporate governance standards that the U.S. Congress relied on them when drafting the Securities Exchange Act of 1934[13].

Today, the NYSE's Listed Company Manual makes express reference to the need for compliance with corporate governance standards (section 303A[14])[15]. They require, for instance, a majority of independent directors, a corporate governance committee composed entirely of independent directors, an independent audit committee with a minimum of three members, a mandatory annual shareholders' meeting and shareholders' prior approval in certain issues.

Around the 1960s, the AMEX followed NYSE's example[16] and began to adopt listing requirements. Their standards, however, were less rigid concerning corporate governance quality when compared to the NYSE's standards. AMEX's listing standards originally required proxy solicitations and shareholder approval of certain transactions[17]. In 1968, they published the first edition of the AMEX Company Guide, which included policies regarding conflict of interests, voting rights (minimum quorum for certain matters) and directors independence

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13 PRITCHARD, Adam C. Op. cit. p. 1008.

14 NYSE Listed Company Manual, § 303A. Available at: http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F. Last visited: Oct. 6th, 2018.

15 The introduction of Section 3 of the NYSE's Listed Company Manual on Corporate Responsibility reads: "Investors expect that if a company's shares are listed on the New York Stock Exchange, the company has complied with specified financial standards and disclosure policies developed and administered by the Exchange. In addition, consistent with the Exchange's long-standing commitment to encouraging high standards of corporate democracy, every listed company is expected to follow certain practices aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareholders.
This section describes the Exchange's policies and requirements with respect to independent directors, shareholders' voting rights, and other matters affecting corporate governance". Available at: http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F. Last visited: Oct. 6th, 2018.

16 Due to SEC pressure, it is true. *See* KARMEL, Roberta S. Op. cit. p. 331.

17 Loc. cit.

(they recommended the appointment of a minimum of two independent directors)[18]. An independent audit committee became a mandatory listing requirement in the early 1990s[19].

The Nasdaq created their listing requirement in 1985, but granted many exceptions to certain companies incorporated in several U.S. states[20]. Their minimum requirements were the disclosure of periodic reports, the presence of independent directors, the adoption of an audit committee with independent directors and the adoption of a minimum quorum to approve certain issues[21]. Nowadays, Nasdaq listing rules provide that companies applying to be listed must meet qualitative corporate governance requirements related to the "company's board of directors, including audit committees and Independent Director oversight of executive compensation and the director nomination process; code of conduct; shareholder meetings, including proxy solicitation and quorum; review of related party transactions; and shareholder approval, including voting rights"[22].

Besides the listing requirements, some stock exchanges have been adopting other incentives to enhance the overall quality of corporate governance. For instance, the BM&FBovespa, the former Brazilian stock exchange[23], developed different degrees of corporate governance segments for their listed companies. In 2000, in addition

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18 Loc. cit.

19 Ibid. p. 332.

20 Loc. cit.

21 DONAGGIO, Angela Rita Franco. *(How) Does Self-Regulation Work? Evidence from Brazilian Corporate Governance Listing Segments*, p. 10. Available at: https://ssrn.com/abstract=3198201. Last visited: Oct. 8th, 2018.

22 Nasdaq Listing Rule, § 5601. Preamble to the Corporate Governance Requirements. Available at: http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp%5F1%5F1%5F4%5F3&manual=%2Fnasdaq%2Fmain%2Fnasdaq%2Dequityrules%2F. Last visited: Oct. 8th, 2018.

23 In March 2017, BM&FBovespa merged with CETIP, creating the new Brazilian stock exchange named B3 S.A. – Brasil, Bolsa, Balcão. Available at: http://ir.bmfbovespa.com.br/static/enu/perfil-historico.asp?idioma=enu. Last visited: Oct. 11th, 2018.

to other listing segments[24], BM&FBovespa implemented a premium list known as "Novo Mercado", with the highest corporate governance standards (much higher than those required by the Brazilian Law).

After B3 S.A. – Brasil, Bolsa, Balcão (B3) establishment in 2017[25], they carried out extensive work to review the "Novo Mercado" listing regulation. This year, a new "Novo Mercado Listing Regulation" came into force[26]. Among others, the new "Novo Mercado Listing Regulation" establishes the following rules related to corporate governance and shareholder rights: (i) the company must issue only common voting shares (compliance with the one share, one vote rule); (ii) the board of directors must be composed of at least 2 or 20% of independent directors (whichever is greater), with unified term of office of 2 years maximum; (iii) the company must set up an internal auditing and compliance department as well as an audit committee; (iv) the company must elaborate and disclose a (a) compensation policy; (b) nomination policy for the board of directors, advisory committees and executive management board; (c) risk management policy; (d) related party transaction policy; and (e) securities trading policy, with minimum requirements; (v) the company must include an arbitration clause in its bylaws stating that the company, its shareholders and executive officers, as well as the members of its fiscal council and their alternates, if any, undertake to seek arbitration by the Market Arbitration Chamber; (vi) the company must extend the same conditions provided to the controller shareholders in the company's control transaction to the minority shareholders (100% Tag Along); (vii) the company must commit to maintain a free float of at least 25%, or 15% in case of ADTV (average daily trading volume) above R$25 million; (viii) the company must hold a Public Tender Offer for a fair price, with a minimum acceptance quorum of 1/3 of the free float shareholders, in case of delisting from "Novo Mercado";

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24 "Nível 1", "Nível 2", "Bovespa Mais" and "Bovespa Mais Nível 2".

25 *See supra* note 22.

26 *See* http://www.bmfbovespa.com.br/en_us/listing/equities/listing-segments/novo-mercado/. Last visited: Oct. 6th, 2018.

(ix) the company must simultaneously disclose, both in Portuguese and in English, Material Information, benefit distribution information and results press releases; (x) the company must monthly disclose negotiations by the controlling shareholders with securities issued by it; etc.

Being part of this selective group of companies is considered to be a valuable seal recognized by the Brazilian capital market which helps to increase listed firms' equity value[27]. The "Novo Mercado" is an incentive to already listed companies to commit to even higher corporate governance standards. Today, 142 companies are listed on this highest corporate governance list[28]. Nevertheless, the Brazilian Stock Exchange still lists other companies which do not want to or cannot commit to these higher corporate governance standards. It is important to continue listing these other companies with different profiles because they are still relevant to the Brazilian corporate market – they represent a relevant market share and investors may be still interested in investing in them.

In conclusion, stock exchanges have been contributing to the development of corporate governance. Nonetheless, the question is whether the increased competition between them will taint this positive role stock exchanges have been playing in corporate governance, leaving it in the past.

II. Effects of the increased competition between stock exchanges on the role they play in corporate governance.

Although competition between stock exchanges is not a new phenomenon, it has substantially increased since the early 1990s and

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27 *See* CARVALHO, Antonio Gledson de; PENNACCHI, George G. Can a Stock Exchange Improve Corporate Behavior? Evidence from Firms' Migration to Premium Listings in Brazil. *Journal of Corporate Finance*, v. 18, nº 4, 2012, p. 883.

28 *See* http://www.b3.com.br/pt_br/produtos-e-servicos/negociacao/renda-variavel/empresas-listadas.htm. Last visited: Oct. 11th, 2018.

broadened to an international level[29]. Advances in technology, globalization and demutualization of stock exchanges were the main reason for today's increased securities market competition. Technological advances made possible an instant flow of information, speeding communication and reducing its costs. Globalization "lowered the barriers to cross-border capital flows"[30]. Finally, demutualization[31] was induced by the former two – technological advances and globalization – and stock exchanges now must be run as efficient business enterprises committed to expanding shareholders' investments[32]. This new environment boosted competition among stock exchanges which had to remodel themselves in order to better face the new challenges.

Today, stock exchanges are for-profit entities seeking profit maximization – due to the aforementioned demutualization movement[33]. Their main source of profits is brokerage commission which is related to the number of listed companies, the trading volume per listed company and the commission amount per trade[34]. Thus, attracting firms – the largest number possible – is one of their main goals.

The question is whether stock exchanges will attract more potential listed companies by strengthening or by weakening corporate

29 CHRISTIANSEN, Hans; KOLDERTSOVA, Alissa. *The Role of Stock Exchanges in Corporate Governance,* OECD Working Paper No. 2009/1, p. 13. Available at: https://ssrn.com/abstract=2384059. Last visited: Oct. 8th, 2018.

30 COFFEE JR., John C. Racing towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance. *Columbia Law Review*, v. 102, 2002, p. 1759.

31 "Demutualization is the process of converting a non-profit, mutually owned organization to a for-profit, investor-owned corporation", *see* AGGARWAL, Reena. Demutualization and Corporate Governance of Stock Exchanges. *Journal of Applied Corporate Finance*, v. 15, 2002, p. 106.

32 Ibid. p. 107. *See* COFFEE JR., John C. Op. cit. p. 1801.

33 *See* CHRISTIANSEN, Hans; KOLDERTSOVA, Alissa. Op. cit. p. 14.

34 KAHAN, Marcel. Some Problems with Stock Exchange-Based Securities Regulation. *Virginia Law Review*, v. 83, nº 7, 1997, p. 1510; AGGARWAL, Reena. Op. cit. p. 105.

governance standards. In order to answer this question, we should answer a prior one: will stock exchanges attract more potential listed companies by focusing on investor's or issuers' interests, i.e. is the competition between stock exchanges mainly driven by investors' or issuers' interests? The answer to the former question will vary according to the answer to this latter question.

II.A. Race towards the top.

For those who believe competition among stock exchanges is driven by investors' interests, i.e. that stock exchanges are focused on attracting more investors to increase liquidity and thus attract more potential listed companies, the increase in competition between stock exchanges will make corporate governance standards go tighter. This is because stock exchanges will be focusing on increasing shareholder's rights and protection to attract a greater number of them, resulting in a "race towards the top"[35].

For instance, we can mention the expressive migration of Brazilian firms to the U.S. stock market before the 2000s. It is argued that the weak protection the Brazilian market offered to minority shareholders and to shareholders in general was the cause of this Brazilian companies' shift to the U.S. market[36]. Brazilian firms decided to cross-list in the U.S. because it offered stronger investor protection and higher disclosure standards, with a consequently higher market liquidity. This made BM&FBovespa, the Brazilian stock exchange at

35 *See* HUDDART, Steven; HUGHES, John; BRUNNENMEIER, Markus. Disclosure Requirements and Stock Exchange Listing Choice in an International Context. *Journal of Accounting and Economics*, v. 26, 1999, p. 237; KARMEL, Roberta S. Special Study on Market Structure, Listing Standards and Corporate Governance. *The Business Lawyer*, v. 57, nº 4, 2002, p. 1496-1497; COFFEE JR., John C. Op. cit. p. 1762-1763; ROMANO, Roberta. The Need for Competition in International Securities Regulation. *Theoretical Inquiries in Law*, v. 2, nº 2, 2001, p. 387.

36 *See* COFFEE JR., John C. Op. cit. p. 1806; CARVALHO, Antonio Gledson de; PENNACCHI, George G. Op. cit. p. 883.

the time, start thinking about ways of enhancing their corporate governance standards and strengthening shareholders' rights in order to better compete internationally.

II.B. Race towards the bottom.

Conversely, for scholars who believe competition is guided by issuers' interests, the increase in competition between stock exchanges will make corporate governance standards less tight. Stock exchanges will try to encompass all the different interests of different companies when it comes to their corporate governance structure in order to attract a greater number[37] of potential listed companies, reducing their listing requirements and producing a "race towards the bottom"[38].

An example that illustrates the conclusion that competition among stock exchanges favors the adoption of less stringent corporate governance standards is the dual-class structure evolution in the U.S. Since 1926, the NYSE has been adopting a more stringent corporate governance standard forbidding dual-class capitalization for their listed corporations[39], whereas the Nasdaq and the AMEX have been allowing it. Nonetheless, the hostile takeover boom of the 1980s made some companies take antitakeover measures such as dual-class recapitalization[40]. Thus, in order to be able to compete against

37 Firms with controlling shareholders are likely to be the majority in most countries, except for the U.S. and the U.K., and they seem to usually prefer lower disclosure requirements and weaker shareholder rights in general. *See* BEBCHUK, Lucian A.; HAMDANI, Assaf. The Elusive Quest for Global Governance Standards. *University of Pennsylvania Law Review,* v. 157, 2009, p. 1267-1268; COFFEE JR., John C. Op. cit. p. 1813.

38 *See* BLOOMFIELD, Robert; O'HARA, Maureen. Can Transparent Markets Survive? *Journal of Financial Economics*, v. 55, 2000, p. 425; CHRISTIANSEN, Hans; KOLDERTSOVA, Alissa. Op. cit. p. 14; PRITCHARD, Adam C. Op. cit. p. 1007-1008; KARMEL, Roberta S. The Future of Corporate Governance Listing Requirements. *SMU Law Review*, v. 54, 2001, p. 330-331 and 347.

39 *See supra* note 7.

40 KARMEL, Roberta S. Op. cit. p. 343-345.

Nasdaq and AMEX, i.e. because of market pressure, the NYSE decided to officially put an end to their historic one share, one vote rule in 1986, allowing their listed companies to have multiple classes of common stock with different voting rights[41-42].

Another more recent example is the 2014 Alibaba group's IPO. Alibaba, a Chinese company, wanted to go public with a dual-class structure in order to consolidate control in the hands of their founders. Thus, they decided to list themselves on the NYSE instead of on the Hong Kong or Shanghai exchanges since Hong Kong and Shanghai exchanges did not allow dual-class structure. Mainly because of Alibaba's profitable IPO, the Hong Kong Stock Exchange amended their rule in April 2018 to allow certain companies (especially innovative and tech companies) to go public with a dual-class structure in Hong Kong[43]. Thus, this is a recent example in which the quest to

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41 *See* LEHN, Kenneth; NETTER, Jeffry; POULSEN, Annette. Consolidating corporate control: Dual-class recapitalizations versus leveraged buyouts. *Journal of Financial Economics*, v. 27, nº 2, 1990, p. 569; SELIGMAN, Joel. Op. cit. p. 693 and 700; KARMEL, Roberta S. Op. cit. p. 345.

42 In 1994, the NYSE, the AMEX and the Nasdaq agreed on the adoption of a uniform rule on the matter (KARMEL, Roberta S. Special Study on Market Structure, Listing Standards and Corporate Governance. *The Business Lawyer*, v. 57, nº 4, 2002, p. 1505). They basically prohibited dual-class recapitalizations but allowed dual-class structures at the Initial Public Offer. Today, the NYSE allows different voting rights as long as shareholders are afforded certain safeguards which align the rights of non-voting shareholders with the rights of the voting shareholders (e.g. non-voting shareholders must receive all communications, including proxy materials, and non-voting shareholders' rights must be substantially the same as those of voting shareholders, except for the voting rights). *See* NYSE Listed Company Manual, § 313.00 (B) (1) and (2). Available at: http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F12%5F7&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F. Last visited: Oct. 8th, 2018.

43 *See* https://www.bloomberg.com/news/articles/2018-04-24/hong-kong-approves-dual-class-shares-paving-way-for-tech-titans and https://www.reuters.com/article/china-stocks-hkex/update-1-hk-china-bourses-agree-to-work-towards-adding-dual-class-shares-to-trading-link-idUSL4N1UE0EW. Last visited: Nov. 13th, 2018. *See also* Hong Kong Stock Exchange, *Research Report: Listing Regime Reforms For Dual-Class Share Structure And Biotech Industry – Summary, April 2018*. Available at: https://www.hkex.com.hk/-/media/HKEX-Market/News/Research-Reports/HKEx-Research-Papers/2018/CCEO_DualClass_201804_Summary_e.pdf?la=en. Last visited Oct. 5th, 2018.

attract more listed companies led to a decrease in the stock exchange's corporate governance standards requirements[44].

Between these two possible "races", we hold that, in overall, a race towards the bottom would be more desirable than a race towards the top. A race towards the bottom would be better because it would allow companies to freely tailor their corporate governance structure according to their own particularities (e.g. industry, lifetime-cycle, ownership structure, business strategy, personal characteristics of controlling shareholders and investors etc.)[45]. We hold that mandating the same high corporate governance standard for all companies is harmful to many of them – corporate governance should be firm-specific.

For instance, firms developing cutting-edge technology may need higher entrenchment with a powerful controller shareholder associated with a huge amount of outside investments, especially in their early life-cycle. Thus, dictating – either through stock exchange listing requirements, through Security Exchange rules or through state or federal legislation – that a dual-class structure is harmful to shareholder's rights and establishing the one share, one vote rule as a mandatory rule for all firms will be disadvantageous to technology development. The same logic is applicable concerning staggered boards: they may be useful for innovative companies in their early stages because they seem to encourage managers to take higher risks and to make long-term investments (investments in capital expenditure, investments in research and development, production of more patents

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44 This paper does not aim to discuss whether the dual-class structure is positive or negative, or whether it enhances or harms corporate governance quality. This case is being used with the sole purpose of illustrating that stock exchanges may change their perception on which arrangements enhance corporate governance and consequently change their listing requirements due to market pressure, producing a race towards the bottom.

45 *See* GOSHEN, Zohar; SQUIRE, Richard. Principal Costs: A New Theory for Corporate Law and Governance. *Columbia Law Review*, v. 117, 2017, p. 826-828.

etc.)[46]. Thus, forbidding staggered boards because they are considered to be "bad governance" from the shareholders' perspective[47] could be truly harmful to certain types of companies.

The best would be letting each firm design the optimum corporate governance arrangement for its own case at its own discretion. Of course, we made these statements considering the existence of a *minimum* state or federal regulation to set *minimum* social acceptable parameters[48] when and where there is a specific market failure[49]. The extent of this regulation will vary according to how the capital market is developed and how strong the institutions are[50]. The more efficient the market is, the greater will be stock exchanges' flexibility to ease corporate governance, allowing each firm to find their own optimum structure.

II.C. A place in-between the "race towards the top" and the "race towards the bottom".

All that being said, we believe that, in fact, competition between stock exchanges would neither cause an exclusive "race to-

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46 *See* DAINES, Robert; LI, Shelley Xin; WANG, Charles CY. Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment. *Harvard Business School Accounting & Management Unit Working Paper No. 16-105*. Available at: https://ssrn.com/abstract=2836463A. Last visited: Oct. 2nd, 2018.

47 *See generally* GOMPERS, Paul A.; ISHII, Joy L.; METRICK, Andrew. Corporate Governance and Equity Prices. *Quarterly Journal of Economics*, v. 188, nº 1, 2003, p. 107; BEBCHUK, Lucian A.; COHEN, Alma; FERRELL, Allen. What Matters in Corporate Governance? *Review of Financial Studies*, v. 22, nº 2, 2009, p. 783.

48 The idea is to have minimum regulation in order to avoid abuses. Its amplitude and scope will vary according to each country – depending on the development of their capital market and the strength of their institutions.

49 *See* GOSHEN, Zohar; SQUIRE, Richard. Op. cit. p. 828.

50 *See generally* GOSHEN, Zohar; HANNES, Sharon. The Death of Corporate Law. *Columbia Law and Economics Working Paper* (April 30, 2017). Available at: https://ssrn.com/abstract=3171023http://dx.doi.org/10.2139/ssrn.3171023. Last visited: Nov. 13th, 2018.

wards the top" nor an exclusive "race towards the bottom", but rather a balance between them both. This is because there is always a market for different interests[51] (higher or lower corporate governance standards) and the exclusive adoption of either direction (top or bottom) will exclude the other – significant – market share.

When a stock exchange decides to increase its corporate governance standards to enhance shareholder rights and to attract more investors and certain types of companies (mainly companies with dispersed ownership), it will be losing other potential listed companies who do not meet those high standards (especially companies with concentrated ownership[52]). Similarly, when a stock exchange decides to lower their corporate governance standards to encompass a greater number of potential listed companies with different corporate governance arrangements, it will probably be losing investors, liquidity and certain types of companies (especially companies with dispersed ownership[53]) that will migrate to "high corporate governance standards" stock exchanges. Thus, there is a trade-off between the choice of enhancing or decreasing corporate governance standards.

Considering this trade-off, we predict two possible paths stock exchanges can follow. The first one is finding the optimum balance between the different competition driven interests (investors' and issuers' interests) that would result in obtaining the biggest market share. The second one is maximizing both of these interests by increasing consumers' options (both investors' and issuers' options) by offering different listing segments with different levels of corporate governance standards. We hold the latter path is the best one.

First, offering different listing segments with different levels of corporate governance standards allows the same stock exchange to

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51 COFFEE JR., John C. Op. cit. p. 1765.

52 Ibid. p. 1764-1765.

53 Loc. cit.

list at the same time both companies which prefer to commit to higher shareholder rights and those which prefer to have a less stringent corporate governance arrangement. They will list the former category in an upper-level corporate governance standard list and the latter category in a less stringent corporate governance standard list. Considering that there are different sorts of clienteles interested in different levels of disclosure, transparency, shareholder rights etc., this same stock exchange will be attracting issuers with different interests, enlarging the range of possible clients by letting them co-exist side by side.

Second, this same logic applies when it comes to attracting more investors and increasing the stock exchange's liquidity. By offering different listing segments with different levels of disclosure, transparency, shareholder protection etc., the same stock exchange will be able to attract more and different types of investors. For instance, the same stock exchange will be able to attract at the same time risk-averse investors, who usually prefer safer investments, by investing in companies with higher shareholder protection and higher disclosure standards despite the related higher compliance costs, and risk-seeking investors, who accept investing in companies who commit to lesser disclosure standards and lesser shareholder protection but which may offer higher returns. Thus, this second path is the best one to increase liquidity within the same stock exchange.

Finally, this second framework is the best one when it comes to the way we think corporate governance should be dealt with: this arrangement of multiple lists conceives corporate governance as being firm-specific, giving more freedom to companies to tailor their own governance structure according to their needs, which may vary over time. Thus, in our view, this would be the best direction for a stock exchange to follow and succeed in this scenario of increasing international competition.

Taking the Brazilian example again, the B3, when describing their special listing segments with different corporate governance standards, expressly says that their "Special listing segments of B3 – Bovespa Mais, Bovespa Mais Nível 2, Novo Mercado, Nível 2 and Nível 1 – were created when we realized that, in order to develop the Brazilian capital market, we would *need to have segments suited to different company profiles*"[54] (emphasis added).

It should be emphasized that this proposed path for a stock exchange to better succeed in a context of increased competition does not impose a specific corporate governance arrangement by forcing companies to seek the highest list with the maximum level of corporate governance. As discussed above, the top list is nothing more than one more option for companies and for investors. There is always a market for different types of profiles and clienteles. In this sense, even with the option of qualifying for the top segment list, a company may choose to remain in a lower corporate governance level list because committing to higher corporate governance standards means incurring higher compliance costs as well. Thus, this is a choice that must be made by each company in their own cost-benefit analysis.

Likewise, this proposed solution does not decrease liquidity. Indeed, a stock exchange will enhance its liquidity by attracting different types of investors through this mechanism of offering different listing segments with different levels of corporate governance standards (investors who care more and who care less about investing in firms with higher corporate governance standards). Again, there is always a clientele for a specific market and allowing firms to list themselves on a higher corporate governance list will not necessarily decrease the liquidity of the lower lists. Each list attracts a specific type of company and a correlate type of investor (and/or vice-versa). The point is that, by offering more options to their consumers (issuers and investors), stock exchanges will not only be increasing their potential listed companies but also their market liquidity.

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54 Available at: http://www.bmfbovespa.com.br/en_us/listing/equities/listing-segments/about-listing-segments/. Last visited: Oct. 11th, 2018.

That being said, the point is that the increased competition among stock exchanges around the world is affecting the way they have been dealing with corporate governance standards – whether you consider that the competition generates a race towards the top, a race towards the bottom or a balance between them both.

Nonetheless, stock exchanges are still playing a relevant role in corporate governance. When they compete more actively between themselves, they are working to find a way to encompass a greater market share by establishing corporate governance rules or standards. Considering that there is a trade-off between establishing a more or a less stringent corporate governance standard, stock exchanges will either find a balance and adopt a set of corporate governance rules that best fits the majority of the companies or develop and offer a different set of rules for companies with different profiles. Therefore, they have not abandoned their remarkable regulatory role yet.

III. Conclusion.

Stock exchanges' historical role in corporate governance is undisputed. Throughout history, we find countless examples by which stock exchanges had influenced corporate behavior. For instance, we can mention the adoption of corporate governance standards and listing requirements. This paper poses the question of whether and how the recent increase in competition between stock exchanges affects the relevant role they have been playing in developing corporate governance standards.

We discuss whether this competition would amount to a more aggressive behavior in protecting shareholder rights (race towards the top), to a more passive behavior in setting corporate governance standards (race towards the bottom) or to a middle ground. We believe that the third option is the most likely to occur and the most desirable.

We found there is a trade-off between the choice of enhancing or decreasing corporate governance standards. When a stock exchange decides to increase its corporate governance standards, it will be losing a significant number of possible listed companies, whereas when it decides to decrease its corporate governance standards it will be losing investors and other types of potential listed companies. Therefore, we hold there will neither be an exclusive race to the top nor an exclusive race to the bottom. In fact, stock exchanges will either try to find the balance between divergent investor and issuer interests that will cover the biggest market share or increase consumer options by offering a range of lists with different levels of corporate governance standards to attract companies with different characteristics. We hold the latter is the best option mainly because it will attract a greater number of firms, increase market liquidity and because it is in line with the idea that corporate governance should be firm-specific.

The fact is that stock exchanges significant, longstanding and positive role in corporate governance is far from coming to an end. They are still playing a relevant role in promoting corporate governance. When competing among themselves, they are trying to find the optimum balance for the trade-off between establishing a more or a less stringent corporate governance standard and developing new listing standards.

One recent example of a product of this increased competition between stock exchanges that corroborates the valuable and positive role stock exchanges are still playing in corporate governance is the "Novo Mercado" listing segment in Brazil. The increase in international competition between stock exchanges led to a reassessment of the Brazilian stock exchange's corporate governance policy, and consequently, the formulation of a listing segment of the highest corporate governance standards. BM&FBovespa, Brazil's former stock exchange, formulated it in addition to other lower corporate governance standards lists in an attempt to attract more potential listed companies and increase market liquidity.

Hence, this current scenario of increased competition between stock exchanges is positive in the way that it instigates stock exchanges to remodel their policies by designing and offering different possible corporate governance arrangements to their potential issuers such that they still play a relevant role in corporate governance – a role we think is far from coming to an end.