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IN FOCUS

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Securities Exchanges: Regulation and Reform Proposals (Section 501 of S. 2155, Section 496 of H.R. 10, and H.R. 4546)

Introduction

Overseen by the Securities and Exchange Commission (SEC), the federal securities laws are broadly aimed at (1) investor protection; (2) maintaining fair, orderly, and efficient markets; and (3) facilitating capital formation. They do so by providing clear rules for honest dealing among securities market participants, including antifraud provisions, and a disclosure regime that requires the various entities involved in securities markets to disclose information deemed necessary for informed decisionmaking.

The Securities Act of 1933 (the Securities Act; P.L. 73-22), the initial federal securities law, has two fundamental objectives: (1) requiring that investors have access to financial and other salient data regarding securities that are offered for public sale; and (2) prohibiting fraud in the sale of those securities. To help accomplish these, the Securities Act generally requires issuers that offer securities for public sale to provide key financial and nonfinancial information on the securities and themselves to the SEC through registering the securities with the agency.

Registration entails SEC disclosures that become publicly available, including disclosures about how much of the company is up for sale and what portion of it will remain in the hands of the existing owners. Also required is information on the financial history of the firm; information on the planned use of the proceeds from the sale of the securities; an explanation of the firm's current business model; the nature of the competition that it faces; and significant information on the prospective securities issue, including the method used to formulate its offering price.

The second federal securities law to be enacted was the Securities Exchange Act of 1934 (Exchange Act; P.L. 73-291). Among its provisions, the Exchange Act authorized the creation of the SEC and requires a host of securities market participants, including securities exchanges, to also register with the agency.

Section 18 of the Securities Act of 1933

Companies seeking to issue their stock on a specific stock exchange must satisfy its listing requirements, both initially and continually. Such minimum thresholds vary depending on the exchange and commonly include variables such as a company's market capitalization, annual income, measures of its financial strength, and the number of shareholders.

The National Securities Market Improvement Act of 1996 (NSMIA; P.L. 104-290) amended the Securities Act by adding Section 18. That section gives a registration exemption from additional state-based registration, described in more detail below, to securities listed on

- the three "national securities exchanges," the New York Stock Exchange, the American Stock Exchange, and the National Market System of the Nasdaq Stock Market (the Nasdaq Exchange); and
- exchanges or their segments or tiers with listing standards that are "substantially similar" to those of the aforementioned three "national securities exchanges" (including Tiers 1 and 2 of the Bats BZX Exchange and the Nasdaq Capital Market).

State Securities Registration

Securities listed on the three national securities exchanges and the "substantially similar" exchanges are called *covered securities* and are exempt from the state-based securities registration protocol known as blue sky laws. The basic reasoning is that investors who acquire securities listed on the three national exchanges or exchanges with "substantially similar" listing standards may find the blue sky regulatory regimen to be not only somewhat duplicative, but potentially onerous in other ways as well (as in the case of merit review, described below).

Reportedly a response to perceived securities offering and sale fraud, state-based securities registration existed decades before the initial adoption of the major federal securities laws in the 1930s and 1940s. They were aimed at protecting investors from fraudulent securities sales practices and related activities. The laws can vary, depending on the particular state. In most states, companies issuing securities must register their securities offerings in advance of their sale in that state. Like the SEC, states generally require corporate securities issuers to provide various disclosures about themselves and the securities that they are issuing. A subset of states also conduct a "merit review" wherein securities cannot be sold in a given state if it has determined that they are prohibitively risky for many retail investors.

Corporate issuers interested in having their securities listed and traded on an exchange that is not deemed to be substantially similar to the three aforementioned national exchanges would likely face the prospect that the securities would not be deemed to be covered securities and would thus be subject to state-based registration and its associated regulatory costs. Those additional costs could deter an issuer from deciding to list and trade securities on a securities exchange.

Legislative Proposals

Section 496 of H.R. 10 (the Financial CHOICE Act, which passed the House); Section 501 of S. 2155 (the Economic Growth, Regulatory Relief, and Consumer Protection Act, passed by the Senate); and H.R. 4546 (marked up by the House Financial Services Committee) are similar bills and are collectively referred to in this In Focus as the *current legislation*.

The current legislation would expand the current exemptions from blue sky securities registration by amending Section 18 of the Securities Act so that a securities issuer's receipt of covered blue sky exempt status would no longer be dependent on it being one of the aforementioned three major securities exchanges or being deemed by the SEC to be "substantially similar." The listing exchange would merely have to be a *national securities exchange*, defined as a securities exchange that has registered with the SEC under the Securities Exchange Act of 1934 (P.L. 73-291). The category includes exchanges that specialize in the stocks of companies with a national focus (for example, the NYSE) and the stocks of companies with a regional focus (such as the Miami International Securities Exchange).

Several arguments have been made in support of the legislation.

One case for the broad-based elimination of all existing state securities registration has been made by a number of observers, including the Heritage Foundation, a free-market-oriented think tank. In 2017, the foundation argued that absent the blue sky laws, states would still be able to use their critical securities antifraud authority. It also argued that registration under the blue sky laws stymies "efficient capital formation," while offering "no economic or societal benefits, such as protection of investors from fraud."

While arguing in support of H.R. 5421 in the 114th Congress, a bill that was similar to the current legislation, the 2016 report accompanying the House Financial Services Committee's markup of the bill (H.Rept. 114-684) observed that Section 18 problematically required the SEC to compare unconventional "innovative" securities listing standards that depart from the standards for the three aforementioned national exchanges "that may have been in effect" when the section was adopted back in 1996. As a consequence, the report argued that Section 18 "place[s] the SEC in a … position to limit innovation and competition to certain exchanges"—a situation that it indicated would be remedied by H.R. 5421.

A frequently discussed example of this kind of innovation is the concept of a venture exchange. As evidenced by other legislation in the 115th Congress (for example, Subtitle L of the Financial CHOICE Act); comments from SEC officials and securities market stakeholders; and some congressional hearings, there is growing interest in using regulatory relief from the regulations in federal securities laws to help foster a so-called venture exchange, a trading platform often envisioned as a centralized secondary market equity trading venue for smaller capitalized (small cap) firms. The current legislation would provide regulatory relief that could arguably help to foster such an exchange. Some, however, have questioned whether the absence of such an exchange simply stems from market forces, not regulatory challenges and costs.

Relatedly, there are some small cap firms that are traded on the Nasdaq Exchange and on the various marketplaces of the OTC markets (OTC markets, or over-the-counter markets, are where stocks are traded via dispersed dealers, in contrast to exchanges, which generally provide for centralized trading). Still, there is a widely held view that there is a problematic deficiency of secondary (resell) market trading opportunities for small cap firm securities. Proponents of the current legislation could arguably find additional support for the bills as mechanisms that could help address such perceived inadequacies.

The North American Securities Administrators Association (NASAA) is an association of state and Canadian provincial securities regulators. The group, whose policy focus tends to include investor protection concerns, has criticized both H.R. 5421 in the 114th Congress and some of the current legislation.

Exchanges establish their own standards for listing and continuing to trade securities. And the NASAA has noted that the current regulatory regime allows for a range of SEC-registered exchanges with their diverse qualitative range of listing standards. The association, however, stressed that unless a trading venue conforms to the "substantially similar" listing standards of the three aforementioned national exchanges, it is then subject to state securities regulatory review.

By eliminating the "substantially similar" reference to a national exchange in Section 18, NASAA argued that the legislation would undermine the potentially important qualitative listing distinctions between alternative securities trading venues and the major national exchanges. As such, the group has raised concerns that investors could potentially be disadvantaged due to the blurring of those distinctions under the legislation. It has argued that securities traded on alternative exchanges with less rigorous listing standards would be exempt from state securities regulation, as are securities listed on the three national exchanges with their generally more rigorous standards.

Relatedly, NASAA also warned that the legislation could help spur the creation of exchanges with lowered listing standards or regulatory requirements. The concern is that such a scenario could help to foster fraud that would victimize investors.

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