

## Justifying Mandatory Disclosure in Contemporary US-Securities Regulation

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*“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”<sup>1</sup>*

Following the Great Depression and the market collapse in October 1929, Congress chose a mandatory disclosure system when regulating securities laws in the US.<sup>2</sup> The aim was to restore investor confidence. The main reasons of the crash were considered to be – although this view does not go unchallenged<sup>3</sup> – the lack or delay of information which then caused an overvaluation of the stock prices.<sup>4</sup> The Federal Securities Act of

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<sup>1</sup> Louis D. Brandeis, *Other People's Money – and How Bankers Use it* 62 (1914).

<sup>2</sup> Cox/ Hillman/ Langevoort, *Securities Regulation: Cases and Materials*, 3 (5th ed. 2006).

<sup>3</sup> Critical about that approach especially: Posner, *Economic Analysis of Law*, 444 (2007): “Securities regulation is rooted in part in a misconception about the great depression of the 1930s. It was natural to think that the 1929 stock market crash must have been the result of fraud, speculative fever, and other abuses, and in turn a cause of the depression: *post hoc ergo propter hoc*. But a precipitous decline in stock prices is much more likely to result from the expectation of a decline in economic activity than to cause the decline, [...] which suggest that the crash was less likely the result of abuses in the securities markets than an anticipation of the depression.”

<sup>4</sup> Friend/ Herman, *The SEC Through a Glass Darkly*, 37 *J. Bus.* 382, 389 (1964).

1933 ('33 Act) requires full disclosure for public offerings of securities through a registration process and the publication of a prospectus containing most of the information to be easily accessible for investors. The Securities and Exchange Commission (SEC) follows this exclusive disclosure orientation in enforcing the provisions of the Securities Exchange Act of 1934 ('34 Act) for trading of securities on secondary markets. The Sarbanes-Oxley Act of 2002 was a step beyond disclosure, establishing important procedural and substantive requirements in order to protect investors. These additional safeguards do not, however, alter the fact that disclosure remains the core feature of the securities laws.<sup>5</sup>

European regulations lack this history of disclosure. Although in the early 19<sup>th</sup> century disclosure was already understood and used as an alternative to substantive or merit regulation, regulators have primarily used the latter in their striving for investor protection.<sup>6</sup> However, it was only in 2002 that the High Level Group of Company Law Experts in Europe prompted a new debate by advocating disclosure as an efficient regulatory tool; this recommendation was based on the view that disclosure is less intrusive and more flexible than other reform approaches. Hence, disclosure is much more in line with the modern understanding of what is state of the art in securities regulation.<sup>7</sup> Since then, the European Union has debated whether disclosure as such is to be favored over traditional merit regulation.<sup>8</sup>

An integration of the European disclosure versus merit regulation debate into the discussion about disclosure in the US is beyond the scope of this

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<sup>5</sup> Cox/ Hillman/ Langevoort, *Securities Regulation: Cases and Materials*, 10 (5th ed. 2006).

<sup>6</sup> Hanno Merkt, *European Company Law Reform: Struggling for a More Liberal Approach*, 1 ECFR 3, 13 (2004).

<sup>7</sup> Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4. November 2002, 33-35.

<sup>8</sup> Hanno Merkt, *European Company Law Reform: Struggling for a More Liberal Approach*, 1 ECFR 3, 13 (2004).

paper. Rather, the debate over voluntary versus mandatory disclosure in the US is understood as a separate one, and one that is on a completely different level, as well as on different history and environment. However, if the European Union wants to continue to be a competitive player in the world's capital markets, it needs to understand the advantages that a disclosure-based legal framework may provide. Thus, this paper shall examine the theoretical basics that provide the legitimacy for the use of disclosure in securities regulation. This inquiry, as a first step, calls for an understanding of the meanings and mechanisms of market efficiency, the role that information plays in the capital markets, and how markets interact with the release of financially significant information. This theoretical framework will then be challenged by empirical research and be opened to legal debate, which will result in the justification of mandatory disclosure requirements. The insights gained by the criticism will, in a third step, be used to highlight some major benefits of mandatory disclosure and address current questions to show where there are needs and possibilities for improvement.

## **I. Market Efficiency**

### **1. Asymmetrical Information and Market Failure**

Nobody has shown as clearly and impressively as George A. Akerlof, the importance that information has for a market. Seeing that market mechanisms are highly dependent on information, he realized that markets fail, should they lack sufficient information. In his "Market for Lemons" he explains this phenomenon, using the example of the purchase of a used car:<sup>9</sup> The owner of a car knows relatively well whether it is reliable or a "lemon" that he wants to get rid of. A potential buyer lacks this knowledge - a classical informational asymmetry thus exists. But, as long

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<sup>9</sup> Akerlof, The Market for „Lemons“: Quality Uncertainty and the Market Mechanism, 84 Q. J. Eco. 488, 489 (1970).

as the buyer is not sure that he will purchase a “good” car, he will not be willing to pay the higher – although justified - price. As long as the market cannot differentiate between good and bad, it will punish this with markdowns of the price. The seller is in a dilemma. He cannot get the true value of his car, and will withdraw from the market. The result is a market failure: the mere existence of the “lemons” prevents trading.

For a capital market, the same could be said to be true. A security as such is nothing but a certificate that grants a certain future right in the company. One cannot see how much it is worth. It is the market that has to determine the price, and it does this based on information. The question thus has to be how the information is disseminated to the market participants.

## **2. Signaling and other ways of providing information**

The classical approach tries to tackle market failures through a phenomenon early identified as “signaling” in the job markets.<sup>10</sup> Returning to the model of used cars, one might imagine a seller who is unwilling to withdraw from the market but, instead, tries to give assurance that his product is worth the price he seeks. Should he be able to differentiate his product from the others, and convince the seller to pay the higher price, the problem is overcome. However, as long as the interests of the parties are not aligned, the buyer will probably not believe the information that is distributed by the seller. He will ask for assurance or only trust repeat players that have proven to be reliable in the market.<sup>11</sup> On the other hand, if the seller could convince the buyer, he will be able to sell his product. So he will probably try to do so by incurring signaling costs, as long as they will be outweighed by his profits, and voluntarily provide the market with information.

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<sup>10</sup> Spence, Job Market Signaling, 87 Q. J. Econ. 355 (1973).

<sup>11</sup> Spence, Signaling in Retrospect and the Informational Structure of Markets, Price Lecture, Dec. 8, 2001.

Before posing the question where and for what amount it might be justified for a regulating state to interfere in the disclosure process of market participants, we need to understand how the securities markets react to information. Or, better to say, in which way financially significant information effects the market prices of securities. The intellectual framework for this discussion is provided by the efficient capital market hypothesis.<sup>12</sup>

### 3. The Efficient Capital Market Hypothesis

Securities markets are commonly defined as being efficient when the prices at any time 'fully reflect' all available information.<sup>13</sup> The prediction of the hypothesis is that, even though information is *not* immediately and costlessly available to all participants, the market will react *as if* it were.<sup>14</sup>

Traditionally, research on market efficiency has occurred in three different forms: the weak, the semi-strong and the strong hypothesis. **Weak-form tests** have examined the claim that an analysis of the history of securities prices could not yield lucrative trading opportunities.<sup>15</sup> Here, over a series of tests, it has been found that there is little or no relationship between changes of security prices. In other words, the future price of a security cannot be predicted by an analysis of its past prices.

**Semi-strong form** tests shifted the view to publicly available information of interest to investors. The studies ask how long it takes until market prices adjust to information that is released to the public<sup>16</sup>. The model can be described as the following: Assuming the price of a security quickly reacts to newly published information, and the available information changes daily, there is no possibility that the new price is dependent on a

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<sup>12</sup> Cox/ Hillman/ Langevoort, Securities Regulation: Cases and Materials, 105 (5th ed. 2006).

<sup>13</sup> Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin 383 (1970).

<sup>14</sup> Ronald J. Gilson/ Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L Rev. 549, 552 (emphasis in original).

<sup>15</sup> Eugene F. Fama, *supra*, at 389-396.

<sup>16</sup> Eugene F. Fama, *supra*, at 404-409.

series of past prices.<sup>17</sup> The assumption of the model essentially is that all information that becomes publicly available immediately is impounded in the price, resulting in an 'efficient' or 'correct' pricing.

The **strong form** of market efficiency, finally, states that all information, whether publicly available or not, will be reflected in the price.<sup>18</sup> However, no significant evidence supporting this hypothesis could be found. The existence of phenomena like insider-trading also shows that there must be possibilities to outperform the market when having access to information that is not available to the other market participants.<sup>19</sup> Moreover, no insight as to the usefulness of mandatory disclosure rules could be gained in such a market. One of the basic insights gained from the research on market processing is that there has to be certain inefficiency and lack of transparency with regard to information, as otherwise there could be no possibility to make arbitrage profits.<sup>20</sup> As the participants withdraw from a market with informational asymmetries of a certain extent, they would also withdraw from a market with full transparency, for there would be no reasonable expectation for arbitrage and thus for profit. The first profound insight gained at this point is that there is no linear relationship between the amount of information and efficiency of markets. Rather, it is the market with a medium level of transparency that will be the most efficient – the so called “efficiency paradox”<sup>21</sup>.

Seeing that only the semi-strong form might lead to further insights, this form shall be more closely analyzed. However, scholars found early that empirical or even theoretical research with such a broad definition is almost impossible. Basic criticism has arisen on the fact that *fundamentally* efficient stock markets, defined as markets in which stock

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<sup>17</sup> Cox/ Hillman/ Langevoort, Securities Regulation: Cases and Materials, 106 (5th ed. 2006).

<sup>18</sup> Eugene F. Fama, *supra*, 409-413.

<sup>19</sup> Baesel/ Stein, The Value of Information: Inferences from the Profitability of Insider Trading, 14 J. Fin. & Quantitative Analysis 553 (1981).

<sup>20</sup> Grossman/ Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 393-408 (1980).

<sup>21</sup> Loss/ Seligman/ Paredes, Securities Regulation, Volume 1, 275 (4<sup>th</sup> ed. 2007).

prices fully reflect the intrinsic value of a security, are hard to imagine, and the correctness of the price could not be proved.<sup>22</sup> Empirical research supports this criticism, showing that there is high volatility in stock prices,<sup>23</sup> and that it usually takes a long time until stock prices stabilize after a period of ups and downs that can be interpreted as overreactions of the market.<sup>24</sup>

If it is not possible to prove full and fundamental efficiency of stock markets, the question can be narrowed to whether markets are *relatively* efficient as to a certain set of information (**informational efficiency**).<sup>25</sup> The price of a security has thus to be defined as established in an efficient market if it is, with respect to specific information, the same price as it would have been if everyone had the same information.<sup>26</sup> This is not to be understood as a 'perfect' or 'the correct' price regarding the value of a corporation. Rather, many market participants may have many different views regarding future predictions or the risk of the security. This seems especially true for the interpretation of 'soft information'. The efficient price is then the result of all the investors' collective actions. The resulting equilibrium price reflects optimistic as well as pessimistic views of the impact that certain information may have, thus being the 'best possible' measure of the price at the moment.<sup>27</sup> This leaves open the possibility of under- or overpriced stock, and thus the incentive for arbitrage profits through additional information.

The convincing approach of Professors *Gilson* and *Kraakman* analyzed and interpreted efficiency in close connection with the **cost of**

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<sup>22</sup> Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Fin. 1575 (1991).

<sup>23</sup> Campbell/ Shiller, *The Dividend-Price Ratio and Expectations of Future Dividends and Discount Factors*, 1 Rev. Fin. Stud. 192 (1988).

<sup>24</sup> Bernard/ Thomas, *Post-Earnings-Announcement Drifts: Delayed Price Response or Risk Premium?*, 27 J. Acct. Res. 1 (1989).

<sup>25</sup> Gilson/ Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L Rev. 549, 560.

<sup>26</sup> William H. Beaver, *Market Efficiency*, Acct. Rev. 23 (1981).

<sup>27</sup> Kraakman, *Taking Discounts Seriously: The implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 891, 898-901 (1988).

**information.**<sup>28</sup> Taking into consideration the costs for acquiring, processing and verifying information, they assumed that the 'level' of efficiency basically depends on how information is distributed to the market in the first place, then interpreted and, if needed be, verified. This would mean that in an 'efficient market' information is widely disseminated in the beginning with low costs of proving and interpreting it. On the other hand, if information is just available for a small number of traders, it will take much more effort with regard to costs and time, until it will be reflected in the price. State legislation could, under this interpretation, help to more quickly and efficiently disseminate information, and thus, through collectivization economize the costs and time. Similar results, on the other hand, could maybe be achieved by self-regulation of the market or the use of good reputation of investment banks or accounting firms.

#### **4. Behavioral Finance and Market Efficiency**

At this point it should not go unnoticed that the rise of modern finance has strongly influenced current views of market efficiency, introducing behavioral finance into the debate. Under this approach, it is assumed that the irrational actions of individuals, or the strong influence of institutions, will prevent markets from being efficient and result in inefficiency.<sup>29</sup> The basic argument is that many investors are not rational in their decision-making, will be biased in their investment decision (or speculatively invest without any information), and that professional traders will face barriers that prevent them from correcting these mistakes.<sup>30</sup> Many such pricing influences are not based on rational expectations and, hence, may lead to

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<sup>28</sup> Gilson/ Kraakman, *The Mechanisms of Market Efficiency*, 70 *Va. L. Rev.* 549, 593, 597 (1984).

<sup>29</sup> Gilson/ Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 *J. Corp. Law* 715 (2002-2003), also published in: Armour/ McCahery, *After Enron*, 29 (2006).

<sup>30</sup> Langevoort, *Taming the Animal Spirits of the Stock Market: A Behavioral Approach to Securities Regulation*, 97 *Nw. U. L. Rev.* 135 (2002), also published in: Armour/ McCahery, *After Enron*, 65 (2006).

market inefficiency; these forces are commonly referred to as “noise trading”.<sup>31</sup>

Challenging market efficiency with the argument of behavioral finance basically began with the discovery that there is no linear relationship between systematic risk and the market price of a security.<sup>32</sup> Moreover, market prices could be predicted more accurately when taking the company size and book-to-market ratio into account.<sup>33</sup> More recent empirical research discovered effects such as high volatility in early January, lower stock returns during the weekends, or even influences of the weather.<sup>34</sup> The list of social and psychological forces that influence stock prices grows rapidly.<sup>35</sup> To mention just a few of them, it was discovered that investors are constantly overconfident with their skills evaluating stock, that they are more willing to take risks in order to avoid a loss than to make profit, and that they constantly overvalue the assets they already own in comparison to those they want to buy. Many investors seem to be influenced by the behavior of others, thus following fashions or unfounded advice of others. These actions in a crowd are likely to make stock prices to exceed the level that could reasonably be explained by the efficient capital market hypothesis.<sup>36</sup> Irrational behavior in crowds could be used to explain the phenomena of extremely high volatility, and excessive trading. Some studies explained that investors constantly overreact or underreact to information that is disclosed, a phenomenon that could be explained by the overconfidence of investors mentioned above.<sup>37</sup> An interesting research on closed-end mutual funds discovered that these

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<sup>31</sup> Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance*, 23 (2002).

<sup>32</sup> Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. Fin.* 383 (1970).

<sup>33</sup> Eugene F. Fama/ Kenneth R. French, *Multifactor Explanations of Asset Pricing Anomalies*, 51 *J. Fin.* 55 (1996).

<sup>34</sup> Nicholas Barberis/ Richard Thaler, *A Survey of Behavioral Finance*, in: *Handbook of the Economics of Finance* (George Constantinides et al. eds., 2003).

<sup>35</sup> Hirshleifer, *Investor Psychology and Asset Prices*, 56 *J. Fin.* 1533 (2001).

<sup>36</sup> Robert J. Shiller, *Market Volatility*, 379-400 (1989).

<sup>37</sup> Lev/ de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 *Stan. L. Rev.* 7, 12-22 (1994).

funds constantly trade at a discount from the value of the underlying assets. That is, the seller does not receive the value of the added-up assets, but only a lower price. The authors blame “noise trading” for that, explaining that the cognitive biases of non-professional investors (who usually buy these funds) simply ignore the true value in speculating for gains.<sup>38</sup> This is not, however, to be understood to blame individuals alone. There is a large amount of research finding that institutional investors lack rationality in a similar matter. Market institutions are even said to be the driving force for misinterpreting the value of stock and thus causing wrong prices.<sup>39</sup> This is not easy to understand, as one would assume an informed trader who is looking for arbitrage profits to immediately buy the underpriced stock. However, there can be limits identified on arbitrage trading as well. Trading against the market is risky, especially if the information can not be verified. Professional traders may err in their analysis as well as individuals, and may be influenced by exactly the same cognitive biases. And who knows how long the stock will be mispriced, or even if it will ever trade at its fair value so that the institutional trader can realize his gain? Institutions will often face regulatory restrictions, such as mandatory portfolio diversification<sup>40</sup>. Additional factors that curtail arbitrage are agency problems and incentive problems.<sup>41</sup>

All in all, it can be said that behavioral sciences have strongly influenced the discussion about market efficiency. Different perceptions and

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<sup>38</sup> Charles Lee/ Andrei Shleifer/ Richard Thaler: Investor Sentiment and the Closed-End Fund Puzzle, 46 J. Fin. 75 (1991).

<sup>39</sup> Ronald J. Gilson/ Reinier H. Kraakman: The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias, 28 J. Corp. L. 715, 739 (2002-2003), also publ. in: Armour/ McCahery, After Enron, 29 (2006).

<sup>40</sup> Note that portfolio theory is not sufficient to replace mandatory disclosure rules. Although the investor’s informational needs about a company might be minimized through diversification of his portfolio, the overall risk of market failure or market development cannot be diversified away. It as well offers no solution so as to problems like excessive management compensation, high underwriting costs, and loss of investor confidence due to fraud. See as to the distinction of alpha (company specific) and beta (market) risk: Sharpe, Portfolio Theory and Capital Markets (1970). For the Capital Asset Pricing Model see Brealey/ Myers, Principles of Corporate Finance, 186 (7<sup>th</sup> ed. 2003).

<sup>41</sup> Andrei Shleifer/ Lawrence Summers, The Noise Trader Approach to Finance, 4 J. Econ. Persp., 19, 23 (1990).

interpretations cause markets to be inefficient, if one asks for a “correct price” evaluating the underlying assets. Probably there are structural forces that cannot be explained, or even discovered, that lead to markets that are “noisy”.<sup>42</sup> An analysis of market efficiency has to take these insights into consideration. A rational approach, however, that tackles the irrationalities seems hard to imagine. If the informed investor will not act rationally and analyze the information that is available for him, there are voices that cry for protection, investor education about market prices, or even going so far as to discourage private investors to buy stock.<sup>43</sup> These voices can be tracked back to the very roots of Securities Regulation, maybe even as far as to the “Bubble Act” of 1720.<sup>44</sup> Not to make any misunderstandings arise, it has to be said here that any regulation has to take public welfare as well as shareholder protection into account. Modern legislation takes these two aims into account, for instance when enabling regulations as “necessary or appropriate in the public interest and for the protection of investors”<sup>45</sup>. Many proposals seem not to recognize, however, that there is a certain **risk** involved in buying securities that the investor has to bear in the end. At the same time, the functioning of the capital markets is a prerequisite for the economy that has to be supported rather than to be suppressed.

## II. Challenging the Mandatory Disclosure System

From the very beginnings, the choice for disclosure in the Securities Act has been challenged by critical voices. In opposition to Justice

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<sup>42</sup> Donald C. Langevoort, Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation, 97 Nw. U. L. Rev. 135 (2002), also published in: Armour/ McCahery, After Enron, 65 (2006).

<sup>43</sup> Hu, Faith and Magic: Investor Beliefs and Government Neutrality, 78 Tex. L. Rev. 777 (2000).

<sup>44</sup> For a description of the frenzy arising for the “undertakings of great importance, but nobody to know what it is” and the following enforcement of the “Bubble Acts”, see: Melville, The South Sea Bubble, 97 (1921).

<sup>45</sup> Sec. 2 (a) (10) of the Securities Act of 1933.

Brandeis, who saw disclosure as a “remedy for social and industrial diseases,”<sup>46</sup> it was seen as not sufficient to protect investors. Early criticism argued that private investors either will not be able to understand the complicated financial statements or they will be driven by speculative profits so that they will ignore their insights and consider them irrelevant.<sup>47</sup> This argument will – also with the insights gained from the efficient capital market hypothesis – have to be analyzed. It aims, however, more at the implementation of material or merit regulation, or stricter fraud rules. Here, on the other hand, the question shall be whether mandatory disclosure rules are justified as such. To make it clear, the Securities Acts uses both prohibitions against fraud and disclosure rules, thereby avoiding substantive regulation. Their justification arises out of the argument that they are the least intrusive way of intervening into the market. Should it turn out, however, that they do not fulfil their aims, or could be replaced by better alternatives, they lose this justification.

What, again, are these aims? The public interest approach, as seen above, justifies disclosure requirements for the well-being of the whole economy:<sup>48</sup> If investors lose confidence in the markets, they will withdraw their money, and the economy will stagnate. Mandatory disclosure might lead to better informed decisions, reduce the risk of investing, prevent fraud, and thus lead to enhanced investor confidence. A second justification might arise out of the need to protect uninformed and unsophisticated investors.<sup>49</sup> Thirdly, the rules might indeed lead to the more efficient dissemination of truthful information at a lower cost, and

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<sup>46</sup> Louis D. Brandeis, *Other People’s Money – and How Bankers Use it* 62 (1914).

<sup>47</sup> Douglas, *Protecting the Investor*, 23 *Yale L. Rev.* (N.S.) 521 (1934).

<sup>48</sup> J. Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (1982).

<sup>49</sup> Shareholder Protection is also a prerequisite of functioning markets, and thus economically justifies disclosure, see: Black, *The Legal and Institutional Proconditions for Strong Securities Markets*, 48 *U.C.L.A. L. Rev.* 781 (2001) (Direct correlation between size, depth, and liquidity of market and the level of shareholder protection).

thus be justified through their beneficiary effect on the accuracy of market prices.<sup>50</sup>

## 1. Empirical research

Thirty years after the enactment of the Securities Laws, a new generation of scholars began challenging the disclosure approach. They did not argue from a theoretical point of view, but tried to prove deficiencies of the system from empirical research and data. A first approach by *Stigler* tried to evaluate the unexpected declines in stock prices before and after the enactment of the Securities Laws.<sup>51</sup> For if investors were protected by the laws, these unexpected declines should be less. They were so for some of the years, but not for all. Only the variance changed significantly, which could be explained by reasons other than the introduction of disclosure. So, in the end, the enactment of the laws was said to not have had any significant influence on the quality of the stock.<sup>52</sup>

A second approach to empirically test the efficiency of the disclosure regulations was tried by *Benston* in 1973, who tried to measure the welfare of the Acts.<sup>53</sup> His hypothesis was that disclosure leads to significantly higher costs for the companies that are not compensated by the benefits for the investors. He proved this by comparing companies that already disclosed information before the enactment of the Securities Laws, and companies that only started disclosing in 1933. His conclusion was that adequate incentives for disclosure existed for companies before 1933, so that the public welfare effect of the laws was nil.<sup>54</sup>

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<sup>50</sup> Gilson/ Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 593 (1984).

<sup>51</sup> Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 117 (1964).

<sup>52</sup> Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 124 (1964).

<sup>53</sup> Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132 (1973).

<sup>54</sup> Benston, The Value of the SEC's Accounting Disclosure Requirements, 44 Acct. Rev. 515 (1969).

In 1981, *Jarrell* modified *Stigler's* approach, but did not come to any significant insights. Although seeing a better informational environment in 1935, he could not prove that for the five years following. He found, however, that the Acts reduced the risks of investing significantly, namely because riskier firms escaped to other market segments.<sup>55</sup>

*Ingram* and *Chewning* concentrated on the timeliness of information, but could not find any significant changes before and after the enactments.<sup>56</sup>

The same result was found by *Chow*, analyzing the advantages for loan creditors: The Securities Acts did not have any significant effect.<sup>57</sup>

The system could be found to enhance allocative efficiency, however.<sup>58</sup>

The last approach to be listed here shall be the one of *Simon* who again improved *Stigler's* model with the insights of the Arbitrage Pricing Theory and differentiating between different stock exchanges and market segments.<sup>59</sup> He found that for smaller stock exchanges the unexpected returns were reduced significantly after 1934, although there were no changes at the NYSE. He, as *Stigler* found a reduced variance of the unexpected returns. So, this as well leads to the conclusion that the enactment of the Securities Acts did not significantly influence the informational efficiency of the securities markets and led, if anything, only to better transparency at smaller exchanges. The reduced variance, however, might have reduced the riskiness for investors.<sup>60 61</sup>

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<sup>55</sup> Jarrell, The Economic Effect of Federal Regulation of the Market for New Securities Issues, 24 J. Law. Econ. 613 (1981).

<sup>56</sup> Ingram/ Chewning, The Effect of Financial Disclosure Regulation on Security Market Behavior, 58 Acc. Rev. 562-580 (1983).

<sup>57</sup> Chow, The Impacts of Accounting Regulation on Bondholder and Stockholder Wealth: The Case for the Securities Acts, 58 Acc. Rev. 485-520 (1983).

<sup>58</sup> Schulte, The Debatable Case for Securities Disclosure Regulation, 13 J. Corp. L. 535, 548 (1988).

<sup>59</sup> Simon, The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues, 79 Am. Econ. Rev. 295-318 (1989).

<sup>60</sup> Fox, Required Disclosure and Corporate Governance, 710, in: Corporate Governance, K. J. Hopt ed. 2005, concludes that the reduction of risk in the development of stock prices (less volatility) enhances the willingness of directors to accept compensation linked to these stock prices, and thus leads to better quality of management. Corporate governance thus justifies mandatory disclosure.

The emphasis of these studies shall be on the effects the securities laws *might have* had. Neither can the result be surely proven, nor can causation be said to be certain. As it is hard to quantify the costs of disclosure and all resulting benefits for the investor, it is almost impossible to empirically conclude anything about the effects on the restoration on public confidence in the capital markets.<sup>62</sup> So, it can be said that different empirical approaches have framed the debate,<sup>63</sup> and they often provide a welcome support for one opinion or the other. However, the conclusions often seem unfounded and arbitrary, and there are strong arguments that empirical data cannot provide proof for the efficiency of mandatory disclosure rules at all.<sup>64</sup> The SEC has thus never reacted to the criticism, stating that the disclosure system “is sound and does not need radical reform or renovation”.<sup>65</sup>

## 2. Theoretical approaches against Mandatory Disclosure

More fundamental than the empirical challenges, however, have been theoretical approaches, stating essentially that the mandatory corporate disclosure system is unnecessary because managers will have sufficient incentives to voluntarily disclose all information of interest to the market. Should the level of information in the market not be improved by the mandatory rules, they could hardly be justified. So, the first question to be

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<sup>61</sup> For a recent study focusing on sovereign bond offerings, see: Choi/ Gulati, An Empirical Study of Securities Disclosure Practice, 80 Tul. L. Rev. 1023 (2006).

<sup>62</sup> Posner/ Scott, Economics of Corporation Law and Securities Regulation, 379 sub 4 (1980).

<sup>63</sup> For a more thorough overview see: Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1369-1394 (1999).

<sup>64</sup> Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. Pa. L. Rev. 851, 853 (1992);

Ronald J. Gilson/ Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 641 (1984).

<sup>65</sup> Report of the Advisory Committee on Corporate Disclosure to the SEC, House Committee on Interstate and Foreign Commerce, 95<sup>th</sup> Congress, 1<sup>st</sup> Session, 2, Comm. Print 95-29 (1977), see also: United States. Securities and Exchange Commission, Disclosure to investors: a reappraisal of Federal administrative policies under the '33 and '34 acts: The Wheat report (New York 1969).

analyzed here would be how the information would be provided to the market without such mandatory rules.

#### a) Why market forces might be enough

First of all, there are many **incentives** for managers **to voluntarily provide** the market with information. In order to get access to the capital markets, they will have to satisfy the informational needs of investors, who will ask for certain information before they are willing to invest their money.<sup>66</sup> As there are limited funds in the market, issuers will compete to gain access to these funds by voluntarily disclosing information to gain investor confidence.<sup>67</sup> *Easterbrook* and *Fischel* illustrate this “principle of self-induced disclosure” by a simple benefits-cost analysis.<sup>68</sup> Generally, a company faces certain costs when disclosing information, the direct costs of dissemination, and the indirect costs, such as giving the information to competitors. On the other hand, an investor will be much more willing to give his money for a project that convinces him. He will expect that a company, in striving to distinguish itself from others, will disclose all good information available. In the same way, it will disclose the bad information, fearing that shareholder otherwise would assume the worst and withdraw their money, causing the value of the stock to sink. This would even work for continuous disclosure, as the after-market would ask for current information, and the company will have in interest to maintain a market for their shares, in order to be able to issue more in the future. As long as the benefits of having access to capital will outweigh the costs, a company will naturally provide all information that the market asks for.

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<sup>66</sup> Kripke, *The SEC and Corporate Disclosure: Regulation in Search for a Purpose* 119 (1981).

<sup>67</sup> Beaver, *Financial Reporting: An Accounting Revolution* 13 (1981).

<sup>68</sup> Easterbrook/ Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 682 (1984).

Additionally, at least some of the investors will have the **power to negotiate**, and they will require certain information; specialists such as financial analysts will probably evaluate as investment-worthy only the stock of companies disclosing information, which will as lead to higher prices in the securities and so to lower costs of capital.<sup>69</sup>

This incentive is often even improved by aligning the interests of managers and shareholders contractually. Stock options or bonus arrangements are a common means to make management act in the best way possible for the value of the firm. Often the pure existence of the arrangement itself signals reliability and trustworthiness to the markets.<sup>70</sup>

All in all, many incentives can be seen for managers to establish a reputation for honest and full disclosure, so that they will not lose their ability to raise money in the capital markets.<sup>71</sup>

**Monitoring** by shareholders can even support these incentives. *Jensen* and *Meckling* support this argument<sup>72</sup>: The separation of ownership and control leads to conflicts of interest. A manager owning all of a company would receive all of the benefits. Having to share these direct benefits with shareholders now, he will try through perquisites or other non-pecuniary benefits to maximize his own income. This misbehavior is – in a ‘lemon-like’ model – discounted from the price an investor is willing to pay for the stock. However, there are incentives for both the managers and investors to incur certain costs to increase the value of the firm. They are willing to enter a control or monitoring contract that involves methods like auditing of

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<sup>69</sup> Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* 121-123 (1981).

<sup>70</sup> Cox/ Hillman/ Langevoort, *Securities Regulation: Cases and Materials*, 251 (5<sup>th</sup> ed. 2006).

<sup>71</sup> Loss/ Seligman/ Paredes, *Securities Regulation, Volume 1*, 285 (4<sup>th</sup> ed. 2007).

<sup>72</sup> Jensen/ Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976).

independent firms, formal control systems, budget restrictions, and the establishment of incentive compensation systems.<sup>73</sup> They might guarantee the payment of dividends, forcing them to repeatedly return to the capital markets. This confidence as well signals quality of a firm.<sup>74</sup> As long as both sides profit in a cost-benefit analysis, they will be willing to incur these costs that necessarily will include the voluntary publication of material information. A similar argument employing signaling theory points out market-based incentives leading to a strong self-interest for managers to disclose relevant information in a competitive market, such as the fear of being removed, hostile takeovers, or the loss of their own value in the small managerial market.<sup>75</sup>

There also is a strong likelihood that stock prices, and thus the value of a firm itself, will rise because of improvements in Corporate Governance. The pure knowledge of being under the controlling eye of the public will probably prevent bad governance decisions, and lead to better and more efficient management.<sup>76</sup>

#### **b) Why market forces might not suffice**

Not to be forgotten, however, the costs of disclosure are significant. This is especially true for the verification and certification costs.<sup>77</sup> One problem is that it is extremely hard to verify information and the effects it has on the market price. For, as seen above, market participants often behave irrationally, so even from the hindsight it will be hard to say

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<sup>73</sup> Jensen/ Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 317 (1976).

<sup>74</sup> Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650 (1984).

<sup>75</sup> Stephen A. Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory, in: Issues in Financial Regulation 177, Franklin R. Edwards ed. (1979) (proposing an incentive-signaling system from a research on insider-trading as a (costly) alternative to disclosure requirements).

<sup>76</sup> Langevoort, Organized Illusions: A behavioral Theory on why Corporations Misled Stock Market Prices (and Caused Other Social Harms), 146 U. Pa. L. Rev. 101 (1997).

<sup>77</sup> Goshen/ Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L. J. 711 (2006) (seeing the main benefits of mandatory disclosure for information traders who face lower verification costs).

whether a profit was made by a wise investment decision, or merely good luck. The efficient capital market hypothesis further implies that investors are essentially price-takers, as the information, when being disclosed, will already be reflected in the price. Often owning only small amounts of stock they will not investigate or challenge the truthfulness of the information they are provided. A rule against fraud, if properly enforced, can significantly reduce all these costs.<sup>78</sup> However, here as well, information is needed in the beginning that can be proven. If a company will not disclose anything, it can not be said to defraud.

It is a well-justified assumption that companies will not engage in the efforts just explained, but favor to remain silent instead. Maybe they are able to raise money that way. There is, after all, a great and well-known appeal to invest in “undertakings of great importance, but nobody to know what it is”<sup>79</sup>. With increasing institutionalization and enlightened investors who will ask for information, it is more likely that companies will disclose information. There is to be great fear, however, that they will do so only if it is more beneficially for them to withhold the information. A mandatory disclosure system could react to critical investment, for instance by additional special requirements for “blank check”-companies as in Rule 419 of the '33 Act.

A powerful incentive for management to withhold information is the possibility for private gains by **insider trading**. Studies repeatedly document that insiders earned abnormal returns on private purchases, exploiting the information they had before the others could.<sup>80</sup> Just by withholding the news for a short time, huge private gains could be made.

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<sup>78</sup> Easterbrook/ Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 677 (1984).

<sup>79</sup> The great demand for such shares is described in Melville, The South Sea Bubble 97 (1921).

<sup>80</sup> Cox, Insider Trading Regulation and the Production of Information: Theory and Evidence, 64 Wash. U. L. Q. 475, 493 (1986).

Another concern is **agency costs**. How much more would a director benefit if he could exploit a business opportunity at the corporation's expense.<sup>81</sup> Or even, not to make him act evil, he might just be trying to protect his job. A 1992 analysis of fraud cases discovered that most misrepresentations occurred when managers tried to conceal bad news, such as declines in earnings, in order to secure their jobs.<sup>82</sup> These concealments might be especially feared in cases where management compensation is aligned with the company's success or otherwise where management contemplates insider trading. So, even if they disclose information, there are doubts as to quality and truth of that information. In other words, the agency-cost argumentation might not work out to provide an optimal amount of information. In practice, it can be seen that a majority of the fraud cases where bad news were concealed occurred in smaller companies not subject to the mandatory disclosure rules.<sup>83</sup>

Returning to the insights of **behavioral finance**, managers cannot always be blamed for exploiting informational asymmetries. They might simply be biased or influenced by psychological or organizational forces that cause them misperceive the risks or value of a certain undertaking.<sup>84</sup> For it is a common problem of humans that they overestimate their own abilities.

Moreover, the various **indirect costs** of disclosure have not yet been mentioned. For instance, there is the constant litigation risk that flows from allegations the disclosed information was misleading.<sup>85</sup> Here, especially to

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<sup>81</sup> Jensen/ Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 317 (1976).

<sup>82</sup> Arlen/ Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 701 (1992).

<sup>83</sup> Loss/ Seligman/ Paredes, Securities Regulation, Volume 1, 287 (4<sup>th</sup> ed. 2007).

<sup>84</sup> Langevoort, Organized Illusions: Why Corporations Misperceive Stock Market Investors (and Cause Other Social Harms), 146 U. Pa. L. Rev. 101, 133 (1997).

<sup>85</sup> Kitch, The Theory and Practice of Securities Disclosure, 61 Brooklyn L. Rev. 763 (1995).

reduce the high risk of liability when providing forward-looking information, government regulation could provide safe-harbors to encourage this beneficial information. Note at this point the value of forward-looking expectations and beneficial effect that the introduction of the MD&A had on information dissemination and market performance generally.<sup>86</sup>

Furthermore, empirical research seems to contradict the assumptions of signaling theory and agency-costs. For example, research reveals that frequently good news are disclosed much faster than bad news,<sup>87</sup> due to the “**proprietary costs**” that economically harmful bad news bring along with them.<sup>88</sup> Hence, we can envision a significant qualification to signaling theory: A corporation will withhold any information if the overall market effects will be worse than the benefits are. This would mean that investors cannot assume the worst any more, if no information is disclosed, as no news could also mean good news that the company does not want to disclose to hide positive developments or expectations from opponents. This, on the other hand, would mean that there would be no clear signals to the market, and signaling theory, in its extreme form could not be upheld.

Taking this into account, some further research has been done in order to answer the question how much information would actually be provided to the market without being compelled by governmental regulation. On the one hand, one can theoretically assume that there will likely be an

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<sup>86</sup> Fox/ Morck/ Durnev, Law, Share Price Accuracy, and Economic Performance: The New Evidence, 102 Mich. L. Rev. 331 (2003) (finding better market performance and more informed prices after the enhanced forward-looking MD&A disclosure requirements); Schwarcz, Rethinking the Disclosure Paradigm, 2004 U. Ill. L. Rev. 1, 10 (Sarbanes-Oxley Act significantly improved financial reporting of off-balance sheet arrangements).

<sup>87</sup> Cooper/ Keim, The Economic Rationale for the Nature and Extent of Corporate Financial Disclosure Regulation: A Critical Assessment, 2 J. Acc. Publ. Pol. 189, 195 (1983);

SEC, Report of the Advisory Committee on Corporate Disclosure XXVII (1977).

<sup>88</sup> Vereccia, Discretionary Disclosure, 5 J. Acc. Econ. 179, 182 (1983).

**overproduction of information.** In a model of limited resources, *Fama* and *Laffer* assumed that investors will compete for access to information in order to exploit it for their own benefit.<sup>89</sup> In that model, the gain of one investor is the cost of the other, as the value of the information is exploited upon use, and has no benefit for the overall economy (information as scarce good). The logical consequence would be, to make as much information publicly available as possible, in order to minimize the costs the individual would have to incur. Mandatory rules could do so for the benefit of the economy.

That approach, however, does not go unchallenged. On the theory of information as **public good**<sup>90</sup> rather than private good, one might as well assume an **underproduction of information.** For public goods can be used without being consumed entirely, making it less profitable to disclose them, if others might then use them for free. These free-riding effects occur with respect to competitors on the market, who will get the information for free as well as for other investors who could not be excluded from taking the benefits. So, in the end nobody would be willing to incur any costs to provide or get information.<sup>91</sup> This model would, as well, justify state interference. Before accepting it, however, one should ask whether it can reasonably be upheld in an efficient market. If, as assumed, the information will fast or slowly be reflected in the price, there are still incentives to gain competitive advantages by finding “new news”.<sup>92</sup>

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<sup>89</sup> Fama/ Laffer, Information and Capital Markets, 44 J. Bus. 289, 298 (1971), Hirshleifer, The Private and Social Value of Information and the Reward to Inventive Activity, 61 Am. Econ. Rev. 561 (1971) (reaching the same result of a market failure due to overproduction of information).

<sup>90</sup> Arrow, Economic Welfare and the Allocation of Resources for Invention, in: D. M. Lambertson, Economics of Information and Knowledge, 141, 152 (1971).

<sup>91</sup> Easterbrook/ Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 685 (1984).

<sup>92</sup> Grossman/ Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 383 (1980).

All in all, **the right amount of information will not be provided on a market.**<sup>93</sup> Both models, however, seem to be convincing. In contradiction to signaling theory and the agency-cost assumption they show that as soon as other market participants are introduced in the model, the optimal amount of information cannot be achieved. It can be said that there are at least as many and as strong incentives not to voluntarily disclose all information, as there are to do so. So, indeed, it is highly unlikely that a market, without any kind of interference, would produce an optimal amount of information, and mandatory disclosure rules would be justified in the public interest.

### **3. Theoretical approaches against the justification of Mandatory Disclosure**

#### **a) Mandatory Disclosure and Path Dependency**

Not being able to prove the mandatory disclosure regime as superfluous, the public interest approach itself has been challenged. Critics assume that mandatory disclosure has not been implemented because of public interest concerns but by **pressure group** legislation and the effect of serving the broader public interest is merely accidental.<sup>94</sup> Indeed, disclosure alone does not eliminate fraud, and the substantive regulations introduced shortly after Enron and Worldcom show that they are far from perfect and sufficient. Arguing from an economic perspective, one might see the competitive advantages that large and established companies gain by the disclosure rules in comparison to smaller firms who have to make the same efforts for much less money. Investment banks and auditing firms have huge interests in maintaining the status quo, having specialized and gained expertise in differentiated markets.<sup>95</sup> In the

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<sup>93</sup> Coffee, Market Failure and the Economic Need for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984).

<sup>94</sup> Peltzman, Toward a More General Theory of Regulation, 19 J. L. & Econ. 211 (1976).

<sup>95</sup> Manne, Economic Aspects of Required Disclosure under Federal Securities Laws, in: Wall Street in Transition, 23, 31, 38 (1974).

same way, securities lawyers profit from their monopoly position.<sup>96</sup> So, one cannot conclude that the securities laws survive because they are the optimal or most efficient solution. Rather, having become an accepted standard they might simply have been retained due to the path dependency of their evolution. This occurs because any change would not benefit any single individual by a significant enough gain so that he would be willing to incur the costs necessary to change the system.<sup>97</sup> On the other hand, even seeing the influences of interest groups, one might as well argue with the insights of path dependency in favor of mandatory disclosure rules: Should a free market work, it would lose its economic legitimacy over time, as standards would evolve that are the result of path dependent behavior rather than optimal solutions.

#### **b) Mandatory Disclosure and Issuer Choice**

Going even further, the securities laws have been seen as a misjudgment altogether, resulting from an overestimation of market failure. It is argued that a market approach would be better, even leading to superior disclosure standards through regulatory competition.<sup>98</sup> With globalization enabling investors and issuers access to world-wide markets, different regulatory regimes could compete for an optimal investment environment, offering diversified amounts of information. This would better answer different investors' and companies' needs than mandated disclosure. Federal government, each state, foreign countries, and the stock-exchanges would all compete for investors, leaving them the choice where to invest, and offering specified conditions. Optimal standards would thus be achieved through specialized markets offering companies more differentiated access to capital at a lower cost.

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<sup>96</sup> Easterbrook/ Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 671 (1984).

<sup>97</sup> Roe, Chaos and Evolution in Law and Economics, 109 Harvard Law Rev. 641 (1996).

<sup>98</sup> Romano, Empowering Investors: A Market Approach to Securities Regulations, 107 Yale L. J. 2359 (1998); Fox, Securities Disclosure in a Globalized Market: Who Should Regulate Whom, 95 Mich. L. Rev. 2498 (1997).

It is highly unlikely however that such an additional choice where to invest will lead to better disclosure of information.<sup>99</sup> Rather, it seems to add uncertainty, and would, furthermore, require a good deal of information as to the conditions of the different markets in addition to the information about the different companies. Some of the supporters even admit that the proposed system would not aim at investor protection, which is said to be sufficiently provided by the efficient capital market hypothesis, but only achieve more efficiency in the market.<sup>100</sup> And, even the enhanced efficiency cannot be expected to lead to overall benefits for society, as the social costs arising from a diversified model would by far exceed the marginal social benefits.<sup>101</sup> Moreover, external factors and monopolies are still not taken into consideration,<sup>102</sup> and it seems much more likely that competition would lead to a race to the bottom rather than a race to the top, leading to an amount of disclosure far below the social optimum.<sup>103</sup> The same doubts occur in a system where issuers can choose among regulatory regimes,<sup>104</sup> adding the uncertainty as to difficulties of enforcement of the applying rules.

### **c) Mandatory Disclosure in a World of Complexity**

A completely different approach has challenged the functioning of market efficiency, and thus the whole disclosure-based system, in a world of growing complexity.<sup>105</sup> Essentially returning to *Akerlof's* findings

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<sup>99</sup> Ill. 2. *infra*, and: Cox, Regulatory Duopoly in U.S. Securities Markets, 99 Colum. L. Rev. 1200 (1999) (using the debate about IAS to defend the strength and competitiveness of the U.S. markets due to their trustworthiness).

<sup>100</sup> Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment, 85 Va. L. Rev. 1335, 1415 (1999).

<sup>101</sup> Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment, 85 Va. L. Rev. 1335, 1338 (1999).

<sup>102</sup> Cox, Regulatory Duopoly in U.S. Securities Markets, 99 Colum. L. Rev. 1200, 1230 (1995).

<sup>103</sup> Loss/ Seligman/ Paredes, Securities Regulation, Volume 1, 284 (4<sup>th</sup> ed. 2007).

<sup>104</sup> Choi/ Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. Cal. L. Rev. 903 (1998).

<sup>105</sup> Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. Ill. L. Rev. 1 (2004).

regarding the difficulty to distinguish the good from the bad<sup>106</sup>, modern financial transactions, especially structured finance, can be seen as so complex and convoluted that even highly sophisticated investors will not be able to understand them.<sup>107</sup> This would lead to the effect that efficient prices could not be established. The conclusion from this scenario is a call for improved corporate governance, such as managers' being free from material conflicts of interest, as the shareholders' only possibility will be to trust the business judgment of the management in their valuation of the deal.<sup>108</sup> Even seeing this complexity, however, one should be careful to conclude that disclosure in these cases is insufficient or even unnecessary. For even disclosing that there are highly complex deals that nobody will understand might suggest a lot about the inherent risk in itself. Moreover, legislation can take these risks and uncertainties into consideration by requiring clear and understandable disclosure. Seeing the risks, the market may discount the price, or open possibilities for speculation on an informed basis.

#### **4. Justification of Mandatory Disclosure Rules**

As could be seen, all market approaches for incentives to encourage voluntary disclosure can be seen as insufficient when third party effects and overall market conditions are taken into consideration. Powerful incentives exist to withhold news so that they may be exploited personally. Hence, there is a high probability of market failure should governments not intervene. The answer now to be found is which kind of government remedy is least intrusive, as the more freedom is left to private incentives, the more effective any intrusion will be.<sup>109</sup> Certainly, a mandatory

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<sup>106</sup> George Akerlof, The Market for „Lemons“: Quality Uncertainty and the Market Mechanism, 84 Q. J. Eco. 488, 500 (1970).

<sup>107</sup> Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. Ill. L. Rev. 1, 7 (2004).

<sup>108</sup> Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. Ill. L. Rev. 1, 23 (2004).

<sup>109</sup> Beales/ Craswell/ Salop, The Efficient Regulation of Consumer Information, 24 J. L. Econ. 491 (1984).

disclosure system is one way of regulating the market, and it has, as opposed to fraud or merit regulation rules, various benefits and advantages. Used in the right way, it can be said to be the most beneficial system possible. Finally, some concluding remarks are provided here as to an optimal use of disclosure in modern securities regulation. The focus of these remarks is to show in which areas the benefits of disclosure can be used best, as well as to set forth the challenges and influences modern developments pose for a mandatory regulatory system so that they need to be considered in any disclosure-based legislation.

### **III. Using the Benefits of Mandatory Disclosure to Improve Modern Legislation**

#### **1. Major benefits of Mandatory Disclosure**

One of the main benefits to be gained from a mandatory disclosure system is **standardization**. It enables comparability and ensures timeliness of the dissemination of information. Through the possibility of standardization, a higher level of predictability can be achieved while significantly reducing the costs. Companies can provide the information at the lowest cost, and investors can easily understand and compare this information, if it is provided in a standardized manner. Uniform statements can more easily be verified and certified, enhancing confidence in their reliability. Standardized forms, moreover, prevent companies from withholding “bad news” from the market, even only for a short time.

Moreover, the “right amount” of information can more easily be achieved by mandatory rules. As seen above, markets are much more efficient for big and well-known corporations. If markets themselves create sufficient information about these companies, fewer burdens may be put upon them from the state. For riskier firms, however, a higher level of disclosure may

be justified. A wise system would thus **differentiate** between different market segments. Scholars have debated whether these segments could be provided by market forces. Of especial interest is the opportunity of free choice between countries or even markets within a single country. On close analysis, however, the conclusion appears compelling that this would add to the uncertainty and thus lower overall welfare as well as the level of investor protection. Nonetheless, there remains the idea of broad regulatory power of the exchanges as they can quickly react to market needs and can create new market segments with additional requirements to ensure an even higher level of quality. Consider at this point the finding that there is “almost no evidence” that the enactment of the Securities Acts led to a higher level of information compared to the “contractual disclosure” already required by the NYSE.<sup>110</sup> Consider as well that even if this finding might be true for highly developed and efficient markets as the NYSE, mandatory rules could react to these findings, reducing disclosure requirements, as they already do for Seasoned and Well-Known Seasoned Issuers. For smaller companies, on the other hand, guidance is important so that they are able to comply with the rules. After the enactment of the Sarbanes-Oxley Act, the SEC considered various ways to provide relief from some of the requirements for smaller public companies.<sup>111</sup> A differentiated system that reacts to the needs of different market participants seems advisable. In the same way as integrated disclosure takes unnecessary burdens of duplicate regulation from large issuers, smaller businesses have to be helped to be able to comply with the rules. This can be reached by exemptions from disclosure requirements, such as in private placements.<sup>112</sup>

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<sup>110</sup> Mahoney/ Mei, *Mandatory vs. Contractual Disclosure in Securities Markets: Evidence from the 1930s* (2006), available at: <http://ssrn.com/abstract=883706>, essentially only repeating *Simon's* findings (Note 58 above).

<sup>111</sup> Hazen, *Treatise on the Law of Securities Regulation*, 5<sup>th</sup> ed. 2005, Jan. 2008 Pocket Part, § 1.2 (2008).

<sup>112</sup> Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws*, in: *Wall Street in Transition*, 23, 47 (1974) (Most regulatory and information-disclosure costs

Mandatory disclosure rules can also harness to their objective the powerful **market incentives** to voluntarily disclose information. An optimal system would focus on historical information that can easily be verified and compared. This would pose the cornerstone for functioning market efficiency. The rules would then open incentives and safe-harbors for the additional dissemination of information. The more accurate and precise these directives and their rewards are the more effectively an overflow as well as misleading statements can be prevented. Predictability is thus added for management as well, reducing the uncertainty and risk of liability, at the same time enabling firms to distinguish themselves from the others through forward-looking statements. The functioning of such a system largely depends on a strong regulatory agency to overview and to correct failures of the system. The costs of such an agency seem to be outweighed by the benefits functioning mandatory disclosure rules.

Still, the probably most elegant benefit of a mandatory disclosure system is that it enables companies to effectively raise capital while at the same time providing a high standard of **protection to investors**. The integrated disclosure system, and especially the possibility of shelf registration under Rule 415, show that to a large extent informational needs can be specifically met and balanced, using the insights of the efficient capital market hypothesis. At the same time, mandatory rules can also limit the flow of information in situations where it can be seen as more beneficial to effectively place an offer in the market and ensure its distribution, preventing price-drops in the distribution period.<sup>113</sup>

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of a registration can be avoided by using some form of private placement). What does this reveal about the attractiveness of the regulated market?

<sup>113</sup> Cox/ Hillman/ Langevoort, Securities Regulation: Cases and Materials, 202 (5th ed. 2006).

## 2. Challenges in modern Securities Regulation

**Globalization** plays an increasingly important role in today's markets. An old saying states that "money knows no fatherland", nor does information. Regulations thus have to react to the increasing world-wide flow of capital and information. The internet enables people all over the world to get the same access to information, and thus widens the choice of investments. Ideally, world-wide standards enforced by a world-wide agency could ensure optimal allocative efficiency. Clear and centralized rules enable foreign companies to access a market. High compliance costs in a complex and hard-to-understand system on the other hand are more likely to discourage a listing abroad. Mutual recognition of already efficiently established prices could, however, enhance access to foreign markets at much lower costs. Uniform international accounting principles and financial statements are a prerequisite for a free flow of funds in the world-wide markets. The U.S. will have to face close cooperation and unification of rules in Europe and the ever increasing significance of the Asian Markets. Reluctance for cooperation seems to pose great dangers to the functioning and competitiveness of the system.<sup>114</sup> It seems unlikely, however, that US regulators will accept a decline in the high level of investor protection, but will rather lose some of the riskier companies to competitive markets – retaining their secure but expensive status. Note the declining percentage of global IPOs that list on the US market. Statistics show that in 2000 one of every two dollars was raised in the United States, whereas by 2005 that number dropped to one in twenty.<sup>115</sup> Many companies today chose a London listing, preferring the British modernized and liberalized system that in 2000 with the enactment of the Financial Services and Markets Act greatly enhanced its clarity, efficiency

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<sup>114</sup> *But see:* Cox, supra note 99 (on why the U.S. should be careful not to lose their superior status).

<sup>115</sup> Interim Report of the Committee on Capital Markets Regulation (December 2006).

and regulatory accountability.<sup>116</sup> They also lead to a reduced level of information available due to broad exemptions from prospectus registration requirements for Euro-securities and other offers in 1999.<sup>117</sup>

In the U.S., there too are a number of broad exceptions of disclosure requirements, reacting to different kinds of market needs and often based on the insights of market efficiency. A mandatory disclosure system, however, can only function if the law is clearly understood, simple, and easy to follow. For what are the benefits of a perfectly regulated system, if it is so complicated that non-experts are not able to follow the rules and specialized legal advice is so expensive that smaller companies simply see no benefit in going public? However well the SEC rules, regulations and releases may be, there is the need for **simplification** of the complex body of law.<sup>118</sup> Clear and uniform safe-harbors, such as one single rule regulating integration, would reduce the risk of a violation of the Acts and thus enhance efficiency.

In 2006, the New York Stock Exchange merger with Archipelago expanded its use of **electronic communication networks**, clearly seeing the increasing importance of electronic trading and the need for international competitiveness in an increasingly electronic world.<sup>119</sup> Most trading today has become automated and electronic, a development not to be under-estimated in its effects on world-wide information dissemination. The NYSE merger plans with Euronext in 2006<sup>120</sup> also show the increasing challenges that internationalization poses upon

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<sup>116</sup> Cox/ Hillman/ Langevoort, Securities Regulation: Cases and Materials, 2007 Suppl. to the 5th ed. 2006, 4.

<sup>117</sup> Bates, United Kingdom Issues New Regulations on Public Offerings of Securities, 31 Sec. Reg. & L. Rep. 647 (1999).

<sup>118</sup> Also the major aims in the Proposals of a Federal Securities Code, see: Hazen, Treatise on the Law of Securities Regulation, 5<sup>th</sup> ed., Vol. I, § 1.2[3][d][2] (2005).

<sup>119</sup> NYSE, Archipelago Merger Complete; New for-Profit Company to begin Trading, 38 Sec. Reg. & L. Rep. (BNA), 414 (2006).

<sup>120</sup> NYSE, Euronext \$20B Merger Plan Would Create World's Largest Exchange, 38 Sec. Reg. & L. Rep. (BNA), 962 (2006).

competitiveness as well as the interconnectedness of today's markets. This has a significant impact on disclosure rules, as their aim and reach suddenly extend far beyond U.S. borders.

As briefly discussed above<sup>121</sup>, mandatory disclosure rules can greatly enhance **Corporate Governance**. Indeed, governance considerations are sometimes seen as the primary justification of such rules, being more important than investor protection or public confidence.<sup>122</sup> In Great Britain, the Companies Act of 2006 seems to solely rely on improved corporate governance in order to implement the proposals of the Final Report of the Company Law Review Steering Group.<sup>123</sup> In the United States, with the enactment of the Sarbanes-Oxley Act, heightened disclosure and compliance requirements have also to a large extent been aimed at enhancing corporate governance.<sup>124</sup> With the growing influence of behavioral corporate finance, theories of corporate governance have generally been introduced in the discussion and are an essential point of consideration in understanding modern corporate theory.<sup>125</sup>

Modern regulation should consider the **institutionalization** of capital markets. In 2004, 62.1 % of all equity securities outstanding in the United States were owned by institutional investors.<sup>126</sup> One should be careful to

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<sup>121</sup> Note 59: Fox, Required Disclosure and Corp. Governance, 710, in: Corp. Governance, K. J. Hopt ed. (2005).

<sup>122</sup> Hopt, Modern Capital Market Problems: Improving European Corporate Governance After Enron, 3 J. Corp. L. Stud. 221, 241 (2003).

<sup>123</sup> Company Law Review Steering Group, Modern Company Law for a Competitive Economy, Final Report (2001).

<sup>124</sup> Hazen, Treatise on the Law of Securities Regulation, Vol. 1, § 1.2, 5th ed. (2005).

<sup>125</sup> Langevoort, Organized Illusions: A behavioral Theory on why Corporations Misled Stock Market Prices (and Caused Other Social Harms), 146 U. Pa. L. Rev. 101 (1997);

for a thorough description of theories of the firm and further examples as to the influences of corporate governance in modern corporation law, see: Loss/ Seligman/ Paredes, Securities Reg., Vol. 1, 16 (4<sup>th</sup> ed. 2007),

see also: Cox/ Hillman/ Langevoort, Securities Regulation: Cases and Materials, 10 (5th ed. 2006) (stressing the growing influences of corporate governance in federal securities regulation).

<sup>126</sup> 2005 Securities Industry Fact Book, 63.

conclude, however, that increased institutionalization necessarily will per se lead to more efficient prices because of better market control. Rather, diversification policies pose the risk that even big institutionalized investors will not adequately analyze a company before making their investment decision, and will often not exercise their power to achieve an optimal influence on management. So, there still remains the need for disclosure rules in order to ensure individual investor protection. Nonetheless, one has to see the growing influence and interdependence in the market.

As seen above, it is essential for the functioning of mandatory disclosure rules that they are properly accompanied by effective rules against **fraud** and that they are **enforced** effectively. In the face of globalization, uniform or interconnected enforcement procedures or regulatory systems are proposed. But also for the U.S. system, clear and consistent regulations are to be a major point of consideration. In the area of self-regulation, the 2007 merger of NASD Regulation and NYSE Regulation into the Financial Industry Regulatory Authority (FINRA) was a major step in eliminating unnecessary inconsistencies between the regulatory bodies.<sup>127</sup> Uniformity and clarity are important in the area of self-regulation. Similarly, the SEC, and more generally U.S. securities regulations, as a whole have been criticized as over-regulating. The public choice argument is just one form for this criticism to occur.<sup>128</sup> Preserving wide discretion may effectively enable the SEC to react to market needs. On the other hand, bright-line rules would make compliance much easier and significantly reduce the risk of later litigation and costs. Still, the SEC seems to be a well-functioning and effective regulatory body. For future reforms, however, it seems important that clarity and especially the interconnectedness with SROs but also foreign regulatory authorities are improved.

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<sup>127</sup> Hazen, *Treatise on the Law of Securities Regulation*, 5th ed., Jan. 2008 Pocket Part, § 1.1[4] (2008).

<sup>128</sup> Cox/ Hillman/ Langevoort, *Securities Regulation: Cases and Materials*, 13 (5th ed. 2006).

The wave of **accounting** fraud in 2001 underlined the importance taking the role of auditing firms into consideration. This is not to say that Enron and other corporate scandals could be prevented by better disclosure or improved auditing. There is a high risk, however, that concentration in the auditing profession will lead to a sub-optimal processing of information and thus less market efficiency. Their gatekeeper role and signaling character are endangered if they become focused on providing non-auditing services, as they were in the pre-SOX era.<sup>129</sup> The power of the audit committees and enhanced independence of directors are steps in the right direction. Much more, however, needs to be done. For this analysis, the failures show how heavily a disclosure-based system depends on the functioning and interaction of every single market participant. The regulation of the whole financial services industry also is essential for a functioning system.<sup>130</sup>

#### IV. Conclusion

Mandatory disclosure rules can be used to effectively regulate the flow of information on a market, leading to a level of transparency that can be considered as optimal for trading. This does not mean that maximum disclosure or the distribution of all information that could possibly be available is optimal. There is a need to take different informational needs in different markets into account.<sup>131</sup> A wisely regulated disclosure system could optimally interact with market forces in areas where they suffice to ensure sufficient protection and the functioning of the system. Weighing

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<sup>129</sup> Cox, *Oligopolistic Gatekeeper: The U.S. Accounting Profession*, in: Armour/McCahery: *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the U.S.*, 295, 296 (2006).

<sup>130</sup> Pitt/ Wilson, *Unified Regulatory Structure Needed for U.S. Financial Services Industries*, 38 *Sec. Reg. & L. Rep. (BNA)* 1807 (2006); Hazen, *Treatise*, xxxv (SOX enhanced attention paid to auditors and research analysts).

<sup>131</sup> Merkt, *European Company Law Reform: Struggling for a more Liberal Approach*, 1 *ECFR* 3, 31 (2004).

the costs, but also the benefits of mandatory disclosure rules, all in all it can be said that they seem to be preferable to substantive or merit regulation. It has to be considered, however, to what extent they should be posed upon all market segments. A modern approach would have to look to all market developments and investors' as well as companies' demands in order to remain competitive and offer liquid and functioning markets with differentiated levels of risk – leaving the possibility of speculative investments on an informed and protected basis. Together, with effective rules against fraud and insider trading, as well as enforcement procedures, it seems to be the least intrusive way to secure functioning markets and, as far as over-regulation is prevented, to be in the best interest of the investors and all other market participants.