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WHITHER SECURITIES REGULATION? SOME BEHAVIORAL OBSERVATIONS REGARDING PROPOSALS FOR ITS FUTURE

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ABSTRACT

Respected commentators have floated several proposals for startling reforms of America's seventy-year-old securities regulation scheme. Many involve substantial deregulation with a view toward allowing issuers and investors to contract privately for desired levels of disclosure and fraud protection. The behavioral literature explored in this Article cautions that in a deregulated securities world it is exceedingly optimistic to expect issuers voluntarily to disclose optimal levels of information, securities intermediaries such as stock exchanges and stockbrokers to appropriately consider the interests of investors, or investors to be able to bargain efficiently for fraud protection.

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> I can calculate the motions of heavenly bodies, but not the madness of people.
>
> Sir Isaac Newton[1]

1. NICHOLAS DUNBAR, INVENTING MONEY: THE STORY OF LONG-TERM CAPITAL MANAGEMENT AND THE LEGENDS BEHIND IT 1 (2000) (quoting Sir Isaac Newton, speaking after he lost £20,000 in the stock market).

INTRODUCTION

United States securities regulation is at a critical juncture. After eight years of investor-friendly Securities and Exchange Commission (SEC) leadership by Arthur Levitt,[2] Congress is contemplating a top-to-bottom review of all federal securities laws, beginning with the 1933 and 1934 Securities Acts.[3] In such a review, Congress might well turn for guidance to the writings of leading academics who propose dramatic changes in federal securities regulation.

For example, Congress might well look at the writings of Professor Paul Mahoney[4] and Professor Adam Pritchard,[5] who have both recommended a dramatically reduced role for current enforcement mechanisms and an attendant increase in the power and responsibility of stock exchanges. In the alternative, they might examine Professor Roberta Romano's proposal to largely replace federal securities regulation with state regulation in a system of competitive federalism.[6] They also might study Professor Stephen Choi's plan to refocus regulatory attention from the professional actors in the securities system to the investors.[7]

These proposals, however, should be considered with some trepidation because they are not informed by a large body of behavioral research[8] that directly bears upon their premises and conse-

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2. *See* Mike McNamee, *Wanted: Another Investor-Friendly SEC Chief*, BUS. WK., Jan. 29, 2001, at 39, 39 (describing that during the bull market of the 1990s "Levitt's SEC championed lower fees, fuller disclosure, and crackdowns on insider games and Internet fraud").

3. Before he resigned as chair of the Senate Banking Committee and announced his imminent retirement, Senator Phil Gramm explicitly promised such a thorough review. Jaret Seiberg, *Gramm Aims to Make Changes in Securities Law*, NAT'L L.J., Feb. 5, 2001, at B11. Certainly the events of September 11, 2001, moved securities law reform down on the nation's, and the Senate's, list of priorities. The unfolding Enron scandal also will likely render any major deregulatory moves politically unpopular for at least a time.

4. *See generally* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

5. *See generally* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999).

6. *See generally* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

7. *See generally* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000).

8. Recent years have seen a significant injection of behavioral research into legal scholarship. Among the leading works not otherwise cited in this article are Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in the Hindsight Bias*, 73 OR. L. REV. 587, 621–30 (1994) (applying the insights of the psychology literature's hindsight bias to the contrasting rules for reviewing decisions of doctors and directors); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an*

quences; and they are inconsistent with a growing body of empirical evidence supporting the developing consensus that American securities regulation is the optimal system for governing capital markets.[9]

Because the debate already has been joined regarding the "exchange as regulator" proposals[10] and Professor Romano's competitive federalism plan,[11] I focus my attention upon Professor Choi's investor

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Effective Legal Response, 63 VA. L. REV. 1099, 1132–56 (1977) (presenting an early effort to apply behavioral psychology and organizational behavior research to the corporate setting); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 43–57 (2000) (using behavioral theory to evaluate the choice between rules and standards); Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107, 164–66 (1994) (suggesting that rational-actor based models used to analyze why parties fail to settle litigation should be replaced with a richer model incorporating psychology literature); Cass R. Sunstein et al., *Assessing Punitive Damages (With Notes on Cognition and Valuation in Law)*, 107 YALE L.J. 2071, 2094–109 (1998) (attempting to explain punitive damages with behavioral insights); Richard L. Hasen, Comment, *Efficiency Under Informational Asymmetry: The Effect of Framing on Legal Rules*, 38 UCLA L. REV. 391, 435–38 (1990) (arguing that psychological models of human behavior produce more realistic and nuanced policy prescriptions than do economic models).

Although the bandwagon for behavioral analysis is quickly adding new riders, several scholars have serious concerns about its implications. *See, e.g.*, Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717, 718 (2000) (suggesting that because behavioral evidence indicates that human behavior is "complex and contradictory," behavioral theory "is not likely to contribute very successfully to instrumental legal reform"); Mark Kelman, *Behavioral Economics as Part of a Rhetorical Duet: A Response to Jolls, Sunstein and Thaler*, 50 STAN. L. REV. 1577, 1586–90 (1998) (expressing reservations that leading behavioral analysis lacks a coherent theory); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1552 (1998) (complaining that behavioral economics is "antitheoretical"); Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1639–46 (2000) (noting the difficulty of generalizing appropriate legal norms from particular behavioral studies).

9. *See infra* notes 472–85 and accompanying text.

10. *See, e.g.*, Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1517–18 (1997) (discussing numerous limitations in a regime with exchanges as regulators, including that exchanges will not always have optimal motivation to sanction violations).

11. *See, e.g.*, Lucian A. Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1199 (1999) (arguing that in the area of tender offer defenses, competitive federalism has created a "race to the bottom"); James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1201 (1999) (arguing that regulatory competition naturally leads to a "race to the bottom"); *see also* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1338–39 (1999) (arguing that competitive federalism will decrease U.S. economic welfare). Romano has responded to Fox, who issued a rejoinder. *See generally* ROBERTA ROMANO, THE NEED FOR COMPETITION IN INTERNATIONAL SECURITIES REGULATION (Yale Int'l Ctr. for Fin., Working Paper No. 00-49, 2001) (on file with the *Duke Law Journal*) (arguing that the absence of a uniform international regulatory scheme benefits investors because it allows for competition between competing regimes, and that there is no

regulation proposal because as of this writing it has not been challenged seriously;[12] due to its grounding in traditional law and economics thinking, it might be the proposal that conservative legislators interested in securities reform would find the most appealing; and its premises are starkly inconsistent with recent behavioral insights arising from scholarship in behavioral economics, behavioral finance, behavioral psychology, decision theory, and related fields. New behavioral insights in these disciplines have prompted Professor Stephen Bainbridge to note that "[f]or corporate and securities law scholars, behavioral economics probably is the most exciting intellectual development of the last decade."[13]

The basic points I make are relevant to any proposal regarding the future of securities regulation, but much of my attention focuses on Professor Choi's bold notion of moving the locus of regulation from securities market professionals to investors—from its potential fraud perpetrators to its potential fraud victims.[14] Investor regulation is consistent with a large body of economic thinking that assumes private contracting is universally superior to government regulation.[15]

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evidence supporting the view that greater competition would lead to a "race to the bottom"); MERRITT B. FOX, THE ISSUER CHOICE DEBATE (Olin Ctr. for Law & Econ., Working Paper No. 01-007, 2001) (on file with the *Duke Law Journal*) ("If Professor Romano is serious . . . she should engage in a serious attempt to show that despite the market failure inherent in issuer choice, there is inevitably an even greater failure in the regulatory response.").

12. Professor Edmund Kitch expresses some mild reservations about Choi's plan, especially the logistics of testing investors' knowledge and sophistication. Edmund W. Kitch, *Proposals for Reform of Securities Regulation: An Overview*, 41 VA. J. INT'L L. 629, 641 (2001).

13. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1058–59 (2000) (advocating caution in assessing behavioralism's usefulness in generating policy prescriptions); *see also* JENNIFER ARLEN ET AL., ENDOWMENT EFFECTS WITHIN CORPORATE AGENCY RELATIONSHIPS 1 (Univ. of S. Cal., Ctr. in Law, Econ., & Org., Research Paper No. C01-1, 2001) (on file with the *Duke Law Journal*) (noting the ascension of behavioral law and economics research in legal scholarship in recent years).

14. This bold plan could be viewed as akin to proposing that the Food and Drug Administration regulate not the drug companies that produce drugs but the patients who consume them, or that consumers be given the option to pay less for food in exchange for promising not to sue producers whose products give them botulism.

Choi asks: "If investor protection is the goal, why not structure regulations directly around investors?" Choi, *supra* note 7, at 282. This is arguably analogous to asking, "If citizen protection is the goal, why not structure criminal laws directly around victims?" and proposing that people be licensed. For example, unless citizens carried a concealed handgun, they would not be allowed to enter certain neighborhoods at certain times of the day and other neighborhoods at any time.

15. *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 157 (1992) (arguing that private dispute resolution in the diamond industry is more efficient than use of the legal system); Jonathan R. Macey, *Public and Private Ordering and the Production of Legitimate and Illegitimate Legal*

This contractarian approach has long been ascendant in academia, but Professor John C. Coffee notes that a "paradigm shift is now underway in the manner in which financial economics views corporate governance, with the new scholarship emphasizing both the centrality of legal protections [such as insider trading regulation] for minority shareholders and the possibility that regulation can outperform private contracting."[16] This Article presents the empirical research and provides behavioral analysis supporting this paradigm shift.

Specifically, Part I briefly summarizes the essential elements of Professor Choi's investor regulation proposal. Part II uses behavioral research and other analysis to examine critical assumptions underlying investor regulation and some of the other recent proposals. Part III extends the behavioral analysis to examine generally the ability of investors to protect themselves from fraud and inadequate disclosure. Part IV raises several potential problems that likely would be caused by investor regulation and the other recent proposals for dramatic securities law reform.

I. INVESTOR REGULATION

Professor Choi's proposed investor regulation model is motivated by his conclusion that the current system of regulating securities professionals indirectly and unnecessarily regulates investors themselves.[17] As an example of problems with the current system, Choi notes that because of the 1933 Act's registration system, investors wishing to buy the stock of a company that chooses not to go public must "participate in a far more restrictive private placement of securities."[18] Similarly, he notes that because exchanges, broker-dealers, and investment advisers must register with a national securities association or with the SEC, "[i]nvestors are effectively prohibited from

Rules, 82 CORNELL L. REV. 1123, 1140 (1997) ("[E]ven in legitimate, democratic regimes[,] private ordering generates substantive legal principles that are superior to those that the state produces.").

16. John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 2 (1999).

17. Choi, *supra* note 7, at 280–83.

18. *Id.* at 281. Although this statement is generally accurate (yet an average individual investor might well be able to buy such stock through a Regulation A offering, a Regulation D offering, or through Rule 144), it turns out that Choi's system is in many ways even more restrictive. An average individual investor under Choi's proposal could not buy this stock either but is instead limited to buying stock in passive mutual funds. *Id.* at 300–01.

receiving advice from the intermediary of their choice without obtaining regulatory approval."[19]

Choi joins Romano, Mahoney, and other commentators who also are naturally concerned with the cost and inefficiency of government regulation.[20] He believes that the market can sort itself out without governmental intervention, and that well-informed investors need no governmental protection:

> [*R*]*egulation of any sort may be unnecessary for rational investors with good information on the risks and returns offered through particular issuers*. These investors will price privately-supplied investor protections, paying more for securities from issuers offering valued protections. Market participants, in turn, will have an incentive to adopt investor safeguards to the extent the increase in the amount investors are willing to pay exceeds the cost of the protections. The same incentive exists for all securities market participants that deal with rational investors, including issuers, broker-dealers, mutual funds, and exchanges. Although different participants pose varying risks to investors, rational investors can price these risks accordingly in their investment decisions. Thus, there is a strong argument for

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19. *Id.* at 282. Choi overstates this point slightly. He makes it sound as if investors choose with whom they wish to deal and then the SEC must pass "yea" or "nay" on that selection when, in fact, thousands of broker-dealers and investment advisers are registered under the system and investors may choose to deal with any one of them without consulting the SEC. Under Choi's scheme, however, many individual investors will not be able to choose the broker-dealers of their choice, but will be limited to dealing with prominent ones that the government deems to be of high visibility. *Id.* at 296–302. Thus, Choi actually reduces rather than increases freedom of choice for a wide range of investors.

20. *Id.* at 331; *see supra* notes 4–6 and accompanying text. Choi is also concerned with "regulatory capture." Choi, *supra* note 7, at 294. This should not be a serious concern. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET xv (rev. ed. 1995) ("Few have suggested seriously that the SEC has been a 'captive' of the industries it regulates. . . . [S]uch a suggestion cannot be sustained by a reasonable reading of the Commission's history."); *see also* Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435, 436 (1991) (noting that "capture has not seemed to be theoretically or empirically fertile to many sociologists and political scientists working in the regulation literature"); John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 543 (2001) (noting that the SEC's responsiveness and resistance to bureaucratic inertia means that it "remains a highly respected government agency, even among political constituencies otherwise inclined to doubt the value or abilities of government regulators"); David B. Spence, *The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Environmental Law*, 819 CAL. L. REV. 917, 961 (2001) ("The most important defect of capture theory is that it is unsupported by the evidence."); David B. Spence & Frank Cross, *A Public Choice Case for the Administrative State*, 89 GEO. L.J. 97, 122–23 (2000) (debunking agency capture theory generally).

> removing the many layers of regulation from market participants that deal with these investors.[21]

Choi's proposal deregulates issuers, and apparently stock exchanges, broker-dealers, investment advisers, and other securities professionals.[22] Only investors will be regulated. Most churning, touting, front-running, insider trading, parking, manipulating, concealing information, outright lying, and other forms of securities fraud apparently become perfectly legal.[23] Choi expects investors, within certain constraints, to protect themselves by contracting for the level of investor protection they desire from issuers, stockbrokers, and others. All forms of wrongdoing essentially become matters of contract law.

Believing that many investors do not have good information on issuers in the marketplace, Choi proposes a scheme that recognizes four categories of investors based on their level of knowledge.[24] He then proposes to restrict their freedom to invest to the extent necessary to prevent the various categories from harming themselves by their lack of information.[25]

Rather than regulating issuers, exchanges, or securities professionals,[26] Choi's proposal regulates the market's more than sixty-five million investors who, under one version of Choi's plan,[27] must take a

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21. Choi, *supra* note 7, at 282–83 (emphasis added).

22. *See id.* at 285 (proposing no regulations in either primary offerings or secondary market transactions for "issuer-level investors"). Although Choi focuses only on deregulating issuers, the logic of his proposal and his notion to regulate investors indicates that he would deregulate other securities actors as well.

23. Choi allows that "[w]here the market is unable to fully internalize third-party effects even under [his scheme of] investor regulation, *some mandatory regulatory response may be necessary*." *Id.* at 325 (emphasis added). It is unclear in exactly what circumstances such regulations would be allowed. The statement follows a discussion of apparently salutary regulations that the SEC instituted to improve price transparency, liquidity, competition, and price stability in trading activity. *Id.* at 319–23. Investor regulation appears to allow the SEC to continue to work toward these ends and to regulate manipulation that affects third parties. Although Choi suggests that such regulation be "based on the risk presented to third parties," *id.* at 325, he is extremely vague regarding its scope.

24. *Id.* at 284.

25. *Id.* at 300–02.

26. *Id.* at 283 (suggesting that the focus of regulation be placed upon investors rather than "issuers or intermediaries").

27. Choi proposes either (a) mandatory licensing, which I discuss; (b) voluntary self-selection under which investors could just choose whether they wished to be treated as sophisticated or unsophisticated investors; or (c) some hybrid of the two. *Id.* at 310–19.

test (drafted, administered, and graded by the SEC) to demonstrate that they are qualified to invest.[28]

Choi deems investors whose test results indicate that they lack the information or expertise to make value-maximizing decisions in the marketplace to be *unsophisticated investors*.[29] Think of them as the market's D students.[30] Under Choi's scheme, these investors may deal only with "high visibility organizations" (HVOs), or HVO-sanctioned market participants.[31] Two types of entities would qualify for regulatory treatment as HVOs. First are organizations aggregating the interests of several intermediaries, such as the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the American Stock Exchange (AMEX).[32] Second are certain high-visibility individual intermediaries, such as Charles Schwab and Merrill Lynch.[33] Unsophisticated investors must deal through these intermediaries and are limited further in that they may invest only in passive index mutual funds supplied by the HVOs.[34] Choi reasons that limiting unsophisticated investors' options in this fashion protects them from the informational asymmetries that disadvantage them in the market.[35]

Other investors will do better on Choi's exam, demonstrating that they have good information about HVOs' reputation and investor protections, even though they might lack information on the reputation and investor protections provided by issuers or other low-profile intermediaries. These investors, whom Choi calls "aggregate-level investors,"[36] are the market's C students. They are free to buy all instruments (not just passive mutual funds) that HVOs offer.[37] They cannot buy through non-HVOs in either the primary or secondary markets,[38] although how this limitation will be enforced is unclear. Market participants who wish to sell to the market's C students, then,

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28. *Id.* at 310–13.

29. *Id.* at 300–02, 310–13.

30. There are no F students in Choi's system.

31. *Id.* at 300.

32. *Id.* at 297.

33. *Id.* at 297–98.

34. *Id.* at 301.

35. *See id.* at 301–02 (noting that the passive nature of index funds keeps informational asymmetries "at a minimum").

36. *Id.* at 296.

37. *Id.* at 299.

38. *See id.* ("[A]ggregate-level investors would be required to go to an HVO for all securities transactions, whether primary- or secondary-market-related.").

must work through HVOs, giving HVOs the ability to impose private regulatory constraints to replace the SEC's current rules and regulations. Choi envisions that an HVO, such as the NYSE, might choose to adopt a self-tailored regulatory system in which it grants itself subpoena powers, provides for criminal penalties,[39] and punishes nonmember parties who use NYSE facilities to manipulate the market.

Investors earn a B on the government's exam by demonstrating that although they lack sufficient issuer-level information to protect themselves fully in their investment decisions, they have knowledge about a range of securities-market intermediaries.[40] These "intermediary-level investors" may deal through non-HVOs, such as Ameritrade.[41] Choi reasons that Ameritrade could, in its own discretion, provide various contractual warranties to assure the market's B students of the suitability of their investments.[42] Thus intermediary-level investors might buy Alpha Corporation stock through Ameritrade not because they know anything about Alpha Corporation, but because they know about Ameritrade. Such investors could not deal directly with Alpha Corporation without first going through an HVO or non-HVO intermediary.[43]

Choi deems issuer-level investors to be those investors who ace the government's exam by demonstrating that they are informed about issuer-specific risks and the various types of investor protections that issuers may adopt.[44] They then may deal directly with issuers, contracting for whatever level of risk and antifraud protection they desire.[45] Issuer-level investors need not go through intermediaries, although, of course, they may choose to do so. Choi reasons that an A student will be willing to pay more for an issuer's shares if that issuer warrants not to defraud her.[46] Therefore, issuers will have an incentive to coordinate with other market participants to "serve[] the interests of all investors."[47] Choi prophesies that issuers will either

39. It is unclear how a private entity can constitutionally command criminal law in this manner.

40. *Id.* at 290.

41. *Id.* at 291.

42. *Id.*

43. *See id.* at 292 (noting that issuers would face the choice of either dealing with "issuer-level investors" or with "intermediary-level investors associated with an intermediary").

44. *Id.* at 285.

45. *Id.*

46. *Id.*

47. *Id.*

self-regulate or select the level of public regulation to which they will be subject ("self-tailored regulation").[48] Issuers may set their liability standard as one of negligence or strict liability.[49] They may choose to face antifraud or criminal liability.[50] They instead simply may choose to do away with private antifraud liability, negligence liability, and, presumably, contract liability.[51] All things are possible for Choi's unregulated market participants when they deal with issuer-level investors.[52]

Importantly, Choi provides "a presumption of issuer-level status"[53] for investors in companies trading on efficient markets. Therefore, even unsophisticated investors presumably can continue to purchase IBM stock.[54]

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48. *Id*.

49. *Id.* at 287.

50. *Id*. Again, the constitutionality and practicality of a system whereby individuals and firms contractually opt in and out of the jurisdiction of the criminal justice system at will is questionable, but beyond this Article's scope.

51. *See id.* at 288 ("[I]ssuers that desire to defraud investors may abuse self-tailored regulation and simply opt out of any liability."). Presumably Choi's plan preempts state statutory regulation and common law liability. Otherwise, it would accomplish none of its goals.

52. *See id.* at 286 ("In a world with full information and without transaction costs, issuers and investors could costlessly specify and enforce contracts that allocate every possible risk between the issuer and the investor."). In discussing the licensing aspect of investor regulation, Choi compares investors to pilots who are licensed by the Federal Aviation Administration (FAA). *Id.* at 312. But the investors are more like passengers on a commercial airliner. It is certainly possible that the FAA does not always strike the perfect balance between cost and safety; many passengers may pay more for their airline tickets than they would choose to pay if they were completely rational and bargaining with full information. Choi's logic would suggest that (a) airline safety be deregulated, (b) passengers negotiate with airlines to pay for just the level of safety they desire, and (c) competition (hopefully) would lead to a race to the top rather than a race to the bottom. Although the events of September 11, 2001, make this deregulation unthinkable, consider a brief thought experiment. Choi's logic suggests that passengers take a test regarding aerodynamics and airplane safety procedures. Presumably those who flunked simply would have to take a train. Those who passed could select Delta over TWA if they were risk-seeking, and Delta could cut thirty dollars from the price of a plane ticket by laying off mechanics. But one might legitimately wonder whether passengers could ever truly have the information and rational decisionmaking capacity to bargain efficiently in this context—to know exactly what increase in the chance of accident they were incurring in exchange for their thirty dollars in savings. Because of the horrific nature of an airplane crash, at least potential air travelers have better information upon which to base such a decision than investors who operate in a world in which most securities frauds are not even detected by the fraudulent issuer's independent auditors who are on the job year after year. In this realm, can investors—even sophisticated investors—ever truly be able to intelligently bargain for less disclosure and less fraud protection and know exactly what price discount they should demand in return?

53. *Id.* at 302.

54. To summarize, "issuer-level investors" (A students) (and all investors in efficient markets) can deal with all issuers and through all intermediaries and HVOs. "Intermediary-level

II. ASSUMPTIONS UNDERLYING INVESTOR REGULATION

Before examining some of Choi's key assumptions about investor regulation, I must clarify just a bit. Because of the wide range of choices that Choi's proposal allows, I must specify which version of his plan I address.[55] For example, under Choi's proposal, an issuer could completely deregulate itself by offering no protection for investors whatsoever. On the other hand, it could opt into a regime that carried all the current protections (or more), complete with SEC and Department of Justice (DOJ) enforcement. Brokers, exchanges, and other actors could do the same. *If* issuers and brokers opt into a relatively full measure of public regulation, then investor regulation really would not accomplish much. It would not save any money or create any meaningful efficiencies. Issuers, for example, would continue to bear the expense of full disclosure and antifraud liability.

Choi stresses that due to the self-tailored nature of his plan, market participants would have lots of flexibility.[56] He suggests, for example, that issuers could choose to subject themselves to antifraud liability, but with fee shifting and a ban on class actions.[57] However, if the changes that investor regulation brings are this minor, clearly it would be superior simply to continue tinkering with the current system with more laws—like the Private Securities Litigation Reform Act of 1995,[58] the National Securities Markets Improvement Act of

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investors" (B students) can deal with all intermediaries and HVOs, but only with issuers that are associated with intermediaries or HVOs. "Aggregate-level investors" (C students) can deal only with issuers and intermediaries associated with HVOs. And, finally, "unsophisticated investors" (D students) can deal only through HVOs and intermediaries associated with them and even then can buy only passive index funds.

55. The great flexibility in investor regulation makes it difficult to criticize with certainty. On the one hand, Choi clearly dislikes current public regulation of the securities markets. On the other hand, he realizes that absence of regulation could create huge problems, so he frequently falls back to the option of allowing issuers or brokers to opt into public regulation if that is what investors really want. By this approach, Choi simultaneously can claim the advantages of deregulation *and* the advantages of regulation. One has to be an illusion; either deregulation will not occur to any great extent because the market participants will opt into public or private regulation that mimics public regulation, or real deregulation will occur and the comfort of a backstop system of public regulation will not exist.

56. *Id.* at 285–88 ("Where public regulatory bodies have a comparative advantage in remedying certain private market defects, market participants may decide for themselves their level of public liability and enforcement.").

57. *Id.* at 288.

58. Pub. L. No. 104-67, 109 Stat. 737 (codified as additions and amendments to 15 U.S.C. §§ 77–78 and 18 U.S.C. § 1964 (2000)).

1996,[59] and the Securities Litigation Uniform Standards Act of 1998[60]—and more rule changes, such as the proposed Aircraft Carrier.[61] It makes little sense to scrap an entire regime of regulation if the unregulated parties simply opt back into a pale version of the original.

Therefore, in discussing investor regulation, I assume that Choi's proposal truly does bring substantial change—that issuers and other market participants take advantage of the options it presents to reduce dramatically the level of public regulation that currently exists.

A. Market Efficiency

Most of the academic reformers assume that the stock market is naturally efficient.[62] This is largely true, of course, but there is overwhelming evidence that its efficiency is substantially bounded.[63] One cause of inefficiency stems from investors' actions that do not fit the rational-man model of economic hypothesizing,[64] creating "noise" in

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59. Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C.).

60. Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

61. The Regulation of Securities Offerings, Securities Act Release No. 33-7606A, 63 Fed. Reg. 67,174 (Dec. 4, 1998).

62. Choi, *supra* note 7, at 302–03 (describing the various forms of efficient markets); Romano, *supra* note 6, at 2366 n.17 (arguing that markets are generally efficient due to the equalizing presence of informed investors and arbitrageurs, but admitting that unsophisticated investors are unprotected against broker fraud).

63. *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT TERM GAIN AND THE ABSENTEE SHAREHOLDER 49–55 (1988) (citing several studies rejecting or limiting the efficient market hypothesis); HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 88 (2000) ("The weight of the evidence—the success of value investing over the long term, post-earnings-announcement drift, and post-recommendation drift—all go against market efficiency."); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 171–90 (2000) [hereinafter SHILLER, IRRATIONAL EXUBERANCE] (pointing out various holes in the efficient market hypothesis while admitting that it is "approximately true"); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 1–27 (2000) (challenging the efficient market hypothesis); LAWRENCE A. CUNNINGHAM, BEHAVIORAL FINANCE AND INVESTOR GOVERNANCE 6 (Cardozo Law Sch., Working Paper No. 32, 2001) (on file with *Duke Law Journal*) (arguing that "the [efficient market hypothesis] has always suffered from theoretical and empirical limitations or exceptions, which of late have gone to consume it"); ROBERT J. SHILLER, BUBBLES, HUMAN JUDGMENT, AND EXPERT OPINION 11 (Cowles Found., Discussion Paper No. 1303, 2001) [hereinafter SHILLER, BUBBLES] (on file with the *Duke Law Journal*) ("[I]f one looks at data over long intervals of time, it appears that the stock market is anything but efficient."); Jeff Madrick, *Market Messes Happen. And Inefficiencies Have Consequences.*, N.Y. TIMES, Aug. 3, 2000, at C2 ("A growing number [of economists] argue that according to the best new evidence, financial markets do not appear all that efficient after all.").

64. *See, e.g.*, WILLIAM J. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 51 (1965) (noting that stock prices are based on "traders' fortuitous hunches and perhaps little

the financial markets.[65] Professor Richard Thaler and several colleagues catalogue numerous "anomalies" that are inconsistent with the efficient market hypothesis.[66] Empirical analyses show, for example, that nice weather tends to make people feel better and their upbeat mood translates into higher daily stock returns,[67] making it diffi-

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else"); JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 153–57 (1936) (noting that stock prices are often the result of "mass psychology"); LARS TVEDE, THE PSYCHOLOGY OF FINANCE 18 (1999) (noting that, because the market can "be subjective, emotional and ruled by the whim of changing trends," it can be argued that "investors' attempts to be rational can therefore actually be irrational behavior"); Kenneth J. Arrow, *Risk Perception in Psychology and Economics*, 20 ECON. INQUIRY 1, 7–8 (1982) (concluding that psychological models of "irrational" decisionmaking can help explain pricing in speculative markets); Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591, 592 (1986) (stating that "existing evidence does not establish that financial markets are efficient in the sense of rationally reflecting fundamentals").

65. *See* Fischer Black, *Noise*, 41 J. FIN. 529, 530 (1986) ("Noise makes financial markets possible, but also makes them imperfect."); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 703 (1990) (contending that asset "prices can diverge significantly from fundamental values"); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 917 (1992) ("Both the behavioralist critique and noise theory call into question some of the first principles underlying [efficient market] models."); Hersh Shefrin & Meir Statman, *Behavioral Capital Asset Pricing Theory*, 29 J. FIN. & QUANTITATIVE ANALYSIS 323, 345–46 (1994) (discussing how behavioral factors can create noise during trading that disrupts efficient market trading).

66. *See* BRUCE I. JACOBS, CAPITAL IDEAS AND MARKET REALITIES: OPTION REPLICATION, INVESTOR BEHAVIOR, AND STOCK MARKET CRASHES 87 (1999) ("A growing body of literature investigating the role of investor psychology in stock pricing suggests that individual investors share common cognitive defects that may cause them to err in the same direction . . . ."); RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE (1992) (explaining anomalies that include the winner's curse, the endowment effect, loss aversion, the status quo bias, mental accounting, and preference reversals); Kent Daniel et al., *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839, 1865 (1998) (noting that "[e]mpirical securities markets research in the last three decades has presented a body of evidence with systematic patterns that are not easy to explain with rational asset pricing models," and proposing a new model taking into account investor overconfidence, self-attribution, and other biases); Daniel Kahneman & Mark W. Riepe, *Aspects of Investor Psychology*, J. PORTFOLIO MGMT., Summer 1998, at 52, 53–63 (cataloguing a large number of cognitive illusions that affect even the decisionmaking of professional investors); Jayendu Patel et al., *The Rationality Struggle: Illustrations from Financial Markets*, 81 AM. ECON. ASS'N PAPERS & PROC. 232, 233–35 (1991) (using behavioral analysis to explain herding behavior and other market inefficiencies); Allen M. Poteshman, *Underreaction, Overreaction, and Increasing Misreaction to Information in the Options Market*, 56 J. FIN. 851, 875 (2001) (finding inefficiencies in options markets consistent with behavioral theories). *See generally* ADVANCES IN BEHAVIORAL FINANCE (Richard Thaler ed., 1993) (collecting numerous articles showing how behavioral research undermines the efficient market hypothesis).

67. David Hirshleifer & Tyler Shumway, Good Day Sunshine: Stock Returns and the Weather 16–18 (Mar. 28, 2001) (unpublished manuscript, on file with the *Duke Law Journal*). Another recent study found that lunar cycles also affect people's moods and, consequently, their stock market behavior. *See* Alison Beard, *Moonstruck Stock Investors Find Another Reason to Howl*, FIN. TIMES, Jan. 10, 2002, at 25 (reporting on a University of Michigan Business School

cult to deny that psychological effects play an important role in the stock markets. In his recent widely publicized book, Professor Robert Shiller notes:

> The market level does not, as so many imagine, represent the consensus judgment of experts who have carefully weighed the long-term evidence. The [current] market is high because of the combined effect of indifferent thinking by millions of people, very few of whom feel the need to perform careful research on the long-term investment value of the aggregate stock market, and who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom.[68]

At a macro-level, investor irrationality has, throughout history, helped cause speculative bubbles and panicky crashes.[69] Any proposal

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study finding that "[o]ver a year, the full moon discount amounts to a return difference of between 5.4 and 6.9 per cent.").

68. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 203. As another prominent commentator notes:

> [I]t is difficult to sustain the case that people in general, and investors in particular, are fully rational. At the superficial level, many investors react to irrelevant information in forming their demand for securities; as Fischer Black . . . put it, they trade on noise rather than information. Investors follow the advice of financial gurus, fail to diversify, actively trade stocks and churn their portfolios, sell winning stocks and hold on to losing stocks thereby increasing their tax liabilities, buy and sell actively and expensively managed mutual funds, follow stock price patterns and other popular models. *In short, investors hardly pursue the passive strategies expected of uninformed market participants by the efficient markets theory.*

SHLEIFER, *supra* note 63, at 10 (emphasis added).

69. *See, e.g.*, EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION 345 (1999) (explicating in detail several of the great bubbles throughout history, and noting that "speculative euphoria" can drive share prices above their intrinsic value); CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES 28 (1978) ("Manias and panics . . . are associated on occasion with general irrationality or mob psychology."); LOWENSTEIN, *supra* note 63, at 33 ("[A]s various academic studies have subsequently shown, the market tends to extremes. Euphoria and despair are as much the faces of the market as objective analysis."); TVEDE, *supra* note 64, at 46 ("[T]he market from time to time gets completely dominated by such irrational emotions as hope, greed and fear."); David M. Cutler et al., *What Moves Stock Prices?*, J. PORTFOLIO MGMT., Spring 1989, at 4, 9–11 (finding no fundamental economic news to cause the dramatic stock market crash of October 1987); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 755–57 (2000) (discussing cognitive errors as causes of stock market crashes).

Professor Peter Garber argues that the famous tulip mania of 1636–37 was not truly a bubble; its causes just have not been understood before. PETER M. GARBER, FAMOUS FIRST BUBBLES: THE FUNDAMENTALS OF EARLY MANIAS 126 (2000). But Mike Dash makes the "tulipomania" seem a prototypical example of irrational trading leading to a bubble. MIKE DASH, TULIPOMANIA: THE STORY OF THE WORLD'S MOST COVETED FLOWER & THE EXTRAORDINARY PASSIONS IT AROUSED 158–64 (1999).

to completely restructure securities market regulation should pay less obeisance to simplifying assumptions of traditional economic reasoning and more attention to that reasoning's limitations than Choi's proposal does.

B. Optimal, Voluntary Issuer Disclosure

If sophisticated investors are insufficiently attentive to matters of issuer disclosure and issuers are insufficiently motivated to voluntarily disclose accurate financial information, Choi's proposal might well create a market reminiscent of that of the 1920s, when fifty percent of all newly issued stocks were worthless.[70] Choi would not want that, but he believes that investors will tend to value accurate disclosure and adequate remedies. Choi thinks that his plan incentivizes market participants to give investors what they want.

Unfortunately, Choi seems to anthropomorphize issuers as a single entity that rationally decides what is in its best interests in terms of long-term disclosure.[71] In so doing, he assumes both that issuers and their managers are rational and that it is in their rational best interests to provide full and accurate disclosure of an optimal amount of information and to refrain from careless and fraudulent acts. Substantial behavioral evidence undermines these assumptions.[72]

Garber also attempts to rationalize the John Law Mississippi bubble, GARBER, *supra*, at 91–107, but, again, a detailed examination of the event makes it seem far from rational. TVEDE, *supra* note 64, at 39–40.

70. Donald A. Ritchie, *The Pecora Wall Street Exposé, 1934*, *in* 4 CONGRESS INVESTIGATES: A DOCUMENTED HISTORY, 1792–1974, at 2555–56 (Arthur M. Schlesinger, Jr. & Richard Burns eds., 1975).

71. Choi had earlier proposed a system of issuer choice regarding disclosure of financial information. Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 228–33 (1996); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 917 (1998). For some insightful criticism of these proposals, see Partnoy, *supra* note 69, at 793–800.

72. Professor Merritt Fox notes that it is the issuer's managers who will make the decision whether or not to disclose, and therefore it is their incentives, and not the hypothetical best interests of the firm as an entity, that must be considered. Fox, *supra* note 11, at 1343. Professor Donald Langevoort notes that "[t]here is ample reason to believe that these [disclosure] decisions [made by managers] often diverge from what would be optimal in the long run from the issuer's perspective." Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 54 (Summer 2000).

1. *Are Individuals and Organizations Rational?*

a. Individuals. Conventional law and economics assumes that individuals are rational, self-interested utility maximizers.[73] However, as Professors Jennifer Arlen, Matthew Spitzer, and Eric Talley note, "a substantial (and growing) body of experimental and empirical evidence suggests that people's behavior deviates from [the] traditional account, often in systematic ways."[74] I explored much of that evidence in some detail in an earlier article[75] and will not repeat that explication here.[76] Suffice it to say that virtually everyone now recognizes that there is a large gap between the manner in which economists traditionally assume that people think and act, and the manner in which people actually do think and act.[77] Assuming individual rationality is a dangerous simplification.[78]

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73. *See* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 750–51 (1990) (summarizing core assumptions of the standard model); W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 RUTGERS L. REV. 625, 636 (1996) ("The foundation of economic analysis of choice is based on the rationality of individual decision making.").

74. ARLEN ET AL., *supra* note 13, at 9; *see also* JACOB JACOBY, IS IT RATIONAL TO ASSUME CONSUMER RATIONALITY? SOME CONSUMER PSYCHOLOGICAL PERSPECTIVES ON RATIONAL CHOICE THEORY 2–3 (N.Y. Univ. Ctr. for Law & Bus., Working Paper #CLB-00-009, 2000) (on file with *Duke Law Journal*) ("Virtually without exception, those familiar with the extensive scholarly empirical literature on (individual) consumer behavior would conclude that, as proposed by those contemporary economists and legal theoreticians who espouse it, Rational Choice Theory is a simplistic theory having little correspondence with the real world of (individual) consumer behavior."); Reinhard Selten, *What Is Bounded Rationality?*, *in* BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX 13, 13 (Gerd Gigerenzer & Reinhard Selten eds., 2001) ("Modern mainstream economic theory is largely based on an unrealistic picture of human decision making.").

75. Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 139–81 (2000).

76. However, some of that evidence is in this Article. *See infra* notes 245–57 and accompanying text.

77. *See, e.g.*, R. Duncan Luce & Detlof von Winterfeldt, *What Common Ground Exists for Descriptive, Prescriptive, and Normative Utility Theories?*, 40 MGMT. SCI. 263, 263 (1994) (defending the normative properties of the classic view, but admitting that "[t]here is no doubt that [subjective utility theory] is descriptively wrong"); Paul J.H. Schoemaker, *The Expected Utility Model: Its Variants, Purposes, Evidence, and Limitations*, 20 J. ECON. LIT. 529, 530 (1982) ("[M]ost of the empirical evidence is difficult to reconcile with the principle of [expected utility] maximization.").

78. In simply assuming human rationality in the manner of the traditional economic model, investor regulation risks implementing unrealistic reforms. *See* Anne C. Dailey, *Book Review: Striving for Rationality*, 86 VA. L. REV. 349, 351–52 (2000) (reviewing JONATHAN LEAR, OPEN MINDED: WORKING OUT THE LOGIC OF THE SOUL (1998)) ("I am quite sure the law's resistance to irrationality reveals a deep flaw in its ability to account for, and hence regulate, human behavior.").

b. Organizations. There is also a wide chasm between the way in which traditional economic analysis presumes organizations to act and the way in which organizations actually act. Economists often assume that firms are the proverbial "black box"; they ignore a firm's actual human-oriented decisionmaking processes and simply assume that firms make value-maximizing decisions.[79] Because they act through agents who are not rational and whose interests are often poorly aligned with those of their employers, organizations often do not engage in value-maximizing behavior. Indeed, they are often just a bit of a mess.[80] The entire field of organizational theory exists because organizations have such difficulty acting rationally.[81] There is an extensive management literature indicating that employees' goals often are not well aligned with those of their employers and that various heuristics and biases often prevent employees from maximizing their employers' goals even when they seek to do so.[82]

2. *Is Honest, Full Disclosure Rational?* Even if one accepts the assumption that issuers and their managers are rational, it is important to examine the concomitant assumption that it is irrational for these managers and issuers to do anything other than make full and accurate financial disclosure to the market. Choi's position, for example, is consistent with numerous studies arguing that it is rational for issuers to develop reputations for honesty because such actions reduce long-term capital costs.[83] It similarly is claimed that it would be

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79. *See* ROBERT K. RASMUSSEN, LAWYERS, LAW AND CONTRACT FORMATION 3 (Vanderbilt Univ. Law Sch., Joe C. Davis Working Paper No. 99-16, 2000) (on file with *Duke Law Journal*) (noting that a "standard criticism of economics . . . is that it too often ignores how decisions are made inside a firm").

80. John Freeman, *Efficiency and Rationality in Organizations*, 44 ADMIN. SCI. Q. 163, 164 (1999) ("Foolishness and rational choice exist side by side in every organization."); Robert Gibbons, *Taking Coase Seriously*, 44 ADMIN. SCI. Q. 145, 146 (1999) (noting that "recent economic models of internal organization predict that organizations will be a mess but not a mystery").

81. *See* John Conlisk, *Why Bounded Rationality?*, 34 J. ECON. LIT. 669, 675 (1996) (contending that many economic models "are motivated by anomalies" involving bounded rationality or imperfect information).

82. Prentice, *supra* note 75, at 181–86.

83. *See, e.g.*, Richard Frankel et al., *Discretionary Disclosure and External Financing*, 70 ACCT. REV. 135, 149 (1995) (finding that firms accessing capital markets are more likely to disclose forecasts than those that do not, although not finding that they do so more frequently in the period surrounding an offering); Mark Lang & Russell Lundholm, *Cross-Sectional Determinants of Analyst Ratings of Corporate Disclosures*, 31 J. ACCT. RES. 246, 269 (1993) (finding that firms issuing securities tend to disclose more than firms not issuing securities); Christian Leuz & Robert E. Verrecchia, The Economic Consequences of Increased Disclosure 33 (July 1999) (unpublished manuscript, on file with the *Duke Law Journal*) (finding in a study of German

irrational for a corporate manager to derail a promising individual career by engaging in financial disclosure shenanigans.[84]

And yet, deceptive financial reporting by corporations remains a serious problem.[85] It is not just that full disclosure is made involuntarily;[86] what is disclosed is often inaccurate and/or fraudulent.[87] Financial fraud and "earnings management" are inconsistent with standard

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firms that a switch from the German to a fuller reporting regime, such as in the United States appeared via indirect measures to allow them to "garner economically and statistically significant benefits").

But there is evidence that firms doing well are more liberal with their disclosure than firms doing poorly. Lang & Lundholm, *supra*, at 269; *see also* Baruch Lev & Stephen H. Penman, *Voluntary Forecast Disclosure, Nondisclosure, and Stock Prices*, 28 J. ACCT. RES. 49, 74 (1990) (finding that stock price behavior reflects that "earnings forecasts generally distinguish firms with particularly 'good' annual earnings from other firms"). It seems more likely that they disclose more because they are doing well than that they are doing well because they disclose more.

It does appear that when firms get caught engaging in financial fraud, their capital costs rise. *See* Patricia M. Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 30 (1996) ("[O]ur results are consistent with the firms experiencing a significant increase in their costs of capital following the revelation that their earnings have been overstated.").

84. One study shows that of the companies that were targeted for accounting irregularities by the SEC between 1982 and 1989, seventy-two percent fired or forced resignations of top managers. Ehsan H. Feroz et al., *The Financial and Market Effects of the SEC's Accounting and Auditing Enforcement Releases*, 29 J. ACCT. RES. 107, 108 (1991).

85. *See* Diana B. Henriques, *Business Fraud of the 90's: Falsifying Corporate Data*, N.Y. TIMES, Sept. 21, 1992, at A1 (noting that in the previous year at least twenty widely traded public companies had disclosed serious lapses in their financial reporting); Louis Uchitelle, *Corporate Profits Are Tasty, But Artificially Flavored*, N.Y. TIMES, Mar. 28, 1999, § 3, at 4 (quoting several sources as indicating that gimmicky accounting inflates the reported profits of U.S. corporations).

86. Baruch Lev, *Information Disclosure Strategy*, CAL. MGMT. REV., Summer 1992, at 9, 9 (finding very modest levels of voluntary financial disclosure).

87. There is an estimated $100 billion of fraud in the financial services industry every year. Rachel Witmer, *House Panel Divides on Antifraud Bill over Privacy, Confidentiality, Fairness*, 33 SEC. REG. L. REP. 719, 719 (2001) (citing an estimate of the Financial Services Roundtable). The SEC is bringing record numbers of financial fraud cases. Kip Betz, *SEC Brought 484 Cases in FY 2001; Financial Fraud, Reporting Top Agenda*, BNA SEC. L. DAILY, Dec. 17, 2001, at D4. Earnings management is also a huge problem. John C. Coffee, Jr., The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting 3–4 (May 21, 2001) (unpublished manuscript, on file with the *Duke Law Journal*) (noting the scope of earnings management and explaining limitations that prevent the current audit industry from effectively curbing the practice); *see also* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1091 (1999) (describing a "pervasive run of [securities] fraud, theft, and malfeasance [that has recently] imposed astounding costs upon our economy").

economic assumptions, yet they exist in abundance.[88] And they tend to fool even professional investors.[89] Why is this so?

a. Issuers. Professor Merritt Fox persuasively argues that companies, if left unregulated, will not disclose the socially optimal amount of financial information.[90] His argument is that even if indi-

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88. Accounting fraud by corporations is currently the SEC's "chief priority" and the Commission is filing 100 accounting-related enforcement cases annually. Michael Schroeder, *SEC Increases Accounting-Fraud Probes*, WALL ST. J., Dec. 9, 1998, at B8 (quoting SEC Director of Enforcement Richard Walker).

Michael Young notes:

> The [recent] accounting irregularities to attract the most public attention, of course, were those that surfaced at Cendant Corporation in April 1998, where the announcement of misstated financial results at Cendant's newly acquired CUC International unit led to a $14 billion loss in market capital in just a few hours. But Cendant is far from alone. Highly publicized financial misreporting problems have also surfaced at McKesson, Livent, Mercury Finance, Donnkenny, Rite Aid, Boston Scientific, Informix, Sunbeam, Micro Warehouse, Northstar Health Services, Paracelsus Healthcare, Penguin, Photran, Sensormatic, Thor Industries, BT Office Products, Guildford Mills, Bankers Trust, and Physician Computer Network. And that's just to name a few.
>
> Evidence of an increase in accounting irregularities is more than anecdotal. A series of surveys conducted by PricewaterhouseCoopers shows that claims based on alleged accounting irregularities have increased from 25% of securities claims in 1997 to 49% just two years later. A similar study concluded that between 1992 and 1998, the number of securities lawsuits based on the need to restate audited financial statements increased by 750%. A separate survey of chief financial officers, conducted on a strictly anonymous basis, found that fully two-thirds had recently been subjected to pressure within their companies to misrepresent financial results. According to the survey, 55% had successfully resisted. At the same time, 12% had not.

Michael R. Young, *The Origin of Financial Fraud*, *in* ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD 1, 1 (Michael R. Young ed., 2000).

Management of earnings is also a major SEC priority, as exemplified by its action against W.R. Grace & Co. in 1999. Ann Davis, *SEC and W.R. Grace Are Near Accord over Alleged Earnings Manipulation*, WALL ST. J., June 25, 1999, at B5; *see also* Jonathan Burton, *When Earnings Bear Closer Scrutiny: What Should CEOs Do to Avoid Embarrassing Blow-Ups over Reported Earnings*, CHIEF EXECUTIVE, May 1, 1999, at 46 (quoting Warren Buffett as complaining that "the attitude of disrespect that many executives have today for accurate reporting is a business disgrace"); Carol J. Loomis, *Lies, Damned Lies, and Managed Earnings*, FORTUNE, Aug. 2, 1999, at 74 (giving numerous examples of companies that manipulated earnings).

89. *See* SHLEIFER, *supra* note 63, at 187 (describing studies that show earnings manipulation and studies that show that "[s]uch manipulation appears to work: analysts are excessively optimistic about the earnings potential of recent IPOs and their growth prospects"); Siew Hong Teoh et al., *Earnings Management and the Long-Run Market Performance of Initial Public Offerings*, 53 J. FIN. 1935, 1966 (1998) (finding that issuers manage earnings around IPOs and investors irrationally fixate on these high earnings and are disappointed with subsequent earnings); Siew Hong Teoh et al., *Earnings Management and the Underperformance of Seasoned Equity Offerings*, 50 J. FIN. ECON. 63, 93–94 (1998) (finding the same earnings management and the same irrational investor reaction in seasoned offerings as those associated with IPOs).

90. *See* Fox, *supra* note 11, at 1390 ("[I]ssuer choice would lead U.S. issuers to disclose at a level significantly below . . . [the] social optimum."). Fox notes that even most economists real-

vidual managers' interests are aligned perfectly with their firms' interests, they will disclose suboptimally because disclosure implicates two types of costs. First are operational costs (out-of-pocket expenses, diversion of staff time, etc.). Second, and more critical, are inter-firm costs that can put a disclosing firm at a disadvantage relative to its competitors. For example, if a company discloses that one of its product lines is particularly profitable, its competitors may plunge into that product line. Although operational costs are costs to both the disclosing firm and society, inter-firm costs are imposed only on the disclosing firm.[91]

Others note that although an unregulated world gives some incentive to disclose, especially to firms that are doing well, firms that are doing poorly have less incentive to disclose and their silence, although a signal to the market, is inferior to full information.[92] Professors Anat Admati and Paul Pfleiderer note that, notwithstanding economic theory to the contrary, "[f]ull voluntary disclosure . . . rarely seems to occur in reality, and *firms typically do not disclose more than regulation requires*."[93] There is substantial evidence that

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ize that corporations will not voluntarily choose to disclose sufficient information for the efficient operation of securities markets and therefore side with the notion of government-mandated disclosure. *Id.*; *see also, e.g.*, Frank H. Easterbrook & Daniel P. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 684–85 (1984) (explaining how disclosure rules may reduce information costs). This conclusion is also shared by the Sommer Commission's extensive study. SELIGMAN, *supra* note 20, at 566–67 (finding several grounds to "doubt[] that market forces alone would result in the publication of sufficient, reliable, and timely data"). Substantial evidence indicates that firms generally do not voluntarily disclose socially optimal financial information to signal the market that they are good investments. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 752 (1984) ("Economic logic also points to the conclusion that there will be inadequate securities research and verification in the absence of a mandatory disclosure system."); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 5–9 (1983) (arguing, based on historical evidence, that corporations will not voluntarily disclose sufficient information).

91. As Fox explains:

> [Inter-firm costs] are not social costs because the inter-firm disadvantages to the issuer from the disclosure are counterbalanced by the advantages disclosure confers on the other firms. Thus, at all levels of disclosure, an issuer's private marginal costs will exceed its social marginal cost by an amount equal to these inter-firm costs. Even managers who completely identify with existing shareholders—managers who seek to maximize share value so that costs to the shareholders are equivalent to costs to them—would therefore choose a regime with a disclosure level below the social optimum.

Fox, *supra* note 11, at 1345–46.

92. *Id.* at 1361–62.

93. ANAT R. ADMATI & PAUL PFLEIDERER, FORCING FIRMS TO TALK: FINANCIAL DISCLOSURE REGULATION AND EXTERNALITIES 2 (Stanford Graduate Sch. of Bus., Working

voluntary corporate disclosure was seriously inadequate before passage of the 1933 Securities Act and the 1934 Securities Exchange Act,[94] and that these Acts created important improvements over pre-

Paper, 1998) (emphasis added) (on file with *Duke Law Journal*) (arguing that although there is a role for government regulation in disclosure policy, "getting it right" can be difficult); *see also* RAY BALL ET AL., INCENTIVES VERSUS STANDARDS: PROPERTIES OF ACCOUNTING INCOME IN FOUR EAST ASIAN COUNTRIES AND IMPLICATIONS FOR ACCEPTANCE OF IAAS 27 (Univ. of Rochester, Working Paper No. FR 00-04, 2000) (on file with the *Duke Law Journal*) (finding in a study of four Asian nations that incentives to disclose, such as liability, are much more important to creating financial transparency than adoption of high-quality accounting standards).

Palmiter argues that in some private placements, issuers often disclose the same information that is typically disclosed in full prospectuses. Alan R. Palmiter, *Toward Disclosure Choice in Securities Regulation*, 1999 COLUM. BUS. L. REV. 1, 21. The main reason is the same reason that summary prospectuses allowed under SEC Rule 431, 17 C.F.R. § 230.431 (2001), are seldom used, and it relates to the status quo bias. *See infra* notes 410–25 and accompanying text. Institutional investors are used to the disclosure format and content of the full-fledged, SEC-mandated prospectus. That is the status quo, and it affects all other disclosure. Once the status quo is changed and the disclosure bar is lowered, ripple effects likely will reduce disclosure broadly.

Other examples that Palmiter gives undermine his point on voluntary disclosure. For example, he notes that over-the-counter (OTC) issuers often provided ongoing periodic disclosure on the same basis as listed issuers even before they were required to do so in 1964. Palmiter, *supra*, at 22. But obviously, these OTC companies simply were trying to appear to be as reputable as the listed companies. Take away the required disclosure of the listed companies, and it is unlikely that either the listed companies or the OTC companies would have voluntarily disclosed nearly as much. Palmiter also notes that Daimler-Benz chose to list on the New York Stock Exchange and disclose in accordance with SEC standards in 1993 to gain access to the U.S. capital markets and that foreign issuers whose American Depository Receipts (ADRs) trade in the United States often list on U.S. exchanges to "move into a new capitalist league." Palmiter, *supra*, at 23. These observations also seem to undermine Palmiter's point. The issuers did not *voluntarily* disclose more than they had to disclose; only when they felt they needed to access U.S. capital did they make the decision to disclose the required information necessary to do so. Voluntary disclosure in many European countries remains limited because legal requirements are lacking. *See* Neal E. Boudette, *Muppet Meltdown: After Buying Kermit and Pals, Firm Finds It Isn't Easy Seeing Green*, WALL ST. J., Jan. 18, 2001, at A1 (quoting London analyst Alan Howard as saying that "[i]t's a Wild West market in Germany").

94. The best history of accounting in the United States that has been written points out how spotty voluntary corporate disclosure was before 1933. Previts and Merino note that "balance sheet secrecy was a distinctive characteristic of financial statement disclosure by railroads" in the late 1800s and that Westinghouse issued no annual financial statements between 1897 and 1905. GARY J. PREVITS & BARBARA D. MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES 117 (2d ed. 1998). When audits did happen to be done on a company's books, "[t]wo out of three new audit engagements during the 1890s were likely to reveal defalcations." *Id.* at 135. Several factors finally improved disclosure somewhat, including not so much the reputational effects of economic theory but more the demands of regulatory agencies such as the Interstate Commerce Commission. *Id.* at 126, 131, 185 (listing threats of additional regulation by government agencies and financial exchanges). When Congress created the Industrial Commission to study combinations in restraint of trade and that commission expressed serious concerns about deception of investors "either through suppression of material facts or by making misleading statements," corporations realized that "[v]oluntary disclosure offered a seemingly vi-

vious practices and thereby improved market efficiency.[95] In his comprehensive history of federal securities regulation, Professor Joel Seligman notes that several SEC and academic studies indicate that mandatory disclosure provisions of the 1933 and 1934 Acts reduced underwriter costs and that the disclosure programs increased investor

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able means of avoiding fundamental structural changes." *Id.* at 185–86. The voluntary disclosure that did occur likely helped corporations avoid passage of a federal incorporation statute that was repeatedly proposed in Congress between 1903 and 1930. *Id.*

Initially, the SEC did not regulate the most important document to shareholders—the annual report to stockholders. Absent SEC requirements, corporate reporting to shareholders remained pitifully inadequate:

> Reports to stockholders, whether judged by the standards set by the SEC or by one's own lights, seem very inadequate. On vital counts, investors are left conjecturing—sales, cost of sales, depreciation, inventories and surplus generally are so inadequately described that an investor does not have a minimum of information upon which to form an intelligent opinion on buying and selling. The seventy corporations included in this study represent the best in American reporting practice—yet their accounting to stockholders falls far short of the minimum requirements which these very corporations must meet in their reports to the SEC.

Maurice C. Kaplan & Daniel M. Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 YALE L.J. 935, 978 (1939); *see also* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 318–19 (1932) (noting the inadequacy of contemporary corporate disclosure).

95. *See* Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 311–13 (1989) (finding lower price variance for new shares issued after the 1933 Act than those new shares issued before); George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 727 (1964) (noting lower variance in stock price ratios after the formation of the SEC than in the 1920s).

George Benston performed a similar study of the 1934 Act. George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973). Benston's study is flawed, being based on some erroneous factual assumptions. As Seligman has pointed out:

> Several economists have criticized the appropriateness of Benston's studies, the quality of his research designs, and his analysis of his empirical findings. The economists, however, generally ignored the rather glaring deficiencies of Benston's historical research. In particular, Benston's suggestion that there was little securities fraud before 1934 was ludicrous. His "search of the available literature" apparently did not lead him to read of a single enforcement action brought by any of the forty-seven states that enacted blue sky securities regulation laws between 1911 and 1933. Yet in the year 1932, the State of New York alone secured injunctions against 1522 persons and firms and instituted 146 criminal prosecutions.

SELIGMAN, *supra* note 20, at 564–65 (footnote omitted).

Even so, Benston's results (and those of George Stigler before him) clearly indicate that the 1934 Act improved pricing accuracy. *See* JOHN C. COFFEE, JR., CONVERGENCE AND ITS CRITICS: WHAT ARE THE PRECONDITIONS TO THE SEPARATION OF OWNERSHIP AND CONTROL? 48 (Columbia Law Sch., Working Paper No. 179, 2000) (on file with the *Duke Law Journal*) ("[T]he total package of new disclosures produced immediate and observable results that are logically interpreted as an increase in pricing accuracy."); Fox, *supra* note 11, at 1376–80 ("Taken as a whole, the Stigler, Simon, and Benston studies suggest that imposition of the current system of mandatory disclosure did increase price accuracy and the amount of meaningful information in the market.").

confidence and led directly to a large increase in investor participation in the stock markets.[96]

As noted, companies not only fail to voluntarily disclose optimal amounts of financial information, they often alter accounting procedures to make their bottom lines look better,[97] and even commit financial fraud, despite the arguable irrationality of such an act.[98] Professor Patricia Dechow and her colleagues note: "Existing research argues that there are long-term benefits to building reputations for providing reliable and timely disclosures. Yet the sample of firms investigated in this study chose to risk (and ultimately lose) these benefits for the prospect of short-term gain."[99]

It is not difficult to detect corporations' motives to commit financial fraud. Studies reveal that firms often misrepresent their financial condition to minimize (at least in the short term) external financing costs.[100] Others misrepresent to encourage investment in the firm and to increase the price of outstanding stock.[101] Some manage earnings in response to unique circumstances, such as increasing the price they

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96. SELIGMAN, *supra* note 20, at 561–62.

97. *See* John W. Hill & Robert W. Ingram, *Selection of GAAP or RAP in the Savings and Loan Industry*, 64 ACCT. REV. 667, 677 (1989) (finding that S&Ls switched accounting methods when traditional GAAP disfavored the firm, and concluding that "[t]hese findings are consistent with earlier studies that have shown that managers select and lobby for accounting alternatives that are consistent with their self-interest").

98. Companies that are caught committing fraud may pay dearly for it. *See* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757, 797 (1993) (finding that corporations caught committing fraud suffer large reputational penalties). One study shows that eighty-one percent of companies targeted by the SEC for enforcement actions because of accounting irregularities were sued by their shareholders. Feroz et al., *supra* note 84, at 108.

On the other hand, another study finds that legal sanctions, not reputational damage, are the most important factors disciplining and deterring environmental violations. JONATHAN M. KARPOFF ET AL., ENVIRONMENTAL VIOLATIONS, LEGAL PENALTIES, AND REPUTATION COSTS 24 (Univ. of Chi. Law Sch., Working Paper No. 71, 1998) (on file with the *Duke Law Journal*).

99. Dechow et al., *supra* note 83, at 31.

100. *See id.* at 30 ("The results indicate that important motivations for earnings manipulation are the desire to raise external financing at low cost and to avoid debt covenant restrictions."); *see also* Richard G. Sloan, *Do Stock Prices Fully Reflect Information in Accruals and Cash Flows About Future Earnings?*, 71 ACCT. REV. 289, 314 (1996) (finding substantial evidence of earnings manipulation, but not speculating as to management's motivation).

101. IRVING KELLOGG & LOREN B. KELLOGG, FRAUD, WINDOW DRESSING, AND NEGLIGENCE IN FINANCIAL STATEMENTS § 5.02, at 5-3 (1991).

can charge for their shares in a planned IPO,[102] or being instigators of a United States International Trade Commission investigation for tariff increases and quota reductions whose case would be strengthened by showing reduced earnings.[103] A recent study finds that most Generally Accepted Accounting Principles (GAAP) violators charged by the SEC had suffered poor stock market performance prior to the violation, concluding that "this likely provided incentives to manage reported earnings."[104] If a firm is on the brink of bankruptcy,[105] Professors Jennifer Arlen and William Carney provide a rationale consistent with the rational economic-man theory that can explain a subset of securities frauds committed by managers in the "last period."[106] However, Professor Donald Langevoort suspects, I think correctly, that there may be additional cases in which it is rational to trade off credibility with investors (and to risk liability) to obtain some profit-enhancing gain in another area.[107]

Regardless of whether the stock market is particularly rational, firms clearly can benefit in the short run by massaging their financial numbers to look better than they truly are,[108] and may feel extreme

102. *See* John M. Friedlan, *Accounting Choices of Issuers of Initial Public Offerings*, 11 CONTEMP. ACCT. RES. 1, 2 (1994) (finding "that issuers make income-increasing accruals before going public").

103. *See* Jennifer J. Jones, *Earnings Management During Import Relief Investigations*, 29 J. ACCT. RES. 193, 223 (1991) (finding empirical support for the hypothesis "that managers make income-decreasing accruals during import relief investigations").

104. Messod D. Beneish, *Detecting GAAP Violation: Implications for Assessing Earnings Management Among Firms with Extreme Financial Performance*, 16 J. ACCT. & PUB. POL'Y 271, 274 (1997); *see also* Mark L. DeFond & James Jiambalvo, *Incidence and Circumstances of Accounting Errors*, 66 ACCT. REV. 643, 653 (1991) (describing an empirical study finding that firms that overstate earnings tend to have lower growth in earnings).

105. *See* Kenneth B. Schwartz, *Accounting Changes by Corporations Facing Possible Insolvency*, 6 J. ACCT. AUDITING & FIN. 32, 40 (1982) (finding that companies on the brink of bankruptcy are much more likely to change accounting methods to increase earnings per share).

106. Professors Arlen and Carney argue that in a "last period" scenario, when a company is about to become insolvent and managers face mass firings, it is rational for them to attempt to postpone or avoid disaster by committing securities fraud. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724–30.

107. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 115 (1997) ("The problem with this theory, however, is that it does not provide a compelling motivational story for the majority of cases that make up the class-action practice today, and that involve the management's concealment of product defects or the company's financial difficulties that are unlikely to lead to insolvency.").

108. *See* Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 161–73 (1997)

pressure to do so when competitors are widely engaged in similar pursuits of "financial statement beautification."[109] Thus, Warren Buffett argued in 1999 that the stock market pressures CEOs into inflating earnings so that their firms can keep up with the ever-rising stock market, like a dog chasing its tail.[110]

In their study of financial fraud cases, Professors Irving Kellogg and Loren Kellogg found thirteen reasons why firms misrepresented their financial condition.[111] There may be eight million stories in the "naked city," but the bottom line is that firms often have what appear to be rational (at least in the short term) reasons to hide financial information and even to affirmatively commit fraud. These violations are often significant. A study of SEC accounting enforcement actions found that the median effect of reversing improper accounting procedures was to lower the reporting firm's income by fifty percent.[112]

Consider Enron's spectacular fall to bankruptcy. Through rather opaque disclosure of its unusual, complex, and aggressive business practices, Enron's management pumped its stock up to almost $90 per

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(describing beautification techniques that companies adopt to improve their financial appearance to investors). Hill explains that appearances matter—and they matter a great deal. Because most firms engage in at least modest amounts of financial manipulation, those that do not "play the game" are ranked poorly by comparison. *See id.* at 195 ("Companies who do not beautify may act at their peril; they are ranked in a world where their peers do."). Companies get away with financial manipulation in large part because money managers engage in the rational ignorance spoken about in this Article, *see infra* notes 267–79 and accompanying text, and settle for "good enough" analysis of companies' finances. Hill, *supra*, at 147.

109. Hill, *supra* note 108, at 145 n.11.

110. *See* Uchitelle, *supra* note 85, § 3, at 4 (quoting Warren Buffett as saying that stock market pressures force firms to resort to "unadmirable accounting stratagems").

111. Among those reasons were:

> 1. Encourage investors to buy an interest in a company stock as owners, or in bonds as creditors. . . .
> 2. Increase the value of the stock of present shareholders of a company. . . .
> 3. Maintain or increase the price of the stock in order to use the stock to acquire companies, obtain financing, or earn bonuses. . . .
> 4. Convince creditors to lend money or advance credit on the most favorable terms. . . .
> 5. Avoid disclosing the fact that management's policies have been unsatisfactory (or, at the worst, disastrous). . . .
> 6. Establish a rationale for increased dividends or special distributions.
> 7. Avoid the discovery of the violation of performance covenants in loan agreements.
> 8. Persuade a buyer to buy the business or to pay a higher price for the business.

KELLOGG & KELLOGG, *supra* note 101, § 5.02, at 5-2 to 5-4.

112. Feroz et al., *supra* note 84, at 113 (finding also that in thirty-six percent of the cases "the income effect of the error exceeded the income reported in the preceding four quarters").

share and told analysts that it should be trading at $126.[113] "Analysts, who were paid to scrutinize the Texas-based group, joked with journalists about failing to understand its books—and proceeded to issue the next 'buy' recommendation."[114] Not too many months after the claim of a $126 share price, Enron's shares dropped from $90 to less than 90 cents and the firm filed for bankruptcy.[115]

Unfortunately, factors such as the drive for economic success and competition for scarce resources mean that "unlawful business conduct is a natural accompaniment of modern life."[116]

b. Managers. Before they were required to do so by outside forces, corporate managers in the United States did not voluntarily disclose much information to investors. "What they did, what they earned, how many assets they controlled, and similar matters were facts which they considered to be purely private affairs. To permit the public or their own stockholders to know even the barest details of their financial affairs was unthinkable . . . ."[117]

Managers make decisions as to how much their firm should disclose and they often make the decisions with an eye "toward[] the impact of that decision on the manager's own utility function."[118] Numerous theories explain why managers do not voluntarily choose to disclose optimal information, even if it is in their firms' best interests:

> Everything else being equal, managers prefer as low a level of periodic disclosure as possible. Low disclosure reduces the effectiveness of devices that limit managerial discretion and hence provides managers with more room to satisfy their own objectives at the expense of shareholders. This preference will exist even when the gains to the managers are smaller than the losses to the shareholders.[119]

Worse still, managers often choose not only to disclose at a less than socially optimal level, they also choose to defraud. Economists who cannot understand why companies would mislead also argue that

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113. Geoffrey Colvin, *One Number That Won't Lie*, FORTUNE, Jan. 21, 2002, at 42, 42 (noting that although Enron made these claims, its return on capital was quite low).

114. Sheila McNulty, *A Victim of Its Opacity*, FIN. TIMES, Nov. 12, 2001, at 13, 13.

115. John R. Emshwiller & Rebecca Smith, *Corporate Veil: Behind Enron's Fall, A Culture of Operating Outside Public's View*, WALL ST. J., Dec. 5, 2001, at A1.

116. Diane Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 MICH. L. REV. 1377, 1401 (1982).

117. GEORGE L. LEFFLER, THE STOCK MARKET 428–29 (1957).

118. Cox, *supra* note 11, at 1236.

119. Fox, *supra* note 11, at 1411.

it is rational for managers to take the long-term view regarding reputation and therefore to report honestly or suffer future wage revisions for their inaccurate signaling.[120] However, managers are not always rational in the long-term view, and there is evidence that when a company faces financial distress, its managers may suffer from myopia, however irrational that may be.[121] And it may not be irrational. Managers as individuals or groups often have seemingly rational motives to deceive.[122]

First, it may appear to be in a manager's best interests to cook the books. Assume that the company is doing poorly; a rational manager looking out for the company's best interests might well attempt to conceal the company's struggles to give it time to recover *and* to preserve his or her own job.[123]

Second, managers sometimes may defraud to help themselves even if it doesn't help their firms or even hurts them.[124] Sometimes they seek to avoid being fired by hiding their poor performance.[125] Given that companies' managers often have bonuses and other incentives tied to their firms' reported financial success, they have incentives to lobby aggressively for favorable accounting standards,[126] and

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120. *See, e.g.*, Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295 (1980) (describing "how pressure from managerial labor markets helps to discipline managers").

121. Schwartz, *supra* note 105, at 41 (finding that financially distressed companies make more accounting changes than healthy companies).

122. *See* Vaughan, *supra* note 116, at 1401 (noting that because of such factors as the drive for economic success and organizations' competition for scarce resources, we should recognize that "unlawful business conduct is a natural accompaniment of modern life").

123. *See* Nicholas Dopuch & Dan Simunic, *Competition in Auditing: An Assessment*, *in* SYMPOSIUM ON AUDITING RESEARCH IV 403, 407 (Dep't of Accountancy, Univ. of Ill. eds., 1982) ("[A] rational top management could be motivated to conceal actions and their associated outcomes which are not in the best interests of current and prospective investors.").

124. *See* KELLOGG & KELLOGG, *supra* note 101, § 1.03, at 1-5 ("There have been, there are, and there will be a substantial number of CEOs, CFOs, and CPAs whose moral standards are low or nonexistent. Those individuals betray the shareholders, partners, lenders, and bondholders to whom they owe a duty of trust.").

125. *See* Langevoort, *supra* note 72, at 54 (noting the "change in managerial thinking [that comes if] managers sense a risk of being fired for inadequate performance").

126. *See* Cox, *supra* note 11, at 1204 ("Indeed, there is a rich history of opportunistic and artful use of accounting standards by managers to advance their interests at the expense of investors."); Lawrence Revsine, *The Selective Financial Misrepresentation Hypothesis*, ACCT. HORIZONS, Dec. 1991, at 16, 21–22 (citing several studies showing that corporate "managers lobby [accounting] standard setting bodies to approve reporting methods that maximize managers' welfare" and then use the resulting standards for that purpose). *But see* Dechow et al., *supra* note 83, at 30 (finding no strong evidence of managers manipulating earnings to boost their bonuses or to engage in insider trading in a study of companies in SEC disciplinary proceedings).

then to use those accounting standards for their own best interests.[127] Not surprisingly, Enron's executives' compensation was calculated by a formula based on internal estimates that were inflated dramatically.[128] "[S]ome managers may shrug [reputational constraints] off if the immediate gains are large enough and if they cannot be required to disgorge their ill-gotten gains."[129]

Although plaintiffs' attorneys no doubt exaggerate insider trading as a motive for securities fraud, it is a real problem.[130] Langevoort

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127. *See, e.g.*, Andrew A. Christie, *Aggregation of Test Statistics: An Evaluation of the Evidence on Contracting and Size Hypotheses*, 12 J. ACCT. & ECON. 15, 33 (1990) (finding managerial compensation to be one of the key variables explaining accounting procedural choice); Dan S. Dhaliwal et al., *The Effect of Owner Versus Management Control on the Choice of Accounting Methods*, 4 J. ACCT. & ECON. 41, 52 (1982) (predicting that "management controlled firms are more likely than owner controlled firms to adopt accounting methods which result in increased or early reported earnings"); Wilbur G. Lewellen et al., *Self-serving Behavior in Managers' Discretionary Information Disclosure Decisions*, 21 J. ACCT. & ECON. 227, 228 (1996) (noting that "managers' accounting decisions appear often to reflect self-serving behavior, as evidenced by systematic relationships between accounting choices and variables that proxy for management's self-interest," and finding that self-serving behavior by managers is also present in discretionary information disclosure decisions in that they choose underperforming peers when publicly benchmarking their own performance); Schwartz, *supra* note 105, at 33, 43 (noting that "management may be motivated to make accounting changes because of the methods that are used to evaluate and reward their performance," and finding that "a considerable number of firms [make accounting changes] to improve financial appearance"); *see also* Hill, *supra* note 108, at 154–55 (finding that although accounting firms apparently have a reputational motive to be strict on such matters, they tend to lobby for lax accounting standards to please their clients); Anthony G. Hopwood, *An Empirical Study of the Role of Accounting Data in Performance Evaluation*, 10 J. ACCT. RES. 156, 166–72 (1972) (finding that managers evaluated on meeting a short-term budget found the system unfair and tended to manipulate accounting reports).

Others point out that managers often have incentives to falsify reports as well, perhaps to increase their own income which may be tied to reported client earnings. *See* David S. Ng & Jan Stoeckenius, *Auditing: Incentives and Truthful Reporting*, 17 J. ACCT. RES. 1, 2 (1979) ("[M]ost remuneration contracts which are nonconstant have the potential for inducing false reporting.").

128. *See* Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58 ("[E]xecutives were compensated based on a market valuation formula that relied on internal estimates.").

129. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 138 (1985); *see also* John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 393 (1981) (noting that "the executive vice president who is a candidate for promotion to president may be willing to run risks which are counterproductive to the firm as a whole because he is eager to make a record profit for his division or to hide a prior error of judgment"); George Getschow, *Overdriven Execs: Some Middle Managers Cut Corners to Achieve High Corporate Goals*, WALL ST. J., Nov. 8, 1979, at 1 (studying a series of cases in which middle managers sent falsified data to corporate headquarters, often to avoid being branded as incompetent).

130. *See, e.g.*, David J. Bershad et al., *A Dissenting Introduction*, *in* SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES 5, 19 (Edward J. Yodowitz et al. eds., 1994):

discusses this problem while assuming good intentions (but bounded rationality) by corporate managers.[131] But there will be other situations, such as the "final period" scenario, where it will be charitable to assume good intentions.[132] Furthermore, managers realize that corporate failures are not easily traceable to specific managers, so even their intentional misdeeds may go undetected and/or unpunished.[133]

C. *Intermediaries and Their Motives*

If issuers and their managers do not always find it in their (perceived) rational best interests to disclose optimally or to hew scrupulously to the truth, then it may be a far stretch to claim that stockbrokers or stock exchanges can be counted on to provide optimal investor protection. In Section C, I examine stockbrokers and stock exchanges in some detail.

1. *Stockbrokers*. Rational actors would not incur sexual harassment liability at the astounding rate that stock brokerage firms do.[134]

> [E]xecutives whose compensation is tied to the stock price of their companies' shares, or who have options to exercise or shares to sell, have a subtle but powerful motive to close their eyes to bad news percolating upward from the ranks, and postpone giving it serious consideration, let alone disclosing it publicly, until the next quarter or the next year.

Although plaintiffs' attorneys may get carried away in attempting to meet recently heightened pleading requirements—allegations of insider trading doubled following passage of the Private Securities Litigation Reform Act of 1995, *see* Vanessa O'Connell, *Lawyers Scan Insider Sales to Build Suits*, WALL ST. J., June 5, 1996, at C1 ("Lawyers who specialize in suing companies whose stock prices drop increasingly are using insider sales to help build class-action securities-fraud suits.")—it is still exceedingly plausible, especially with small companies whose officers have their entire net worth tied up in the company's stock, that insider trading (selling) often accompanies the issuing of overoptimistic projections or the hiding of bad financial news. Indeed, studies show that short selling often begins to increase a couple of months before earnings manipulation is disclosed. *See* Pritchard, *supra* note 5, at 930–37 (discussing insider trading and other causes of corporate misstatements).

131. Langevoort, *supra* note 107, at 101.

132. The traditional economic assumption is that managers' interests are aligned with those of corporate owners, but this ceases to be the case in a "final period" scenario when managers fear that they are about to lose their jobs and will not be able to secure comparable jobs in the labor market. *See* Arlen & Carney, *supra* note 106, at 702–03 (noting that managers' incentives change when they're about to lose their jobs); Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277, 292–94 (1991) (referring to studies showing that managers become more risk averse as financial ruin draws near).

133. *See* Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694 (1999) ("[A] company's stock price is, at best, only a rough and noisy signal of corporate managerial performance.").

134. The randy antics depicted in the movie *Boiler Room* and books such as *License to Steal* apparently have more than a little basis in fact, judging from the outcome of litigation. *See, e.g.*,

But without reexamining the issue of stock brokerage firm rationality, consider whether it is always in the best interest of brokerage firms and individual brokers to provide investors with optimal accurate information and suitable investments and whether the reputational advantage is likely sufficient to constrain their self-serving behavior.

As he did with issuers, Choi again assumes that the reputational constraint will be sufficient to keep brokerage firms on the straight and narrow, yet the discussion in Section B demonstrates that the reputational constraint is often insufficient to prompt managers and issuers to disclose optimal amounts of accurate information to investors. "[T]here are limits to reputation."[135] Even economists concede

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Brokerage Agrees to Pay $330,000 to Settle Harassment Suit by EEOC, BNA CORP. COUNS. DAILY, Aug. 31, 2000, at D10 (reporting that brokerage firm Josephthal & Co. will pay $330,000 to settle an EEOC suit based on "fairly egregious" sexual and other illicit harassment); *Brokerage Harassment Suit Settled*, CHATTANOOGA TIMES, Mar. 24, 2000, at C6 ("Two Wall Street brokerage houses Thursday settled a $10 million sexual harassment lawsuit that was filed over antics so outrageous they prompted comparisons to 'Animal House.'"); Kate Kelly, *Floor Governor at Big Board Claims Sex Bias at ING Barings*, WALL ST. J., Jan. 11, 2001, at C1 (noting an addition to the "long list of sexual-harassment cases that have been brought on Wall Street in recent years"); Elizabeth Sanger, *1998 Stars and Stumblers*, NEWSDAY (New York, NY), Dec. 27, 1998, at F6:

> First Asset Management Corp., the Garden City firm that used to be called Lew Lieberbaum & Co., shut down in August after agreeing to pay $1.75 million to settle federal charges of sexual harassment and racial discrimination. The U.S. Equal Employment Opportunity Commission said the settlement was the second largest in history involving sexual harassment.

John Schmeltzer, *Millions Offered for Harassment: 1,850 Women Receive Salomon Smith Barney Offer*, CHI. TRIB., Nov. 23, 1999, at N1 ("Salomon Smith Barney offered millions of dollars altogether Monday to settle sexual harassment claims that nearly 2,000 women filed against the brokerage house."). Sexual harassment—and just about every other form of wrongdoing imaginable—also played a prominent role in the Prudential-Bache limited partnership scandal. KURT EICHENWALD, SERPENT ON THE ROCK 200, 258–59 (1995) (describing the nefarious, prodigious, and prolific sexual and alcoholic escapades of Prudential employees); *see also* Reed Abelson, *A Survey of Wall St. Finds Women Disheartened*, N.Y. TIMES, July 26, 2001, at C1 (describing a survey of Wall Street employees finding that one-third of women reported working in a sexually hostile environment). Are these the results of actions by rational actors?

135. George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 FORDHAM L. REV. 273, 288 (1998); *see* Philip B. Heymann, *The Problem of Coordination: Bargaining and Rules*, 86 HARV. L. REV. 797, 823 (1973) ("[I]f we had to rely on reputation alone, the benefits of coordination would escape us in a myriad of situations . . . ."); Donald C. Langevoort, *Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 94 (1998) ("Reputation [of corporate managers] provides a check on the incentive to deceive, but hardly a complete one."); Peter V. Letsou, *The Political Economy of Consumer Credit Regulation*, 44 EMORY L.J. 587, 595 n.21 (1995) ("[E]ven in a competitive market, reputational concerns do not completely deter the temptation of parties to evade their contractual responsibilities."); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 907 n.23 (1986) (observing in the financing context that "the incentive to protect commercial reputation and good will does not completely deter the debtor from misrepresenting his financial status").

that providers of both goods and services with high-quality reputations are constantly "tempted to provide a low-quality service at a high-quality price and thus earn a large return."[136]

I demonstrate elsewhere that the reputational constraint, assumed by economists to be so critically important to audit firms, often is insufficient to constrain their improper behavior.[137] Professor Ted Schneyer makes the same point regarding law firms,[138] as does Professor G. Richard Shell regarding businesses in general.[139] It is not difficult to construct a similar case regarding stockbrokers as well.

Surely all securities firms would love to have a reputation for impeccable service to clients. Why is it then that the securities business is well known as an industry in which prominent firms such as Bankers Trust had derivatives sales representatives who, in their own words, liked to "lure [clients] into that calm and then just totally fuck 'em,"[140] where Morgan Stanley employees enjoyed "ripping [the client's] face off,"[141] where Salomon Brothers employees became "minor heroes" by "blowing up" their customers,[142] where Dean Witter allegedly sold $2 billion of high-risk bond funds by targeting elderly clients and presenting the funds as safe and secure investments,[143] where Republic New York Securities Corporation assisted a financial adviser in

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136. Michael Firth, *Auditor Reputation: The Impact of Critical Reports Issued by UK Government Inspectors*, 21 RAND J. ECON. 374, 374 (1990); *see also* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981) ("[I]t is possible that economic agents with well-known brand names and reputations for honoring contracts may find it wealth maximizing to break such potentially long-term exchange relationships and obtain a temporary increase in profit.").

137. *See* Prentice, *supra* note 75, at 199–217 (discussing countervailing pressures to reputational capital and damage to auditor reputation).

138. *See* Ted Schneyer, *Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Story Teller*, 84 VA. L. REV. 1777, 1779–87 (1998) (illustrating limits of law firm reputational bonding).

139. *See* G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 266–70 (1991) (describing nonlegal mechanisms to deter opportunism).

140. FRANK PARTNOY, F.I.A.S.C.O.: BLOOD IN THE WATER ON WALL STREET 33 (1997). Unfortunately for Bankers Trust, this statement was made on tape, preserved for posterity.

141. *Id.* at 61.

142. MICHAEL LEWIS, LIAR'S POKER: RISING THROUGH THE WRECKAGE OF WALL STREET 164–70 (1989) (recounting the tale of ripping off institutional investor "Herman the German").

143. *Broker-Dealers: Dean Witter*, *Officials Face NASDR Charges over Sales of Risky Bond Trust Investments*, BNA SEC. L. DAILY, Nov. 21, 2000; *see also* MITCHEL Y. ABOLAFIA, MAKING MARKETS: OPPORTUNISM AND RESTRAINT ON WALL STREET 4 (1996) (noting "a seemingly unending stream of recent scandals" involving professional stock traders).

bilking more than one hundred institutional investors out of $700 million even though the president of its futures division stated on tape that "a doofus flipping a . . . coin every day" would have had more success than the adviser (who lost $556 million while trading)?[144]

Although securities firms can be and sometimes are seriously damaged by scandals involving their wrongdoing, the ability of the reputational constraint to encourage firms and individual brokers to act on behalf of their clients is often limited by several factors. First and foremost, reputational constraint theory notwithstanding, the interests of stockbrokers and their clients often are not well aligned. Brokerage firms make money in the retail business through the commissions and mark-ups charged in each transaction.[145] Individual brokers' compensation is largely commission-based and tends to be larger if the securities are either house products or at the riskier end of the spectrum.[146] Other things being equal, it is in both the firm's and the individual broker's best interests to have more trades rather than fewer, and to sell riskier securities rather than safer ones, regardless of whether these practices are in the client's best interest.[147] On Wall Street, where "bonuses are in the millions of dollars, there

144. Mitchell Pacelle, *Republic New York Pleads Guilty to Fraud, Agrees to Pay Restitution*, WALL ST. J., Dec. 18, 2001, at C10.

145. Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 648–49 (1996).

146. *Id.* at 649 & n.71; *see also* NORMAN S. POSER, BROKER-DEALER LAW AND REGULATIONS § 1.2, at 21 (1995) (discussing the inherent conflict of interest arising from brokers being compensated by volume-based commissions).

147. *See* ANONYMOUS & TIMOTHY HARPER, LICENSE TO STEAL: THE SECRET WORLD OF WALL STREET AND THE SYSTEMATIC PLUNDERING OF THE AMERICAN INVESTOR 19 (1999) ("Like most brokers, I always wanted to make money for my clients. But, like any other broker, I was more likely to make recommendations from the handful of stocks that I followed—all stocks that gave me higher commissions."); LEWIS, *supra* note 142, at 180 (noting that brokers pushed products known as priorities "either because selling them would make us [Salomon Brothers] rich or because not selling them would make us poor"); MARTIN MAYER, STEALING THE MARKET: HOW THE GIANT BROKERAGE FIRMS, WITH HELP FROM THE SEC, STOLE THE STOCK MARKET FROM INVESTORS 34–35 (1992) (giving examples of incentives given to brokers to push "house products"); Leah N. Spiro & Michael Schroeder, *Can You Trust Your Broker?*, BUS. WK., Feb. 20, 1995, at 70, 70 ("[I]ngrained commission compensation policies, which are at the very core of the way Wall Street does business, still tend to encourage brokers who work almost entirely for commissions, to put their own interests ahead of their customers' [interests].").

The 1990s Prudential limited partnership interest scandal poses a classic example of this type of misdeed. *See generally* EICHENWALD, *supra* note 134 (relating the seamy, seductive, and scandalous side of Prudential).

are strong rational reasons to push the limits of normative behavior."[148]

Second, even when brokers pursue their own interests at their clients' expense, their reputations may not suffer. For much of the 1990s, the stock market rose so dramatically that it was difficult for even dishonest and incompetent brokers to lose money for their clients. Clients who are making money often do not notice that they could have made a lot more had their brokers made better decisions.[149] Additionally, due to cognitive dissonance[150] and other factors, investors often will remember having made more money than they truly did.[151] Even if they do notice that they did relatively poorly at their brokers' hands, many investors will not complain for reasons explained by regret theory.[152]

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148. ABOLAFIA, *supra* note 143, at 187.

149. If an investor's fixed reference point is the pre-investment position, a modest profit may seem just fine even if a greater profit was easily possible. This is so because people tend to evaluate gains and losses in terms of fixed reference points. *See* Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference for Cash Dividends*, *in* ADVANCES IN BEHAVIORAL FINANCE, *supra* note 66, at 393, 408. Shefrin and Statman reference Kahneman and Tversky's work showing that decisionmaking is often strongly affected by how choices are framed. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, *in* CHOICES, VALUES, AND FRAMES 17, 32 (Daniel Kahneman & Amos Tversky eds., 2000) ("Our perceptual apparatus is attuned to the evaluation of changes or differences rather than to the evaluation of absolute magnitudes.").

150. Cognitive dissonance is the tendency of people who have made decisions to process information that supports their decisions and to ignore information calling their decisions into question. *See, e.g.*, LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE 1–33 (1957) (explaining cognitive dissonance generally); SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 22–30 (1993) (same).

151. SHEFRIN, *supra* note 63, at 130 (finding that mutual fund owners remembered that their funds had performed much better than was truly the case).

152. "Regret" combines loss and a feeling of responsibility for loss. Shefrin illustrates by noting that if a person drives her normal route to work and ends up in an accident, she will feel bad. But if she deviated from her normal route to try a short cut and ended up in an accident, she will feel worse, thinking "If only I had done what I always do!" *Id.* at 30–31.

This phenomenon plays a major role in financial decisions. Consider an institutional investor, such as the ABC Fund. Sam is in charge of investments for ABC. Sam can put ABC's money into mutual funds and probably do quite well, although if the funds struggle Sam will obviously feel that he is to blame. Therefore, Sam, like most other people in his position, will hire a money manager to make these decisions for him even though the studies show that money managers in general do not improve performance. As Shefrin points out:

> The treasurer's office directs pension assets by transferring the responsibility for investment decisions to money managers. If things go well, employees can pride themselves on having selected top performers. However, if things do not go well, they can mitigate the criticism directed at them by blaming the money managers. People look for ways to minimize their exposure to regret.

Id. at 222.

Third, even if investors do notice and complain about their brokers' poor decisions, any firm's ability to trade on its reputation depends more on appearance than fact.[153] "To be an effective deterrent . . . information regarding a party's untrustworthiness must be transmitted efficiently throughout the market."[154] Therefore, it is often in a firm's interest not to find out which of its employees are crooks, not to disclose their existence to the outside world if they do find them, and even if they find and catch them not to fire them because they then become adverse witnesses against the company, helping investors who might want to sue the company. In the Prudential-Bache scandal of the early 1990s, it was clear that Prudential-Bache often refused to fire its crooked employees because it needed them as friendly witnesses in litigation already filed or about to be filed by the very customers they had ripped off.[155]

Firms often can keep their defalcations and other errors quiet,[156] especially because most disputes are handled through low-profile arbitration rather than more newsworthy litigation.[157] Due to the availability heuristic,[158] investors bombarded with advertisements about

153. *See* Randolph A. Shockley, *Perceptions of Auditors' Independence: An Empirical Analysis*, 56 ACCT. REV. 785, 785 (1981) (stating that an auditor's "credibility depends ultimately on the perception rather than on the fact of independence").

154. Shell, *supra* note 139, at 269–70.

155. EICHENWALD, *supra* note 134, at 227.

156. *See* PARTNOY, *supra* note 140, at 51 (noting that "[i]n the early 1990s a few DPG [Derivative Products Group] clients lost significant amounts of money on derivatives, but Morgan Stanley had kept those losses quiet—and even those clients who lost money kept coming back for more").

157. *See* Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1101 (1993) ("Today, arbitration has largely, but by no means entirely, replaced litigation as the method of resolving disputes between customers and their brokers."); Donald C. Langevoort, Monitoring: The Behavior Economics of Inducing Agents' Compliance with Legal Rules 25 (July 2001) (unpublished manuscript, on file with the *Duke Law Journal*) ("In the securities area, for example, there has been a sustained effort by the industry to move customer complaints out of public litigation forums into private arbitration. This makes threatening information less available.").

The arbitration provisions also will likely contain confidentiality provisions that, under Choi's plan, will presumably be enforceable since they were "freely" negotiated. *See* Cariveau v. Halferty, No. A087296, slip op. at 1 (Cal. Ct. App. Aug. 18, 2000) (invalidating a provision prohibiting customers from discussing a broker's wrongdoing with regulators).

158. When affected by the availability bias, people estimate frequencies or probabilities by the ease with which they can remember examples or associations. Thus, people tend to think that more people die of homicides than strokes (when the ratio is 11-1 the other way) because they read about homicides in the paper and see them on the television frequently and can therefore call them to mind. *See generally* Timure Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683, 707 (1999) ("While underestimating dangers that

the reliability of a brokerage firm are likely to believe them despite numerous problems with the company's true actions.[159] Thus, in the mid-1990s Dean Witter successfully marketed its reputation with the "we measure success one investor at a time" advertising slogan, while seventy-five percent of the mutual funds its brokers sold were Dean Witter products, the highest percentage in the industry.[160] Dean Witter brokers were not pushing those products because they were in the customers' best interests—Dean Witter's funds placed ninth out of the ten largest independent and brokerage-fund families rated by Morningstar Mutual Funds.[161] Rather, the brokers were motivated by the fact that the highest profit margins for Dean Witter arose from its own products and by the firm's special contests for its brokers, who could win prizes by selling particular Dean Witter products.[162] As with most other behavioral foibles, the availability heuristic affects professional investors as well as amateurs,[163] perhaps even more.[164]

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are not highly publicized (heart disease, strokes, asthma), [people] grossly overestimate risks to which the media pay a great deal of attention (accidents, electrocution)."); Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163, 178 (Daniel Kahnemen et al. eds., 1982) [hereinafter JUDGMENT UNDER UNCERTAINTY] (noting that "availability provides a mechanism by which occurrences of extreme utility (or disutility) may appear more likely than they actually are").

159. *See* HOWARD KURTZ, THE FORTUNE TELLERS 35 (2000) (explaining the "Squawk effect"—the tendency of traders to buy the stock of whatever company was featured on the CNBC show "Squawk Box"); Jonathan Clements, *How Stock Investors Take It Personally*, WALL ST. J., Aug. 29, 2000, at C1 (quoting Professor Meir Statman as noting that many investors buy stocks just because the stocks are in the news and have caught their attention); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 731 (1999) ("[T]he availability heuristic can be easily tapped into by simply maximizing the frequency and intensity of advertisements.").

As Salomon Brothers president Tom Strauss once noted, "Customers have very short memories." LEWIS, *supra* note 142, at 167 (noting that the guiding principle of customer relations at Salomon seemed to be "Screw 'em, they'll eventually forget about it!").

160. Spiro & Schroeder, *supra* note 147, at 74.

161. *See id.* ("The average Morningstar rating for a Dean Witter fund is 2.72 stars out of 5 stars, placing it ninth out of the 10 largest independent and brokerage-fund families.").

162. *See id*. (detailing how one broker won a trip to California by selling $1 million of a Dean Witter fund).

163. *See* Werner F.M. De Bondt & Richard H. Thaler, *Do Security Analysts Overreact?*, 80 AM. ECON. REV. 52, 53–57 (1990) (finding that securities analysts' forecasts are affected by the availability heuristic); Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 820 (2000) (noting that derivatives industry participants are likely not immune to the availability heuristic).

164. Mark Seidenfeld, *Cognitive Loafing, Social Conformity and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 502 (2002) ("[E]xperts may be more susceptible to the availability heuristic than are laypeople.").

Fourth, even if customer mistreatment does receive some media attention, firms can (and do) blame the wrongdoing on a "rogue" employee and thereby limit reputational damage to the firm.[165] This scapegoating involves the firm portraying itself as the real victim of the fraud.[166]

Fifth, even if the "rogue" broker defense does not fly in the court of public opinion, a securities firm always can point to its competitors' misdeeds and functionally tell its clients "Hey, you're not going to do any better with them." After all, most prominent securities firms have had their own major scandal.[167]

Finally, for the reputational constraint to work, individual stockbrokers must have a long-term focus. For even established firms, long-term focus often remains more of an aspiration than a reality in an atmosphere in which so many of their employees are evaluated on the basis of short-run results.[168] Because seventy-five percent of all

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165. Prudential-Bache tried to use the "rogue broker" defense even in a scandal in which it ultimately became clear that treachery toward its clients had been widespread within the firm. *See* KATHLEEN SHARP, IN GOOD FAITH 217 (1995) (noting that the new CEO blamed "the firm's past problems on 'rogue bankers' rather than rogue chiefs"). Kidder Peabody labeled trader Joseph Jett a "rogue" soon after naming him "Man of the Year." James Denn, *Conquest, Controversy on Wall Street*, TIMES UNION (Albany, NY), May 30, 1999, at B1.

This "rogue employee" defense often has been used by other types of professional firms to limit reputational damage. *See, e.g.*, Dan Atkinson, *Accountants Pay $2.5m Settlement*, GUARDIAN (London), Jan. 15, 1999, at 23 (noting that PricewaterhouseCoopers had blamed various independence violations on a small group of "rogue" employees even though a later study found thousands of violations, including by most partners on the firm's governing committee); Christopher Lee, *Flurry of Enron Hearings to Begin*, DALLAS MORNING NEWS, Jan. 24, 2002, at 1D (noting that accounting firm Arthur Andersen sought to blame the shredding of documents episode in the Enron scandal on "rogue employees").

166. Langevoort, *supra* note 157, at 26.

167. Several of these scandals have merited book-length investigations. As noted earlier, Michael Lewis's famous *Liar's Poker* detailed wrongdoing at Salomon Brothers, *see supra* note 142 and accompanying text, Kathleen Sharp's *In Good Faith* skewered Prudential-Bache, *see supra* note 165, and Frank Partnoy's *F.I.A.S.C.O.* hammered Morgan Stanley, *see supra* notes 140–41 and accompanying text, and struck First Boston a glancing blow. Most recently, Kidder Peabody suffered through the Joseph Jett scandal. *See, e.g.*, *G.E. Stockholder Lawsuit Settled for $19 Million*, L.A. TIMES, Mar. 30, 2000, at C3 ("Government regulators have called Jett's fraud one of the largest in the history of the securities industry."). Merrill Lynch got embarrassed in the Sumitomo copper debacle. *See, e.g.*, Martin Waller, *Copped It*, TIMES (London), May 25, 2000, at 31 (noting that Merrill Lynch paid $275 million to settle the case).

168. As two experts note:

> Sales managers rarely remain with any branch longer than two years and are both paid and promoted based on the short-term results of those two years. They have little or no incentive to emphasize the development of asset-gathering and long-term relationships over short-term sales. As a result, they tend to hire, praise, and hold up as models those brokers who produce large amounts of commission by selling even

new brokers leave the industry within the first three years,[169] it is nearly impossible for most brokers to take a long-term view consistent with the theory of reputational constraint.

In sum, the ambiguous nature of reputational feedback means that securities industry professionals' bad acts often do not translate directly into reputational damage.[170] Even if they do, "[r]eputational sanctions also have limited effect on especially venal parties,"[171] and there is never a shortage of them in the securities industry. Unsurprisingly, empirical evidence indicates that the reputational constraint affects brokers, but weakly.[172] There are so many different ways that bond traders, for example, can exploit their informational advantage to the detriment of their customers that only close monitoring of the trading process can prevent exploitation and "even the institutional investor is not in a position to design or enforce" such monitoring.[173]

2. *Securities Exchanges*. Professors Choi, Mahoney, Pritchard, and others propose a significant expansion of the role that stock exchanges play in the securities regulation scheme. When considering

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> larger amounts of product. Unfortunately, selling is viewed as transactional, while the long-term benefits to the firm of consultative selling are played down.

STEVEN R. DROZDECK & KARL F. GRETZ, THE BROKER'S EDGE: HOW TO SELL SECURITIES IN *ANY* MARKET 27 (1995).

169. *Id.* at 29.

170. *See* Amar Bhide & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay?*, HARV. BUS. REV., Sept.–Oct. 1990, at 121, 121 ("There is no compelling economic reason to tell the truth or keep one's word—punishment for the treacherous in the real world is neither swift nor sure.").

171. Shell, *supra* note 139, at 269.

172. Thus, one prominent study shows evidence of a reputational constraint, but also evidence that the constraint is hardly a strong one. Carleton, Chen, and Steiner studied thousands of stock recommendations made by national brokerage firms, regional brokerage firms, and non-brokerage firms. *See* Willard T. Carleton et al., *Optimism Biases Among Brokerage and Non-Brokerage Firms' Equity Recommendations: Agency Costs in the Investment Industry*, FIN. MGMT., Spring 1998, at 17, 19–20 (exploring the influence of reputation on brokerage and non-brokerage environments). The brokerage firms have an incentive to give more positive recommendations than non-brokerage firms because they want to stay on goods terms with the issuers whose business they would like to cultivate. And, indeed, the study's findings were that brokerage firms' recommendations were more optimistic than those of non-brokerage firms. *Id.* at 19. On the other hand, they found that "regional brokerage firms, which have less reputational capital to protect, tend to inflate their recommendations as compared to national brokerage firms." *Id.* at 19–20. Thus, the non-brokerage firms that had less self-interest at stake had more accurate recommendations than the brokerage firms. *Id.* at 20. But among the brokerage firms, the national firms with more reputational capital to protect proffered more accurate recommendations than the regional firms. *Id.*

173. ABOLAFIA, *supra* note 143, at 33.

turning much of the responsibility for producing an honest and efficient securities market over to exchanges, a few points are worth consideration. First, the same misalignment of interests that exists between brokers and their customers also exists between exchanges and the investing public.[174] For example, a former NYSE broker sued the exchange, alleging that exchange officials knew about illegal trading by its floor brokers and did nothing to stop it because the illegal trading generated both trading volume and profits.[175] A subsequent investigation discovered concerted efforts to hide the practices from the SEC.[176]

Second, company managers will have effective control over where a company's stock is listed, and they are not necessarily motivated to list with the exchange that best protects investor interests. There is substantial evidence that managers make self-serving decisions in choosing where their firms should incorporate, and, as Professor Marcel Kahan has pointed out, "incentives for managers to engage in opportunistic relistings [on exchanges] for personal benefit are, if anything, higher than incentives to engage in opportunistic reincorporations or charter amendments."[177]

Third, investor regulation in this area and others can provide its envisioned benefits only if there develops substantial competition so that exchanges and other intermediaries will engage in a "race to the top" to provide desirable investor protections. Because the same increased trading that hurts investors will profit exchanges and other intermediaries, what may well develop is a "race to the bottom" instead.[178] After all, exchanges "exist to maximize the profits of their

174. *See* JOHN S. GORDON, THE GREAT GAME: THE EMERGENCE OF WALL STREET AS A WORLD POWER, 1653–2000, at 213 (1999) ("It is a law of human nature that, absent outside pressure, organizations tend to evolve in ways that favor their elites. . . . [F]ew better examples of this phenomenon exist than the New York Stock Exchange in the 1920s.").

175. *NYSE Ex-Broker Sues Big Board over Issue of Illegal Floor Trades*, WALL ST. J., June 27, 2000, at C8. The NYSE eventually won dismissal of the suits on grounds that it enjoyed absolute immunity in performance of its self-regulatory function. D'Alessio v. N.Y. Stock Exch., 258 F.3d 93, 95 (2d Cir. 2001).

176. Greg Ip, *New Issues Arise in NYSE Trading Controversy*, WALL ST. J., Feb. 20, 2001, at C1.

177. Kahan, *supra* note 10, at 1511–12.

178. One scholar has pointed out that in the area of consumer products, competitive pressures did not lead automobile makers to compete to see which could win customers with the most pro-consumer contract; instead, competitive pressures acted "to compel every producer to make its contracts at least as unfair as the contracts of the other members of its industry." W. DAVID SLAWSON, BINDING PROMISES: THE LATE 20TH–CENTURY REFORMATION OF CONTRACT LAW 35 (1996).

members."[179] As indicated, this factor is exacerbated by the exchanges' "incentive to compete for the favors of managers or controlling shareholders and to relax listing conditions that constrain them."[180]

Another possibility is that there will be no race at all. Before federal securities regulation began, the New York Stock Exchange was pretty much the only game in town.[181] It was often rife with fraud.[182] Even after the creation of the SEC, the NYSE strove to regain a monopoly position.[183] With the rise of electronic competition, it certainly seems that it would be more difficult for the NYSE to regain a monopoly position.[184] Still, the NYSE has the characteristics of a natural monopoly,[185] and Kahan points out that "presently, there is little international or intranational competition among stock exchanges . . . . [W]e cannot be confident that the market for stock listings that will evolve will be one characterized by vigorous competition rather than a near monopoly or oligopoly."[186]

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179. Pritchard, *supra* note 5, at 1020.

180. JOHN C. COFFEE, JR., THE RISE OF DISPERSED OWNERSHIP: THE ROLE OF LAW IN THE SEPARATION OF OWNERSHIP AND CONTROL 81 (Univ. of Chi. Ctr. for Research in Sec. Prices, Working Paper No. 182, 2001) (on file with the *Duke Law Journal*).

181. *See* MARSHALL E. BLUME ET AL., REVOLUTION ON WALL STREET: THE RISE AND DECLINE OF THE NEW YORK STOCK EXCHANGE 21–34 (1993) (detailing the rise of the NYSE as a monopoly).

182. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA 254 (1970) (noting that during the 1920s, there "was a marked decline in [investment] banking judgment and ethics and unscrupulous exploitation of public gullibility and avarice"); GORDON, *supra* note 174, at 215 ("[In light of pools, wash sales, bear raids, and the like, the NYSE] was, at least for the quick-witted and financially courageous, a license to steal. Whom they were stealing from in general, of course, was the investing public at large.").

183. *See* SELIGMAN, *supra* note 20, at 498 (quoting economist Paul Samuelson as criticizing an NYSE proposal as a mere attempt "to re-establish the eroding monopoly power of the New York Stock Exchange and to subject that power primarily to regulation by the monopolist").

184. *See, e.g.*, Paula Dwyer & Mike McNamee, *Why the Bourses Are Spooked*, BUS. WK., Mar. 15, 1999, at 46, 46 (discussing the inroads that electronic-communications networks (ECNs) were making on the NYSE and NASDAQ).

185. *See* Hans R. Stoll, *The Causes and Consequences of the Rise in Third Market and Regional Trading*, 19 J. CORP. L. 509, 514 (1994) (arguing that the NYSE "has many of the characteristics of a natural monopoly," such as an average cost of production that continues to decrease with increased production).

186. Kahan, *supra* note 10, at 1515; *see also* Cox, *supra* note 11, at 1232 ("We may question [in looking at international regulatory competition] whether there are indeed a sufficient number of regulatory jurisdictions for competition."); Pritchard, *supra* note 5, at 963 n.156 ("With the merger of the AMEX and NASDAQ, there are effectively now only two competitors among the national exchanges . . . .").

Mahoney sings the praises of the NYSE, pointing to its listing requirements and its gradual increase in the disclosures it required of its listed companies in the years preceding 1933.[187] No doubt these were important developments in the history of corporate financial reporting. However, at least three points are clear. First, the pre-1933 disclosure practices were egregiously bad and although the NYSE's requirements for its listed companies clearly improved earlier practices, the NYSE did not go nearly far enough. For example, Fox points out that opponents of mandatory disclosure assume that the stock exchanges required that listed companies send certified financial statements to stockholders before annual meetings, but "[i]n fact, there were no such rules."[188] In the late 1920s, Professor Laurence Sloan did an exhaustive study of the financial disclosures of all the major corporations in the United States,[189] finding that industrial financial reports were "*woefully inadequate*," lacked uniformity, and lacked meaningful explanation.[190] Indeed, he concluded that "[i]n several important respects, no criticism of the abuses that exist can be too harsh."[191]

Second, the disclosure requirements that the NYSE did impose were often enforced indifferently.[192] For example, one of the most in-

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187. *See* Mahoney, *supra* note 4, at 1466 (noting that the NYSE developed requirements for an independent auditor and a quarterly reporting system).

188. Fox, *supra* note 11, at 1376. Fox points out also that:

> Kaplan and Reaugh conducted a survey of the 1930 annual reports of a representative sample of the nation's 500 or 600 largest publicly traded industrial corporations. While most firms (though not all) provided some kind of income statement, almost one-third did not reveal how much depreciation, if any, was deducted to arrive at their earnings figures. Without information about depreciation, earnings numbers are virtually meaningless.

Id. at 1378 (citations omitted). Furthermore, thirty-eight percent of NYSE-listed firms did not even disclose sales prior to the 1934 Act. Benston, *supra* note 95, at 142; *see also* WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET 155 (1926) (noting that corporate financial statements "have more or less conformed to the instructions . . . 'to be clear and cryptic'").

189. LAURENCE H. SLOAN, CORPORATION PROFITS: A STUDY OF THEIR SIZE, VARIATION, USE, AND DISTRIBUTION IN A PERIOD OF PROSPERITY 1–2 (1929).

190. *Id.* at 333–37.

191. *Id.* at 334.

192. SELIGMAN, *supra* note 20, at 47 ("Nor did the New York Stock Exchange scrupulously enforce its listing requirements.").

During the late 1800s, of course, the situation was even worse given the power of the robber barons. *See* ROBERT L. HEILBRONER, THE WORLDLY PHILOSOPHERS: THE LIVES, TIMES AND IDEAS OF THE GREAT ECONOMIC THINKERS 215–16 (7th rev. ed. 1999) ("Gulling and milking the investor were taken as a matter of course, and the stock market was regarded as a kind of private casino for the rich in which the public laid the bets and the financial titans fixed the croupier's wheel."). Things had not improved markedly by the time of the Great Crash. *See* GORDON, *supra* note 174, at 213 (noting that in the 1920s, as in the 1820s, the NYSE "was a pri-

famous scandals of the time—the Ivar (the "Match King") Kreuger scandal that began before and ended after the great crash of 1929—was made possible by Kreuger's total secrecy.[193] When auditors questioned him, he simply refused to answer any of the questions or provide any of the information that would have disclosed his Ponzi scheme.[194] "Krueger, Samuel Insull, the utility wizard and other promoters had no fear that independent auditors would be called in."[195] When the American Institute of Accountants (AIA) attempted to devise a plan for auditing all corporations, "[t]he reaction of the [NYSE] was disinterest."[196]

Third, and most important, the inadequately designed and imperfectly enforced disclosure requirements that were imposed by the Exchange before 1933 were motivated largely by the NYSE's desire to forestall passage of more stringent state and federal legislation. The few improvements the NYSE made before the 1933 Act were the result of numerous investigations and threats of federal legislation. The first may have been the congressionally created Industrial Commission's final report in 1902 that called for required publication of a properly audited annual report by larger corporations.[197] Then came the Hughes Committee investigation (1909), the "Money Trust" investigation (1913), and the hearings on Proposed Bill S. 3895 (1914), all contemplating increased federal regulation and all encouraging self-regulation.[198] Potential state regulation in New York also

vate club, operating for the benefit of its members, the seat holders, and not the investing public"); CHRIS WELLES, THE LAST DAYS OF THE CLUB 13 (1975) ("When Exchange members exploited their position to conduct blatant stock manipulations and swindles, other members cheered them on. Even officials of the NYSE regarded such activities as one of the inalienable privileges of Exchange membership and simply looked the other way.").

193. *See generally* JOHN KENNETH GALBRAITH, THE GREAT CRASH, 1929, at 82–83 (5th ed. 1979) (detailing an interview in which Kreuger said his success was attributable to "silence," "more silence," and "still more silence," and noting that "his aversion to divulging information, especially if accurate . . . kept even his most intimate acquaintances in ignorance of the greatest fraud in history").

194. PREVITS & MERINO, *supra* note 94, at 234–35.

195. *Id.* at 235.

196. *Id.*

197. Anita Dennis, *Taking Account: Key Dates for the Profession*, J. ACCT., Oct. 2000, at 97, 99.

198. J. EDWARD MEEKER, THE WORK OF THE STOCK EXCHANGE 463 (rev. ed. 1930). The NYSE did make some improvements as a result of the Hughes Committee investigation, for example. ROBERT SOBEL, THE BIG BOARD: A HISTORY OF THE NEW YORK STOCK MARKET 198 (1965).

prompted disclosure reforms.[199] During this time, "demand for reform and government supervision of the securities industry was incessant."[200] Other NYSE reforms often have been motivated by an attempt to buy off regulation.[201] Absent the government pressure that Choi's plan removes, it is unclear that the NYSE would make any significant steps toward requiring mandatory disclosure.

The fundamental misalignment of interests often has caused the NYSE to be slow to take action against fraudsters[202] and to make

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199. PREVITS & MERINO, *supra* note 94, at 250 ("The New York Stock Exchange, faced with demands by New York State legislators for reform in the Progressive Era, had imposed reporting requirements on companies listed after 1913.").

Even in its early history, the Stock Exchange in New York kept one eye on government regulators:

> Most of the time, the [Stock and Exchange] Board could regulate so as to advance the interests of its own members, without explicit regard for . . . anti-market thought . . . . But the Board's long-term self-interest required it to act strategically on occasion. *Too much speculation or too much price manipulation in the short run might cause government to step in and impose broad limits on trading, as it periodically threatened to do, and might result in losses in the long run.* The Board had to keep one eye on public opinion.

STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860, at 279 (1998) (emphasis added).

200. CAROSSO, *supra* note 182, at 155.

201. *See* SELIGMAN, *supra* note 20, at 12 (observing that the 1932 amendments requiring brokers to secure written permission from clients before lending their shares to short-sellers were passed to "thwart congressional action"); *id.* at 75 (noting that in 1933 the NYSE opposed all New Deal stock exchange reforms, but agreed to take "modest" actions to avoid legislation); *id.* at 119 (describing how in 1935 the NYSE "voluntarily" adopted several SEC recommendations in the face of legislative proposals to make those changes and more); *id.* at 163 (noting that the mid-1930s reorganization of the NYSE was undertaken when the NYSE's "President Gay and much of the Old Guard realized how much more financially expensive SEC-imposed trading rules and a public feud with the Commission would be than reorganization"); *see also* ALEC BENN, THE UNSEEN WALL STREET OF 1969–1975: AND ITS SIGNIFICANCE FOR TODAY xi (2000) (noting that during the 1969–1975 period "the opposition [in the NYSE] to nearly every reform that would benefit investors was formidable"); CHARLES R. GEISST, WALL STREET: A HISTORY 249 (1997) (noting that important NYSE reforms in the 1930s stemmed from "[p]racticality and the implied threat of [government] intervention"); GORDON, *supra* note 174, at 238–39 (noting that it was government pressure that prompted the NYSE to make reforms in 1934); ROBERT SOBEL, N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE, 1935–1975, at 373 (1975) (noting that twentieth-century NYSE reforms have come "at times because of internal pressures but more often as a result of demands from the outside, from Washington and its rivals").

202. *See* SELIGMAN, *supra* note 20, at 11 (noting the NYSE's reluctance to answer Herbert Hoover's call for action against pool operators and bear raiders in 1932); COFFEE, *supra* note 180, at 80 (arguing that "the NYSE seldom, if ever, enforced its own disciplinary rules" in the context of market manipulation before creation of the SEC); John E. Tracy & Alfred Brunson MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1034–35 (1934) (noting that the Hughes Commission in 1907 had "chided the New York Stock Exchange for its spirit of conservative camaraderie that made members lax in punishing culpable fellow-

other necessary reforms.[203] Indeed, even Pritchard, who advocates a much greater role for the exchanges, admits that they traditionally have not done much to stop fraud.[204] Nor have they been active in stopping manipulation, as those sharing Choi's point of view have long theorized that they would. As Professor Oliver Williamson points out, "[r]eputational effect mechanisms are no exception to the general proposition that all theories of economic organization must eventually be confronted by the realities."[205] And the reality is, as Professor Stephen Pirrong demonstrates in some detail, "[a]n examination of the history of self-regulation at 10 exchanges [including the NYSE] prior to the passage of laws proscribing manipulation shows that they took few, if any, measures to curb manipulation."[206]

Indeed, exchanges have structural incentives to refrain from investigating or discovering wrongdoing by their listed companies, for to do so creates adverse publicity that harms the exchange's reputation and hurts its profits.[207] As Coffee notes,

> Exchanges do not have ideal incentives, however, for the task of enforcement. Because they profit on trading volume, and they compete to list companies, they will not wish to delist an actively traded

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members, with the result that punishment, though swift, was only meted out after the horse, figuratively speaking, had been stolen").

203. SELIGMAN, *supra* note 20, at 359 (quoting former SEC chairman Manuel Cohen as stating that Wall Street "rarely moves toward reform unless it is pushed"). Even those who strongly support exchanges admit that the NYSE's actions regarding the nonvoting common stock issue indicate that it will forfeit the interests of shareholders at the altar of self-interest. Pritchard, *supra* note 5, at 1013–14. The NYSE was unwilling to enforce its pro-shareholder rule against the issuance of such stocks when it faced the possibility of losing listings to rivals that did not have such a rule; it was a classic "race to the bottom" situation. *See* Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1039 (1990) (discussing the NYSE's abandonment of the rule).

204. Pritchard, *supra* note 5, at 981–82 (offering some rather lame excuses for why after a couple of hundred years the NYSE still has never responded vigorously to fraudulent activity).

205. Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J.L. ECON. & ORG. 159, 169 (1991).

206. Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141, 141 (1995). Pirrong also points out that the regulation of manipulation that did occur was "primarily due to the threat of further government intervention." *Id.* at 143 (referring to the commodities markets); *see id.* at 174–75 (discussing the Chicago Board of Trade's reluctance to implement rules proscribing manipulation); *see also* Stephen Craig Pirrong, *The Efficient Scope of Private Transactions-Cost-Reducing Institutions: The Successes and Failures of Commodity Exchanges*, 24 J. LEGAL STUD. 229, 254–55 (1995) (finding that exchanges do not always adopt the most efficient rules and that government intervention can sometimes improve the situation).

207. Kahan, *supra* note 10, at 1518.

> company, even when it misbehaves badly. Similarly, their incentives to take enforcement action against powerful broker-dealers may also be suboptimal.[208]

Recent examples include the NYSE's failure to police widespread illegal trading by floor brokers[209] and the NASD's failure to control widespread market-maker collusion and price fixing.[210]

It is certainly arguable that a large part of the reason that the NYSE's enforcement record has been reasonably good is that it has been backed by SEC enforcement attorneys.[211] When he was chairman of the SEC, William O. Douglas recognized regarding both the NYSE and NASD that "without an SEC 'shotgun in the closet,' there was little incentive for an industry self-regulatory organization to perform the unpleasant task of disciplinarian."[212] To eliminate the SEC's role as a backup enforcer could eviscerate the NYSE's desire and ability to do an adequate job. Professor Bernard Black observes:

> In the United States, for example, investment bankers must belong to either the New York Stock Exchange or the National Association of Securities Dealers. A member evicted by one is unlikely to be ac-

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208. Coffee, *supra* note 16, at 32; *see also* Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 787 (2001) ("The . . . backbones [of intermediaries such as accounting firms, investment banks, and law firms] are stiffened by liability to investors if they endorse faulty disclosure, and by possible government civil or criminal prosecution if they do so intentionally."); COFFEE, *supra* note 95, at 49 (noting that an "enforcement shortfall" is "inherent in a self-regulatory system" because "(1) A private body has weak incentives to enforce rules against its own members and clients; (2) Enforcement is too costly for a private body to undertake on a thorough-going basis; and (3) Private bodies necessarily lack the investigative tools and punitive sanctions that the state has at its disposal.").

Furthermore, as Pritchard points out, "the threat of SEC enforcement against fraudsters adds credibility to the exchanges' promises of antifraud efforts because the exchanges' reputations as antifraud enforcers will be diminished if the SEC uncovers frauds that the exchanges missed or ignored." Pritchard, *supra* note 5, at 981. Investor regulation will probably eliminate this current incentive for the exchanges to enforce good behavior.

209. *See* Gary Weiss, *Can the Big Board Police Itself?*, BUS. WK., Nov. 8, 1999, at 154, 154 ("In June, the NYSE settled SEC charges that it had systematically failed to curb or detect illegal trading by many of its 500 floor brokers.").

210. *Brokerages, Investors Settle $1 Billion Suit*, AUSTIN AM.-STATESMAN, Nov. 10, 1998, at C1 (reporting a "$1.03 billion class-action settlement between 37 brokerages and investors who alleged they were cheated by the firms in a price-fixing conspiracy involving Nasdaq-listed stocks"); *see also* ABOLAFIA, *supra* note 143, at 35 (noting that self-regulation "has little impact on the day-to-day actions of [bond] traders whose opportunism is aimed at other traders and at large financial institutions such as insurance companies and mutual funds").

211. *See* SELIGMAN, *supra* note 20, at 179 (contrasting the NYSE with the American Stock Exchange, which reform efforts had largely ignored).

212. *Id.* at 189.

> cepted by the other. Thus, a mandatory SRO [(self-regulatory organization)] can put a misbehaving member out of business, not merely deprive it of the reputational enhancement from voluntary membership.[213]

Choi's confidence in exchanges is excessive in the first instance;[214] his proposal then weakens exchanges and their ability to enforce best practices by eliminating this mandatory feature.[215]

III. INVESTOR SELF-PROTECTION

A. *Dealing with Issuers*

Because investor regulation is potentially such a radical change from the status quo and because Choi's article admittedly "does not provide all the details of a fully functional regulatory system,"[216] it is difficult to envision how investor regulation will work when imple-

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213. Black, *supra* note 208, at 788.

214. In an earlier article, Choi cited kosher foods as an example of a purely private certification market that could work successfully as he envisions the exchanges working under his plan of investor regulation. *See* Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 920 n.18 (1998) (noting that courts have held that state regulation of Kosher foods is unconstitutional). However, there is evidence that this market has traditionally been flawed, *see generally* Harold Philip Gastwirt, Fraud, Corruption and Holiness: *Kashrut* Supervision in New York City, 1881–1940, at 349–50 (1971) (unpublished Ph.D. dissertation, Columbia University) (on file with the Columbia University Library) (summarizing the failure of New York organizations to effectively supervise *kashrut*, the ritual lawfulness of food), and remains so today. For instance, there was a scandal in Washington, D.C., where it appears that the Rabbinical Council of Greater Washington, the certifying agent for kosher foods in the area, whitewashed a major violation by a kosher restaurant to suppress a scandal in the Jewish community. *See generally* Judith Colp, *Koshergate; the Strange Case of the Moshe Dragon Restaurant*, WASH. TIMES, Mar. 15, 1990, at E1 (presenting the facts of the scandal); Alicia Mundy, *The Case of the Smoking Duck; Moshe Dragon Chinese Kosher Restaurant Investigation*, REGARDIE'S MAG., Apr. 1990, at 86, 86 (same).

Perhaps these flaws with the private certification market account for why it has been widely supplemented by false advertising legislation enforced by governmental bodies. *See* Gastwirt, *supra*, at 3 ("The degree of fraud and scandal in the kosher food industry has been great enough to prompt . . . legislation in an attempt to protect the consumer."). Authorities have supplemented the private certification agencies by punishing false claims of compliance with kosher requirements via either general deceptive trade practices provisions or statutes specifically addressing misrepresentation about kosher food. For example, Maryland has a law subjecting violators to a year's imprisonment, a fine of $500, or both. Colp, *supra*, at E1.

215. Seligman points out that one of the reasons the NYSE's disclosure requirements in the 1920s had so little impact was that "[b]eing purely voluntary standards, they could be avoided by any corporation that chose to register as an 'unlisted' security on" another exchange. SELIGMAN, *supra* note 20, at 47.

216. Choi, *supra* note 7, at 334.

mented. In this Section, I raise questions about investor regulation's impact on investors dealing directly with issuers. In Section B, I go into a little more depth about how it might affect investors dealing with broker-dealers. In that Section, I intend to delve heavily into the behavioral literature to question Choi's argument that his proposal will allow investors to bargain for an optimal arrangement with market intermediaries like stockbrokers.

1. *Small Companies Raising Capital*. Consider a relatively small company that is trying to position itself to go public, but is not there yet. Choi complains early in his article that because of SEC registration provisions in the 1933 Act, investors are unable to purchase securities of companies that have yet to go public unless they qualify to participate in a private placement.[217] In regard to unsophisticated investors, Choi's proposal is intentionally even more restrictive than the status quo. Although widows, orphans, and grandmothers (WOGs), as well as other unsophisticated investors can now invest in such a small company under Rules 504, 505, or 506 of Regulation D or under Regulation A, or can buy from sophisticated investors who have held the shares for a year under Rule 144, Choi keeps them out of the market altogether.[218] In this regard, he is much more paternalistic than the SEC.[219] If this were truly a good idea, it easily could be accomplished with relatively minor revisions of the status quo.

Choi aims to benefit issuers who can sell to sophisticated investors without worrying about the strictures of private placement rules, such as Rule 506. Although there is no doubt that it can be difficult to comply with the technical requirements of some of these rules, in light of the huge amount of venture capital and private placement activity in the American economy,[220] it seems unlikely that the rules serve as an undue constraint on raising capital.

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217. *Id.* at 281.

218. Remember, Choi limits the market's "D" investors to passive mutual funds and shares traded on an efficient market. *Id.* at 301–02; *see supra* note 54.

219. *See* William J. Carney, *Jurisdictional Choice in Securities Regulation*, 41 VA. J. INT'L L. 717, 738 (2001).

220. U.S. companies received a record $19.6 *billion* in venture capital money in the second quarter of 2000. Jerry Mahoney, *By All Accounts, Accounting Not the Same; Amounts of Venture Capital*, AUSTIN AM.-STATESMAN, Aug. 21, 2000, at C2. Indeed, in 1999 private placement activity was nearly a half a trillion dollars. Akil Salim Roper, *Year-End Rankings: Weathering the Storm*, PRIVATE PLACEMENT LETTER (Sec. Data Pub., New York, N.Y.), Feb. 21, 2000, at 1. Certainly the stock market and overall economic downturn in 2000–2001 had a dampening impact on this activity and will continue to do so for a time.

The real advantage that Choi claims is that the investors can bargain for just the right level of protection, paying more for securities if they want higher levels of protection (e.g., strict liability or negligence standards) and less if they want lower levels of protection (e.g., antifraud protection or no liability standards). However, it is unclear that investor regulation will produce results meaningfully different from the status quo. Venture capital funds are Choi's prototypical sophisticated investors. In terms of the contracts these funds negotiate with issuers, the funds are usually form-givers rather than form-takers.[221] Already under Regulation D, for example, if an issuer sells to sophisticated investors such as Choi's issuer-level (A student) investors, there is no requirement that they provide any particular financial information.[222] In other words, in private placements and small offerings, sophisticated investors already can bargain for lots of information, some information, or no information.[223] Thus, Professor John Coates notes "the large degree of private choice of securities regulation already available to issuers, as well as the extent to which even the most full-blown of the SEC's disclosure requirements are tailored by the issuer to itself and to the issue."[224]

Already under the status quo, investors, if they so choose, can sign documents indicating that the issuer has made no promises to them, thereby effectively bargaining away antifraud liability.[225] Be-

221. *See generally* STEVEN KAPLAN & PER STROMBERG, FINANCIAL CONTRACTING THEORY MEETS THE REAL WORLD: AN EMPIRICAL ANALYSIS OF VENTURE CAPITAL CONTRACTS (Univ. of Chi. Ctr. for Research in Sec. Prices, Working Paper No. 513, 2000) (on file with the *Duke Law Journal*) (presenting an extensive study of venture capital contracts).

222. *See* 17 C.F.R. § 230.502(b)(1) (2001).

223. Even with regard to public offerings, Palmiter has noted that due to substantial deregulation by the SEC, "[i]ssuers can now choose from among a richly-layered set of disclosure levels and methods in offering their securities to public investors." Palmiter, *supra* note 93, at 3–4.

224. Coates, *supra* note 20, at 534. Furthermore, Professor Amir Licht has identified a substantial trend toward choice of international securities exchanges that provides many of the benefits urged by Choi. *See* Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583, 626 (2001) (identifying "stock exchange mobility as a new type of dynamic affecting today's international securities market" and arguing that "stock exchanges have become the new agents of change in regulatory reform").

225. There are many cases holding that such clauses are enforceable and will bar recovery even from plaintiffs who can prove that the defendant made fraudulent oral statements. *E.g.*, Rissman v. Rissman, 213 F.3d 381, 387 (7th Cir. 2000); Carr v. CIGNA Sec., Inc., 95 F.3d 544, 547–48 (7th Cir. 1996); Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 415–17 (1st Cir. 1989); One-O-One Enter., Inc. v. Caruso, 848 F.2d 1283, 1286–87 (D.C. Cir. 1988); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1517–18 (10th Cir. 1983).

cause sections 11 and 12 of the 1933 Act do not apply to private placements,[226] and section 10(b) antifraud liability can (unfortunately) be bargained away,[227] it is difficult to see what significant added negotiating flexibility Choi's proposal grants to sophisticated investors in this setting.

2. *Companies Preparing to Go Public*. For companies on the brink of what the current system deems "going public," it seems unlikely that investor regulation feasibly could bring many advantages. A company preparing to issue hundreds of thousands or millions of shares is unlikely to desire to negotiate individually each specific sale with each specific investor, creating several classes of obligation and several layers of confusion for future investors, who would have difficulty knowing what sorts of liabilities went with which classes of shares. Absent some degree of uniformity, a Tower of Babel is created.[228] Shareholders will be more hesitant to buy shares carrying rights they cannot understand, and liquidity will be impaired.

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226. Section 11 covers only false statements made in registration statements. *E.g.*, Anisfeld v. Cantor Fitzgerald & Co., Inc., 631 F. Supp. 1461, 1464 (S.D.N.Y. 1986). Section 12 of the 1933 Act does not apply to private placement transactions. Gustafson v. Alloyd Co., 513 U.S. 561, 567–84 (1995).

227. *See generally* Robert A. Prentice, Contractualizing Federal Securities Fraud Litigation: A Behavioral Analysis (2001) (unpublished manuscript, on file with the *Duke Law Journal*) (criticizing a recent trend in the case law that permits contractual waiver of federal securities fraud provisions).

228. Choi himself recognizes that if too many overlapping private enforcement regimes replace the single SEC regime, mass confusion could result. Choi, *supra* note 7, at 289. Under Choi's plan, an investor looking at a particular security must determine whether the issuer has opted in or out of public enforcement. If the issuer opted in, then the investor needs to know if it opted for contract liability, negligence liability, antifraud liability, strict liability, criminal liability, or some combination thereof. If the issuer opted out of public enforcement, then the investor must determine which of a possible multitude of private enforcers is responsible, which types of liability are present (breach-of-contract, negligence, strict, antifraud, criminal) and how efficient and reliable the private enforcer's enforcement mechanisms are. If all this is determined, the investor must learn if there is anything preventing the issuer from leaping back and forth between public and private regulation or keeping it from raising or lowering its standard of liability. And, if the bargaining that Choi envisions has occurred, all these things must be determined for each of many different classes of stock. And, all the while, the investor must compare financial statements that may now be totally lacking in uniformity and comparability.

Choi suggests that perhaps issuers will opt into an SEC-promulgated menu of default options, and perhaps his system "might spawn sets of relatively standardized publicly available procedures." *Id.* at 290. Keep in mind, however, that the less uniformity Choi's system spawns, the more confusion, investor reluctance, and inefficiency will be created. But if more uniformity occurs, then Choi's system is not creating that diversity of options that is the centerpiece of his plan.

Rather, the issuer is likely to issue shares under a single liability regime. That decision alone eliminates most of the claimed advantage of Choi's scheme. What liability regime is the issuer likely to offer? I suspect it often will be a no-liability regime. Choi hypothesizes that because issuers will want more money for their shares and investors will be willing to pay more if there are meaningful investor protections attached to the shares, issuers will be motivated to provide valued protections.[229]

But Choi may be wrong. It seems surpassingly clear that issuers going public are willing to leave large amounts of money on the table for a variety of reasons. The underpricing of IPOs is a well-known phenomenon that reached surprising levels in the late 1990s.[230] The causes of underpricing are not certain. One theory, that IPO–underpricing is prompted by liability considerations,[231] has been largely discredited.[232] There are a number of more plausible theories of IPO underpricing,[233] but whatever the cause, it is clear that issuers are not hesitant to leave large amounts of money on the table.

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229. *Id.* at 282.

230. For a long time, the standard underpricing seemed to be between five and twenty percent. *See, e.g.*, Robert Hansen, *Evaluating the Costs of a New Equity Issue*, MIDLAND CORP. FIN. J., Spring 1986, at 42, 42 (noting underpricing of 15–20%); Roger G. Ibbotson, *Price Performance of Common Stock New Issues*, 2 J. FIN. ECON. 235, 254 (1975) (finding underpricing of 11.4%); Robert E. Miller & Frank K. Reilly, *An Examination of Mispricing, Returns, and Uncertainty for Initial Public Offerings*, 16 FIN. MGMT. 33, 34 (1987) (finding underpricing of 9.87%); Jay R. Ritter, *The "Hot Issue" Market of 1980*, 57 J. BUS. 215, 218 (1984) (finding underpricing of around 19%); Clifford W. Smith, Jr., *Investment Banking and the Capital Acquisition Process*, 15 J. FIN. ECON 3, 20–21 (1986) (finding underpricing of 15% or more).

Between 1990 and 1998, $27 *billion* dollars was left on the table due to IPO underpricing. Timothy J. Mullaney, *Is the Street Lowballing IPOs?*, BUS. WK., Apr. 3, 2000, at EB112, EB112 (citing a study by scholars at Notre Dame and the University of Florida). In 1999 and early 2000, the average underpricing for IPOs underwritten by prestigious firms skyrocketed. *Id.* (citing average first day gains of 178% for Morgan Stanley, 141% for Goldman Sachs, 103% for Merrill Lynch, and 78.5% for First Boston).

231. Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 790 (1988).

232. *See* Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17, 20 (1988) (arguing that the lawsuit avoidance theory accounts for but a small portion of underpricing); John H. Langmore & Robert A. Prentice, *Contribution Under Section 12 of the Securities Act of 1933: The Existence and Merits of Such a Right*, 40 EMORY L.J. 1015, 1082–89 (1991) (showing, inter alia, that underpricing is just as prevalent in countries with virtually no securities liability as in the United States).

233. Two such theories are that underwriters use their market power to reward institutional investors who are repeat customers and that much of the run-up is due to irrational exuberance of day traders. *See* John C. Coffee, Jr., *IPO Underpricing and Dutch Auctions*, N.Y.L.J., Sept. 16, 1999, at 5 ("[T]he phenomenon of IPO underpricing . . . has increased at a hyperbolic rate.").

That being the case, issuers likely will be motivated to leave a little on the table in return for a lifetime of minimal securities liability. The years 1999 and 2000 saw repeated instances of companies going public at, say, $28 and the price jumping to $58 in secondary trading the very next day.[234] Assume that if the issuer offers no investor protection, investors are willing to pay $2 less per share than they otherwise would be willing to pay. To drop that $28 to $26 and the $58 to $56 would be unlikely to raise significant qualms for the issuer. After all, the company may never dip into the market again and likely will not do so often;[235] it therefore will be happy to take $26 or $25 or $24 in exchange for liability immunity.

Perhaps even more important, the managers making the decision to accept the underwriter's suggested pricing of the firm are the same people who are potential civil and criminal defendants in securities lawsuits. These agents are particularly motivated to accept a few dollars less on their principal's behalf to preserve substantial personal peace of mind. In another context, Choi addresses this agency problem and suggests that stock options be used to align the agent's interest with the company's.[236] However, the agent can make just as much money on $18 shares that go to $23 as on $20 shares that go to $25. Furthermore, using options to align managers' interests with those of their firms often just encourages fraud as the officers manipulate their own company's share price to maximize their option profits.[237]

Investors may appreciate the price-break from $20 to $18. More importantly, for a variety of psychological reasons,[238] these investors

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234. When Netscape went public on August 9, 1995, it debuted at $28 per share and was trading at $58-1/4 by day's end. *E.g.*, John Cassidy, *Striking It Rich; The Rise and Fall of Popular Capitalism*, NEW YORKER, Jan. 14, 2002, at 63, 63. Netscape was not alone. For example, Red Hat Software went from $14 per share to $302.63 per share in less than five months, and VA Linux Systems went from $30 per share to $239.25 per share on its first day of trading. *E.g.*, Lisa F. Smith, *Durham, N.C.-Based Red Hat, Other Linux Stocks Take a Beating*, HERALD-SUN (Durham, NC), Aug. 10, 2000. In the 1998–2000 period, high tech IPOs "skyrocket[ed] as a matter of routine." Sandy Portnoy, *Jupiter Takes Shareholders into Orbit*, COMPUTER RESELLER NEWS, Nov. 29, 1999.

235. *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 1992 DUKE L.J. 977, 1014 (noting that for most companies their only public offering is their first and even for others "public offerings are exceptional occurrences"); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 647 (1988) ("On average, publicly held corporations issue only once every eighteen years—less often than locusts.").

236. Choi, *supra* note 7, at 288–89.

237. *See supra* notes 126–29 and accompanying text.

238. *See infra* notes 267–444 and accompanying text.

probably will not worry very much about the protections and therefore will accept the proffered no-liability contract. Investors will be overly optimistic that they will not be ripped off, overconfident that they will be able to sell the shares before the bottom drops out even if fraud is involved, and (assuming that the missing investor protections are valued at $2 per share) just as happy to buy at $18 and sell at $23 as to buy at $20 and sell at $25.[239] Secondary market purchasers will be similarly confident and optimistic and will tend not to worry much about the low-probability event of a major fraud occurring, so they will buy happily at $23.

The bargaining between investor and issuer that Choi envisions as the raison d'être of his entire proposal may not occur. For all sorts of reasons, including simplicity, issuers will likely offer a low-liability regime on a take-it-or-leave-it basis and investors will likely accept.

B. Dealing with Stockbrokers

Choi assumes that investors could perfectly shape their world but for their lack of only one thing—information. As noted in Part II,[240] it seems unlikely that investor regulation will lead to investors having more *accurate* information; less accuracy is more probable. Today investors have tons of information thanks to the SEC requirements that investor regulation would eliminate.

More fundamentally, Choi is likely wrong in believing that lack of information is the key problem for investors. Thanks to SEC disclosure requirements, EDGAR, and the Internet, even the most unsophisticated and dunderheaded investors have access to much the same information available to the most sophisticated of professional and institutional investors.[241] Regulation FD ("Fair Disclosure") will

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239. IPO investors are usually looking for a quick flip to capture profits. *See* Adam Levy, *Shut Out: Getting In on IPOs Is a Game Rigged for Wall Street's Favored Few*, ORANGE COUNTY REG., May 7, 2000, at K01 (quoting Professor Laura Field as saying that, "'[g]enerally the pros flip their shares within a few hours or days. . . . [t]hat generates big returns'").

240. *See supra* Part II.B–C.

241. Indeed, many believe information overload is a bigger problem for investors than insufficient information. *See* GARY BELSKY & THOMAS GILOVICH, WHY SMART PEOPLE MAKE BIG MONEY MISTAKES—AND HOW TO CORRECT THEM 188 (1999) ("Investors who tune in too closely to financial reports probably fare worse than those who tune the news out."); KURTZ, *supra* note 159, at 306 ("The fact is, America is drowning in financial information."); Paul Andreassen, *On the Social Psychology of the Stock Market: Aggregate Attributional Effects and the Regressiveness of Prediction*, 53 J. PERSONALITY & SOC. PSYCHOL. 490, 495 (1987) (finding that media explanations for movements in the stock market tend to lead investors to fail to regress sufficiently to the mean in their predictions of future stock performance, and noting "one might

only add to the previously "inside" information now available to lay investors,[242] as might the disclosure reforms contemplated by SEC Chairman Harvey Pitt.[243]

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very well ask how much news an investor ought to try to absorb, given that in the process of explaining the past, we may allow ourselves to justify the present") (citation omitted); Alex Berenson, *Of Information Overload and the 'Efficient' Market*, N.Y. TIMES, May 21, 2000, § 3, at 1 (stating that increased stock market volatility may be due to information overload of investors); Stacy Forster, *The Cop: An SEC Commissioner Talks About the Challenges of Battling Online Fraud*, WALL ST. J., June 12, 2000, at R18 (quoting SEC commissioner Laura Unger as remarking that individual "[i]nvestors also have massive amounts of information available to them that was previously available only to professionals" that might give them "a false sense of security"); Sara Hewitt et al., *SEC Internet Report*, NAT'L L.J., Jan. 24, 2000, at B5 (remarking that the Internet has "resulted in many over-informed investors who are unsure of how to digest the information made available to them"); Charles Zehren, *Online Investing: Here's a Winnow of Opportunity*, NEWSDAY (New York, NY), May 24, 2000, at A50 (observing that information overload "rank[s] among online investors' greatest enemies").

Information overload has been noted as a potential problem in other areas, such as product warnings and health care disclosure. *See* Howard Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations*, 41 UCLA L. REV. 1193, 1211–15 (1994) (discussing the phenomenon of information overload, and warning of its problems for product safety warnings); Jason Ross Penzer, Note, *Grading the Report Card: Lessons from Cognitive Psychology, Marketing, and the Law of Information Disclosure for Quality Assessment in Health Care Reform*, 12 YALE J. ON REG. 207, 238–40 (1995) (exploring information overload's implications for health care information delivery).

Information overload is a particular problem because studies show that as people are flooded with more information, they examine a smaller percentage of that information in part because they systematically underestimate the benefits of larger sample sizes. *See* Chip Heath et al., *Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings*, 20 RES. ORG. BEHAV. 1, 11–12 (1998) (summarizing the relevant research).

242. Regulation FD, adopted by the SEC on August 10, 2000, Release Nos. 33-7881, 34-43154, is aimed at minimizing the informational advantage that industry insiders, particularly professional analysts, have over lay investors by requiring corporations to widely disseminate information that they formerly leaked selectively to such analysts. *See generally SEC Bans Tradition of Advance Notice*, N.Y.L.J., Aug. 11, 2000, at 2 (discussing the promulgation); David Schellhase, *Arthur Levitt's Cultural Crusade*, RECORDER (San Francisco), Aug. 16, 2000, at 4 (critiquing Regulation FD).

In its first year of operation, Regulation FD received mixed reviews. Most observers seemed to think that it had improved fairness. Whether it had increased or decreased overall disclosure remained unclear. *See Broker-Dealer: AIMR Survey Finds Reg FD Succeeding in Fairness Goal, Overall Disclosure Reduced*, BNA SEC. L. DAILY, Oct. 22, 2001 (reporting that an Association for Investment Management and Research survey of financial analysts and portfolio managers found that they believed the rule had "succeeded in providing small investors and investment professionals with the same information" but had "given many companies an excuse to provide less information to the marketplace"); Lynn Cowan, *Disclosure Rule is Receiving Mixed Reviews*, WALL ST. J., Oct. 30, 2001, at B11F (noting that small investors and large corporations liked the effects of Regulation FD, but analysts and institutional investors thought it had reduced the quality of corporate disclosure).

243. Pitt is apparently considering reforms that would require companies to make more trend-like information available to all investors on a monthly or even weekly basis. John Labate, *SEC Disclosure Reforms May Override RegFD*, FIN. TIMES, Oct. 22, 2001, at 26.

Choi assumes that given the right amount of factual information, investors can bargain for just the right amount of disclosure and investor protection. But what makes investors vulnerable often is not their lack of information, but a wide variety of limitations on human reasoning exposed by a substantial body of behavioral literature that Choi largely ignores.[244] That literature indicates that many if not most investors, even with more information, will be unable to adequately protect themselves under his system. Psychological factors often prevent investors from adopting sufficiently wary attitudes.[245] Importantly, even sophisticated (issuer-level) investors tend to be subject to these limitations.

In his article, Choi offers several personalized illustrations. To use his method, assume that Kira, an underemployed college graduate, has put much of her modest resources into (a) studying for the SEC's investor test so that she can have a wide variety of investment options, and (b) investing in several Internet services so that she can have real-time access to great amounts of market information. Assume that Kira's studying paid off—she qualified to be an intermediary-level investor (a B student) and can deal through any intermediary in the country. Are there grounds to worry that Kira will not be able to adequately protect herself from fraud? Yes, several.

Before examining Kira's ability to negotiate effectively on her own behalf, note the type of form contract that the brokerage firm she selects would likely present to her. Unlike a venture capital fund, Kira is likely to be a form-taker rather than a form-giver. The brokerage firm's self-interest[246] will likely prompt it to insert in its adhesion

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244. *See* Donald McCloskey & Arjo Klamer, *One Quarter of GDP Is Persuasion*, 85 AM. ECON. REV. 191, 191 (1995) ("Knowledge is information plus judgment. An economics of information alone is going to miss the judgment part and is not going to be a complete economics of knowledge.").

245. *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 102 (1993):

> The apparently ascendant view in psychology is that "hot" influences—such as ego, emotion and mood—have demonstrably significant effects on both perception and inference that can lead to diminished as well as enhanced vigilance. And within this genre, much of the inquiry focuses on the role of self-serving biases in the cognitive process. This research suggests strongly that under special circumstances, people will be motivated preconsciously to avoid the appreciation of adverse information and hence fail to adopt appropriately vigilant cognitive modes. Their thinking turns wishful . . . .

See also TVEDE, *supra* note 64, at 127 (listing psychological phenomena that distort how financial journalists and their audiences process financial information).

246. Presumably Choi would agree that the securities firms and issuers with whom Kira deals will tend to act in their own best interests. *See* ELAINE WALSTER ET AL., EQUITY:

contract a provision substantially limiting, if not eliminating altogether, its liability for negligence, and even fraud. Brokerage firms might well use as their model the contract that automobile dealers used in selling new cars before courts and legislatures imposed the strict liability doctrine. A nice example was the landmark case of *Henningsen v. Bloomfield Motors*, *Inc.*[247] The plaintiff was seriously injured when the steering mechanism in her brand-new car broke, causing the car to veer off the road.[248] According to the adhesion contract, willingly signed by plaintiff Henningsen and millions of other car purchasers, defendant Chrysler's liability was limited to repairing the broken steering mechanism if plaintiff shipped it to Chrysler (apparently in Detroit), *return shipping prepaid*![249] Even this extraordinarily limited warranty, available only to the purchaser within the first ninety days or four thousand miles (whichever came first), was in tiny print in a sea of form provisions.[250]

If one listens to the contractarians, one would think that rational product consumers would not have accepted contracts that left them so vulnerable and without remedy, but they did until the courts intervened.[251] Stockbrokers provided and investors accepted very similar contracts before the 1933 Act was passed. A standard contract spoke at length about the *rights of the broker*—to hold securities as collateral, to make transfers among the customer's accounts without notice, to segregate collateral in excess of margin requirements, to demand

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THEORY AND RESEARCH 6–7 (1978) ("Even the most contentious scientist would find it difficult to challenge [the] proposition . . . that . . . individuals will try to maximize their outcomes."); Linda J. Keil & Charles G. McClintock, *A Developmental Perspective on Distributive Justice*, *in* EQUITY THEORY: PSYCHOLOGICAL AND SOCIOLOGICAL PERSPECTIVES 13, 19 (David M. Messick & Karen S. Cook eds., 1983) ("[I]t is safe to assume that humans are generally motivated to maximize their own gain . . . ."). This is a widespread human tendency, as I have explored elsewhere. *See* Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1606–29 (2000) (analyzing the self-serving bias and providing illustrations of the way in which the self-serving bias affects different professionals).

247. 161 A.2d 69 (N.J. 1960).

248. *Id.* at 75 (noting that the car had been driven only 468 miles).

249. *Id.* at 74.

250. *Id.* Before the courts intervened, "*all* manufacturers disclaimed liability for the costs of personal injuries in their warranties." Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 MICH. L. REV. 683, 727 (1993).

251. Professor W. David Slawson has discussed the evolution of contract law in this arena, illustrating with the *Henningsen* case, and noting that before the courts and legislatures intervened, "the chief and most evident consequence of these systematic inequalities of bargaining power was to make contracts very unfavorable to consumers. Producers everywhere took advantage of the opportunities their superior bargaining powers opened to them." SLAWSON, *supra* note 178, at 32.

additional security at any time, to receive payment of commissions on demand, to employ sub-brokers, to sell, assign or deliver the customer's securities without advertisement or notice of sale whenever necessary to protect the broker's interests, to hold the customer liable for any deficiencies, and to be held harmless and indemnified by the investor from any loss, damage, or liability arising out of securities transactions.[252] The contract provided that a customer could not rely on the oral statements of his broker agreeing to liquidate the customer's accounts: "all such agreements must be in writing."[253] The only *duties* of the broker mentioned in a standard agreement were to execute orders in compliance with exchange rules and to use reasonable care in selecting sub-agents.[254]

Before passage of the Trust Indenture Act of 1939,[255] issuers and underwriters marketed debentures, bonds, and notes by relying in large part upon the reputation of the trustees who would supposedly look out for the best interests of the investors; unfortunately, the indentures themselves usually exonerated the trustees from liability when they abandoned the investors' interests.[256]

Similarly, the exchange rules did not vigorously protect investors.[257] The NYSE rules did require that no investor pay *less* than the minimum commission rates prescribed by the exchange,[258] but beyond that price-fixing provision, did little more than formally forbid circulation of rumors, demoralization of the market, and "reckless and unbusinesslike dealing."[259] The rules did make a member subject to ex-

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252. TWENTIETH CENTURY FUND, INC., THE SECURITY MARKETS, app. XIX, at 773–74 (1935).

253. *Id.* at 774.

254. *Id.* at 773, 774.

255. 15 U.S.C. § 77aaa–77bbbb (2000).

256. *See generally* 6 SEC. EXCH. COMM'N, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES: TRUSTEES UNDER INDENTURES 2–6 (1936) (discussing the facts underlying passage of the TIA). As the Supreme Court noted in *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416 (1972), "[e]ven in cases where misconduct by the indenture trustee was the proximate cause of injury to debenture holders, they found themselves impotent under the terms of most indentures to take action against the trustee." *Id.* at 425.

257. For the most part, the rules prohibited stealing from investors. *See* TWENTIETH CENTURY FUND, INC., *supra* note 252, at 757 (summarizing stock exchange rules regulating the broker-customer relationship).

258. *Id.* at 760.

259. *Id.* at 763.

pulsion for fraud,[260] but whether this was meant to protect customers or other exchange members and how stringently it was enforced are unclear.[261]

If Choi's assumptions were correct, investors before passage of the 1933 Act should have bargained for just the right level of disclosure and protection from fraud. They did neither. According to Choi, investors should have demanded full disclosure. They did not.[262] The massive increase in individual investors in the 1920s "did not translate into increased demand for audits."[263] Similarly, securities industry professionals provided and investors accepted a status quo of relatively little investor protection from fraudulent, deceitful, and unfair securities practices before the 1933 and 1934 Acts changed the situation.[264]

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260. CONSTITUTION, BY-LAWS AND RULES OF THE NEW YORK STOCK EXCHANGE, art. XVII, § 2 (1914), *reprinted in* SAMUEL P. GOLDMAN, A HANDBOOK OF STOCK EXCHANGE LAWS AFFECTING THE MEMBERS AND THEIR CUSTOMERS, BROKERS, AND INVESTORS 117, 140 (1914).

261. Underwriters acted similarly. In 1927, National City Company investigated bonds from Peru. All the information it discovered was unfavorable, yet it undertook to underwrite the bonds. It did not disclose any of the negative information it had discovered, but simply put this disclaimer in the prospectus: "The above statements are based on information received partly by cable from official and other sources. While not guaranteed, we believe them to be reliable, but they are in no event to be construed as representations by us." Unsurprisingly, the bonds went south and investors lost nearly $75 million although underwriters' commissions were a neat $4.5 million. SELIGMAN, *supra* note 20, at 28.

262. PREVITS & MERINO, *supra* note 94, at 250; Pritchard, *supra* note 5, at 1008 ("More fundamentally, the failure of the securities markets to impose [voluntarily] more stringent disclosure requirements also suggests that the demand for such disclosure among investors was limited.").

263. PREVITS & MERINO, *supra* note 94, at 250. The authors go on to note that "[t]he handful of reformers who called for greater protection of investors were ignored. Nor were investors, who did not rebel when stripped of their voting rights through issuance of nonvoting common stock, likely to demand independent audits to protect their interests." *Id.*

264. Despite the failure of pre-1933 securities professionals to voluntarily provide protection to investors, there was at least Blue Sky regulation and state common law. Unfortunately, states typically did not allocate sufficient funds so that Blue Sky antifraud provisions could have any teeth. *See* SELIGMAN, *supra* note 20, at 46 (noting that only eight states appropriated enough money for full-time enforcement staff and that in most states securities regulation was a political football). The hornbook law was that stockbrokers, as other agents, owed a duty of skill and diligence and well as good faith to their customers. *See* DOUGLAS CAMPBELL, THE LAW OF STOCKBROKERS 41 (2d ed. 1922) ("The degree of skill and diligence which he must exercise is that which competent and experienced stockbrokers are accustomed to show under similar circumstances.") (citation omitted). However, the pre-1933 cases imposing liability on stockbrokers are few and far between. My own search uncovered very few: Boyle v. Henning, 121 F. 376, 376 (C.C.W.D. Ky. 1902) (holding a stockbroker to a duty of due care in handling an investor's money and carrying out his instructions); Hopkins v. Clark, 53 N.E. 27, 27 (N.Y. 1899) (affirming a judgment against a stockbroker for engaging in an unauthorized transaction); Levy v.

Today, industry professionals' self-interest has not changed, only the law has changed. Unregulated, securities professionals are still unwilling to provide much in the way of investor protection. For example, the field of derivative products remains relatively unregulated. However, under governmental pressure the key firms (CS First Boston, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley and Salomon Brothers) set up the Derivatives Policy Group (DPG) to establish a plan of self-regulation.[265] What were the results of the DPG's plan? "Although it appears that the DPG was willing to agree to protect itself, it was not willing voluntarily to provide protection to end-users. Th[e] section dealing with sales practices is carefully worded to avoid creating any legal obligations to purchasers of the derivatives . . . ."[266]

The following Sections explain why investors were willing to settle for inadequate protection in the 1920s, and why they would probably be willing to do so again today.

1. *Bounded Rationality and Rational Ignorance*. If Kira, as an intermediary-level investor, walks into the office of an intermediary, she will be at an immediate disadvantage. Whereas standard economic theory assumes that economic actors such as Kira are rational decisionmakers in possession of the full information needed to make important decisions, the reality, of course, is that human rationality is bounded. It is now widely recognized, as Professor Herbert Simon noted forty-five years ago, that because they seldom have complete and perfectly accurate information and never have perfect capacity to process that information, people are "*intendedly* rational, but only *limitedly* so."[267] Because of bounded rationality, it is erroneous to assume that the parties usually will negotiate the most efficient possible contract.[268]

Loeb, 85 N.Y. 365, 365 (1881) (finding a stockbroker liable for breach of contract); Harris v. Tumbridge, 83 N.Y. 92, 92 (1880) (affirming a judgment based on unauthorized transactions).

265. Allen D. Madison, *Derivatives Regulation in the Context of the Shingle Theory*, 1999 COLUM. BUS. L. REV. 271, 320–21.

266. *Id.* at 321.

267. HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1957).

268. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1505 (1998) (suggesting that "bounded rationality, in particular the endowment effect, casts doubt on the conventional law and economics claim" that parties negotiate the most efficient contracts and that any imposition of mandatory terms makes them worse off).

Related to bounded rationality is the concept of rational ignorance. It is reasonable for decisionmakers such as Kira, who do not have unlimited time and unlimited resources, to choose not to gather all the relevant information for their decisionmaking. Decisionmakers must choose among numerous demands on their time and attention and will often sensibly choose to "satisfice" rather than to optimize their decisionmaking.[269]

Bounded rationality and rational ignorance apply as well to professional investors as to lay investors. Professor Jacob Jacoby reports that "[r]esearch shows that, operating under conditions that have both financial and ego consequences and where information acquisition costs are virtually zero, even professional security analysts deciding on which securities to select do not acquire most (or even much) of the information available."[270]

Given bounded rationality and rational ignorance, it is unlikely that Kira's contracting with her intermediary (or issuer) will go as Choi assumes. Whereas economic analysis assumes that contracts should be complex, in fact they are generally simple, at least the part that is actually bargained over.[271] Because an intermediary likely will present Kira with a relatively detailed form contract (investor regulation invalidates the SEC's "plain English" requirements,[272] so the intermediary is free to inundate Kira with massive legal boilerplate), her ability to understand its obscure terms is bounded.[273] An investment of the time and mental energy needed to master the details of the contract may not be cost-justified, especially because the agent with whom Kira is dealing probably has no authority to alter the con-

269. *See* ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 50–56 (1988) (discussing the implications of the tendency of people to "satisfice" rather than to optimize, choosing the first alternative that produces a satisfactory result rather than searching for the alternative that would provide an optimal result); Herbert A. Simon, *Rational Choice and the Structure of the Environment*, 63 PSYCHOL. REV. 129, 129 (1956) (noting that organisms tend to "satisfice" rather than optimize when making decisions).

270. JACOBY, *supra* note 74, at 66–67 (citing Jacob Jacoby et al., *Effectiveness of Security Analyst Information Accessing Strategies: A Computer Interactive Assessment*, 1 COMPUTERS & HUM. BEHAV. 95, 95–113 (1985)).

271. *See* KAREN EGGLESTON ET AL., SIMPLICITY AND COMPLEXITY IN CONTRACTS 13–14 (Univ. of Chi. Law Sch., Working Paper No. 93, 2000) (on file with the *Duke Law Journal*) (suggesting that bounded rationality is one of the reasons that real world contracts are much simpler than economic analysis predicts).

272. Plain English Disclosures, Securities Act Release No. 7497, Exchange Act Release No. 39,593, Investment Company Act Release No. 23,011, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,003 (Jan. 28, 1998) (codified as amended in scattered sections of 17 C.F.R.).

273. *See* EGGLESTON ET AL., *supra* note 271, at 13–14.

tract anyway.[274] Therefore, rather than bargain extensively over the terms of the contract and how much she will pay for protection from fraud or unsuitable recommendations, Kira likely will sign the contract without meaningful negotiation and usually without reading more than a few parts of it. It is well known that investors typically do not read disclosure documents when investing in securities,[275] and Professor Melvin Aron Eisenberg notes in the context of insurance contracts and other similar types of contracts that this is a sensible (if not optimally rational) strategy,[276] concluding that "most form takers will find it irrational to engage in search and deliberation on any given form."[277]

In other commercial contracts, the consumer is protected by the doctrine of unconscionability[278] and the general rule that provisions of

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274. *See* Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1225 (1983) ("Customers know well enough that they cannot alter any individual firm's standard document."). Such written contracts often contain provisions that agents have no authority to alter or to make any statements inconsistent with.

Economists recognize that negotiation "costs" justify parties' decisions to enter into incomplete contracts. *See* Ronald A. Dye, *Costly Contract Contingencies*, 26 INT'L ECON. REV. 233, 236–37, 245–46 (1985) (arguing that a simple contract with few contingencies would be extremely expensive to write).

275. Kripke argued for years that SEC disclosure rules needed revamping in light of the fact that investors typically did not read the required disclosure documents. *See generally* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979); Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631 (1973). *See also* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures . . . ."); Kenneth B. Firtel, Note, *Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933*, 72 S. CAL. L. REV. 851, 870 (1999) ("[T]he average investor does not read the prospectus . . . .").

276. *See* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 240–45 (1995) (describing cognitive problems associated with form contracts). Eisenberg notes:

> The bottom line is simple: The verbal and legal obscurity of preprinted terms renders the cost of searching out and deliberating on these terms exceptionally high. In contrast, the low probability of these nonperformance terms' coming into play heavily discounts the benefits of search and deliberation. Furthermore, the length and complexity of form contracts is [sic] often not correlated to the dollar value of the transaction."

Id. at 243.

277. *Id.* at 244.

278. *See generally* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 147–73 (2d ed. 1980) (discussing the unconscionability doctrine in sales law).

adhesion contracts are unenforceable if they are surprising or unfair.[279] Under investor regulation, these protections are missing.

2. *Overoptimism and Overconfidence*. Even if she reads the contract with the issuer and clearly sees and understands its limitation of liability provisions, Kira still may not bargain to change them. Humans are inherently overoptimistic in most settings; they think that good things are going to happen to them and that the bad things that happen to others will not happen to them.[280] Manufacturers often play on consumers' naïve optimism[281] in selling risky products. Studies indicate that the overoptimism bias affects humans in the sphere of investments as well.[282] Thus, Kira will be overly optimistic that she will

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279. *See, e.g.*, Budget Rent A Car Sys., Inc. v. Crawford, No. 97-17131, 1999 U.S. App. LEXIS 10987, at *9 (9th Cir. May 25, 1999) (holding that adhesion contracts are enforceable unless they are oppressive or unfairly surprising); Hartland Computer Leasing Corp. v. Ins. Man, Inc., 770 S.W.2d 525, 527 (Mo. Ct. App. 1989) (noting that form contracts are not unenforceable unless they contain terms that are unexpected or unconscionably unfair).

280. *See* Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW & HUM. BEHAV. 439, 443 (1993) (finding that most people know that half of married couples will divorce but place their own chance at zero); AMY FARMER ET AL., THE CAUSES OF BARGAINING FAILURE: EVIDENCE FROM MAJOR LEAGUE BASEBALL 23 (Univ. of Ala., Econ., Fin. & Legal Studies Working Paper Studies, Working Paper No. 00-08-04, 2000) (finding "evidence that excessive optimism is a source of bargaining failure in major league baseball arbitration"); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1512 (1999) ("Considerable evidence suggests that smokers perceive smoking as significantly less risky for themselves than for other smokers, that smokers view their own risks as not significantly higher than those for non-smokers, and that smokers tend to underestimate the actual risks to themselves."); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 809–14 (1980) (finding, for example, that six times as many college students believed they were more likely to own their own home than the average person than believed that they were less likely).

281. Hanson & Kysar, *supra* note 159, at 729 (defining naïve optimism as "past experiences free from harm, a perception that risks are of low frequency, and a perception that the harm is preventable by human action").

282. *See* Werner F.M. De Bondt, *A Portrait of the Individual Investor*, 42 EUR. ECON. REV. 831, 839 (1998) (finding that investors tend toward overoptimism); SHILLER, BUBBLES, *supra* note 63, at 6 (explaining how overoptimism and overconfidence by investors, even professional investors, help contribute to market bubbles). Even when investors know they're involved in a bubble, their confidence remains high. During the Railway Mania in England in the 1840s, a letter to the editor of the London *Times* noted:

> There is not a single dabbler in scrip who does not steadfastly believe—first, that a crash sooner or later, is inevitable; and, secondly, that he himself will escape it. When the luck turns, and the crack play is *sauve qui peut*, or devil take the hindmost, no one fancies that the last mail train from Panic station will leave him behind. In this, as in other respects, "Men deem all men mortal but themselves."

CHANCELLOR, *supra* note 69, at 136 (quoting TIMES (London), July 12, 1845).

obtain good results from her investments[283] and will avoid victimization.

Kira's optimism will be fueled by a Wall Street "marketing juggernaut whose dominant message is simple: Wall Street can make you rich—and fast."[284] Today the hype must bear some relation to reality or the SEC will take action. If Choi's proposal is adopted, reality may well fly out the window. Even with regulation, a top priority for the SEC continues to be the false advertising conducted by mutual funds, broker-dealers, investment advisers, and other industry professionals[285]—the very actors that Choi would deregulate. Although investor regulation gives legal *carte blanche* to those willing to exaggerate or outright lie, Choi assumes that the market will sort this out; perhaps he is the optimist.[286]

After the stock market tanked in 2000–2001, one expert investor admitted, "[w]e were all wink-winking at each other and saying 'This is great. We love it. We hope it goes on forever,' knowing that it wouldn't go on forever but not wanting to be the first guy to say it's over." Gregory Zuckerman et al., *Looking Back: Experts Learn Tech Rallies, Too, Must End*, WALL ST. J., Mar. 9, 2001, at C1 (quoting an unnamed investor). The more things change, the more they stay the same.

283. *See* Hu, *supra* note 163, at 861 ("Investors have a patently unrealistic view of the true downside [of investing in the stock market].").

284. Marcia Vickers & Gary Weiss, *Wall Street's Hype Machine*, BUS. WK., Apr. 3, 2000, at 112, 112.

285. *See* Sarah O'Brien, *SEC Muddling Ad Rules, Critics Say*, INVESTMENT NEWS, Feb. 28, 2000, at 1, 1 (discussing the recent SEC emphasis on false mutual fund advertising).

286. Even with seventy years of regulation on the books, investment advisers, broker-dealers, and mutual funds continually misrepresent their performances. *See, e.g.*, *Accusations Against Day Trading Concerns*, N.Y. TIMES, July 18, 2000, at C8 (reporting NASD charges of false advertising against day-trading firms); *E-Trade's Ads Under Scrutiny of SEC and NASD*, L.A. TIMES, Aug. 26, 2000, at C3 (describing lawsuits for false advertising filed against an Internet brokerage firm); John Hechinger, *Pay Attention to the Fine Print*, CHI. TRIB., Jan. 20, 2000, at C3 (describing new forms of misleading mutual fund ads); *Investment Advisers: Pittsburgh Firm, Official Settle Charges Ads Inflated Client Returns on Investment*, BNA SEC. LAW DAILY, June 7, 2000 (describing the settlement of an case of false advertising against an investment advisor); Laura Lallos, *Reading Between the Numbers; Why Those Explosive Returns Can Be Misleading*, MONEY, July 2000, at 38, 38 (noting several instances of misleading advertising by mutual funds and reporting Dreyfus's $1 million fine for exaggerating results paid in May 2000); Benjamin Y. Lowe, *Pennsylvania Money Manager Fined over Fraudulent Claims*, PHILA. INQUIRER, Aug. 10, 2000, at C2 (reporting $100,000 in fines for false advertising levied by the SEC against a fund manager and his firm); *Morgan Unit Settles Disclosure Charge*, L.A. TIMES, Sept. 9, 1999, at C4 (noting a $125,000 payment by Morgan Stanley Dean Witter & Co.'s Van Kampen Investment Advisory unit for misleading mutual fund advertising); Jeff D. Opdyke, *Wade Cook and Regulators Near Settlement*, WALL ST. J., Aug. 31, 2000, at C1 (reporting that the SEC and FTC were nearing settlement with investment guru Wade Cook on false advertising charges); Steve Raabe, *Firm Fined for False Advertising: SEC Says Lakewood Company Overstated Investors' True Returns*, DENVER POST, June 1, 2000, at C2 (noting that the SEC had

Thus, Kira's optimism will tend to lead her to believe that she will succeed where others will fail, that she will know the right path where others will be misled, that she will be impervious to fraud where others are victimized. Kira's vulnerability to overoptimism will be reinforced by her overconfidence. Just as studies show that she will tend to believe that she is a better driver and better manager than her peers,[287] she also will tend to believe that she is a better investor,[288] even though numerous academic studies show that amateur investors are poor traders.[289]

Because of the attribution bias, Kira will tend to view her investment successes as the result of her analysis and strategies and her failures as due to bad luck and forces beyond her control.[290] Due to the illusion of control,[291] she will believe that the general tide of a ris-

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imposed a censure and a fine of $80,000 against an investment advisory firm for false advertising).

287. *See* MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 95 (4th ed. 1998) ("[P]eople have been found to perceive themselves as being better than others across a number of traits, including honesty, cooperativeness, rationality, driving skill, health, and intelligence.") (citation omitted).

288. *See* De Bondt, *supra* note 282, at 831 (finding overconfidence in investors generally, as well as overoptimism, a tendency to discount diversification, and a rejection of the notion that there is a positive tradeoff between risk and return); *see also* SHEFRIN, *supra* note 63, at 132–33 (discussing studies showing investor overconfidence); SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 142 ("I find that overconfidence is apparent when I interview investors; they seem to express overly strong opinions and to rush to summary judgments.").

289. *See* Vickers & Weiss, *supra* note 284, at 112 ("Numerous academic studies have shown that amateur investors make poor traders—buying stocks for the wrong reasons, holding losers for too long, and acting on whims and emotions.").

290. This general effect is well-established. *See* Tom Pyszczynski & Jeff Greenberg, *Toward an Integration of Cognitive and Motivational Perspectives on Social Inference: A Biased Hypothesis-Testing Model*, 20 ADVANCES EXPERIMENTAL SOC. PSYCHOL. 297, 298 (1987) (describing the "well-replicated finding that people tend to make dispositional attributions for their successes and situational attributions for their failures"); Barry R. Schlenker & Rowland S. Miller, *Egocentrism in Groups: Self-Serving Biases or Logical Information Processing?*, 35 J. PERSONALITY & SOC. PSYCHOL. 755, 762–63 (1977) (describing a self-serving bias explanation for egocentrism in groups).

It affects investors as well. *See* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 59 ("Even though a rising market 'lifts all boats,' there is still at tendency for investors to interpret their investing success as confirmation of their own abilities, and this reinforces their interest in trading stocks.").

291. *See* BAZERMAN, *supra* note 287, at 95 (arguing that "[p]eople falsely believe that they can control uncontrollable events, and they overestimate the extent to which their actions can guarantee a certain outcome") (citations omitted); THALER, *supra* note 66, at 138 (noting that lotteries in North America did not become popular until New Jersey introduced a game which allowed players to pick their own numbers, leading them to feel that they had a better chance of winning than when numbers were selected at random for them); Ellen J. Langer, *The Illusion of Control*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 231, 231 (reporting the results

ing market is actually due to her own wise decisions regarding either the investments she has made or the broker she has selected.[292] The illusion of control may well prompt her to resort to margin borrowing, as investors did at record rates during the recent stock market boom (three times the historic norm) thus taking on "unprecedented risk."[293] It also leads investors to trade more, even though investors who trade more tend to do worse than investors who trade less.[294]

Kira's vulnerability to these cognitive limitations does not disappear when she educates herself beyond the level of an unsophisticated investor. Educated people and professionals are generally just as subject to phenomena such as overoptimism[295] and overconfidence[296] as are unsophisticated investors. Indeed, because of the availability heuristic they may well focus on their own past successes and be even

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of studies indicating that "[w]hile people may pay lip service to the concept of chance, they behave as though chance events are subject to control"); Ellen J. Langer & Jane Roth, *Heads I Win, Tails It's Chance: The Illusion of Control as a Function of the Sequence of Outcomes in a Purely Chance Task*, 32 J. PERSONALITY & SOC. PSYCHOL. 951, 954–55 (1975) (finding that initial success in correctly predicting the outcome of a purely chance event, a coin toss, can lead to a skill attribution and a superrational expectation of future success).

292. In 2000, the *Wall Street Journal* ran a series of ads based on the illusion of control. They contained only two words in large print: "Manipulate fate." WALL ST. J., Apr. 27, 2000, at C5. People generally know at some level that they cannot manipulate fate, but Shiller believes there is an element of what psychologists call "magical thinking" at work here in that "[p]eople have occasional feelings that certain actions will make them lucky even if they know logically that the actions cannot have an effect on their fortunes." SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 143; *see also* SHEFRIN, *supra* note 63, at 132–33 (noting that illusion of control, along with overconfidence, seems especially rampant among day traders).

293. Vickers & Weiss, *supra* note 284, at 112 (quoting Professor Terrance Odean as noting that "[c]ontrol is put forth as an unquestioned good, and the simple fact is that investors are not in control of the stock market").

294. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 59.

295. *See, e.g.*, Neil D. Weinstein, *Unrealistic Optimism About Susceptibility to Health Problems: Conclusions from a Community-Wide Sample*, 10 J. BEHAV. MED. 481, 494–96 (1987) ("[U]nrealistic optimism is prevalent among the population as a whole. . . . and [is] largely unrelated to age, sex, level of education, or occupational prestige.").

296. BELSKY & GILOVICH, *supra* note 241, at 152 (describing many studies over the years, which have shown that a wide variety of professionals, including securities analysts, tend to be overconfident); Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411, 412 (1992) (arguing that experts "are often wrong but rarely in doubt"); Hanson & Kysar, *supra* note 159, at 660 (noting that "when the pertinent events are not easily predictable and the feedback is unambiguous, experts tend to be even more overconfident than laypersons"); Pamela Kent & Ron Weber, *Auditor Expertise and the Estimation of Dollar Error in Accounts*, 34 ABACUS 120, 127 (1998) (finding overconfidence in accountants); Stuart Oscamp, *Overconfidence in Case-Study Judgments*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 287, 287–93 (finding that psychologists were greatly overconfident in their judgments).

more overconfident than lay investors.[297] Empirical studies show that professional stock analysts who experience random success become overconfident in their stock-picking prowess.[298]

Robert Citron, controller of Orange County comes to mind. He likely would have done very well on an SEC-administered investor's test, but his overconfidence bankrupted wealthy Orange County.[299] Boston University's former president John Silber, who was almost as smart as he thought he was, put twenty percent of the university's portfolio in a single biotech company, with disastrous results.[300] Or consider Long-Term Capital Management. The overconfidence of Nobel laureates Robert Merton and Myron Scholes and of John Meriwether, one of the most respected Wall Street traders in recent memory, almost sank the entire American financial structure.[301] Thus, even issuer-level investors are subject to these cognitive limitations.[302]

In one version of his proposal, Choi would allow investors to voluntarily self-select into appropriate regulatory categories.[303] By be-

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297. *See* Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301, 315 (2000) ("[N]ot only is the superstar trader more likely to be overconfident about his abilities, but his supervisors and co-workers are also likely to be overconfident about the abilities of a trader that they respect and admire.").

298. Gilles Hilary & Lior Menzly, Does Past Success Lead Analysts to Become Overconfident? 28 (Apr. 2, 2001) (unpublished manuscript, on file with the *Duke Law Journal*).

299. *See Agent Orange*, ECONOMIST, Apr. 15, 1995, at 19, 19 ("At the height of his success Mr. Citron was confident enough to ridicule the acumen of investment bankers at Goldman Sachs who tried to persuade him that he was riding for a fall.").

300. SHILLER, BUBBLES, *supra* note 63, at 8–9.

301. *See* DUNBAR, *supra* note 1, at 45 (describing how LTCM's troubles caused a "near meltdown of the global financial system"); ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT 233–36 (2000) (noting the extreme hubris of LTCM's principals); Gregory Zuckerman, *Long-Term Capital Chief Acknowledges Flawed Tactics*, WALL ST. J., Aug. 21, 2000, at C1 (quoting Meriwether as saying that "[o]ur whole approach was fundamentally flawed [and] I feel enormous remorse").

302. *See* JACOBS, *supra* note 66, at 88–89 (noting several studies indicating that stock analysts are overly optimistic); Lucy F. Ackert & George Athanassakos, *Prior Uncertainty, Analyst Bias, and Subsequent Abnormal Returns*, 20 J. FIN. RES. 263, 272 (1997) (finding that securities' analysts are, on average, overly optimistic except in situations where uncertainty is low); Willard T. Carleton et al., *supra* note 172, at 19 (finding that brokerage firms' investment recommendations are more optimistic than the recommendations of nonbrokerage firms, although it is difficult to tell whether this is due to an unconscious optimism or a more studied pursuit of self-interest); David Hirshleifer et al., *Security Analysis and Trading Patterns When Some Investors Receive Information Before Others*, 49 J. FIN. 1665, 1686 (1994) (finding that investment experts are overconfident regarding their stock-picking abilities); Zuckerman, *supra* note 301, at C1 (noting that, before the stock market fall of 2000–2001, expert investors were optimistically claiming that the new economy made P/E ratios irrelevant and that the bull market could go on indefinitely).

303. Choi, *supra* note 7, at 312.

lieving that investors will choose "just right" categories for themselves, Choi underestimates the overconfidence and overoptimism biases.

3. *The False Consensus Effect*. Another problem for Kira is the false consensus effect, the tendency of people to believe that others see the world as they do.[304] This affects investors who often think that because they believe that ABC is a stock worth buying, other investors will also.[305] More importantly, people who are honest and who personally view the commission of a brazen fraud as unthinkable may falsely ascribe to their intermediaries, such as stockbrokers, a similar worldview.[306] Overconfidence and overoptimism exacerbate this vulnerability to fraudsters.

4. *Insensitivity to the Source of Information*. Another reason Kira's tendency will be to fail to realize that she is being defrauded and to fail to contract to protect herself from that fraud is the general human insensitivity to the source of information.[307] This insensitivity, among other factors, causes even trained auditors to tend to overweight explanations for accounting anomalies that are given by their clients even though they are cognizant of their clients' incentive to mislead.[308] If suspicious circumstances arise, auditors tend to focus

304. *See* Colin F. Camerer, *Individual Decision Making*, *in* THE HANDBOOK OF EXPERIMENTAL ECONOMICS 587, 612–13 (John H. Kagel & Alvin E. Roth eds., 1995) (explaining the phenomenon). *See generally* Lee Ross et al., *The "False Consensus Effect": An Egocentric Bias in Social Perception and Attribution Processes*, 13 J. EXPERIMENTAL & SOC. PSYCHOL. 279 (1977) (same).

305. *See* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 143 (describing how psychological experiments show that people often think "'[i]f I buy a stock, then others will probably want to buy the stock, too, because they are like me . . . .'")

306. *See* Langevoort, *supra* note 245, at 107 (using a case study to explain how this effect induces lawyers with crooked clients to overlook obvious frauds); Prentice, *supra* note 75, at 163 (noting a similar potential effect with auditors).

307. *See* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 3, 7–11 (noting that decisionmakers suffer from, among other problems (a) insensitivity to predictability—for example, if given a description of a company and asked to predict its profitability, people's predictions tend to remain the same regardless of whether the information is reliable or unreliable, and (b) the illusion of validity—people will be confident in the prediction that a person is a librarian when a description of that person matches a stereotype of a librarian, even if the information contained in the description is scanty, unreliable, or outdated).

308. *See* Urton Anderson & Lisa Koonce, *Explanation as a Method for Evaluating Client-Suggested Causes in Analytical Procedures*, AUDITING: J. PRAC. & THEORY, Fall 1995, at 124, 130 (finding that auditors have a tendency to find evidence supporting causes of unexpected fi-

their attention on the client's supposed integrity, and that factor dominates the suspicious facts.[309] Kira is likely to have the same difficulty with her stockbroker's explanations for facts that seem to contradict its recommendations,[310] especially because studies show that people have difficulty disregarding information, even when they learn that it is from an unreliable source.[311] A recent empirical study showed that people recognized that rumor sources were noncredible and claimed that they were not influenced by them, but traded stocks as if the rumors were news.[312]

Fraudulent acts by defendants can worsen this problem. Professors Jon Hanson and Douglas Kysar note how the tobacco industry often published pro-tobacco propaganda pieces under the names of "independent" writers, hiding their links to the cigarette trade to make the articles seem objective.[313] Touting is a cottage industry in the securities business these days[314] and one that will move into larger

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nancial statement fluctuations suggested by their clients); D. Eric Hirst & Lisa Koonce, *Audit Analytical Procedures: A Field Investigation*, 13 CONTEMP. ACCT. RES. 457, 474 (1996) ("[Auditors] do not normally seek information that contradicts or refutes [client] explanations, *unless* information comes to their attention indicating that an explanation may not be valid."); Lisa Koonce, *Explanation and Counterexplanation During Audit Analytical Review*, 67 ACCT. REV. 59, 74 (1992) (finding that auditors tend to evaluate hypotheses inherited from management as more plausible than they really are).

309. *See* Mark E. Peecher, *The Influence of Auditors' Justification Processes on Their Decisions: A Cognitive Model and Experimental Evidence*, 34 J. ACCT. RES. 125, 136–39 (1996) (finding that this effect is greater when the client had higher credibility than when it had lower credibility).

310. Martha Brannigan, *Victims of Investment Scams Seem Condemned to Repeat Past Errors*, WALL ST. J., Mar. 24, 1988, at 29 (describing the case of a fraud victim who "continued to invest even though the saleswoman offered only excuses for why [the victim's] prior ventures hadn't started paying off").

311. *See generally* Tversky & Kahneman, *supra* note 307, at 7–11 (describing people's insensitivity to predictability, and describing, for example, how, if given a description of a company and asked to predict its profitability, people's predictions tend to remain the same regardless of whether the information is reliable or unreliable).

312. Nicholas DiFonzo & Prashant Bordia, *Rumor and Prediction: Making Sense (but Losing Dollars) in the Stock Market*, 71 ORG. BEHAV. & HUM. DECISION PROCESSES 329, 346 (1997) ("[R]umors do not have to be believed or trusted to powerfully affect trading, they simply have to make sense.").

313. Hanson & Kysar, *supra* note 280, at 1491.

314. *See* Noelle Knox, *FBI Swoops Down on Wall Street Mob: Authorities Arrest 120 in Farthest-Reaching Securities Fraud Yet*, USA TODAY, June 15, 2000, at B1 (discussing how stock touting was part of the Mob's securities fraud scheme); E. Scott Reckard, *SEC Files Internet Stock Fraud Suit*, L.A. TIMES, May 4, 2000, at C3 (describing a suit filed for touting via the Internet); Dean Starkman & John R. Emshwiller, *Authorities Probe Growing Wave of Stock-Market Touts*, WALL ST. J., Apr. 23, 1998, at C1 (noting a rise in touting activity); Jonathan Weil & Brenda L. Moore, *Houston P.R. Firm Is Fined by SEC over Disclosure*, WALL ST. J., Aug. 23,

quarters under investor regulation. Supposedly objective stock analysts are often subject to the grossest conflicts of interest.[315] So even if Kira is sensitive to the sources of her information, what seems to be an objective source may not be objective at all. After all, under Choi's regime of investor regulation, it apparently is legal for Issuer A to pay money to Analyst B to state her "objective" opinion that Issuer A's stock is a "steal" at current prices. Kira is unlikely to learn of A's under-the-table payments to B.

Critical to investor regulation is Choi's assumption that people will know when they need to bargain for fraud protection and when they don't. Unfortunately, people generally believe that they are good at detecting when they are being lied to,[316] when the behavioral research shows that they are not.[317] Most scholars conclude (a) "that

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2000, at T2 (reporting the story of a firm that was fined for touting the stocks of microcap companies without disclosing how much those companies had paid them in exchange).

315. *See* Gretchen Morgenson, *Telecom's Pied Piper: Whose Side Was He On?*, N.Y. TIMES, Nov. 18, 2001, at BU3 (explaining how a stock analyst shared in the millions of dollars of fees that his recommendations of telecom companies brought his firms in business from the companies he recommended, while costing investors millions in losses); Louis Lowenstein, Corporate Governance and the Voice of the Paparazzi 52 (unpublished manuscript, on file with the *Duke Law Journal*) (noting that analysts "are under exquisite pressure to hear and see no 'evil,' to write only upbeat reports about the companies which they too see as the source of business far more profitable than the trading commissions that are the immediate *raison d'être* of those reports"); *see also* Debbie Galant, *The Hazards of Negative Research Reports*, INSTITUTIONAL INVESTOR, July 1990, at 73, 73 (noting the results of a survey in which sixty-one percent of surveyed analysts reported that they had been pressured by employers into tempering negative reports, and giving an example of when Donald Trump successfully intimidated a client into firing an analyst with whom Trump was unhappy); Robert McGough, *Bearish Call on Banks Lands Analyst in Doghouse*, WALL ST. J., Nov. 23, 1999, at C1 ("It is no longer news that analysts' recommendations may lack objectivity.").

Hayward and Boeker recently performed an extensive empirical study of security analysts' ratings of corporate equity securities, finding that if securities firms are hired by a client to assist in a transaction, the firms' financial analysts tend to assign higher ratings to the client's securities than other analysts. This conflict of interest is, they found, a dominant, entrenched result, and the larger the client, the greater the effect. Mathew L.A. Hayward & Warren Boeker, *Power and Conflicts of Interest in Professional Firms: Evidence from Investment Banking*, 43 ADMIN. SCI. Q. 1 (1998).

316. *See* ARTHUR A. LEFF, SWINDLING AND SELLING 84–87 (1976) (describing the difficulty people have in believing that they could be fooled). Authors of popular books often give "tips" to readers about how to detect liars. *See, e.g.*, SUZETTE H. ELGIN, THE LAST WORD ON THE GENTLE ART OF VERBAL SELF-DEFENSE 212–17 (1987) (teaching the art of protecting one's self from becoming susceptible to lies); HIRSH GOLDBERG, THE BOOK OF LIES 233–36 (1990) (giving practical advice on avoiding others' deception).

317. EVELIN SULLIVAN, THE CONCISE BOOK OF LYING 206 (2001) ("In scientifically conducted experiments, the success rate of people being asked to sort out lies from truth, say by watching people on videotape either lying or telling the truth, has been shown to be poor."); Annette Baier, *Trust and Its Vulnerabilities*, *in* 13 TANNER LECTURES ON HUMAN VALUES 109,

few people do better than chance in judging whether someone is lying or truthful," and (b) "that most people think they are making accurate judgments even though they are not."[318] Choi's sophisticated investors often do no better; "scams work all economic classes."[319] Langevoort is likely correct when he observes that "once a broker successfully cultivates trust, willing reliance by the sophisticated investor—imprudent though it may seem in hindsight—is quite likely and, for that reason alone, worthy of some protection."[320]

Choi admits that a totally fraudulent brokerage firm might come into existence and rip off everyone it can.[321] In his mind this is a good thing because "investors who choose intermediaries that fail to implement any investor protections . . . pay less for intermediary services."[322] For a wide variety of reasons covered in this Section, it is clear that Choi's observation may not be true. Unless investors have a good sense of the likelihood of their being ripped off, they may not bargain

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110 (Grethe B. Peterson ed., 1992) (noting that the bases of trust, such as feelings, beliefs, and intentions can be faked by the other party, and concluding therefore that "[t]rust is a notoriously vulnerable good"); Shell, *supra* note 139, at 266 ("[H]uman perception overall is not a reliable defense to opportunistic behavior."); Peter Vallentyne, *The Rationality of Keeping Agreements*, *in* CONTRACTARIANISM AND RATIONAL CHOICE: ESSAYS ON DAVID GAUTHIER'S MORALS BY AGREEMENT 177, 177 (Peter Vallentyne ed., 1991) ("[I]n the real world, people's dispositions are opaque enough that it is often possible to deceive others into thinking that one is trustworthy.").

Part of the problem comes from the confirmation bias and cognitive dissonance in that people who place their trust in others search for data to confirm the wisdom of that action. *See* David Good, *Individuals, Interpersonal Relations, and Trust*, *in* TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 31, 42 (Diego Gambetta ed., 1988) (reporting evidence indicating that "the nature of the information available to individuals, and the way they process it, can serve to maintain an individual's theory or theories about other people and society, even though one might believe that a careful consideration of that information would lead to rejection of those theories").

318. PAUL EKMAN, TELLING LIES 162 (1985). There are techniques that may work to determine whether someone is lying. However, the clues liars give off are subtle and not many people can detect them. *Id.*; *see also* Peter J. DePaulo et al., *Lying and Detecting Lies in Organizations*, *in* IMPRESSION MANAGEMENT IN THE ORGANIZATION 377, 387 (Robert A. Giacalone & Paul Rosenfeld eds., 1989) (describing an experiment in which participants had done no better than chance in guessing when sales representatives were pushing products they believed in and when they were pushing products they disliked).

319. ROBERT J. STEVENSON, THE BOILER ROOM AND OTHER TELEPHONE SALES SCAMS 110 (1998) (presenting a study by an ethnographer who worked in product boiler rooms).

320. Langevoort, *supra* note 145, at 631. Langevoort goes on to note that "[a]lthough bad decisions by sophisticated buyers and instances of seller cheating (i.e., any abuse of trust to sell an investment that is inconsistent with the buyer's best interests) are surely the exception rather than the rule . . . they should not be trivialized as 'random noise' in the study of investing." *Id*.

321. Choi, *supra* note 7, at 295–96.

322. *Id.* at 296.

for a lower price, and Choi only hopes that they will. He points optimistically to customers who complain that Internet broker E*Trade is slow in executing trades during times of high market volume, but are compensated by paying only $14.95 per trade.[323] If there were a strong correlation between price charged and quality of service, Choi would have a stronger point, but there is not.[324]

Indeed, investors most likely will not be able even to discover if they are getting a good deal or not,[325] which makes it rather difficult for them to bargain to protect themselves. Many investors who save money on commissions actually lose money overall because they do not receive the best execution from the brokers.[326] Many online brokers are able to offer low commissions by getting order flow payments from market makers who often do not offer the best execution.[327] Brokers never deign voluntarily to disclose information on best execution, although the SEC has imposed some mandatory disclosure.[328] As former SEC Commissioner Arthur Levitt noted, "'It just

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323. Choi is talking about the difference between buying from Saks's website and buying from K-Mart's website. But the real distinction is that between buying from Sears's website and buying from the website of a crook who takes the customer's money never intending to send the ordered merchandise.

324. Lack of correlation between fees and performance is far from unknown in the securities industry. One of the early leading studies of mutual funds found "no significant relation between the rates of management fees and performance results nor between the initial sales charges and performance results." SELIGMAN, *supra* note 20, at 366.

325. It is exceedingly difficult for investors, especially small investors, to determine whether their brokers have sent their orders to the best market. *See* ALLEN FERRELL, THE ALLOCATION OF INVESTORS' ORDERS AND INEFFICIENT MARKET COMPETITION: A PROPOSAL 18 (Harvard Law Sch., Discussion Paper No. 281, 2000) (on file with the *Duke Law Journal*) ("It may very well be prohibitively expensive for many small investors to acquire the necessary expertise and information to make a meaningful judgment about whether a broker has sent their orders to the appropriate market. Indeed, many small investors are probably unaware that they are uninformed.").

326. "Small orders have been routinely routed to securities markets offering inferior prices." *Id.*; *see also* Charles M.C. Lee, *Market Integration and Price Execution for NYSE Listed Securities*, 48 J. FIN. 1009, 1035 (1993) (finding evidence that "order flow patterns may be responsive to cash inducements, rather than price execution"); Rachel Witmer, *Options Markets: Payment for Order Flow in Options Markets Affecting Order Routing, SEC Study Says*, BNA SEC. L. DAILY, Dec. 20, 2000, at 1 (reporting the results of a study finding that most firms accepting payment for order flow do not pass the benefit on to customers).

327. Floyd Norris, *SEC Is Seeking to Open the Curtains on Stock-Trading Executions*, N.Y. TIMES, July 26, 2000, at C1. Furthermore, as Ferrell notes, "[t]he more side payments a broker receives, the lower its commission rate is likely to be. The full true cost of trading, as a result, will not be fully reflected in the broker's commission rate." FERRELL, *supra* note 325, at 27.

328. Disclosure of Order Execution and Routing Practices, Release No. 34-43590, 65 Fed. Reg. 75,414 (Dec. 1, 2000); *see also* Greg Ip, *New SEC Rules on Execution Disclosure Will Tell Investors of Hidden Trade Costs*, WALL ST. J., Nov. 16, 2000, at C1 (discussing the new rules).

doesn't make sense [that investors don't know what happens after they click 'submit'] when you recognize that missing the best price by the minimum increment available—1/16—on a 1,000-share order is worth $62.50, an amount that dwarfs the commission of the online firms.'"[329] The investors' situation in this regard likely will deteriorate noticeably under Choi's investor regulation model.

5. *Oral Versus Written Communications*. It is likely that Kira will enter into a contract with a securities professional after a period of negotiation. These negotiations likely will be oral, either in person or via telephone,[330] and eventually Kira will find a professional whom she trusts. Once Kira decides that she likes a stockbroker or perceives the broker's intentions as being favorable, all her subsequent views of that broker's actions will be significantly influenced.[331] Studies show that people whose success depends on the efforts of others tend naturally to form positive impressions of those on whom they depend.[332] Once they decide to trust, they "overdraw" on the information available; this simplifies life and allows customers to act as though they possessed real knowledge about a broker's future conduct.[333] Only after that trust and positive impression are established will the securities professional provide the written adhesion contract for Kira to sign.[334]

Although Kira would be wise to read the contract in its extensive detail and to bargain for fraud protection, she probably will not do so. One simple reason is that in daily commercial intercourse, oral communications trump written communications.[335] Securities professionals

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329. Ip, *supra* note 328, at C1 (quoting SEC Commissioner Levitt).

330. *See* Langevoort, *supra* note 145, at 629 ("Most investment sales interactions are oral, occurring either over the telephone or in face-to-face meetings.").

331. *See* Hanson & Kysar, *supra* note 280, at 1524 ("[C]onsumers can be significantly influenced by their perceptions of a seller's conduct and intentions.").

332. Langevoort, *supra* note 245, at 99 (citing Steven L. Neuberg & Susan T. Fiske, *Motivational Influences on Impression Management Formation: Outcome Dependency, Accuracy-Driven Attention and Individuating Processes*, 53 J. PERS. & SOC. PSYCHOL. 431 (1987)); Ziva Kunda, *The Case for Motivated Reasoning*, 108 PSYCHOL. BULL. 480, 486–87 (1990).

333. Klas Borell, *Trust and Fraud: Occupation and Resistance in Norway, 1940–1945*, 27 J. POL. & MIL. SOC. 39 (1999).

334. This is not a phenomenon limited to lay investors. Hu notes evidence that "[s]ome banks have exhibited a persistent tendency to commit verbally to swap transactions and document them later." Henry Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1491 (1993).

335. In arguing that investors are not as foolish as some believe when they fall prey to oral misrepresentations and do not heed written warnings (e.g., when a stockbroker makes all sorts

are well aware of this.[336] Many consumer purchases result from oral communications between consumer and sales representative, followed by the signing of a form contract provided by the seller. In most of these transactions, the parties' true "meeting of the minds" results solely from their oral communications. The writing plays no part in the negotiation process. It is provided after the real agreement is reached and is signed, typically by consumers who have, at most, glanced at it. As Shiller notes:

> The channels of human communication that we know today seem to favor the interpersonal face-to-face and word-of-mouth communication that developed over millions of years of evolution, during times when such communication was virtually the only form of interpersonal communication. The patterns of communication hard-wired into our brains rely on there being another person's voice, another person's facial expressions, another person's emotions, and an associated environment of trust, loyalty, and cooperation. Because these elements are missing from the written or electronic word, people find it somewhat more difficult to react to these

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of oral promises and then presents the investor with a contract stating that "the customer agrees that no representations not appearing in this contract have been made"), Sachs points out:

> [A]ny assessment of whether it is reasonable to rely on oral fraud must also reckon with the possibility that oral statements are by their nature more seductive than writings. Indeed, the interpersonal dimension may make an oral statement seem more persuasive than would a written statement, or it may reduce the likelihood that the investor will evaluate the statement dispassionately. Courts ought to assess the reasonableness of an investor's reliance in light of this psychological reality.

Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 911 (1994).

336. In counseling stockbrokers on how to effectively market securities, Drozdeck and Gretz note:

> According to Albert Mehrabian, 55 percent of our communication is through posture, gestures, and facial expressions; 38 percent is through our tone of voice; and only 7 percent through words themselves. These percentages have proved themselves valid through scores of other studies that also indicate that 85 to 93 percent of communication occurs below the conscious level of awareness. Therefore, in a face-to-face presentation, you are able to deliver 100 percent of the message, while a telephone presentation allows you to deliver only 45 percent; and a letter only 7 percent.

DROZDECK & GRETZ, *supra* note 168, at 222 (citing ALBERT MEHRABIAN, SILENT MESSAGE 248–57 (1971)); *see also* Donald C. Langevoort, *Markets and Information Gathering in an Electronic Age: Securities Regulation in the 21st Century: Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 761–62 (1997):

> [T]he permissibility of oral selling efforts during the waiting period invites promoters to persuade buyers of the virtue of the investment before there is much of an opportunity for review of the required disclosure . . . [so that] salesmanship can readily trump the late-arriving prospectus (if the investor ever had any inclination to read it at all.

Louis Menard, *Comp Time*, NEW YORKER, Sept. 11, 2000, at 92, 94 (noting that even body language can be more effective than written communications).

> sources of information. They cannot give these other sources the same emotional weight, nor can they remember or use information from these other sources as well. This is an important reason why we still have teachers—why we cannot tell our children simply to sit down and read books or rely on computer-aided instruction.[337]

The fact that investors generally will find oral representations more persuasive than written disclaimers is true of institutional investors as well as lay investors, as Langevoort demonstrates.[338]

6. *Other Heuristics and Biases*. Other reasons that Kira will hesitate to confront the intermediary over its form contract (and likely elicit the "What, you don't trust us?" response in an attempt to shame her into signing the contract immediately)[339] include the availability bias noted in Part II.C,[340] and her realization that failure to show trust poisons relationships.[341] Additionally, while making decisions, people tend to concentrate on facts that are "available" in their memories. Thus, they are likely to give undue weight to vivid events, underestimating the impact of pallid events, which may be just as im-

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337. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 155.

338. Writing about both sophisticated and unsophisticated investors, Langevoort argues that it is inconsistent with human nature to expect them to read and rely on written warnings that contradict oral statements made by a trusted person:

> Ready characterization [by the courts] of a failure to read a dense and detailed prospectus as "reckless" is troublesome on a number of levels. Most obviously, there is an empirical problem. It is awkward to use the term reckless to describe behavior that is quite normal and expected. Yet anecdotal evidence, supported by many people's assumptions about investment practices, indicates that most nonprofessional investors do not read the prospectuses and other legal disclosure documents they are given. If this perception is accurate, the court's assumption that reasonable investors know better than to rely on brokers' oral representations and selling brochures is a flight from reality.

Langevoort, *supra* note 145, at 682. Langevoort goes on to note that for sophisticated investors:

> Reading a prospectus after accepting the recommendation of a broker whom the customer is inclined to trust, then, is inconsistent with several phenomena: (1) the time-saving and responsibility-shifting reasons for using that broker in the first place, (2) the cognitive commitment to the broker as a credible source of recommendations, and (3) the preference for making the investment. The motivation is *not* to read unless suspicions have otherwise been aroused.

Id. at 683–84.

339. *See id.* at 654 (noting that stockbrokers often pretend to be the customer's friend because social mores don't allow friends to challenge each other's credibility).

340. *See supra* note 158 and accompanying text.

341. *See* Carol M. Rose, Lecture, *Trust in the Mirror of Betrayal*, 75 B.U. L. REV. 531, 540–41 (1995) (observing that in the absence of trust "constant monitoring and checking can poison the atmosphere").

portant but are less memorable.[342] Even professional investors are more likely to capriciously buy assets that have their attention, just because they have been thinking about them.[343]

Successful sellers of stocks, rather than focusing on drab numbers like price/earnings ratios, "often tend to tell a story about the stock, a vivid story describing the history of the company, the nature of the product, and how the public is using the product."[344] Eisenberg recommends that beneficiaries not be allowed to waive the fiduciary duty owed them by trustees, noting that

> [b]eneficiaries would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid.[345]

Obviously, Kira may react similarly to the vivid, good initial relationship she has established with the broker.

There is also the representativeness heuristic, which causes people to tend to judge probabilities by flouting numerous rules of statistics and to focus instead upon the degree of similarity that an item seems to bear to a category or parent population.[346] Because of this influence, Kira "would tend to overestimate the extent to which the

342. *See* Eugene Borgida & Richard E. Nisbett, *The Differential Impact of Abstract vs. Concrete Information on Decisions*, 7 J. APPLIED SOC. PSYCHOL. 258, 269 (1977) (finding that unreliable but vivid information had more impact than much more statistically reliable base rates); Matthew Rabin, *Psychology and Economics*, 36 J. ECON. LITERATURE 11, 30 (1998) ("A pervasive fact about human judgment is that people disproportionately *weight salient, memorable,* or *vivid* evidence even when they have better sources of information.").

343. *See* SHILLER, BUBBLES, *supra* note 63, at 5–6 (discussing a survey that showed institutional investors' holdings were influenced by attention getting past price increases in stock).

344. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 139. This is particularly important because the vast majority of investors' attention is drawn to stocks by tips from other people rather than their own analysis from reading periodicals. *Id.* at 154. Shiller notes studies of juries that highlight that the winning side in litigation is often that which can produce the most compelling narrative for the jurors. *Id*. at 139; *see also* Nancy Pennington & Reid Hastie, *Reasoning in Explanation-Based Decision Making*, 49 COGNITION 123, 136 (1993) (demonstrating that jurors construct narrative representations of evidence as part of their decisionmaking process).

345. Eisenberg, *supra* note 276, at 249.

346. *See generally* DAWES, *supra* note 269, at 66–89 (explaining the representativeness heuristic); PLOUS, *supra* note 150, at 109–20 (discussing the Kahneman and Tversky representativeness heuristic); Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativesness*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 32, 33 (reporting on a study of the use of the representativeness heuristic by Israeli high school students).

present relationship with the [broker] is a reliable index of the future relationship."[347]

The representativeness heuristic plays a large role in investing, leading investors to see patterns in truly random sequences[348] and to believe that recent winners are likely to keep on winning and recent losers are likely to keep on losing.[349] Even professionals are subject to the bias; Professor Werner De Bondt demonstrates that security analysts' long-term earnings forecasts are biased in the direction of recent success.[350] And Professor Hersh Shefrin observes that institutional investment committees tend to believe, based on the representativeness heuristic, that they can select successful money managers, money managers with the proverbial "hot hand."[351]

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347. Eisenberg, *supra* note 276, at 249.

Related to this phenomenon, and reinforcing it, is the fundamental attribution error. In this context, it induces Kira to believe that the relatively brief encounter she has with the securities professional gives her a firm basis to conclude what he is really like overall:

> "The basis of the illusion is that we are somehow confident that we are getting what is there, that we are able to read off a person's disposition . . . . When you have an interview with someone and have an hour with them, you don't conceptualize that as taking a sample of a person's behavior, let alone a possibly biased sample, which is what it is. What you think is that you are seeing a hologram, a small and fuzzy image but still the whole person."

Malcolm Gladwell, *The New-Boy Network: What Do Job Interviews Really Tell Us?*, NEW YORKER, May 29, 2000, at 68, 72 (quoting University of Michigan psychologist Richard Nisbett); *see also* Daryl Koehn, *Should We Trust in Trust?*, 34 AM. BUS. L.J. 183, 201 (1996) ("If we are wise, we will treat our judgments of others' character as suspect.").

348. *See* SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 144 (citing work on the representativeness heuristic by Tversky and Kahneman for the proposition that people make judgments in uncertain situations by assuming future patterns will resemble past ones).

349. *See* De Bondt & Thaler, *supra* note 163, at 57 (finding that stock market professionals overreact to recent market crashes or other dramatic events when forecasting future market behavior).

350. SHEFRIN, *supra* note 63, at 16 (citing WERNER DE BONDT, EARNINGS FORECASTS AND SHARE PRICE REVERSALS (1992) for the proposition that analysts are more optimistic about recent winners than recent losers).

351. *Id.* at 213. Certainly lay investors have a similar tendency to erroneously choose investment advisers with poor long-term records on the basis of a recent short-term success. *See* Mark Hulbert, *The Ways of One-Year Wonders*, N.Y. TIMES, July 2, 2000, at BU8 (discussing academic studies indicating that while some advisors may have hot hands they are still not beating the market).

Shefrin points out other problems with institutional investors, based largely on frame dependence, the notion that decisions can be influenced based on how information is couched:

> Placing funds with an active money manager is typically a bad bet. Yet institutions continue to hire active money managers. Why?
>
> The short answer is that the individuals who serve on institutional investment committees exhibit frame dependence and heuristic-driven bias. When it comes to framing, committee members tend to think of portfolios as a series of mental accounts, with associated reference points known as benchmarks. Therefore, committee

7. *General Psychological Susceptibility to Influence*. As Professor Cass Sunstein notes, "[a] primary claim of behavioral economics is that human preferences and values are constructed, rather than simply elicited, by social situations. . . . [P]references can be a product of procedure, description, and context at the time of choice."[352] In other words, sellers can influence people to believe that they want or need things that, absent the persuasive effort, they would not buy. Hanson and Kysar have written extensively on this point in the context of product marketing generally,[353] and tobacco marketing specifically.[354] This is surely what stockbrokers do as well, even with sophisticated investors.[355]

Professor Robert Cialdini posits six basic categories of influence technique that "compliance professionals" (advertisers, marketers, stockbrokers, etc.) can use to influence the behavior of human beings.[356] Even intelligent, educated consumers and investors are subject to these techniques. The techniques will not work all the time, but most people will be subject to their influence much of the time. Most call on "fixed-action patterns" in which a certain action elicits a nearly automatic psychological response. Cialdini believes that rather than thinking rationally about the stimulus, people's minds tend to go "click, whirr"[357] and respond in a patterned manner.[358] Stockbrokers

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> members tend to mistake variety in manager "styles" for true diversification. In addition, reference-point thinking leads people to give opportunity costs less weight than out-of-pocket costs of the same magnitude.

SHEFRIN, *supra* note 63, at 213.

352. Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 AM. L. & ECON. REV. 115, 117 (2000).

353. Hanson & Kysar, *supra* note 159, at 635 ("[M]arket outcomes frequently will be heavily influenced, if not determined, by the ability of one actor to control the format of information, the presentation of choices, and, in general, the setting within which market transactions occur."). If product consumers are easily manipulated, investors likely are also.

354. Hanson & Kysar, *supra* note 280, at 1467–1553 (presenting a case study on manufacturer manipulation in the tobacco industry).

355. *See* Langevoort, *supra* note 145, at 634 ("It should be recognized that intuitively, the role of the [stock] salesperson is to *shape* demand, and, whether or not we like to admit it, such a role extends to interactions with sophisticated customers.") (emphasis added).

356. *See generally* ROBERT B. CIALDINI, INFLUENCE: SCIENCE AND PRACTICE (3d ed. 1993) (discussing various means through which compliance practitioners are able to stimulate shortcut responses by giving certain signals for them).

357. One of the biggest failings of economic reasoning's rational man model is that it fails to recognize that much human behavior is based upon unconscious factors. *See* JACOBY, *supra* note 74, at 28 ("[A] considerable amount of research over the past two decades reveals that much, perhaps most, human behavior is controlled by unconscious, not conscious factors.").

358. CIALDINI, *supra* note 356, at 3–5. As a modest example, Cialdini notes that when people ask others for a favor, they will be more successful if they provide a reason. *Id*. at 20–22. For

and others have used six techniques to influence investors to make investments that were perhaps not in the investors' best interest.

Among the six principles that Cialdini distills is that of reciprocation. Many societies follow the notion that if someone does something for you, you have an obligation to do something for them.[359] Stockbrokers who are initially unsuccessful in making a sale are counseled to offer something free (such as a free valuation of the customer's portfolio, which will require the customer to provide valuable personal information) to the potential customer to take advantage of this human reaction.[360]

Cialdini's second principle is commitment and consistency: "*Once we make a choice or take a stand, we will encounter personal and interpersonal pressures to behave consistently with that commitment.*"[361] In our society, a high degree of consistency is associated with logic, rationality, and honesty, whereas inconsistency is viewed quite negatively.[362] Marketers in several fields successfully have used this technique to induce people to buy products they likely did not want

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example, one study found that if people are in line for a copying machine, they will be successful ninety-four percent of the time if they say: "Excuse me, I have five pages. May I use the Xerox machine because I'm in a rush." *Id*. at 3. However, they will be successful only sixty percent of the time if they provide no reason: "Excuse me, I have five pages. May I use the Xerox machine?" *Id*. at 4. However, if they provide a reason, even if it seems bogus, their success rate will be ninety-three percent: "Excuse me, I have five pages. May I use the Xerox machine because I have to make some copies?" *Id*. at 4–5. Cialdini explains that "the word *because* triggered an automatic compliance response from Langer's subjects, even when they were given no subsequent reason to comply. *Click, whirr*." *Id*. at 5.

359. For an illustrative experiment, see Dennis T. Regan, *Effects of a Favor and Liking on Compliance*, 7 J. EXPERIMENTAL SOC. PSYCHOL. 627, 630–32 (1971). A subject was placed in a room with "Joe." *Id*. at 21. Supposedly they were there to rate paintings as part of an experiment in "art appreciation." *Id*. In some instances, Joe left the room for a couple of minutes and came back with a couple of sodas, telling the subject: "I asked him [the experimenter] if I could go get myself a Coke, and he said it was OK, so I bought one for you, too." *Id*. at 21–22. In other instances, Joe did not do the favor. *Id*. at 22. At the end of the experiment, Joe asked the subject to buy 25 cent raffle tickets for a $50 prize. *Id*. Later, the subject was asked how much he liked Joe. *Id*. As a general rule, the more the subject had liked Joe, the more tickets the subject had bought. *Id*. However, when Joe had done the subject a favor, even those who had disliked Joe bought as many tickets as those who had liked him. *Id*.

Cialdini attributed the phenomenal early success of the Hare Krishnas in this country to this principle. *Id*. at 23–25. They began surprising people in airports with the gift of a flower or a book and then asked for donations with great success. *Id*. at 23. Only when people learned techniques for avoiding the gift did the Krishnas' financial situation start to decline. *Id*. at 23–25.

360. *See* LEROY GROSS, THE ART OF SELLING INTANGIBLES: HOW TO MAKE YOUR MILLION($) BY INVESTING OTHER PEOPLE'S MONEY 122 (rev. ed. 1985) ("Properly handled, the offer of a free service will be accepted more than 50 percent of the time.").

361. CIALDINI, *supra* note 356, at 51.

362. *Id.* at 52.

or need,[363] and stockbrokers also have employed the technique.[364] Once investors, even sophisticated investors, choose a stockbroker, then for consistency reasons they will wish strongly to trust that broker regardless of formal warnings to the contrary.[365]

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363. Cialdini notes that he had always wondered why big companies such as Procter & Gamble or General Foods often ran contests where customers had to write, in twenty-five words or less why they liked a particular product. *Id*. at 67. Once people put in writing that they like a product, the commitment and consistency concept makes them much more loyal customers. *Id*. at 67–68. As another example, door-to-door sales companies using high-pressure techniques started suffering high numbers of cancellations after states enacted home solicitation statutes giving customers three days to back out of a deal. *Id*. They quickly learned that the cancellation rate was much lower if they had the customer rather than the salesperson fill out the sales agreement. *Id*. The act of filling out the contract greatly increased the customer's personal commitment to the sale and made it psychologically more difficult to back out. *Id.* at 67.

In World War II, psychologist Kurt Lewin greatly increased people's consumption of intestinal meats by having them make a public commitment to do so. *See* Kurt Lewin, *Group Decision and Social Change*, *in* READINGS IN SOCIAL PSYCHOLOGY 197, 197 (Eleanor E. Maccoby et al. eds., 3d ed. 1958). More recently, this technique has been successfully used to reduce teen promiscuity. *See* Diana Jean Schemo, *Virginity Pledges by Teenagers Can Be Highly Effective, Federal Study Finds*, N.Y. TIMES, Jan. 4, 2001, at A22 (summarizing data showing that voluntary virginity pledges work to postpone sex among adolescents).

364. Brannigan, *supra* note 310, at 33:

> Some victims [of stock frauds] are reluctant to accept that they have been swindled and continue sending money to a boiler room "because they have a stake in the investment," says Mr. [Kent C.] Neal of the Broward County state attorney's office. Albert Krieger, a 68-year-old retiree in Gackle, N.D., says over the course of a year starting in August 1985, he invested $300,000 in some 11 oil partnerships through [fraudsters] Miller & McKinzie in Fort Lauderdale. "When you're in that deep," he says, "you don't want to believe you're in a bad investment."

These words are very reminiscent of those in an experiment recounted in CIALDINI, *supra* note 356, at 100–05. In a famous study, social scientists Festinger, Riecken and Schachter joined a doomsday cult. *Id*. at 100. When the appointed hour came and went and neither the flood that would end civilization nor the spaceships that would save the cult members arrived, most of the cult members actually became *more*, rather than less, committed to the demonstrably bogus (to outsiders) cult. *Id*. at 105. One of the cult leaders stated: "I've had to go a long way. I've given up just about everything. I've cut every tie. I've burned every bridge. I've turned my back on the world. I can't afford to doubt. I have to believe. And there isn't any other truth." *Id.*

Investors have similar reactions. A gold investor who became so enthralled with the metal that he actually bought gold mines, sought investors, and watched the price of gold drop 70% between 1980 and today while missing out on the 1200% rise in the Dow Jones said:

> "Every day, I want to give up . . . . But what do I do? I have eighteen hundred shareholders. We have three kids to educate. It's brutal. There are days when I have to force myself to get out of bed to see the gold price. I just hope I'm going to be right one more time."

James Collins, *Gold People*, NEW YORKER, July 17, 2000, at 32, 35 (quoting Michael Levinson, a gold investor).

365. Langevoort notes:

> Most investors lack the time or information necessary to digest all information relating to potential investments, yet they feel substantial pressure to act. They anticipate the sort of regret that comes when they have no one to blame for making unwise

The third basic principle is social proof, the notion that people in a particular situation tend to take their cues for correct behavior from others they observe.[366] This is why laugh tracks work for television shows, and why a person in trouble is often better off having only one person be nearby rather than fifty.[367] This is generally a sensible heuristic—if everyone else is acting in a particular way, it is likely the proper way to act. Marketers long have used this technique to market all manner of products as "best-selling" or "fastest-growing." "Man on the street" testimonials also draw on this principle, because people are more likely to draw their cues from people they view as similar to themselves. Securities often are marketed in the same manner.[368] Indeed, social proof is a key explanation for the persistent success of Ponzi schemes. As Shiller explains:

> A critical observation to be made about these examples of Ponzi schemes is that initial investors were reportedly very skeptical about the schemes and would invest only small amounts. A story about an arbitrage profit opportunity in postage reply coupons [the scam of the original Charles Ponzi], if merely told directly, without the evidence that it had made others a lot of money, would not sound

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> choices but themselves, and thus they are highly motivated to seek out apparent experts, such as stockbrokers and investment advisers, shifting away the locus of responsibility. Having committed to a particular expert, of course, investors feel a strong tendency to bolster their choice. *Under these circumstances, reliance is apt to occur regardless of formal warnings or disclosures. To heed them against the recommendation of one's chosen broker or adviser is to admit the possibility that one has chosen foolishly.*

Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 879 (1995) (emphasis added) (citations omitted).

366. CIALDINI, *supra* note 356, at 95 ("*We view a behavior as correct in a given situation to the degree that we see others performing it.*").

367. The notion of "pluralistic ignorance" may explain why cases like the Kitty Genovese case occur. A woman is attacked in broad daylight several times over a period of some minutes. Thirty-eight witnesses see or hear the event and no one calls for help. *See* A.M. ROSENTHAL, THIRTY-EIGHT WITNESSES 30–45 (1964) (recounting details of the attack). In such a case, people often think: "If something were really wrong, someone else would be helping or calling the police. Since nobody else is concerned, nothing must be wrong." *See* BIBB LATANE & JOHN M. DARLEY, THE UNRESPONSIVE BYSTANDER: WHY DOESN'T HE HELP? 125 (1968) (observing that, if bystanders see other bystanders being passive, they may be misled into thinking the situation must not be serious); Bibb Latane & John M. Darley, *Group Inhibition of Bystander Intervention in Emergencies*, 10 J. PERSONALITY & SOC. PSYCHOL. 215, 221 (1968) (describing a study, which found "that individuals are less likely to engage in socially responsible action if they think other bystanders are present").

368. Experts in securities sales urge brokers to identify their customers who are most vulnerable to social proof and to make continual references to how popular the product or service is. *See* DROZDECK & GRETZ, *supra* note 168, at 177, 186, 192 (describing techniques for persuading socially oriented people-persons to invest).

> credible enough to entice many investors. Investors do not become truly confident in the scheme until they see others achieving large returns.[369]

The principle works just as effectively on those Choi would term "issuer-level investors" as it does on "unsophisticated investors."[370] A classic example is the New Era scandal of the early 1990s. John G. Bennett, Jr. made what seems in retrospect to have been a fantastical proposition to charitable institutional investors: "Give your money to me for six months, and I will return twice as much by matching it with gifts from anonymous donors." It was a classic Ponzi scheme—the anonymous donors did not exist—but bank presidents, money managers, former Treasury Secretaries, and all manner of sophisticated investors were taken in. Why? They saw other people like themselves invest in the scheme, and that convinced them to invest as well:

> This is the dirty secret of experts. Outsiders view them with awe, particularly when their field is an abstruse one such as investing. But in truth, experts are courageous or impressionable, independent or conventional, in the same degrees as other two-legged beasts. And all of an expert's brains and training will not count for much if, at the crucial moment, he relies on somebody else's brains instead of his own.[371]

The principles underlying social proof also may account for the inefficient "herding" behavior often observed in the securities mar-

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369. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 66. In the setting of a Ponzi scheme, "[e]ach victim thinks that the others must know what they are doing. 'Surely,' each thinks, 'they can't all be as ignorant as I am.'" Rose, *supra* note 341, at 552 (citing LEFF, *supra* note 316, at 80–81).

370. *See* Bradley Hitchings & Stan Crock, *The Fast-Buck Artist Is Alive and Well and Selling Dubious Investments*, BUS. WK., Dec. 30, 1985, at 143, 143 (discussing Bank of America's falling for a Ponzi scheme of junk mortgages).

371. Roger Lowenstein, *Intrinsic Value: Why Gurus Weren't Wise to New Era's Wiles*, WALL ST. J., May 25, 1995, at C1.

Another example is Chris Bagdasarian's Normandy America scam. Bagdasarian had a net worth of $3 million but claimed one of $400 million; he also managed $45 million of other people's money but claimed to manage $731 million. He induced "sophisticated" Salomon Brothers to underwrite a $200 million offering with just a little help from a fraudulent accountant. As Choi himself has observed, "[i]n the end, no one asked Bagdasarian for any real evidence of his net worth or investing prowess. Instead, the financial institutions and their executives relied on one another." Choi, *supra* note 214, at 917; *see also* Roger Lowenstein, *Even Vigilant Gatekeepers Can Blow It*, WALL ST. J., Oct. 10, 1996, at C1 (relating the facts of the Bagdasarian scandal).

kets.[372] And they account for phenomena such as the spectacular run-up of Enron stock in the late 1990s. Analysts overlooked trouble signs simply because Enron was fashionable with other analysts.[373] As Shiller notes, even "[p]rofessionals ultimately must end up generally assuming that what their colleagues believe is true."[374]

Cialdini's fourth principle is that "*we most prefer to say yes to the requests of people we know and like.*"[375] This "liking principle" is no surprise and holds the key to the success of the Tupperware Home Parties Corporation, which persuades people to buy plastic goods they neither want nor need by transforming their friends into the seller's agents.[376] Individuals tend to like people who are physically attractive, who are similar to themselves, and who compliment them. Cialdini notes that people are "phenomenal suckers for flattery" and tend to believe praise and to like those who provide it even when it is

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372. BELSKY & GILOVICH, *supra* note 241, at 182–84. They attribute the herding effect to the fact that "people tend to conform to the behavior of others." *Id.* at 176; *see also* Hirshleifer et al., *supra* note 302, at 1689 (modeling herding behavior even among professional money managers); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 466 (1990) (producing a model showing that money managers concerned with their reputations might choose to mimic the behavior of other money managers); Mark Hulbert, *Leaders of the Pack Mentality*, N.Y. TIMES, Sept. 17, 2000, at BU7 (noting a new academic study by Patrick J. Dennis of the University of Virginia and Deon Strickland of Ohio State University showing that large money managers are even more prone than lay investors to quickly dumping their shares during market corrections, thereby exaggerating declines); SHILLER, BUBBLES, *supra* note 63, at 11 (discussing the relevance of theories of herding behavior and "groupthink" for professional investors). Herding behavior is widespread in the markets, but insufficiently accounted for in traditional economic theory. *See* BELSKY & GILOVICH, *supra* note 241, at 19 ("[E]conomic theory was essentially at a loss—even if economists wouldn't admit it—to explain why people stampede to invest in the stock of companies for no better reason than that other investors were doing the same."). *But see* SUSHIL BIKHCHANDANI & SUNIL SHARMA, HERD BEHAVIOR IN FINANCIAL MARKETS: A REVIEW 27 (Int'l Monetary Fund Inst., Working Paper No. WP/00/48, 2000) (on file with the *Duke Law Journal*) (observing that in developing countries "investment managers do not exhibit significant herd behavior and [their] tendency to herd is highly correlated with a manager's tendency to pursue momentum investment strategies").

373. "Wall Street is a fashion show and Enron was fashionable," says Mark Roberts, director of research at Off Wall Street, a consulting firm. "The analysts were not analysing [sic], they were believing. They overlooked signs that there might be trouble because they were personally enthused."

McNulty, *supra* note 114, at 13; *see also* James K. Glassman, *What to Learn from the Fall of Enron, a Firm That Fooled So Many*, INT'L HERALD TRIB., Dec. 10, 2001, at 10 (noting, in a story about Enron, that "[i]f a few top analysts start buying a story, then practically every analyst buys the story").

374. SHILLER, BUBBLES, *supra* note 63, at 7.

375. CIALDINI, *supra* note 356 , at 136.

376. *See* Rex Taylor, *Marilyn's Friends and Rita's Customers: A Study of Party-Selling as Play and as Work*, 26 SOC. REV. 573, 590–92 (1978) (studying the dynamics of such selling methods).

likely untrue.[377] He notes that people "have such an automatically positive reaction to compliments that [they] can fall victim to someone who uses them [even] in an obvious attempt to win [their] favor. *Click, whirr.*"[378] Securities marketers use this all the time.[379] It seems obvious that the striking success of "affinity scams" relates to this principle.[380] Even sophisticated investors often fall victim to such schemes.[381]

Fifth, Cialdini notes the impact of authority. He refers to the famous Stanley Milgram experiments when subjects continued to give what they thought were painful and even life-threatening electric shocks to confederates of the experimenter simply because they were

377. CIALDINI, *supra* note 356, at 145.

378. *Id.*

379. Experts recommend to stockbrokers that while they need not become their clients' closest friends, they should "learn what most friends would know about significant changes in their life situation . . . [such as] [t]he birth of a child, the death of a loved one, the changing of a job." DROZDECK & GRETZ, *supra* note 168, at 16; *see also* GROSS, *supra* note 360, at 85 (giving an example of how the author used flattery to sell shares to a company president).

380. Affinity scams occur when members of religious, ethnic, or other groups prey on other members of their group with a "Hey, I'm one of you so you can trust me" approach. Religious groups seem to be particularly vulnerable, because perpetrators prey on victims' religious faith. *See generally Antifraud: Religious Groups Members Vulnerable to 'Affinity Fraud,' NASAA Warns*, BNA SEC. L. DAILY, Sept. 2, 1999 (describing a $200 million scam originating in Florida involving fundamentalist Christians, as well as similar scams in Texas, Illinois, and Wisconsin); Ianthe J. Dugan, *Broken Trust: A Young Man's Talk of Stock Riches Lures Host of 'Regular Folks,'* WALL ST. J., Sept. 12, 2000, at A1 (discussing an affinity scam in Washington, D.C. that victimized African Americans); Earl C. Gottschalk, Jr., *Churchgoers Are the Prey as Scams Rise*, WALL ST. J., Aug. 7, 1989, at C1 (noting $450 million in affinity scams targeting Lutheran ministers, Baptists, Jews, Mormons, black church goers, Hispanic Catholics, and others); Louis Lavelle, *N.J. Man Took Investors for $2.8M, SEC Says Black Communities Targeted in Alleged Scam*, RECORD (Bergen County, NJ), Oct. 1, 1999, at B1 (describing an affinity fraud targeting African Americans); Brenton R. Schlender, *Religion and Loyal Investors Play Big Role in Alleged Trading Fraud*, WALL ST. J., Sept. 20, 1985, at 19 (describing a $70 million scam involving mostly Seventh Day Adventists); Randall Smith, *Loss-Plagued Baptist Foundation of Arizona Undergoes Investigation by Regulators in State*, WALL ST. J., Sept. 1, 1999, at C1 (noting $100 million dollar loss by Baptist organization in what "could turn out to be an example of what state securities regulators call 'affinity fraud'").

381. Joseph Borg, *Affinity Fraud Takes in Friends and Relatives*, MONTGOMERY ADVERTISER, Dec. 8, 1998, at 6B (noting that the victims of affinity schemes can be members of the same profession, such as doctors, accountants, and lawyers, and describing a scam that cost thousands of doctors over $50 million). Arguably, the infamous New Era scandal is an example of this, as well-heeled fraudster John G. Bennett, Jr. scammed numerous well-heeled investors, such as former Treasury Secretary William E. Simon, Philadelphia bank president Richard Smoot, money manager Julian Robertson, and many others. *See* Lowenstein, *supra* note 371, at C1 (remarking with amazement that such exalted wise men could fall for the equivalent of a schoolboy's chain letter).

told to do so by someone in a position of authority.[382] Obviously marketers use this principle all the time with "three out of four doctors recommend" and even "I'm not a doctor, but I play one on TV" ploys. Cialdini notes that "[w]hen in a *click, whirr* mode, [people] are often as vulnerable to the symbols of authority as to the substance."[383] Based on such evidence, Shiller notes, "it is not at all surprising that many people are accepting of the perceived authority of others on such matters as stock market valuation."[384] Stockbrokers often use this susceptibility to market securities.[385]

Finally, Cialdini notes the "rule of the few"—"*that opportunities seem more valuable to us when they are less available.*"[386] Advertisers often use this scarcity principle to persuade consumers by advertising that "only a limited number have been minted" or that the offer is for a "limited time only." In one study, researchers found that subjects who tasted one cookie in a jar that contained only two cookies rated the cookie higher than did those who tasted an identical cookie in a jar of ten even if they didn't rate the cookies as tasting any better. Even though the first cookie didn't taste any better, it was less available and therefore more desirable.[387] Cialdini illustrates this principle by citing a standard securities boiler room tactic: an investor is called by a sales representative who simply attempts to induce the customer to accept some literature about the firm.[388] A second call describes the great potential profits of a deal in which, it turns out, it is no longer possible to invest.[389] The third call gives the customer an opportunity

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382. CIALDINI, *supra* note 356, at 173–77 (citing STANLEY MILGRAM, OBEDIENCE TO AUTHORITY (1974)).

383. *Id.* at 180.

384. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 151.

385. *See* DROZDECK & GRETZ, *supra* note 168, at 279 (reminding stockbrokers that they are recognized experts upon whom investors will rely for advice); GROSS, *supra* note 360, at 68 (encouraging stockbrokers to use endorsements as a sales technique).

386. CIALDINI, *supra* note 356, at 195. Unsurprisingly, Benjamin Cheever's recent article in the *New Yorker* about his brief career as a car salesman contained illustrations of all six of Cialdini's principles. *See* Benjamin Cheever, *How to Sell Cars*, NEW YORKER, Apr. 24 & May 1, 2000, at 136, 136–38 (illustrating the liking principle); *id*. at 140 (illustrating the reciprocation principle); *id*. at 144 (illustrating the social proof and authority principles); *id.* at 154 (illustrating the commitment, consistency, and availability principle).

387. *See* CIALDINI, *supra* note 356, at 209 (citing Stephen Worchel et al., *Effects of Supply and Demand on Ratings of Object Value*, 32 J. PERSONALITY & SOC. PSYCHOL. 906, 910 (1975)).

388. *Id.* at 201 (citing Peter Kerr, *Officials Warn Public on Frauds by Phone*, N.Y. TIMES, May 14, 1983, at 12).

389. *Id*.

to invest in a deal, but only if he acts immediately.[390] The strategy is to frame the matter as an opportunity about to be lost and to impart a sense of desirability and urgency by threatening to take away the carrot being dangled before the investor.[391] Brokers often urge investors to act quickly, before a particular opportunity passes.[392]

All of these strategies are persuasive; stockbrokers often use them to induce investors to make unwise investments.[393]

8. *Calculating Probabilities*. Investor regulation assumes that Kira (a) will realize when she is in danger of being defrauded, (b) will be able to rationally contract to avoid the danger, and (c) will be able to calculate exactly how much risk of fraud she faces and how much it is worth to her to pay for contractual protection from such fraud. It is already clear that the first two assumptions are questionable. But even if Kira did realize that she was in danger of being defrauded, she would have great difficulty in calculating the odds of that danger or rationally converting those odds into contractual terms.

First, although Choi argues that "rational investors with adequate information on the risks posed by intermediaries will adjust the amount they are willing to pay,"[394] I am unsure exactly what information Choi believes investors need to make such judgments. What information does Kira need to determine the odds that her brokerage firm will assign her an individual broker with a drinking and gambling habit who will churn her account?[395] If the firm could determine that such a broker were engaging in risky behavior, it might well fire him (one would hope). How is Kira to make such a judgment? There are many brokers with these and similar problems. Each top-notch bro-

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390. *Id*.

391. *See* Kerr, *supra* note 388, at 12 (describing how 81-year-old Daniel Gulban lost his life savings); *see also* GROSS, *supra* note 360, at 83 (telling stockbrokers that "[t]he *sense-of-loss close* is probably the most universally accepted of all closes as well as the *most powerful* close for any seller of intangibles to use on any prospect").

392. *See* GROSS, *supra* note 360, at 115 (suggesting to stockbrokers that they should "[i]f possible, present a product that has the appeal of scarcity"); MARTIN D. SHAFIROFF & ROBERT L. SHOOK, SUCCESSFUL TELEPHONE SELLING IN THE '90S, at 84 (1990) (suggesting this tactic as a technique for stockbrokers).

393. *See generally* Langevoort, *supra* note 365, at 879 (describing several such techniques that stockbrokers are trained to use).

394. Choi, *supra* note 7, at 295.

395. For a frightening portrait of the completely crooked broker, and evidence that this type of broker is an unfortunately common scourge, see Calvin Trillin, *Marisa and Jeff*, NEW YORKER, July 10, 2000, at 26 (describing the personalities involved in the recent insider trading scandal in Smith Barney's control-group).

kerage firm in the country has some of them in its ranks, so it is difficult to use reputation as a proxy.[396] How do investors calculate these odds? Or how do investors calculate the odds that a respected firm like Prudential will undertake a massive, nationwide fraud,[397] or that a respected firm like Morgan Stanley will have employees who want to "rip her face off" even though she is a client?[398]

People are not good at calculating probabilities in general,[399] tending to substitute simple rule-of-thumb heuristics, such as the availability and representativeness biases, for statistical accuracy.[400] Kira, even if she studies hard for her investor exam and earns a high score, likely will not overcome this limitation. Scholars suggest that people in general,[401] and professionals such as auditors[402] and physi-

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396. In the analogous realm of products liability where it has been argued that consumers can use reputation as a proxy for product quality and safety, Slawson has pointed out:

> First, whatever the producer's reputation, the particular product the consumer buys may fall short of it. In order adequately to protect themselves against this eventuality, consumers would have to understand the probabilities of each respect in which the product might fall short, how great a loss or injury such a defect probably would cause, and what rights, if any, the contract of sale provides for their protection if such a defect should occur. Second, consumers have no way of quantifying a producer's reputation; that is, no effective way of estimating how much higher a price it is worth.

SLAWSON, *supra* note 178, at 27.

397. *See generally* SHARP, *supra* note 165 (describing the Prudential-Bache fraud scandal).

398. *See supra* note 141 and accompanying text.

399. *See* JACOBY, *supra* note 74, at 39 (noting that many people "haven't the foggiest idea of how to work with independent and especially joint probabilities").

400. Kahneman & Tversky, *supra* note 346, at 32 ("[P]eople do not follow the principles of probability theory in judging the likelihood of uncertain events."); Paul Slovic & Sarah Lichtenstein, *Comparison of Bayesian and Regression Approaches to the Study of Information Processing in Judgment*, 6 ORG. BEHAV. & HUM. PERFORMANCE 649, 724 (1971) (stating that people have great difficulty weighting and combining information to make probabilistic decisions and therefore "resort to simplified decision strategies, many of which lead them to ignore or misuse relevant information").

401. *See* Stanley F. Biggs & John J. Wild, *An Investigation of Auditor Judgment in Analytical Review*, 60 ACCT. REV. 607, 622 (1985) (noting that "[e]vidence from experimental studies indicates that most individuals lack the ability to make accurate extrapolations," in part because they cannot intuitively deal with quantitative data, they use nonoptimal heuristics, and they are deficient in the ability to extrapolate from a relatively simple time-series); Robin M. Hogarth & Hillel J. Einhorn, *Order Effects in Belief Updating: The Belief-Adjustment Model*, 24 COGNITIVE PSYCHOL. 1, 38 (1992); Wilfred C. Uecker, *A Behavioral Study of Information System Choice*, 16 J. ACCT. RES. 169, 181–82 (1978) (finding in study of accounting students results consistent with other studies showing that learning in complex probabilistic environments is very difficult for humans).

402. *See* Stephen K. Asare & Arnold M. Wright, *Evaluation of Competing Hypotheses in Auditing*, 16 AUDITING: J. PRAC. & THEORY 1, 11 (1997) (finding that auditors, rather than reasoning in accordance with Bayes's theorem, tend to use a boundedly rational approach by evaluating competing hypotheses independently and thereby sacrificing decisional efficiency for gains in decision confidence and cognitive economy); Lee Roy Beach & James R. Frederickson,

cians,[403] tend, rather than doing the Bayesian rational thing of evaluating evidence with respect to both a hypothesis under consideration and its alternative, to evaluate the evidence with respect to a single hypothesis because it is simpler.[404]

One other point about probabilities is that behavioral studies demonstrate that people tend to ignore low probability risks.[405] This finding is illustrated by the fact that most people did not use seatbelts before use was legally required.[406] Nor do they buy flood insurance even when it is available.[407] Thus, if due to overoptimism or some other cause, Kira deems it quite unlikely that the intermediary will defraud her, she will tend simply to ignore the possibility of that happening while negotiating her contract.[408] Financial models assembled by sophisticated investors also tend to ignore low probability events.[409]

Audit Decisions, *in* DECISION MAKING IN THE WORKPLACE: A UNIFIED PERSPECTIVE 91, 95 (Lee Roy Beach ed., 1996) ("[I]t is highly unlikely that audit evidence is used in a strictly Bayesian manner . . . . The auditor's judgments of what constitutes 'close enough' or materially correct are determined by many nonstatistical variables."); Michael A. Crosby, *Implications of Prior Probability Elicitation on Auditor Sample Size Decisions*, 18 J. ACCT. RES. 585, 592 (1980) (finding that "the lack of correspondence between the Bayesian [sample sizes] and judgmental sample sizes [produced by individual auditors] may indicate that auditors are not Bayesian information processors, that they rely instead on some kind of judgmental heuristic or a sequential or contingent processing model").

403. *See* David M. Eddy, *Probabilistic Reasoning in Clinical Medicine: Problems and Opportunities*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 249, 249 (finding "that physicians do not manage uncertainty very well, that many physicians make major errors in probabilistic reasoning, and that these errors threaten the quality of medical care").

404. The heuristics that investors use in place of Bayesian rationality are often termed "investor sentiment." SHLEIFER, *supra* note 63, at 12, 113–14.

405. Colin F. Camerer & Howard Kunreuther, *Decision Processes for Low Probability Events: Policy Implications*, 8 J. POL'Y ANALYSIS & MGMT. 565, 570 (1989) (discussing how people make judgments about events that carry serious consequences but are not likely to happen); Paul Slovic et al., *Regulation of Risk: A Psychological Perspective*, *in* REGULATORY POLICY AND THE SOCIAL SCIENCES 241, 260 (Roger G. Noll ed., 1985) (same).

406. Richard Arnould & Henry Grabowski, *Auto Safety Regulation: An Analysis of Market Failure*, 12 BELL J. ECON. 27, 28–29 (1981).

407. *See* Howard Kunreuther, *Limited Knowledge and Insurance Protection*, 24 PUB. POL'Y 227, 255 (1976) (finding that consumers used simple rules of thumb in deciding whether to purchase earthquake or flood insurance).

408. Issacharoff suspects that factors such as this factor, when coupled with illusion of control and overconfidence, tend to account for the fact that employees tend to underweigh protection from premature dismissal when negotiating employment contracts. Samuel Issacharoff, *Contracting for Employment: The Limited Return of the Common Law*, 74 TEX. L. REV. 1783, 1801 (1996). Garvin notes that in negotiating contracts generally, overoptimism and underappreciation for remote risks leads parties to "undervalue the risk of breach, and thus [they] will set too low a risk premium." Larry T. Garvin, *Adequate Assurance of Performance: Of Risk, Duress, and Cognition*, 69 U. COLO. L. REV. 71, 151 (1998).

409. Hu, *supra* note 334, at 1489.

9. *Anchoring and Adjustment and the Status Quo Bias*. Human minds are easily anchored to a particular suggested point. When new information arises, people adjust for it, but typically not in a sufficient amount.[410] Thus, morticians who wish to sell an expensive coffin likely will first show their most expensive one to prospective buyers to anchor the buyers to that price range. Although the buyers may not purchase the most expensive model, they are much more likely to purchase a relatively expensive one than if they first had been shown a cheap coffin.[411] Studies indicate that even trained auditors[412] and securities analysts[413] are affected significantly by the anchor and adjustment phenomenon.

Thus, when the intermediary presents Kira with a contract that contains a "no fraud liability" provision, it frames the negotiations. People prefer what they perceive to be the status quo.[414] Thus, studies

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410. Thus, jurors often use a plaintiff's *ad damnum* clause as an anchor in making damage awards. *See* Jeffery R. Boyll, *Psychological, Cognitive, Personality and Interpersonal Factors in Jury Verdicts*, 15 LAW & PSYCHOL. REV. 163, 170 (1991) (citing various studies of jury awards).

411. *See* Hanson & Kysar, *supra* note 280, at 1440 (giving a car sale example).

412. *See* James A. Heintz & Gwendolen B. White, *Auditor Judgment in Analytical Review—Some Further Evidence*, AUDITING: J. PRAC. & THEORY 22, 31 (1989) (finding strong anchoring and adjustment effects even though auditors were clearly informed that the preliminary numbers they were exposed to were unaudited); William R. Kinney, Jr. & Wilfred C. Uecker, *Mitigating the Consequences of Anchoring in Auditor Judgments*, 57 ACCT. REV. 55, 69 (1982) (concluding that the "anchoring" heuristic was applied by auditors in both analytical review and compliance sampling settings); John J. Wild & Stanley F. Biggs, *Strategic Considerations for Unaudited Account Values in Analytical Review*, 65 ACCT. REV. 227, 238 (1990) (finding anchoring and adjustment impact upon auditors).

413. SHEFRIN, *supra* note 63, at 20. Related to anchoring and adjustment are order effects. Under some circumstances, information that is first presented to people has the most impact on them (primacy effect). In other circumstances, information that is presented last has the most impact (recency effect). Traditional economic reasoning posits that the order of information presentation should have no effect upon a hypothetical rational man's decisionmaking, but the evidence shows that sequence of information is very important. *See* RICHARD NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF HUMAN JUDGMENT 172 (1980) ("Although order of presentation of information sometimes has no effect on final judgment, and recency effects sometimes are found, these are the exception; several decades of psychological research have shown that primacy effects are overwhelmingly more probable."). This is true even as to professional securities analysts. *See* Jacob Jacoby et al., *New Directions in Behavioral Process Research: Implications for Social Psychology*, 23 J. EXPER. SOC. PSYCHOL. 146, 161–63 (1987) (finding anchoring and adjustment effects in securities analysts).

414. *See* William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8 (1988) ("Faced with new options, decision makers often stick with the status quo alternative, for example, to follow customary company policy, to elect an incumbent to still another term in office, to purchase the same product brands, or to stay in the same job."). As an example of the status quo bias and its effect on products, Aaker notes that for perhaps two decades in the 1970s and 1980s General Motors had by most objective measures inferior cars that should have driven its market share to zero. Instead, GM's market share stayed

indicate that "contrary to the Coase theorem, different default rules may lead to dramatically different outcomes, even if transaction costs are minimal."[415] Therefore, Kira's strong inclination will be to accept the "no fraud liability" clause, because to her it seems to represent the status quo.[416]

Professor Russell Korobkin notes that because contracting parties tend to prefer the status quo, "lawmakers can probably change private parties' preferences for contract terms quickly by altering contract default rules via legislation or judicial decision."[417] The current regime protects investors via section 29(a) of the 1934 Act, which theoretically renders void any contractual attempt to waive protection of the securities laws.[418] Investor regulation would quickly change the default rule.[419] That legislative change, coupled with the incentive of the securities industry's form-givers to present forms that exclude liability for fraud,[420] may combine to substantially reduce antifraud protection for investors.

Anchoring and adjustment impacts this process in another way. If Kira is told during oral negotiations that her investment is not risky, this representation may anchor her view of the situation. To the

around thirty-three percent. DAVID A. AAKER, MANAGING BRAND EQUITY 49 (1991). "The fact is that customers do not like to change; you almost have to beat some of them off with a baseball bat." *Id*.

415. Sunstein, *supra* note 352, at 119; *see also* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 664 (1998) ("The most fundamental insight for contract theory provided by evidence of the status quo bias is that the choice of default rules matters all of the time, not just when the parties face high transaction costs or asymmetric information."); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1113 (2000) (noting that many of our rules of law, such as the employment-at-will doctrine, may be the result more of the status quo bias than of their inherent efficiency).

416. *See* Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 221 (2001) ("Default rules have a tendency to stick . . . .").

417. Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583, 1602 (1998).

418. 15 U.S.C. § 78cc(a) (2000). The comparable provision in the 1933 Act is section 14, 15 U.S.C. § 77n.

419. Korobkin argues:

> [W]hen lawmakers anoint a contract term the default, the substantive preferences of contracting parties shift—that term becomes more desirable, and other competing terms becoming less desirable. Put another way, contracting parties view default terms as part of the status quo, and they prefer the status quo to alternative states, all other things equal.

Korobkin, *supra* note 415, at 611–12.

420. Korobkin, *supra* note 417, at 1606 ("[T]he use of a form contract as a basis for negotiations should create a similar bias in favor of the form terms.").

extent that a subsequently signed, written contract contains written warnings to the contrary, Kira likely will ignore them.[421] Especially because oral promises trump written warnings,[422] it is unlikely that Kira will be alert to the retraction of those promises in the contract.

People do not understand the effect that these behavioral phenomena have on them, which bears on whether their waivers of legal rights should be taken as sufficiently informed.[423] Thus, Sunstein concludes that "[w]hen people's decisions mispredict their experience, a common argument against paternalism—to the effect that ordinary people choose what will promote their welfare—is no longer plausible."[424] Anchoring and adjustment affects knowledgeable people as well as the unsophisticated.[425]

10. *Repeat Errors*. One of the most unsettling facets of investor activity is the tendency for investors to repeat their errors. The behavioral literature, however, provides several explanations. First, an investor who receives evidence that an intermediary or issuer has deceived him or her is unlikely to process fully that information. Because of the well-established "confirmation bias," people look for information that confirms, rather than undermines, their beliefs.[426] Similarly, because of their desire to maintain consistency, the concept of "cognitive dissonance" keeps people from accepting information that is contrary to decisions they already have made.[427] The effect is so

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421. *See* Hanson & Kysar, *supra* note 159, at 731–32:

> [M]anufacturers [in the consumer product field] may treat anchoring as a valuable mechanism for fixing consumer risk perceptions during the initial product purchase context, when all products are safe and attractively packaged; and they may rely on adjustment from that initial anchor to account insufficiently for the enclosed risk information which is read, if at all, well after the product has been purchased.

422. *See supra* notes 330–38 and accompanying text.

423. *See* Issacharoff, *supra* note 408, at 1800–03 (discussing this issue in the context of employees' ability to adequately protect themselves while negotiating employment contracts).

424. Sunstein, *supra* note 352, at 145.

425. *See* BELSKY & GILOVICH, *supra* note 241, at 141 ("[P]eople can be susceptible to anchoring even when they are especially knowledgeable about the subject at hand . . . .").

426. *See generally* PLOUS, *supra* note 150, at 231–34 (summarizing key studies regarding the confirmation bias, a "catch-all phrase . . . refer[ring] to a preference for information that is consistent with a hypothesis rather than information which opposes it"); SHEFRIN, *supra* note 63, at 62 ("Investors search only for confirming evidence; and they ignore disconfirming evidence."); *see also* Hanson & Kysar, *supra* note 159, at 647 (noting the impact of confirmation bias on product consumers).

427. Ellickson points out that cognitive dissonance predicts that plaintiffs who have three-day windows to undo contracts under Home Solicitation Clauses will generally tend not to do

strong that investors even will remember having had more investment success than they truly did.[428] Having made a decision to trust an intermediary, Kira's tendency will be to ignore evidence showing that the intermediary lied to her.[429] People who have been the victims of Ponzi schemes continue to believe in the scheme even after it has been discredited in the eyes of all reasonable outside observers; such beliefs die hard.[430]

Additionally, because of a susceptibility to framing, investors easily can be manipulated from risk aversion to risk seeking. Thus, Professors Daniel Kahneman and Amos Tversky found that 84% of subjects preferred (a) a 100% chance of gaining $240 over (b) a 25% chance of gaining $1000 and a 75% chance of gaining nothing, but, inconsistently, 87% preferred (a) a 75% chance of losing $1,000 and a 25% chance of losing nothing over (b) a 100% chance of losing $750.[431] The subjects' preferences reversed completely, depending on whether the chance was framed as a potential gain or as a potential loss.[432]

Hanson and Kysar argue that product marketers intentionally or intuitively apply framing principles to successfully manipulate con-

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so. Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 42 (1989).

Chancellor notes the role that cognitive dissonance plays in the mass psychology of stock manias. He notes a description of William Fowler in the 1860s that said that Fowler and his fellow speculators were engaged "'in bolstering each other up, not for the money, for we thought ourselves impregnable in that respect, but by argument in favour of another rise. We knew we were wrong, but tried to convince ourselves that we were right.'" CHANCELLOR, *supra* note 69, at 212 (quoting WILLIAM FOWLER, TEN YEARS ON WALL STREET 322 (1870)).

428. Don A. Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORG. BEHAV. & HUM. DECISION PROCESSES 95, 110 (1999) (finding that study participants were not only overly optimistic regarding future performance but also consistently overestimated the past performance of their investments).

429. *See* Langevoort, *supra* note 145, at 660 ("Having committed to both the relationship with the broker and the particular transaction, the customer is motivated to bolster these decisions, finding it ego-threatening and shameful to conclude that he or she acted on bad advice.").

430. SHILLER, IRRATIONAL EXUBERANCE, *supra* note 63, at 66. As noted earlier, *see supra* note 364, doomsday cult members often become *more* devoted to their cause after predicted dates for the world's end come and go. *See* CIALDINI, *supra* note 356, at 100 ("Rather than disbanding in disillusion [after the obvious failure of their prophecy], the cultists often become strengthened in their convictions.").

431. *See* Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 454–55 (1981) (describing the risk averse nature of majority choices).

432. *See also* DAWES, *supra* note 269, at 122–25 (discussing the basics of preference reversals); Kris N. Kirby & R.J. Hernstein, *Preference Reversals Due to Myopic Discounting of Delayed Reward*, 6 PSYCHOL. SCI. 83, 88 (1995) (same).

sumers' preferences, including those for risk,[433] and studies show that via framing techniques, fraudsters inside client companies can fool a majority of auditors.[434] By convincing investors, even intelligent and educated ones,[435] that they are losing the opportunity for wealth that others are enjoying, industry professionals can induce excessive risk-taking by investors.[436] What in hindsight appears to be greed is simply the natural human tendency to avoid a loss,[437] especially relative to others. What appears in hindsight to be gullibility is simply the strong human need to trust.[438]

So Kira, once bitten by an intermediary's fraud, may be induced to invest in a risky new venture to attempt to recoup the losses from the first venture, just as gamblers who have fallen in the hole can be induced to "double up" in an attempt to avoid their losses.[439] Even

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433. *See* Hanson & Kysar, *supra* note 280, at 1507 ("The tobacco industry also seems to have developed ways to take advantage of framing effects by portraying the product so as to minimize smoker risk perceptions."); Hanson & Kysar, *supra* note 159, at 724 ("Once it is acknowledged that consumer risk perceptions may be affected by, for instance, the manner in which information is framed, then it becomes inevitable that manufacturers will exploit those framing effects in a way that maximizes manufacturer profits.").

434. *See* Karim Jamal et al., *Detecting Framing Effects in Financial Statements*, 12 CONTEMP. ACCT. RES. 85, 102 (1995) (reporting the results of a study finding that some auditors were able to detect management's misleading description of the company (the frame) and the underlying fraud, but, that "[d]espite their motivation, training, and experience, over half (13) of the audit partners who participated in this study were deceived by management's frame"); Paul E. Johnson et al., *Effects of Framing on Auditor Decisions*, 50 ORG. BEHAV. & HUM. DECISION PROCESSES 75, 102–04 (1991) (reporting results of a study finding that a majority of subjects—both novice and experienced auditors—were fooled by framing effects and failed to detect a fraud; however, the auditors—novice and experienced—with experience in the particular industry did detect the fraud).

435. In a recent article journalist David Denby wrote of his experience with investing and how he dove into the market because "like many Americans, I have begun to wonder if risk is now something I can afford to avoid." David Denby, *The Quarter of Living Dangerously*, NEW YORKER, Apr. 24 & May 1, 2000, at 221, 221.

436. Thus, an ad for online trading by Fidelity.com asks readers: "What if opportunity knocks and you're not home?" *E.g.*, NEW YORKER, Apr. 24 & May 1, 2000, at 15, 15.

437. More evidence to support this human aversion to loss is the tendency for investors to hold on too long to stocks that have lost value while they are more eager to sell stocks that have gained value. This tendency is inconsistent with standard economic reasoning, but consistent with prospect theory developed by psychologists Kahneman and Tversky. *See* Sunstein, *supra* note 352, at 124 (giving several real world examples of consumer and investor behavior that are consistent with prospect theory).

438. *See* Good, *supra* note 317, at 32 ("[W]ithout trust, the everyday social life which we take for granted is simply not possible.").

439. Numerous studies show that betting on long shots becomes more pronounced at racetracks near the end of the day because bettors, most of whom are losing money, would like to go home winners without risking much in the way of additional sums. They become risk-seeking and bet on long shots, inconsistent with the rational economic man hypothesis. *See* THALER,

corporate executives[440] and sophisticated investors[441] are subject to this tendency. Nick Leeson sank Baring's Bank by losing money and then doubling up in an attempt to make back the bank's money.[442]

Securities professionals are well aware of this tendency of investors, even sophisticated investors, and take advantage of it. For example, citing Procter & Gamble, Dell Computer, Mead Corporation, and other firms' announcement of large losses from trading derivatives, Frank Partnoy, a former employee of Morgan Stanley, reports:

> Soon after the first losses were announced [Morgan Stanley's president John] Mack told a group of managing directors, "There's blood in the water. Let's go kill someone." The idea was that if our derivatives customers were in trouble, and we could convince them that they needed us—perhaps to "double-down" on their losses—we could make even more money off their hardship. Management salivated at these potential victims, known euphemistically as distressed buyers. As my bosses told me repeatedly during this period, "We love distressed buyers."[443]

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supra note 66, at 135 (citing several studies supporting bettors tendency to bet on long shots in an attempt to break even for the day).

440. SHEFRIN, *supra* note 63, at 24, 107–17. Shefrin gives as an example of what he calls "get-evenitis" the inability of corporate executives to terminate losing projects. This tendency is related to the phenomenon known as "escalation of commitment." *See generally* Max H. Bazerman et al., *Escalation in Individual and Group Decision Making*, 33 ORG. BEHAV. & HUMAN PERFORMANCE 141, 150 (1984) (finding that the escalation phenomenon affects groups as well as individuals who made the initial decision); Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGMT. REV. 577, 584 (1981) (finding that people have a tendency to escalate commitment beyond the point warranted by "objective" facts).

441. *See* THALER, *supra* note 66, at 137 (suspecting that "portfolio managers trailing the market in the fourth quarter may behave much like the racetrack bettors who bet on longshots when behind at the end of the day"); Keith C. Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85, 108 (1996) (finding that mutual fund managers who are in the middle of their comparison group at midyear tend to increase the risk of their fund's portfolio during the second half of the year to improve their annual performance); Michael J. Roszkowski & Glenn E. Snelbecker, *Effects of "Framing" on Measures of Risk Tolerance: Financial Planners are Not Immune*, 19 J. BEHAV. ECON. 237, 244 (1990) (finding that financial planners show a greater tendency to take risks in a loss frame than in a gain frame).

442. *See* Raymond G. Falgui, "*Masters of the Universe" (The Nineties' Traders)*, BUSINESSWORLD, Jan. 3, 2000, at 13, 13 (reporting that, when Leeson started losing money, he took "on more and more risks as he prayed for a turnaround that would allow him to cover his losses").

443. PARTNOY, *supra* note 140, at 99; *see also* Brannigan, *supra* note 310, at 29 ("'It's like the guy who goes to Vegas to the 21 or craps tables. He's losing, but he keeps playing because he thinks there's a chance of winning it back.'") (quoting a former boiler room operator).

Some people have difficulty summoning sympathy for investors who repeat their mistakes, but it is important to remember that "the primary emotions that determine risk-taking behavior are not greed and fear, but *hope* and fear."[444]

C. Choi's Behavioral Analysis

Just as a thorough recounting of an ex-spouse's faults ultimately makes him sound worse than he really was, the totality of the foregoing description of behavioral research as it applies to investors makes them sound more dunderheaded than they usually are. Certainly not all heuristics and biases apply at all times and in all settings to all investors. Nonetheless, this body of evidence should give one substantial pause before jumping on the private-ordering bandwagon of investor regulation. Even the most intelligent, expert investors are subject to the vast majority of the cognitive limitations just discussed.[445]

To his credit, Choi builds a positive case for investor regulation, rather than simply basing arguments on a laundry list of mistakes that the SEC has made over the years.[446] However, Choi's discussion of the vast body of behavioral literature that undermines his proposal is sur-

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444. SHEFRIN, *supra* note 63, at 3 (emphasis added).

445. *See* SHILLER, BUBBLES, *supra* note 63, at 2 (arguing that the human errors in judgment that created the speculative bubble in the stock market in the mid- and late 1990s infected some of the most intelligent people in our society).

446. Of course, because the SEC may be even busier under Choi's plan of investor regulation than it is today, it would have been unseemly for him to have attacked the SEC excessively. Although many SEC policy decisions over the years can be strongly criticized, it remains perhaps the most admired federal administrative agency and Choi certainly takes great advantage of it under his proposal. Under investor regulation, the SEC will, at a minimum: (a) prepare a test and administer it to all potential investors (currently sixty-five million in number, Bryan Meyer, *Don't Get Burned; A Beginner's Guide to What to Look for and What to Avoid in the Stock Market*, BUFFALO NEWS, June 22, 1999, at 1D, not to mention the additional foreign investors who bought $141 billion of U.S. securities in just the first quarter of 2000, Michael Sesit, *Foreigners Flocked to U.S. Securities in First Quarter*, WALL ST. J., June 27, 2000, at A24), Choi, *supra* note 7, at 310; (b) provide a menu of default options of public regulation that issuers may opt into and the SEC will enforce, *id.* at 286; (c) monitor transactions between issuers and investors to ensure that only qualified investors are approached, *id.* at 287; (d) regulate manipulation of third parties, *id.* at 287; (e) create a menu of default options for regulation of broker-dealers and other market participants that they can opt into and the SEC will enforce, *id.* at 291–93; (f) publicize the new plan and all its options, *id.* at 290; (g) select who can qualify as an HVO, *id.* at 297; (h) publicize information on market participants to minimize investors' search costs, *id.* at 311; (i) inform the market as to the proportion of different classes of investors that exist, *id.* at 312; and (j) provide whatever regulation is needed to minimize third-party effects of investor regulation, *id.* at 325.

prisingly thin. After noting several heuristics and biases, but seemingly focusing on only cognitive dissonance, Choi initially ventures that "[c]ognitive dissonance is likely to be correlated with an investor's investment experience."[447] Choi offers not one iota of evidence to support this surmise. One point worthy of repetition is that professional and institutional investors generally are subject to the same heuristics and biases that render amateur investors vulnerable.[448] Indeed, "studies show that experience can *reinforce* cognitive errors"[449] rather than cure them.

Nor are these problems easily remedied by information or education. Certainly more information and more education are good things for investors. To the extent that a scheme of investor regulation

447. Choi, *supra* note 7, at 317.

448. *See* SHEFRIN, *supra* note 63, at 58 ("Wall Street strategists are prone to committing a variety of behavioral errors and biases: gambler's fallacy, overconfidence, and anchoring."); ROBERT J. SHILLER, MARKET VOLATILITY 379–400 (1989) (finding that in the wake of the October 1987 stock market crash, institutional investors, like others, based their reasons for trading on hunches, emotions, and intuitions); SHLEIFER, *supra* note 63, at 12 ("Professional money managers are of course themselves people, and as such are subject to the same biases as individual investors."); Hu, *supra* note 163, at 863 ("[I]nstitutional investors are managed by humans, and humans are susceptible to cognitive biases."); Benjamin M. Friedman, *Comments and Discussion*, *in* Robert J. Shiller, *Stock Prices and Social Dynamics*, *in* ADVANCES IN BEHAVIORAL FINANCE, *supra* note 66, at 212, 215 ("There is simply no reason to believe that institutional investors are less subject to such social influences on opinion [that cause "herd behavior"] than other investors, and there are substantial grounds for thinking that they may be even more so."); Langevoort, *supra* note 65, at 867 ("These traits apply not only to the average individual investor, but to professionals as well."); Riva D. Atlas, *Even the Smart Money Can Slip Up*, N.Y. TIMES, Dec. 30, 2001, § 3, at 1 (noting that in 2001 many sophisticated "superrich" investors lost hundreds of millions if not billions of dollars in the stock market by making the same cognitive and strategic errors that plagued unsophisticated investors); Peter Huang, Regulating Securities Professionals: Emotional and Moral Aspects of Fiduciary Investing 29–30 (2001) (unpublished manuscript, on file with the *Duke Law Journal*) (discussing studies showing that even professional securities traders react emotionally to financial decisions, information, and outcomes); Peter R. Locke & Steven C. Mann, Do Professional Traders Exhibit Loss Realization Aversion? 27 (Nov. 2000) (unpublished manuscript, on file with the *Duke Law Journal*) (finding in empirical study that professional traders exhibit the same irrational loss realization aversion as unsophisticated traders).

Interestingly, the fact that professionals are subject to the same behavioral foibles as lay investors coupled with the recent increase in institutional ownership of equity securities magnifies the impact that their errors have on the stock market. *See* SHEFRIN, *supra* note 63, at 6–7 (citing as an example the Long-Term Capital Management (LTCM) hedge fund, whose failure nearly scuttled the American economy); John Cassidy, *Time Bomb*, NEW YORKER, July 5, 1999, at 28, 28 (noting that, before a massive bailout, LTCM "nearly went bankrupt and, according to some observers, almost took the entire financial system of the United States down with them").

449. Hersh Shefrin & Meir Statman, *Ethics, Fairness and Efficiency in Financial Markets*, FIN. ANALYSTS J., Nov.–Dec. 1993, at 21, 23.

would encourage investors to learn more about the process of investing and the workings of the securities markets, it would accomplish some real good. Professor James Fanto argues extensively for increased education of investors.[450] But Professor Henry Hu notes that "there are limits to the efficacy of education,"[451] and even Fanto admits that he "does not suggest that education alone can deal with financial fraud or that it should be used to lessen the scope of the duties of financial professionals toward consumers."[452] Indeed, the evidence shows that most of the cognitive limitations and biases discussed in this Article are extremely robust and greatly resistant to attempts to "educate them away."[453]

Overoptimism, for example, is greatly resistant to de-biasing.[454] Regarding overconfidence by institutional investors, Langevoort notes,

> The natural objection here is that over time investors should learn from their mistakes, acquiring a natural humility. But while this does happen, overconfidence has proven to be a sticky behavioral phenomenon. Again, self-esteem plays a motivating factor. People dwell on successes and attribute them to skill and diligence. Failures are more readily dismissed as the product of chance and other unforeseeable external causes. Learning is thus difficult with respect to investing. Feedback is neither unambiguous nor immediate. For any active investor, a number of successes will provide the more heavily weighted source of feedback. Market volatility and the

450. *See* James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 107–08 (1998) (arguing for greater investor education, and focusing on more than issuer disclosure).

451. Henry C. Hu, *Illiteracy and Intervention: Wholesale Derivative, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2372 (1996); *see also* Latin, *supra* note 241, at 1253 ("[C]onsumer education often proves relatively ineffective, though not valueless, with regard to product-related accident risks.").

452. Fanto, *supra* note 450, at 135 n.108.

453. *See* SHEFRIN, *supra* note 63, at 80 ("The evidence from behavioral decision-making studies is that people learn slowly."); Ward Edwards & Detlov von Winderfeldt, *Cognitive Illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 244–46 (1986) (noting that debiasing does not generally work very effectively); Garvin, *supra* note 408, at 168 (arguing that "effective learning is far from common"); Hanson & Kysar, *supra* note 280, at 1551 (discussing how de-biasing cigarette consumers who have been subject to manipulation by tobacco companies may be impossible or, at least, prohibitively expensive); JACOBY, *supra* note 74, at 86 ("From a behavioral scientist's perspective, it would be naïve to believe that education or therapy would be sufficient to dispel such deep-rooted irrational tendencies.").

454. *See* Neil D. Weinstein & William M. Klein, *Resistance of Personal Risk Perceptions to Debiasing Interventions*, 14 HEALTH PSYCHOL. 132, 132 (1995) (arguing that manipulating perceptions of risk is difficult).

> predictable occurrence of bull markets assure that there will be positive feedback to distort. As to losers, most investments continue indefinitely: there is always the hope of reversals of fortune after initial setbacks, and hence no closure. In this sense, a sophisticated investor's optimistic, self-serving schema of competence and expertise can resist downward revision for unusually long periods of time. Conversely, it will be subject to significant inflation as a result of any hot streak that appears to occur.[455]

Choi's second response to the behavioral literature is to argue that because his proposal "focuses on determining investor knowledge not at the time of any particular transaction but rather before any investment transactions commence . . . many of the biases from cognitive dissonance are reduced."[456] But no matter what category of investor an investor's test results assign her, she must make investment decisions thereafter (unless she is a D student) and all of the biases will apply. Choi's argument seems inapt.

Third, Choi hazards a guess that "the licensing process itself may warn investors of the possibility of different biases including, for example, hindsight bias."[457] Unfortunately, it is not just a matter of informing people of the existence of a hindsight bias,[458] for humans find it difficult to disregard information that they know even when they

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455. Langevoort, *supra* note 145, at 639–40.

456. Choi, *supra* note 7, at 317.

457. *Id.* at 317–18.

458. The hindsight bias is the tendency of people to regard things that have occurred as having been relatively obvious and predictable. Fischhoff describes the bias in these terms:

> In hindsight, people consistently exaggerate what could have been anticipated in foresight. They not only tend to view what has happened as having been inevitable but also to view it as having appeared 'relatively inevitable' before it happened. People believe that others should have been able to anticipate events much better than was actually the case.

Baruch Fischhoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 158, at 335, 341; *see also* Baruch Fischhoff, *Hindsight [not] Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 288, 288 (1975) (reporting the results of studies indicating existence of the hindsight bias); Baruch Fischhoff & Ruth Beyth, *"I Knew It Would Happen"—Remembered Probabilities of Once-Future Things*, 13 ORG. BEHAV. & HUM. PERFORMANCE 1, 3–13 (1975) (reporting the results of one of the first studies showing hindsight bias); Scott A. Hawkins & Reid Hastie, *Hindsight: Biased Judgments of Past Events after the Outcomes Are Known*, 107 PSYCHOL. BULL. 311, 323 (1990) (concluding that "research and theory on hindsight phenomena suggest that the decision maker is unlikely to even be aware of the influence of the to-be-disregarded information, much less able to undo its effects").

are specifically instructed to do so.[459] Unfortunately, evidence shows that the hindsight bias, like many other biases, is notoriously difficult to "de-bias."[460]

Finally, Choi points out that because the current regulatory regime relies primarily on disclosure, it is equally vulnerable to problems caused by investors' cognitive limitations.[461] This is a good point, but not precisely true. Investor regulation not only creates an atmosphere that will likely increase securities fraud activity by a substantial amount,[462] it also leaves fraud victims largely without remedy. That is a significant disadvantage as compared to the status quo.

Professor Robert Ellickson rightly notes that "a legal system devoted to rationalism might undercut its authoritative credibility if the system were to cater to weaknesses in human cognition."[463] But simply to recognize limits on human reasoning is not tantamount to "catering to" those weaknesses.[464] "If the law posits a hopelessly unrealistic world and holds all comers to its standards, the law runs the risk of unfairness."[465]

Choi does his own catering by developing an elaborate scheme to protect unsophisticated investors from themselves. To protect unsophisticated investors from themselves, investor regulation dramati-

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459. Thomas A. Buchman, *An Effect of Hindsight on Predicting Bankruptcy with Accounting Information*, 10 ACCT., ORGS. & SOC'Y 267, 267 (1985). *But see* Paul Slovic & Baruch Fischhoff, *On the Psychology of Experimental Surprises*, 3 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 544, 544, 550–51 (1977) (indicating that, if subjects are forced to consider specific reasons why things might have turned out differently, the bias can be mitigated to some extent).

460. In laboratory experiments, researchers have attempted numerous methods for debiasing in this context, but "[c]omplete elimination of the [hindsight] bias has eluded psychologists." Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 587 (1998). Still, researchers have had more luck de-biasing the hindsight bias than most others. *See* Philip G. Peters, Jr., *Hindsight Bias and Tort Liability: Avoiding Premature Conclusions*, 31 ARIZ. ST. L.J. 1277, 1289 (1999) ("[M]ost of the studies indicate that forcing subjects to think concretely about all possible outcomes reduces the hindsight bias markedly.").

461. Choi, *supra* note 7, at 316–17.

462. *See infra* notes 504–20 and accompanying text.

463. Ellickson, *supra* note 427, at 39; *see also* Hillman, *supra* note 8, at 734 ("Robust law that encourages communication and planning by holding the parties to their contract ultimately may be more effective than law that liberally absolves promisors from their obligations.").

464. Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739, 757 (2000) ("In the absence of adequate feedback, adopting a hard line on cognitive errors will simply penalize parties for mistakes that they could not have avoided.").

465. Garvin, *supra* note 408, at 164; *see also* Langevoort, *supra* note 145, at 671–72 ("[B]laming the investor for her own cognitive failings created by the broker's manipulative selling tactics hardly seems fair.").

cally reduces their freedom of investment. This practice will help protect them from their own mistakes, but it comes at a substantial cost in terms of freedom of choice. True, unsophisticated investors will fare better if confined to passive mutual funds.[466] But the investor regulation proposal proves too much. Even the most sophisticated investors will fare better if they are similarly constrained.[467] Unsophisticated investors, like sophisticated ones, want a large measure of freedom to invest.[468] They are entitled to that freedom, but the law should protect investors' natural mistakes caused by the limitations of human decisionmaking processes from the intentional frauds of securities professionals.[469] Every system of securities regulation should carry a right to be free from fraud.[470]

IV. UNINTENDED CONSEQUENCES OF INVESTOR REGULATION

Any radical redesign of the federal securities regulatory system that might be enacted is sure to have several unintended and adverse

466. As Choi notes, most investors do better through a passive index fund than through an actively managed fund or by picking their own stocks themselves. *See* Burton G. Malkiel, *Indexes: Why the Critics Are Wrong*, WALL ST. J., May 24, 1999, at A30:

> In most years, a Standard & Poor's 500 index fund has a rate of return about two percentage points better than the average manager's; for the 10 years ending in 1998, the index outperformed the average manager by 3.5 percentage points, and did better than more than nine out of 10 active managers.

467. Passive mutual funds are likely the best investment for most other investors as well. "[I]n most years the majority of . . . *professional* money managers actually performs worse than stocks in general. Indeed, over periods of a decade or more, roughly 75 percent of all stock funds underperform the market." BELSKY & GILOVICH, *supra* note 241, at 162.

468. Jonathan Clements, *Racier Bets May Not Be Best Route*, WALL ST. J., Aug. 15, 2000, at C1 ("'People want to be players. They want to own the stocks they read about in the paper every day.'") (quoting financial planner Harold Evensky); *see also* Hu, *supra* note 163, at 838 ("Private economic decisionmakers are entitled to make decisions on whatever grounds they wish, no matter how substantively foolish in the eyes of the government or anyone else, so long as they do not create significant externalities or offend key social policies.").

469. Langevoort, *supra* note 145, at 641 (noting that, because of the various heuristics and biases previously stated, even sophisticated investors do make mistakes); *id.* ("[I]t is precisely these [behavioral] motivations that some brokers will try to manipulate to create customer demand for investment products. Thus, legal responsibility must be assigned in cognizance of the subtle opportunism that tempts brokers. The law may wish to protect unconscious investment motivations from conscious and deliberate manipulation.").

470. Shefrin and Statman maintain that market fairness has various entitlements. One is freedom from misrepresentation, which they define as "entitl[ing] people to rely on voluntarily disclosed information." Shefrin & Statman, *supra* note 449, at 22. Another aspect of "fairness" is "freedom from impulse," defined as "entitl[ing] people to protection from possible imperfect self-control." *Id.*

consequences.[471] The disadvantages of investor regulation and other reform plans are discussed in this Part.

A. Reducing the Efficiency of the Capital Markets

The proposals by Choi, Romano, Mahoney and the others come at an odd time in that they fly in the face of a developing global consensus favoring American-style securities regulation as the optimal approach to producing efficient securities markets.[472] The chord they strike is that much more dissonant in light of substantial recent empirical evidence indicating that "more is better" (at least to a degree) in securities regulation. Often, legal regulation fosters, rather than restrains, business.

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471. Choi is justified in criticizing the complexity of current securities regulation by referring to a "vast number" of regulations, Choi, *supra* note 7, at 280, and to "many layers of regulation," *id.* at 283. But consider this problem. If ABC, a small start-up company, wishes to hire India, a top-notch programmer who has just graduated from Stanford's computer science department, India may well demand stock or stock options in ABC in addition to salary. ABC cannot oblige until India takes Choi's investor certification exam and if she gets a "D", ABC cannot meet her demand even if it is in desperate need of her services.

India may then choose to start her own company to exploit a brilliant idea she has. Her tax accountant advises her to incorporate and when she does so, she discovers that it is illegal for her company, India, Inc., to issue any shares to her because she got a "D" on the investor certification exam.

Now, surely with some minor exemptions built into Choi's proposal, these problems can be avoided. But it is problems such as these, arising continuously over the course of the past seventy years, which account for the complexity of the current scheme of federal regulations. Any author of a dramatic reform proposal such as Choi's is optimistic if he or she thinks increased simplification is likely to be an advantage of the new plan.

472. *See* SHEN-SHIN LU, INSIDER TRADING AND THE TWENTY-FOUR HOUR SECURITIES MARKET: A CASE STUDY OF LEGAL REGULATION IN THE EMERGING GLOBAL ECONOMY 20–21 (1999) (describing the emergence of a global consensus that insider trading should be regulated by governments); CHARLES R. MORRIS, MONEY, GREED, AND RISK: WHY FINANCIAL CRISES AND CRASHES HAPPEN 78 (1999) ("The securities regulatory system that evolved through the 1930s . . . has proven itself the most successful in the world."); Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 233 (1998) (discussing the success of the SEC and the International Organization of Securities Commissions (IOSCO) in creating a "convergence" of insider trading regulations based on the U.S. model); Alfred Keuppers, *Germans Look Longingly at SEC Model*, WALL ST. J., Sept. 6, 2001, at A15 (noting that many people in Germany believe that recent German reforms in securities are helpful but don't go far enough because the country needs an SEC-like institution); COFFEE, *supra* note 180, at 82 (describing how, between the late 1960s and the 1980s, each of the major European economies created an agency modeled after the SEC). The Organisation for Economic Co-operation and Development's (OECD) recent adoption of principles recommending U.S.-style mandatory corporate disclosure is one indication of this trend. Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance*, OECD Online, *at* http://www.oecd.org/daf/governance/principles.htm (Apr. 16, 1999) (on file with *Duke Law Journal*).

Professors Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer, and Robert Vishny, with each other and with others, have done much of the empirical work in this area. They have found evidence that countries with better investor protections, measured by both the character of legal rules and the quality of law enforcement, have more valuable stock markets, larger numbers of listed securities per capita, and a higher rate of initial public offering activity than do countries with worse investor protections;[473] that firms in countries with better protection of minority shareholders from the depredations of majority shareholders are valued higher;[474] and that in Poland, strict enforcement of American-style securities laws was associated with rapid development of a nascent stock market, whereas in the neighboring Czech Republic, hands-off regulation was associated with a near-collapse of the stock market.[475]

Numerous other authors make similar findings. Empirical academic studies have (a) determined that countries that enforced their

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473. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131 (1997). These authors later extended this study beyond the effect of legal protections of investors on the efficiency of capital markets to examine the impact of the quality of government on economic development. Rafael La Porta et al., *The Quality of Government*, 15 J.L. ECON. & ORG. 222, 222 (1999). Their findings were interesting, including that bigger governments tended to be more efficient than smaller governments and that effective governmental institutions (arguably the SEC would be an example) contribute to economic development. *Id.* at 266. On the other hand, it seems clear that less interventionist legal regimes, such as the U.S.-style common law, are more efficient than more interventionist regimes such as French civil regimes and socialist regimes. *Id.* at 265; *see also* Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. 22, 26 (2000) (finding that the legal reform to reduce the diversion of corporate resources from the corporation to controlling shareholders ("tunneling") is "a crucial element of promoting financial and economic development"); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1152 (1998) (reviewing substantial evidence that "describes a link from the legal system to economic development").

474. Rafael La Porta et al., Investor Protection and Corporate Valuation 4 (Oct. 1999) (unpublished manuscript, on file with the *Duke Law Journal*). The authors note that "[b]y limiting expropriation [by majority shareholders through such practices as insider trading], the law raises the price that securities fetch in the marketplace." *Id.* at 2. There is no evidence that the supposed savings in securities prices that investor regulation would achieve for those sophisticated investors willing to bargain away investor protections would counterbalance the adverse effect of eliminating minority investor protections, such as insider trading rules. Even sophisticated investors are subject to exploitation if they are minority shareholders.

475. Simon Johnson & Andrei Shleifer, Coase v. the Coasians 28 (Nov. 1999) (unpublished manuscript, on file with the *Duke Law Journal*) ("The regulated Polish stock market has grown faster, has maintained greater liquidity, and has been a better source of capital for firms than the less regulated Czech market."). In particular, Johnson and Shleifer note the aggressive Polish oversight of intermediaries. *Id.* at 25. Choi relies heavily on intermediaries in his scheme, but without governmental oversight they are unlikely to protect the integrity of the markets.

insider trading laws had a lower cost of equity;[476] (b) found that "weaker insider trading regimes have, on average, less liquid equity markets";[477] (c) concluded that "[c]ountries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable";[478] (d) learned that both laws on the books and effective legal institutions are needed to create optimal access to external finance;[479] (e) found that "[f]irms in

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476. Utpal Bhattacharya & Hazen Daouk, The World Price of Insider Trading i (2001) (unpublished manuscript, on file with the *Duke Law Journal*) ("We find that the cost of equity in a country, after controlling for a number of other variables, does not change after the introduction of insider trading laws, but decreases significantly after the first prosecution.").

477. Laura N. Beny, A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading 6 (Sept. 1999) (unpublished manuscript, on file with the *Duke Law Journal*).

478. Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 33 (1999). This is especially important for Choi who creates a plan that relies extensively upon financial intermediaries, yet by eliminating mandatory corporate disclosure surely weakens those same intermediaries.

479. Black, *supra* note 208, at 783 (arguing that the two essential prerequisites for vibrant securities markets are "laws and related institutions [that] must give minority shareholders (1) good information about the value of a company's business; and (2) confidence that the company's insiders (its managers and controlling shareholders) won't cheat investors out of most of the value of their investment"); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 644 (1999) (stating that "only those legal systems that provide significant protections for minority shareholders can develop active equity markets"); John H. Welch, *The Americas: Making Investment in Brazil Fair for the Little Guy*, WALL ST. J., Sept. 22, 2000, at A23 ("The lack of protection for minority shareholder rights in Latin America may explain why the region's domestic equity markets are highly illiquid and local business development is so stunted."); Maria Maher & Thomas Andersson, Corporate Governance: Effects on Firm Performance and Economic Growth 36 (Feb. 2000) (unpublished manuscript, on file with the *Duke Law Journal*) (comparing corporate governance features of OECD countries, and observing that "[t]he empirical evidence to date seems to suggest that . . . protection of minority shareholders is critical to the development of equity markets"); Katharina Pistor et al., Law and Finance in Transition Economies 15–16 (2000) (unpublished manuscript, on file with the *Duke Law Journal*).

Although several of the articles discussed in this section paid particular attention to what would be denominated corporation laws rather than securities laws, Coffee points out that

> the critical restraints that most limit agency costs are today contained in federal securities laws. Indeed, the importance of federal securities law may so overshadow that of state corporate law as to make the distinctions among state laws relatively unimportant in the case of the publicly held corporation (at least with regard to limiting agency costs).

Coffee, *supra*, at 699. *See generally* Zdenek Drabek & Warren Payne, The Impact of Transparency on Foreign Direct Investment (1999) (unpublished manuscript, on file with the *Duke Law Journal*) (finding that increased transparency, as affected by efficient government institutions, strongly enforced property rights, the relative absence of corruption, and the like, was correlated to increased foreign investment); Franco Modigliani & Enrico Perotti, Security versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules 19 (Feb. 12, 1998) (un-

countries that have active stock markets and high ratings for compliance with legal norms are able to obtain external funds and grow faster";[480] (f) determined that countries with better protections for minority shareholders suffered milder financial crises in 1997–98;[481] (g) discovered that protection for minority investors is associated with greater firm-specific returns variation and lower synchronicity in stock prices, opening the way for more efficiency-producing firm-specific risk arbitrage;[482] (h) found evidence indicating that strong minority-investor rights curb over-investment in declining industries;[483] and (i) learned that if countries want efficient financial sectors, they should reform their judicial systems by emphasizing the rights of outside investors, by making contract enforcement more efficient, and by creating flexible legal systems that evolve to meet changing conditions.[484] Overall, La Porta and his colleagues conclude,

> Such diverse elements of countries' financial systems as the breadth and depth of their capital markets, the pace of new security issues, corporate ownership structures, dividend policies, and the efficiency of investment allocation appear to be explained both conceptually and empirically by how well the laws in these countries protect outside investors.[485]

published manuscript, on file with the *Duke Law Journal*) (finding that the degree to which a legal system fosters corruption is inversely correlated with the efficiency of its securities markets); Edward B. Rock, Encountering the Scarlet Woman of Wall Street: Speculative Comments at the End of the Century (Dec. 1999) (unpublished manuscript, on file with the *Duke Law Journal*) (arguing that not private ordering or self-help, but corporate law protections account for the elimination of many of the frauds and manipulations that occurred in the 1880s).

480. Alsi Demirgüc-Kunt & Vojislav Maksimovic, *Law, Finance, and Firm Growth*, 53 J. FIN. 2107, 2134 (1998). The authors note that "[a]n effective legal system is important because a firm that wishes to obtain long-term financing must be able to commit credibly to controlling opportunistic behavior by corporate insiders." *Id.* at 2108.

481. Simon Johnson et al., *Corporate Governance in the Asian Financial Crisis*, 58 J. FIN. ECON. 141, 172–78 (2000).

482. Randall Morck et al., *The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?*, 58 J. FIN. ECON. 215, 258 (2000).

483. Jeffrey Wurgler, *Financial Markets and the Allocation of Capital*, 58 J. FIN. ECON. 187, 210 (2000).

484. Thorsten Beck et al., Law, Politics, and Finance 38 (Apr. 2001) (unpublished manuscript, on file with the *Duke Law Journal*).

485. Rafael La Porta et al., Investor Protection and Corporate Governance 1 (2000) (unpublished manuscript, on file with the *Duke Law Journal*).

All of these studies[486] call into question the traditional law and economics view,[487] which Choi and some other reformers adopt, that regulation is essentially unneeded when economic actors simply can privately order the world. La Porta and his colleagues note that whether private contracting is a better approach than government-enforced regulations is an empirical question and all the recent studies "reject[] the hypothesis that private contracting is sufficient."[488] As Coffee notes:

> This claim that financial contracting largely renders regulation irrelevant cannot explain, however, the close correlation between a country's level of capital market development and the nature of its legal system. The more logical conclusion is that law does matter, and regulation can somehow better promote economic efficiency than can reliance on financial contracting alone. By themselves, private contracting and the voluntary incentives for disclosure seem incapable of producing the level of continuing disclosure necessary to sustain active securities markets.[489]

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486. While some of these studies have been legitimately criticized on methodological grounds, *see, e.g.*, Partnoy, *supra* note 69, at 766 (questioning the quality of the authors' data); Amir N. Licht et al., Culture, Law, and Finance: Cultural Dimensions of Corporate Governance Laws 5 (May 2001) (unpublished manuscript, on file with the *Duke Law Journal*) (challenging, for example, the La Porta paper's grouping of countries according to legal families), or on grounds that they overemphasize the causal role of the law in bringing about these good results, *see* COFFEE, *supra* note 180, at 9 (arguing that legal change tends to follow rather than precede economic change); Mark J. Roe, The Quality of Corporate Law Argument and Its Limits 6 (Apr. 20, 2001) (unpublished manuscript, on file with the *Duke Law Journal*) (arguing that the "law-driven story" is certainly largely true but often overdrawn), there certainly are many different studies by many different authors pointing to the same basic conclusions.

487. La Porta and his colleagues acknowledge the traditional law and economics view that argues that most regulation of financial markets is unnecessary because the parties can simply protect themselves contractually. La Porta et al., *supra* note 485, at 6 (observing that, according to the law and economics perspective, "most regulations of financial markets are unnecessary because financial contracts take place between sophisticated issuers and sophisticated investors"); *see also* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 22 (1991) (arguing that a contractual approach to corporate law is largely optimal); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 357 (1976) (lauding the complex set of contractual relationships that make up the successful modern corporation).

488. La Porta et al., *supra* note 485, at 6.

489. Coffee, *supra* note 16, at 4; *see also* Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1339 (1996) (arguing that the American financial reporting systems' openness "makes American industry more efficient and competitive . . . . [because] corporate executives, like the rest of us, behave more honestly, diligently and competently when they know that their stewardship of other people's money is open to scrutiny"); Michael J. Trebilcock, *External Critiques of Laissez-Faire Contract Values*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 93 (F.H. Buckley ed.,

B. Undermining Trust

There are several reasons that American-style regulation produces the deepest, broadest, and most efficient stock markets. One of those reasons is trust.[490] Black observes:

> The United States is not the only country with a successful securities market, but it surely has one of the best. The United States markets are, for many countries, a source of envy (unlike, for example, our tort system). It's magical, in a way. People pay enormous amounts of money for completely intangible rights. Internationally, this magic is pretty rare. It does not appear in unregulated markets.[491]

Trust is a basic building block of a well-functioning society[492] and an efficiently functioning economy.[493] Although some economic theorists view trust as irrational, it often exists even in the absence of legal compulsion.[494] Certainly the reputational constraint encourages economic actors to be trustworthy and to honor their commitments. However, it is also true that "legal sanctions support a vital process of

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1999) ("Markets cannot function without effective government, and moreover markets cannot do everything. To pretend otherwise is to define complex problems out of existence."); Daniel Akst, *The Invisible Hand of Uncle Sam*, N.Y. TIMES, July 2, 2000, at 4 ("[T]he idea that government can't—or shouldn't—do anything is hubristic nonsense, and was recognized as such by no less than Adam Smith.").

490. By "trust," I mean trust in all its forms, including what contractarian Ribstein denominates "weak form" reliance—the decision to rely on another person or institution because of the availability of legal sanctions to punish noncompliance. Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 571 (2001). Barney and Hansen model trust as coming in this weak form, in a semi-strong form where the trustor is protected by structures the parties have set up, and in a strong form where the trustor is protected only by the values, principles and standards of behavior internalized by the parties to the agreement. Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. 175, 179 (1994). By defining trust to eliminate what he calls "weak form reliance," Ribstein argues that the law undermines trust (as narrowly defined). Ribstein, *supra*, at 576–84. However, Ribstein admits several times in his recent article that the law actually bolsters trust when trust is used in the broader sense than I use it here.

491. Bernard S. Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 92–93 (1998).

492. BERNARD BARBER, THE LOGIC AND LIMITS OF TRUST 166 (1983) (observing that trust is "one essential source of social order").

493. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 185 (2d ed. 1977) (noting that trustworthiness "reduce[s] the costs of transactions"); Stephen Knack & Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation*, 112 Q.J. ECON. 1251, 1283 (1997) (finding evidence indicating "that trust and civic cooperation have significant impacts on aggregate economic activity").

494. Rose, *supra* note 341, at 533.

trust building."[495] Fiduciary law strengthens what Professor Tamar Frankel calls the "culture of trust" in America,[496] and securities law does the same.[497] Any investor rationally would be more willing to invest in an issuer or deal with a broker if she knew that mistreatment by the issuer or broker would be met not just with some ephemeral loss of reputation, but also legal sanctions. The availability of plentiful legal sanctions for wrongdoers in the United States is not unrelated to the fact that American managers, among managers around the world, score highest in their tendency to trust.[498] Frankel notes that "[t]here is tentative evidence that poor societies are grounded in mistrust while prosperous economies are based on a culture of trust."[499]

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495. Shell, *supra* note 139, at 282; *see also* Lawrence E. Mitchell, *Trust. Contract. Process.*, *in* PROGRESSIVE CORPORATE LAW 185, 205 (Lawrence E. Mitchell ed., 1995) (discussing how, once a society is organized around the trust principle, untrustworthy behavior cannot be sustained, but until society is so organized, "law is necessary in the short run"); Arvind Parkhe, *Understanding Trust in International Alliances*, 33 J. WORLD BUS. 219, 223 (1998) ("Trust can emerge even when significant vulnerabilities exist, *if* parties to an alliance are protected through various governance devices.") (emphasis added); Partnoy, *supra* note 69, at 764 ("[A]n important role of law is to preserve trust."); Rose, *supra* note 341, at 538 ("[P]eople use legal arrangements to shore up trust and smooth out business relations.").

496. TAMAR FRANKEL, TRUSTING AND NON-TRUSTING: COMPARING BENEFITS, COST AND RISK 5 (Boston Univ. Sch. of Law Working Paper Series, Law & Econ. Working Paper No. 99-12, 1999) (on file with the *Duke Law Journal*).

497. *See* Oliver E. Williamson, *Calculativeness, Trust, and Economic Organizations*, 36 J.L. & ECON. 453, 477–78 (1993) ("Provided that the regulation in question is 'appropriate,' both parties to the transaction—the regulated firm and its customers—will be prepared to make investments in specialized assets on better terms than they would in the absence of such regulation.").

498. DONALD L. HARNEET & L.L. CUMMINGS, BARGAINING BEHAVIOR: AN INTERNATIONAL STUDY 124 (1980).

499. FRANKEL, *supra* note 496, at 4; *see also* FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 7 (1995) (arguing that a country's ability to compete is correlated to its level of trust); POSNER, *supra* note 493, at 185 ("Honesty, trustworthiness, and love reduce the costs of transactions . . . .").

In a recent paper, Professors Margaret Blair and Lynn Stout note the importance of trust in the functioning of corporations. Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law 2 (2000) (unpublished manuscript, on file with the *Duke Law Journal*). While they argue in response to contractarian theory that the influence of law on trust can be overstated, *id.* at 13–14, they also state that legal rules can shape norms which influence individual behavior, *id.* at 72, noting the importance of judicial opinions in this regard. Blair and Stout argue that it would be a mistake to allow corporate directors to contract out of their fiduciary duties because it would send the wrong message to them regarding their responsibilities to shareholders. *Id.* at 71. They state that "[c]orporate case law accordingly can encourage corporate participants to internalize norms of cooperation through social framing—providing information about the social context of relationships within the firm." *Id.* The same point can and should be made regarding any proposal to allow broker-dealers to contract out of fiduciary obligations to vulnerable customers.

A contractarian "take advantage of the other guy if he lets you can get away with it" approach like investor regulation inevitably reduces trust.[500] Without legal sanctions, parties often have to resort to "constant monitoring and checking [that] can poison the atmosphere."[501] Reducing trust can create a downward spiral, for those who trust others less cheat more themselves.[502] Frankel argues:

> Scholarship advocating contract models for the relationship of investors and their financial institutions is pernicious because it threatens our financial system. It may induce investors and savers to put their money in gold and other unproductive goods, and hide it under the mattress. As improbable as it seems in the age of millions of American investors in the securities markets, this possibility should not be ignored. It happened before, not only in other countries, but also in the United States. It can happen again.[503]

C. Stimulating Fraudulent Behavior

Investor regulation, if adopted, would stimulate fraudulent behavior by making it more acceptable. Just as morals shape laws,[504] laws shape morals.[505] When Congress outlaws racial discrimination or

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500. *See* Mitchell, *supra* note 495, at 186 (noting that laws "which encourage individuals in our society to seek their own ends without regard for those of others, except to the extent that they choose to have such regard . . . disregard[s], and ultimately diminish[es], the values of community built upon the foundation of trust").

501. Rose, *supra* note 341, at 540.

502. *See* FRANKEL, *supra* note 496, at 16 ("Under conditions of distrust, the assumption and expectation that others will be treacherous and deceitful gives rise to treachery and deceit."); Julian B. Rotter, *Interpersonal Trust, Trustworthiness, and Gullibility*, 35 AM. PSYCHOLOGIST 1, 2 (1980) (citing a study finding that "low trusters had cheated significantly more often than had high trusters").

503. FRANKEL, *supra* note 496, at 33; *see also* Tamar Frankel, *Accountants' Independence: The Recent Dilemma*, 2000 COLUM. BUS. L. REV. 261, 271 ("Investors who cease to trust the informational integrity of particular issuers may cease to trust the integrity of the entire markets [sic]. The available literature on public mania suggests as much.").

504. *See* ROBERT AXELROD, THE COMPLEXITY OF COOPERATION: AGENT-BASED MODELS OF COMPETITION AND COLLABORATION 60 (1997) (noting the interaction between law and societal norms and emphasizing the importance of norms).

505. *See* Robert Cooter, *Expressive Law and Economics*, 27 J. LEG. STUD. 585, 586, 607 (1998) (using economic analysis to argue that "law can change the individual values of rational people," and that "[l]aw provides an instrument for changing social norms by expressing commitments"); Jeffrey J. Rachlinski, *The Limits of Social Norms*, 74 CHI.-KENT L. REV. 1537, 1538 (2000) ("[C]hanges in law can influence social norms. For example, passing a law against smoking in public places had a dramatic effect on smokers, not because of the formal penalty for public smoking (which is hardly ever imposed) but because it empowered nonsmokers to levy social sanctions on smokers."); Huang, *supra* note 448, at 5 (observing that economists recog-

insider trading, people's views of the acceptability and even morality of those actions change.[506] One theory is that legislation changes what people believe about approval patterns in their society and because people value approval, their new beliefs affect their behavior.[507] When the SEC bans manipulation and insider trading, "financial morality" similarly evolves.[508] These unfair and inefficient acts become less acceptable, and people become less likely to engage in them for both legal and moral reasons. And, indeed, it is widely acknowledged that passage of the 1933 and 1934 securities acts reduced securities fraud.[509]

Investor regulation takes the securities industry in the wrong direction. By removing prohibitions on all manner of securities fraud, investor regulation makes such fraud more acceptable and therefore more likely to occur. Although the situations are obviously quite disparate, the result when the Czech Republic adopted a laissez-faire oriented system is instructive: "Fraud, manipulation, insider trading—these practices became endemic."[510] When the Reagan administration

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nize that "making behavior illegal stigmatizes that behavior differently than raising the cost of that behavior, for example via taxes"); Steven Shavell, Law Versus Morality As Regulators of Conduct 34 (Nov. 2001) (unpublished manuscript, on file with the *Duke Law Journal*) (noting that "legal rules can affect our moral beliefs as well as the operation of the moral sanctions").

506. *See* THOMAS DONALDSON & THOMAS W. DUNFEE, TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS 95–96 (1999):

> Outside sources may influence the development of norms. Law, particularly when it is perceived as legitimate by members of a community, may have a major impact on what is considered to be correct behavior. Thus, the U.S. Corporate Sentencing Guidelines may be expected to influence perceptions of appropriate structures and policies for assigning managerial responsibility pertaining to corporate social responsibility. Conventional wisdom holds that U.S. law has influenced changes in ethical norms pertaining to racial or gender-based discrimination and also as to the legitimacy of insider trading.

See also Mark Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669, 695 (1979) (noting that "[p]erhaps society learns what to value in part through the legal system's descriptions of our protected spheres"); Richard H. Pildes, *The Unintended Cultural Consequences of Public Policy: A Comment on the Symposium*, 89 MICH. L. REV. 936, 938–39 (1991) (discussing how law has cultural consequences); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1731 (1996) ("[L]aws inevitably strengthen or weaken social norms by signaling an official stance toward them . . . .").

507. Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339, 389 (2000).

508. SELIGMAN, *supra* note 20, at 178–79 (describing the long-term impact of the SEC's "revolution in financial morality" accomplished in the 1930s).

509. *See id.* at 561–62 (stating that "the securities laws had reduced, though not eliminated, securities fraud"); *see also* Rachlinski, *supra* note 505, at 1544 ("[E]ven in the absence of enforcement, the mere act of criminalizing conduct can reduce its prevalence.").

510. Coffee, *supra* note 16, at 38.

adopted a deregulatory attitude, traders on Wall Street adopted shady practices they previously had abjured.[511]

Choi has two responses to the argument that fraudsters will opt out of regulation and abuse his self-tailored regulation scheme. First, he argues that rational investors will refuse to buy fraudsters' securities.[512] Many will refuse, but some will not, if current experience is any guide. Under investor regulation, those who can be suckered will provide free money for the bad guys—no civil liability, no criminal liability. Even today, the SEC has great difficulty stopping and punishing career securities criminals.[513] Investor regulation hands them a livelihood on a silver platter.

Second, Choi argues that investors who do buy will pay less for the securities.[514] Maybe, but if the sellers are crooks, any money is free money. No doubt they would rather get ten dollars per share than five dollars, but if the shares are bogus they still are earning a handsome, if illicit, profit.

By increasing fraud, investor regulation will undermine all honest issuers and intermediaries, because of Professor George Akerlof's market for lemons concept.[515] With less trust and more fraud, legiti-

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511. *See* ABOLAFIA, *supra* note 143, at 22 (noting that after the Reagan administration began sending signals that regulatory oversight would be reduced, many opportunistic practices that previously had been thought of and dismissed as "trashy," suddenly became widespread among bond traders); Krawiec, *supra* note 297, at 329 (detailing how "increased competition, financial innovations, and the deregulatory attitude of the Reagan administration" created a new Wall Street "culture significantly different from pre-1980's norms," a culture that "ignored specific regulatory or institutional rules and encouraged more opportunistic behavior").

512. Choi, *supra* note 7, at 295 (suggesting that, under investor regulation, regulators could maintain a record of past complaints against specific intermediaries so investors could use that information to avoid doing business with them).

513. *See* Anne H. Wright, *Form U-5 Defamation*, 52 WASH. & LEE L. REV. 1299, 1299 (1995) ("The extent to which securities professionals with significant disciplinary histories or multiple investor complaints manage to remain in the securities industry has attracted considerable attention in recent years."); Julie Kay, *Federal Prosecutors, SEC Team Up in Unusual Effort to Put Away South Florida Scam Artists*, MIAMI DAILY BUS. REV., Jan. 8, 2001 ("'A portion of the cases we do are frustrating, because we see the same players again and again.'") (quoting SEC regional director Dave Nelson).

514. Choi, *supra* note 7, at 295.

515. In a market where consumers cannot obtain adequate information about the products they are to buy, sellers have an incentive to sell products that are "lemons" because consumers do not have the requisite knowledge to choose a competitor's better products. Black, *supra* note 208, at 786. Professor George Akerlof illustrated the market for lemons problem with used cars. George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). However, the point is even stronger for securities. Potential automobile purchasers can examine the engine and kick the tires. Potential securities investors are generally relying on representations and pieces of paper. If investors cannot verify the information relia-

mate and honest issuers will have more trouble raising funds because investors will have to be more wary. Intermediaries and issuers are not optimally motivated to earn a good reputation from their actions because crooks will free-ride on honest players' efforts to establish industry-wide credibility.[516] This tendency helps explain why legitimate actors in the securities industry show no interest in investor regulation.

On the other side of the table, even the most sophisticated venture capitalists and institutional investors will have to incur greater expense to protect themselves in deals.[517] It is difficult enough under existing securities laws to determine the wisdom of an issuer's business plan and the adequacy of its resources. How much more expensive will due diligence be when financial disclosure is not mandated, regular, or uniform, when a company can choose whatever accounting approach best massages its financial appearance, and when it is no longer illegal for the company to lie to its auditor?[518] How are even institutional investors to uncover issuer frauds when most that occur are not even discovered by the independent auditors who often have been on the job for years?[519] How much money can investors really

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bly, then they will discount the value and decide to pay less for what they are receiving. In such a market, even reputable sellers have an incentive to sell lemons, because their representations are no more believed than those of the crooks.

516. As Black has noted:

> In the language of welfare economics, investment banking (or accounting or securities lawyering) involves an externality—any one participant can't fully capture its own investment in reputation. Some of the investment enhances the reputation of the entire profession. That externality reduces incentives to invest in reputation. And new entrants can free ride on reputational spillover from established firms. . . .
>
> The result is ironic: The principal role of reputational intermediaries is to vouch for disclosure quality and thereby reduce information asymmetry in securities markets. But information asymmetry in the market for reputational intermediaries limits their ability to play this role.

Black, *supra* note 208, at 788.

517. Investor regulation could set markets back one hundred years to a situation where "[i]n the nineteenth-century American market . . . intrinsic values were actually hidden by the operations of speculators. Under such conditions, the outsider could only trust to luck in making an investment decision." CHANCELLOR, *supra* note 69, at 189–90.

518. Investor regulation would apparently eliminate the current 1934 Act provision making it illegal for issuers to lie to their auditors. 15 U.S.C. § 78m(b)(5) (2000).

519. Most issuer frauds are not brought to light by the issuer's auditor. *See* HOWARD R. DAVIA ET AL., MANAGEMENT ACCOUNTANT'S GUIDE TO FRAUD DISCOVERY AND CONTROL vii–ix (1992) (referencing a study finding that most frauds are discovered not by outside auditors or by internal auditors, but by accident, and observing that "it is overwhelming to think that companies must rely on 'accidental discovery' for detection of a majority of fraudulent activity"). Many frauds go on for years. *See, e.g.*, Charles Gasparino & Mitchell Pacelle, *Cendant Nears Settlement with Holders*, WALL ST. J., Dec. 7, 1999, at A3 (noting that the fraud in the

save by bargaining away unwanted legal protections when due diligence expenses and legal costs (for negotiating to secure the legal protections that are desired) rise substantially, as they inevitably will under a system of investor regulation?[520]

D. Creating Opportunities for Organized Crime

Evidence from Russia[521] and Japan[522] indicates that where there is a dearth of legal regulation, organized crime often streams into the vacuum. Investor regulation's presumed world of rational economic actors efficiently ordering their private affairs is in many settings unrealistic. In an extensive article, Professors Curtis Milhaupt and Mark West argue that opportunities for organized crime are created by deficiencies in state-supplied institutions and that organized crime is the "dark side" of private ordering.[523] West demonstrates that corporate extortion by "sokaiya" gangsters (nominal shareholders who are paid large sums to refrain from disrupting annual shareholder meetings) who have ties to Japanese mobs flourishes because of low levels of corporate disclosure.[524]

Cendant scandal went undetected for more than three years); Debra Sparks, *Asleep at the Audit?*, BUS. WK., Mar. 6, 2000, at 150, 150 (describing a hedge fund fraud that went undetected for more than three years).

520. Even institutional investors are inherently at a disadvantage when dealing with an issuer:

> Although institutional investors have the power to bargain with the issuers, the question remains as to how far the institutional investors can protect themselves. Can the institutional investors get material nonpublic information before insiders trade on it? The answer is "no" because no matter how strong their bargaining power will be, outsiders are still outsiders. If the institutional investors finally figure out the insiders' intentions and follow the insiders' direction to purchase or sell securities, the impact of insider trading would be more serious. More public investors will sustain damage because of the greater trading volume by the institutional investors. . . . The claim that institutional investors can protect themselves because their portfolios are diversified is flawed. If insiders in half of the institutional investors' portfolio companies trade on inside information, institutional investors will lose badly no matter how diversified their portfolios are.

LU, *supra* note 472, at 19–20.

521. *See, e.g.*, Mike Cormaney, *RICO in Russia: Effective Control of Organized Crime or Another Empty Promise?*, 7 TRANSNAT'L L. & CONTEMP. PROBS. 261, 268–69 (1997) (describing how organized crime had taken advantage of a "legal vacuum" in Russia to increase its control of the economic marketplace).

522. *See, e.g.*, Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 U. CHI. L. REV. 41, 97 (2000) (examining organized crime in Japan).

523. *Id*.

524. Mark D. West, *Information, Institutions, and Extortion in Japan and the United States: Making Sense of Sokaiya Racketeers*, 93 NW. U. L. REV. 767, 769–70 (1999).

By eliminating effective securities regulation, investor regulation creates a lush opportunity for organized crime. Clearly the United States is in a much different position than Russia, or even Japan. But the implications of these studies cannot be overlooked in the United States, given organized crime's penchant to invade the securities industry even in the presence of stringent SEC monitoring. In June 2000, the federal government charged 120 people, including members of five organized crime families with wide-ranging securities fraud. The investigation upon which the charges were based had uncovered "mob-related figures threatening violence and extortion—even a murder-for-hire plot—related to stock fraud scams. Prosecutors also alleged that there were attempts to rip off union pension plans, to infiltrate brokerage houses, and to manipulate stocks."[525] Another example is the influence on the Myers Pollock Robbins brokerage firm by associates of the Bonanno and Genovese crime families.[526] Using the old "pump and dump" scheme, supplemented by bullying clients and numerous fraudulent statements, conspirators defrauded 16,000 investors out of more than $176 million between 1992 and 1997.[527] In one aspect of the scheme, an associate of the Bonanno family and two others worked with Myers Pollock Robbins broker Jonathan Lyons to use boiler room tactics to sell HealthTech securities.[528] Defunct brokerage firm Stratton Oakmont also may have had mob ties in its fraudulent heyday.[529] In March 2000, the federal government announced indictments in connection with a stock-fraud operation involving ten licensed stockbrokers, four of the five traditional organized crime families operating in New York, as well as members of

525. Jeffrey Goldfarb, *Mob-Related Stock Fraud Charges Involve 120 Defendants, $50 Million*, BNA SEC. L. DAILY, June 15, 2000, at D2.

526. *See Seven Plead Guilty in Wall Street Mob Case*, NAT'L POST, Jan. 22, 1999, at C2 (noting that seven defendants had pled guilty in a 97-page racketeering indictment naming nineteen men involved with Myers Pollock Robbins); Greg B. Smith, *Brokers Nailed in Stock Scam*, DAILY NEWS (New York, NY), Apr. 15, 2000, at 45 (noting that "capos" in the Genovese and Bonanno crime families and a Bonanno soldier had all pled guilty and gone to jail in connection with the Myers Pollock Robbins scheme).

527. David Rohde, *44 Indicted in a Huge Stock Fraud Scheme*, N.Y. TIMES, Apr. 26, 2000, at B3.

528. *See Broker Pleads Guilty in Mob-Linked Fraud; Key Figure in HealthTech Securities Case*, RECORD (Bergen County, NJ), Nov. 6, 1998, at B2 (describing the scheme and the liability arising from it).

529. *See Stratton Tied to Mob Case?; Defunct Brokerage May Come up at Trial, Judge Says*, NEWSDAY (New York, NY), Mar. 23, 1999, at A43 (stating that evidence of ties between the brokerage firm and organized crime was expected to be presented at trial).

Russian organized crime.[530] In December 2001, federal prosecutors charged a Colombo crime-family associate and others with attempting to profit from anthrax fears by manipulating the market for shares of a company claiming to be the sole distributor of a device that kills the disease in seconds.[531] There are other examples,[532] and some involve prominent firms.[533] If the problem is this severe with stringent government regulation, investor regulation seems certain to exacerbate it substantially.

By significantly limiting the governmental enforcement structure for the securities industry, investor regulation not only encourages fraudulent activity and creates opportunities for organized crime, it

530. *CNN Moneyline News Hour*, (CNN television broadcast, Mar. 2, 2000) (quoting Howard Safir, Commissioner, New York City Police Department).

531. Nichole M. Christian, *Four Are Charged in Scheme that Preyed on Anthrax Fears*, N.Y. TIMES, Dec. 12, 2001, at D2.

532. *See, e.g.*, *Brokers Facing Sanctions*, CALGARY SUN, July 15, 1999, at 59 (noting that the British Columbia securities commission was taking action against two Vancouver stockbrokers arrested in the U.S. in connection with mob-linked stock dealings); Gina Edwards, *Former A.S. Goldman CFO Arrested in Murder-for-Hire Plot*, NAPLES DAILY NEWS, Aug. 10, 2000 (describing the arrest of former "mob-tinged" boiler room operation executive in a plot to kill the judge in his case); *It's Time to Jail Penny Stock Crooks*, BUS. WK., Nov. 20, 1989, at 156, 156 (editorializing that organized crime was a huge problem among penny stockbrokers); Edward Iwata, *Alleged Mob Ties of S.F. Brokerage Probed*, S.F. EXAMINER, Feb. 1, 1998, at A1 (noting that investigators believe that twenty or more stock brokerage firms are "run by bosses and soldiers of the underworld's most powerful Mafia families: Gambino, Genovese, Bonanno, Colombo and DeCavalcante"); David Lefer, *Stock Scams Are Eyed in Dual Slay*[;] *Victims Had History of Shady Deals and Betrayal of Business Associates*, DAILY NEWS (New York, NY), Nov. 7, 1999, at 27 (reporting the investigation of suspected Russian or American mob ties to murders of a former stockbroker and his associate); Helen Petterson, *2 Brokers Plead Guilty in Mob-Tied Stock Plot*, DAILY NEWS (New York, NY), Jan. 27, 1998, at 30 (reporting the guilty plea of two stockbrokers "in cahoots with the mob" in a stock manipulation scheme); Michael Schroeder, *Brokers Charged in Big Stock-Fraud Case*, WALL ST. J., June 17, 1999, at A3 (noting the indictment by New York officials of eighty-five stockbrokers in three separate cases involving more than $100 million in losses and ties to the Colombo crime family and Russian mobsters); Michael Schroeder, *U.S. Accuses 13 of Major Stock Fraud With Links to Organized-Crime Family*, WALL ST. J., Nov. 14, 1997, at B5 (describing federal indictments in a fraud scheme linked to the Gambino crime family); Gary Weiss, *The Mob on Wall Street*, BUS. WK., Dec. 16, 1996, at 92, 92 (describing how "substantial elements of the small-cap market have been turned into a veritable Mob franchise"); Rachel Witmer, *Law Enforcement and Regulatory Agencies Battle Organized Crime on Wall Street*, BNA SEC. L. DAILY, Sept. 14, 2000, at D2 (quoting an FBI official as testifying before Congress that "[i]n the past approximately eight years, organized crime's involvement in the financial and securities markets has become significant").

533. Weiss, *supra* note 532, at 92 ("Among the firms that have been subject to Mob intimidation, sources say, is the premier market maker in NASDAQ stocks—Herzog, Heine, Geduld Inc.").

retards the growth of law as an efficient force in the securities field.[534] As Milhaupt and West note:

> Japan illustrates that states can miss out on enforcement network and learning externalities. Laws and enforcement institutions exhibit increasing returns characteristics. Widely used laws are likely to be well serviced by lawyers and judges. The more laws are used, the more they will lead to the development of precedents and the sophistication of legal professionals. The growth of experienced, state-sanctioned rights-enforcement and information agents, in turn, is likely to foster demand for law reform generally.[535]

Government enforcement is a public good[536] that investor regulation may substantially dissipate.

CONCLUSION

In 1998, Long-Term Capital Management (LTCM) lost four billion dollars in a matter of months. Its struggles dragged a vibrant stock market down fourteen percent, dealt a long-lasting blow to the bond market, and required a $3.4 billion bailout to ensure that the entire American financial structure did not collapse.[537] According to then-Secretary of the Treasury Robert Rubin, LTCM's losses created the greatest financial crisis in a half-century.[538] LTCM was loaded with Nobel laureates in economics and the most respected traders on Wall Street whose sophisticated trading models made one crucial mistake—the models did not take into account the fact that human behavior is often irrational.[539]

534. *See* Tamar Frankel, *Trusting and Non-Trusting on the Internet*, 81 B.U. L. REV. 457, 475 (2001) ("The law can regulate intermediaries more effectively than individuals."); Steven Walt, *Introduction: Privatization and Its Prospects*, 41 VA. J. INT'L L. 517, 527 (2001) (noting that governments are the most efficient enforcers of any securities violations).

535. Milhaupt & West, *supra* note 522, at 95.

536. *See* COFFEE, *supra* note 180, at 51 ("[T]he creation of the SEC gave public investors a public guardian to champion their rights—in effect, a public subsidy for the prevention of fraud."); Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 267 (1995) (noting that regulatory enforcement is a public good).

537. Zuckerman, *supra* note 301, at C1.

538. LOWENSTEIN, *supra* note 301, at 195.

539. DUNBAR, *supra* note 1, at 184, 205, 206–07 (observing that LTCM was, in large part, done in by the fact that other investors and markets more generally acted "irrationally"); JACOBS, *supra* note 66, at 293 ("Markets have a way of confounding such solutions [as LTCM's powerful mathematical models] precisely because they are comprised not of computers, but of human beings subject to behavior outside the realm of mathematics."); LOWENSTEIN, *supra*

John Meriwether, one of LTCM's principals, has been accused of becoming overly cautious in light of his experience.[540] However, no one can accuse Professors Choi, Romano, Mahoney, and the other reformers of lacking confidence or of being risk averse. All propose that regulation of the most successful capital market in the history of the world[541] be turned on its head. All make plausible arguments that should be considered seriously, but ardor for these paradigm-shifting changes should be tempered by both the raft of new empirical evidence supporting American-style regulation as the optimal approach to regulating securities markets,[542] and the large body of behavioral evidence indicating that investors, even sophisticated institutional investors, are unlikely to protect themselves adequately through private ordering.[543] It is a telling point that although many academics take these proposals seriously, virtually no one in the "real world" does.[544] That investment banks, stock exchanges, venture capitalists, institutional investors, and others who would seem to be the primary beneficiaries of Choi's proposal show no interest in it, or, for that matter,

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note 301, at 173 ("[LTCM's principals] had programmed the market for a cold predictability that it had never had; they had forgotten the predatory, acquisitive, and overwhelmingly protective instincts that govern real-life traders. They had forgotten the human factor."); Zuckerman, *supra* note 301, at C1 ("Despite sophisticated trading models mapping past behavior of securities prices, the firm's brainy traders had little understanding of human behavior. Such as: Investors often bail out in a panic.").

540. Zuckerman, *supra* note 301, at C1.

541. *See* Kahan, *supra* note 10, at 1518–19 ("While the present system of securities regulation is far from perfect, the U.S. securities markets have grown at impressive rates, investor confidence in the system is high relative to other countries, companies have been able to raise substantial amounts of capital, trading is cheap, and liquidity is high.").

542. *See supra* notes 8–9 and accompanying text; *see also* Lowenstein, *supra* note 489, at 1355 (noting that the U.S. disclosure system as enforced by the SEC "has helped to create markets that are the standard for the world, markets that offer access to pools of equity capital that exist nowhere else").

543. *See* Madison, *supra* note 265, at 327 (arguing that recent incidents "make a strong case that institutional investors are no match for the derivatives-dealer 'rocket scientists'"). Indeed, the derivatives debacles of the early 1990s certainly showed that institutional investors are often as vulnerable as unsophisticated investors to the sharp sales practices of industry professionals. *See generally* Geoffrey B. Goldman, Note, *Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed"?*, 95 COLUM. L. REV. 1112 (1995) (recounting the huge losses rolled up by Procter & Gamble, Metallgesellschaft, Glaxo, Orange County, West Virginia and others, as well as the unfair practices of many of their derivatives dealers); G. Bruce Knecht, *Houston Firms Sold Risky "Toxic Waste" for Wall Street Giants*, WALL ST. J., Dec. 20, 1994, at A1 (describing how inappropriate derivatives were sold to small institutional investors).

544. Kitch, *supra* note 12, at 630 ("There is no groundswell of interest from either the industry or its customers to change the current regulation. It is as if the academic writers think it is 1932.").

in those offered by Romano, Mahoney, and the others, should give one pause.[545]

In light of the behavioral evidence provided, it is apparent that uniform, mandated disclosure is more thorough and efficient than hit-and-miss privately negotiated disclosure, and even sophisticated investors are quite vulnerable to securities fraud. The current federal securities regulation scheme can be improved in a myriad of ways (many of which are hinted at in Choi's proposal), but before Congress seriously considers any changes as dramatic as those discussed in this Article, recent behavioral insights must be considered seriously.[546]

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545. Coates, *supra* note 20, at 533 ("Good companies . . . are not, to put it mildly, in the vanguard of the renewed assault on the SEC. In fact, industry trade groups have been supporting movement in the opposite direction . . . .").

546. *See* Kyron Huigens, *Law, Economics, and the Skeleton of Value Fallacy*, 89 CAL. L. REV. 537, 538 (reviewing BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2001)) ("Ultimately, these [behavioral] considerations undermine the economic analysis of law, and indicate the need for a fundamental re-orientation of legal theory.").