

# The Inevitability of a Strong SEC

Robert A. Prentice

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# THE INEVITABILITY OF A STRONG SEC

Robert A. Prentice†

*There are many visions for the future of securities regulation. One prominent view features significant private contracting for disclosure and fraud protection. Another envisions regulatory competition, enabling companies to choose from among a menu of regulatory regimes provided by different states, nations, or securities exchanges competing for incorporations or listings. This article demonstrates that these two regulatory regimes rely too heavily upon the reputational constraint, which is insufficient for the significant task of securities regulation. Tenets of behavioral psychology suggest that self-serving bias and other factors will too often cause managers to choose regulatory regimes that serve their own best interests rather than those of shareholders.*

*Around the globe, most developed economies have rejected private contracting and regulatory competition in favor of emulating the United States' current strong-SEC model. An impressive body of transnational empirical evidence supports the viewpoint that the strong-SEC regulatory model is significantly more effective than alternatives at promoting capital markets. This article explains why the strong-SEC model best facilitates capital market development and economic growth.*

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## INTRODUCTION

A familiar cycle has occurred in U.S. securities regulation over the past few years: Loose regulation allows for scandal, which then creates a political atmosphere supportive of aggressive regulation, followed by a backlash by those regulated. This scenario in the 1920s and 1930s led Congress to introduce the first federal securities laws.<sup>1</sup> More recently, Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley)<sup>2</sup> in response to the Enron and related corporate scandals<sup>3</sup> that resulted from a decade of an underfunded Securities

<sup>1</sup> See, e.g., JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE I* (3d ed. 2005) ("The Securities and Exchange Commission was created at the conclusion of the Senate Banking and Currency Committee's 1932-1934 investigation of stock exchange practices . . ."). The primary federal securities laws include the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (2000), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (2000). See Elisabeth Keller & Gregory A. Gehlmann, *A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 342-47 (1988).

<sup>2</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

<sup>3</sup> See S. REP. NO. 107-205, at 2 (2002); H.R. REP. NO. 107-414, at 18-19 (2002).

and Exchange Commission (SEC).<sup>4</sup> Now the backlash has begun, as many criticize the specifics of Sarbanes-Oxley, especially section 404's provisions for internal financial controls and the Act's aggressive extraterritorial application.<sup>5</sup> This paper does not take a position on the specifics of Sarbanes-Oxley. Rather, it anticipates the broader, philosophically based critiques that are on the horizon.

For serious students of securities regulation, the Enron scandal and the Sarbanes-Oxley response raise an overarching question: What should the future of securities regulation look like? Sarbanes-Oxley embodies the "strong-SEC" model, which many people abhor for political and philosophical reasons.<sup>6</sup> Indeed, much brainpower has been spent in the last few decades in a seemingly quixotic quest for a preferable alternative to this strong-SEC model for securities regulation.<sup>7</sup>

The most persuasive alternative has been a regulatory competition model.<sup>8</sup> Supporters argue that companies should be free to choose from a menu of securities regulation options offered by the fifty states,<sup>9</sup> nations around the world,<sup>10</sup> and the world's stock exchanges.<sup>11</sup> These supporters assert that if managers can choose their firm's regulatory environment, they will choose the level of regulation most efficient for the purchasers and sellers of securities.<sup>12</sup> Implicitly,

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<sup>4</sup> U.S. GEN. ACCOUNTING OFFICE, GAO-03-969T, SECURITIES AND EXCHANGE COMMISSION: PRELIMINARY OBSERVATIONS ON SEC'S SPENDING AND STRATEGIC PLANNING EFFORTS 3 (2003), available at <http://www.gao.gov/new.items/d03969t.pdf> (reporting testimony of Richard J. Hillman, Dir., Fin. Markets and Cmty. Inv., before the Subcomm. on Gov't Efficiency and Financial Mgmt., of the H. Comm. on Gov't Reform).

<sup>5</sup> See, e.g., Dan Roberts, *The Boardroom Burden: Calls for Reform Are Replaced by Concern that Corporate Shake-Up Has Gone Too Far*, FIN. TIMES, June 1, 2004, at 15 (noting that business leaders believe that the pendulum has swung too far toward regulation and needs recentering).

<sup>6</sup> See, e.g., Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 111 (2005).

<sup>7</sup> See Edmund W. Kitch, *The Privatization of Securities Laws: Proposals for Reform of Securities Regulation: An Overview*, 41 VA. J. INT'L L. 629, 629 (2001).

<sup>8</sup> See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383, 384 (2003) ("According to the view that appears to dominate the current thinking of corporate law academics, state competition produces a 'race to the top' that benefits shareholders. On this view, the desire to attract incorporations induces states to develop and provide corporate arrangements that enhance shareholder value." (footnote omitted)).

<sup>9</sup> See, e.g., ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* (2002).

<sup>10</sup> See, e.g., Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 925-27 (1998).

<sup>11</sup> See, e.g., A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 983-1000 (1999) (suggesting that securities exchanges play the most prominent role in securities regulation).

<sup>12</sup> See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2366 (1998) ("Regulatory competition is desirable because when the

this regulation may be little or none. Indeed, much less regulation than currently exists is clearly the desired agenda of many of these commentators.<sup>13</sup>

Other commentators suggest that private contracting should replace government regulation. These commentators suggest both that rational investors can bargain with securities sellers whose reputations constrain them to act fairly and that the whole process needs neither government intervention nor a legal backdrop other than contract law.<sup>14</sup>

In a recent paper, Frank Cross and I surveyed the relevant empirical literature and supplemented it with a study of our own.<sup>15</sup> That empirical literature forms the basis for an extraordinarily strong argument that the strong-SEC model is much more effective than any existing competing model. The empirical evidence strongly indicates that countries with mandatory disclosure, strong antifraud protections, insider trading prohibitions, and effective remedies in the form of governmental and private rights of action tend both to have stronger, more efficient capital markets and to enable companies to raise capital more efficiently.<sup>16</sup>

This Article surveys the nonempirical literature and argues that a strong-SEC model is superior to other existing or proposed alternatives. This Article also emphasizes that the realities of human greed and short-sightedness on a grand scale have swamped deregulation's dream of freeing issuers' managers and securities professionals from any restraints other than those imposed by competition and reputation.

It was reasonably clear before the Enron scandal, and is even clearer now, that substantial federal government regulation of securities transactions in the United States will continue. When a crime wave occurs, the answer is seldom fewer police. When a national market crisis takes place, all players in the market and all governmental actors look to Congress and the SEC for a solution.<sup>17</sup> By enacting and implementing Sarbanes-Oxley, Congress and the Commission could,

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choice of investments includes variation in legal regimes, promoters of firms will find that they can obtain a lower cost of capital by choosing the regime that investors prefer.”)

<sup>13</sup> See Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1367–68 (describing the free market goals of regulatory competition advocates).

<sup>14</sup> See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 283 (2000).

<sup>15</sup> Frank B. Cross & Robert A. Prentice, *Economies, Capital Markets, and Securities Law* (2006) (unpublished manuscript on file with author).

<sup>16</sup> See *id.*

<sup>17</sup> See William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* 12 (European Corporate Governance Inst., Law Working Paper No. 23/2004, 2004; Georgetown Univ. Law Ctr. Bus., Econ. & Regulatory Policy, Research Paper No.

and apparently did, restore confidence in the securities markets,<sup>18</sup> similar to how the 1930s securities acts restored confidence following the Great Crash of 1929.<sup>19</sup>

Part I of this Article reminds the reader that the short-term self-interest of actors in the securities markets subverts the reputational constraint, rendering it unlikely that capital markets can prosper without stringent regulation. The discussion seeks to explain the inherent shortcomings of the reputational constraint in a large-scale modern market economy. Part II establishes the SEC's overall success during

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606481 (2004), available at <http://ssrn.com/abstract=606481> ("When a problem with national market implications arises, all parties expect the national system to address it.").

<sup>18</sup> See Dan Roberts, *Corporate US Begins to Reflect*, FIN. TIMES, Nov. 29, 2004, at 7 ("If investors—presumably still scarred by past scandals—are indeed a reliable guide to newfound corporate responsibility, then the [post-Sarbanes-Oxley] improvement is easy to measure: the S&P 500 is up 50 per cent since its 2002 low."); Bengt R. Holmström & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?* 22 (European Corporate Governance Inst., Finance Working Paper No. 23/2003, 2003), available at <http://ssrn.com/abstract=441100> ("At this point, [Sarbanes-Oxley] has probably helped to restore confidence in the U.S. corporate governance system."). It is impossible to know the role of Sarbanes-Oxley, but it is clear that during the dot-com crash, stocks "never reached the depths hit in other collapses, such as in the 1930s or the 1970s." E.S. Browning, *Ah, the 1990s*, WALL ST. J., Feb. 23, 2004, at C1.

<sup>19</sup> Because investors in the 1930s did not yet know that federal regulation can and does help restore stability to markets, it is not surprising that there is little conclusive evidence that the 1930s securities acts restored confidence to the markets. In fact, Stephen Choi and A.C. Pritchard argue that SEC regulation failed to restore confidence in the markets, pointing to the fact that "the volume of trading remained below 1929 levels for another three decades." Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 31 n.151 (2003). However, some historians believe that SEC regulation did have a salutary effect. See JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 197 (1997) (noting that the 1930s securities acts "bolstered investor confidence by ensuring the greater transparency of corporate affairs"); SELIGMAN, *supra* note 1, at 561–62 (observing that SEC regulation led to a dramatic increase in investor participation in the markets).

Significantly, Choi and Pritchard chose the wrong benchmark for comparison; they chose the insane heights of perhaps the greatest speculative bubble in American stock market history—1929. The better method, of course, is to compare postregulation trading volume with the levels of investor confidence in 1933 after the Great Crash. Not surprisingly, the stock market crash of 1929 scared investors out of the stock market for quite a long time, as it should have. See STEVE FRASER, EVERY MAN A SPECULATOR: A HISTORY OF WALL STREET IN AMERICAN LIFE 479 (2005) (noting the "profound aftershock" of the Crash "seared" memories into the public mind, and caused Americans to shun trading); JOHN KENNETH GALBRAITH, THE GREAT CRASH 151–52 (Avon Books 1979 ed.) (1954) (noting that stock market collapses, such as that of 1929, inoculate investors against speculative fever for at least a time).

The ensuing Great Depression and World War II likely also discouraged investors from returning to the securities markets. For "most people living then and for a long generation after, the Crash and the Depression were joined at the hip." FRASER, *supra*, at 414. Even though automobile purchasers were not shell-shocked by the mendacity of their market, as were securities investors, the impact of the Great Depression and World War II meant that it took automobile sales nearly as long to recover (eight million cars were made in 1929 and it was not until 1950 that sales reached that level again) as securities sales. See Stephen Kindel, *The Wrong Lesson*, FORTUNE, July 18, 1983, at 44 (reporting auto sales).

the past seventy years, explains that success, and notes that countries around the world are currently emulating the strong-SEC model.

This Article does not address Sarbanes-Oxley in detail, but does indicate the reasons why Sarbanes-Oxley's broad philosophy and some of its most important prescriptions are consistent with evolving academic notions of best practices in securities regulation. This Article also describes a growing worldwide consensus that the best way to create and preserve efficient securities markets, a key to successful capitalism, is to have an effective central regulatory agency enforcing mandatory disclosure, antifraud rules, and insider trading prohibitions.

## I

### THE REPUTATIONAL CONSTRAINT

Advocates of securities deregulation rely heavily upon the reputational incentive of company managers, securities professionals, and market gatekeepers to maintain the integrity of the markets. Proponents of deregulation assume away the problem that virtually all corporate and securities law aims to minimize: the agency problem identified by Adolph Berle and Gardiner Means.<sup>20</sup> In the deregulation worldview, investors, securities professionals, and ancillary actors such as auditors and attorneys are rational. Furthermore, deregulation assumes that these rational actors' concern for their long-term reputations will constrain them from acting improperly, even without regulation.

Similarly, those deregulation advocates who would replace the SEC's mandatory requirements with the flexibility of regulatory competition assume that managers of corporations will choose the optimal securities regime for their firm. Thus, depending on what is in the best interest of their shareholders, managers may choose the securities law of Delaware in a system of state regulatory competition, the law of Chad in a regime of international regulatory competition, or listing on the Deutsch Bourse in a scheme of exchange-based regulatory competition. Deregulation advocates further assume that managers will choose to subject the firm to stringent mandatory disclosure requirements that decrease manager discretion, strong insider trading rules that decrease manager profit opportunities, and punitive antifraud civil and criminal punishments that increase manager liability exposure. These assumptions ignore the record of the past decade. They allow the fox to choose the rules that will govern the henhouse.

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<sup>20</sup> See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

While it may seem unnecessary and even trite to recount the details of recent frauds, memories are short, and many people cling to overly optimistic views about the tensile strength of the reputational constraint. As with reports of violent crimes in Detroit or civilian deaths in Iraq, frequently repeated information eventually loses its impact. Thus, a brief summary of the recent scandals is worth recounting to remind us one more time that we should not become too hardened to the evidence of grand-scale agency problems that cannot be assumed away.

#### A. The Firm and Its Principals

##### 1. *Issuing Companies: Earnings Management and Earnings Fraud*

A company can benefit when it develops a reputation for disclosing accurate information to investors. In theory, then, we should not need an SEC to enforce voluntary, accurate disclosure. Corporate practices of the last decade or so, however, stand in marked contrast to economic theory. The \$6 trillion collapse in stock wealth when the dot-com bubble burst makes this point clear.<sup>21</sup> The first shock came when it became clear that Enron had used smoke, mirrors, and a phalanx of special purpose entities to make itself appear to be the seventh largest company in the country; its investors lost \$70 billion.<sup>22</sup> A flurry of subsequent revelations followed. HealthSouth overstated its earnings by \$4.6 billion.<sup>23</sup> Adelphia hid more than \$2 billion in debt.<sup>24</sup> Not to be outdone, WorldCom inflated its earnings by \$11 billion<sup>25</sup> and wiped out nearly \$180 billion in shareholder wealth when fraud disclosures collapsed its stock.<sup>26</sup> Global Crossing collapsed under \$12.4 billion in debt after revealing that it had inappropriately reported its revenue.<sup>27</sup>

These instances represent only a sampling of such cases. Ten percent of all publicly listed companies restated earnings because of accounting irregularities between 1997 and June 2002.<sup>28</sup> Write-offs "in excess of \$148 billion erased virtually all of the profits reported by

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<sup>21</sup> James Toedtman, *Securities Law Tested*, NEWSDAY, July 27, 2003, at A43.

<sup>22</sup> William M. Sinnett, *Are There Good Reasons for Auditor Rotation?*, FIN. EXEC., Oct. 2004, at 29, 32 (quoting Dr. Robert A. Howell of Dartmouth).

<sup>23</sup> Shawn Young, *MCI to State Fraud Was \$11 Billion*, WALL ST. J., Mar. 12, 2004, at A3.

<sup>24</sup> Mark Hamblett, *Adelphia Fraud Case Allowed to Proceed*, N.Y.L.J., Aug. 12, 2003, at 1 (noting false filings with the SEC from 1999 to 2002).

<sup>25</sup> See Young, *supra* note 23.

<sup>26</sup> *WorldCom Agrees to Pay Record \$500M to Settle SEC Civil Fraud Charges*, SEC. LITIG. & REG. REP., June 4, 2003, at 6.

<sup>27</sup> Gretchen Morgenson, *Global Crossing Settles Suit on Losses*, N.Y. TIMES, Mar. 20, 2004, at C1.

<sup>28</sup> U.S. GEN. ACCOUNTING OFFICE, GAO-03-138, FINANCIAL STATEMENT RESTATEMENTS: TRENDS, MARKET IMPACTS, REGULATORY RESPONSES, AND REMAINING CHALLENGES 4 (2002), available at <http://www.gao.gov/new.items/d03138.pdf>.



Nasdaq companies between 1995 and 2000.”<sup>29</sup> In 2004, companies filed a record 414 restatements, many of which covered multiyear periods.<sup>30</sup>

Moreover, these restatements were only a part of the larger problem. For instance, IBM, Microsoft, PepsiCo, and other companies misled investors but managed corporate earnings in such a way as to avoid restatements.<sup>31</sup> Academic studies show that in addition to the blatant examples of earnings management, a much larger percentage of companies stretched to barely meet or top their previous quarter’s earnings rather than fall short of the previous benchmark.<sup>32</sup>

Thus, although companies can benefit from a reputation for providing timely, accurate disclosures, the reputational constraint has proven inadequate even in the shadow of substantial securities regulation. Empirical evidence indicates “that there are long-term benefits to building reputations for providing reliable and timely disclosures. Yet the sample of firms investigated in [the] study chose to risk (and ultimately lose) these benefits for the prospect of short-term gain.”<sup>33</sup> Given this backdrop, one shudders at how bad things would have been without federal regulation.

## 2. CEOs

Corporate managers are primarily responsible for earnings management and accounting frauds.<sup>34</sup> CEOs and other top managers theoretically run their companies in the best interests of the shareholders. Short-term greed, a false sense of entitlement, or some other psychological malady must account, then, for recent evidence that CEOs too often run their companies primarily to feather their own nests. Why else did the pay of Fortune 500 companies’ CEOs rise

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<sup>29</sup> Eugene Spector, *Fraud Made Easy*, NAT’L. L.J., Sept. 23, 2002, at A17; see also Charles Handy, *What’s Business For?*, HARV. BUS. REV., Dec. 2002, at 49, 49 (“John May, a stock analyst for a U.S. investment service, pointed out that the pro forma earnings announcements by the top 100 NASDAQ companies in the first nine months of 2001 overstated actual audited profits by \$100 billion.”).

<sup>30</sup> Jonathan D. Glater, *Restatements Are at a High, and Lawsuits Are Rising*, N. Y. TIMES, Jan. 20, 2005, at C2 (citing Huron Consulting Group study); Carrie Johnson, *Restatements Up 28 Percent in 2004*, WASH. POST, Jan. 20, 2005, at E4 (same).

<sup>31</sup> See ROGER LOWENSTEIN, *ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING* 62 (2004).

<sup>32</sup> See *id.* (citing Francois Degeorge et al., *Earnings Management to Exceed Thresholds*, 72 J. BUS. 1 (1999)).

<sup>33</sup> 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, 31 (1996) (citation omitted).

<sup>34</sup> See Tom Horton, *Tone at the Top: There Is Nothing More Important for the Board to Care About, and to Assess*, DIRECTORS & BOARDS, June 22, 2002, at 8 (citing study by the Committee of Sponsoring Organizations finding that of 200 cases of alleged financial fraud investigated by the SEC from 1987 to 1997, five out of six involved either the CEO, the CFO, or both colluding in the fraud).

from forty times that of the average worker in 1980 to 530 times higher in 2003?<sup>35</sup> Why does CEO compensation now average 7.89% of corporate profits and 17.19% of dividends?<sup>36</sup> Never before have top officers taken so large a piece of the corporate pie.<sup>37</sup> As Public Company Accounting Oversight Board Chief William McDonough has noted, “There is no economic theory on God’s planet that can justify [current executive pay levels].”<sup>38</sup>

The huge pay increase derives primarily from the stock option craze of the 1990s, which is, in turn, traceable to an article by economists Michael Jensen and Kevin Murphy, who argued that “it’s not how much you pay, but how.”<sup>39</sup> The theory underlying options-based compensation was to motivate CEOs and other managers to work hard by allowing them to share in their firms’ success, at least insofar as that success is reflected in stock price. Unfortunately, as implemented, stock options generally decoupled pay from performance and usually protected the executives from downside risk.<sup>40</sup> Even Jensen and Murphy now admit that “many of the corporate scandals [of 2001 and 2002] were driven, in large part, by executives desperately trying to justify or increase short-run stock prices at the expense of long-run value creation.”<sup>41</sup>

CEO pay has been described as the “mad-cow disease of American boardrooms.”<sup>42</sup> As Frank Partnoy notes:

[E]conomists had long argued that corporate executives would never systematically take advantage of investors, because their reputations would be destroyed if they did. . . .

It became clear during the 1990s that this argument, although perhaps sound in theory, was wrong in practice. CEOs manipulated their companies’ earnings, paid themselves huge amounts of op-

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<sup>35</sup> See, e.g., Joseph T. Hallinan, *It Still Pays to Be a Consecro CEO*, WALL ST. J., Aug. 17, 2004, at C1.

<sup>36</sup> STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 262, 264 (2002).

<sup>37</sup> See Daniel J.H. Greenwood, *Democracy and Delaware: The Puzzle of Corporate Law* 31 (George Washington Univ. Law Sch., Pub. Law & Legal Theory, Research Paper No. 55, 2003), available at <http://ssrn.com/abstract=363480>.

<sup>38</sup> Hallinan, *supra* note 35.

<sup>39</sup> Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

<sup>40</sup> See Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 274 (1999) (“Compared to other shareholders, performance-based pay seems to make corporate executives a privileged class that does not have to pay for its stock and is largely protected from downside risk”).

<sup>41</sup> Michael C. Jensen et al., *Remuneration: Where We’ve Been, How We Got to Here, What are the Problems, and How to Fix Them* 18 (Harvard NOM, Working Paper No. 04-28, 2004; European Corporate Governance Inst., Finance Working Paper No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>.

<sup>42</sup> John A. Byrne et al., *How to Fix Corporate Governance*, BUS. WK., May 6, 2002, at 68, 71 (quoting J. Richard Finley, chairman of Canada’s Ctr. for Corporate and Pub. Governance).

tions, and established cozy relationships with their accountants and securities analysts, but they did not acquire bad reputations—at least not until several years later.<sup>43</sup>

### 3. *Boards of Directors*

In theory, public company directors monitor managers on behalf of passive shareholders. However, “directors who do not direct” have long been a problem.<sup>44</sup> Sometimes directors remain passive out of self-interest. Empirical evidence indicates that high director compensation corresponds with high CEO pay.<sup>45</sup> “Timing opportunism”—the tendency of companies to bestow stock options upon officers immediately before good news is disclosed or after bad news is disclosed—is not only widespread and increasing, but also more common in companies in which directors receive a larger proportion of their pay in the form of options.<sup>46</sup> Jensen and Murphy admit that executive compensation contracts in American public corporations “have become so extreme and so abusive that they call into question the integrity of important parts of the remuneration process and the fiduciary responsibilities of boards and remuneration committees.”<sup>47</sup>

In addition to economic incentives, social, behavioral, and psychological factors encourage directors to subordinate shareholder interests.<sup>48</sup> These include friendships with and loyalty to the CEO,<sup>49</sup> collegiality and team spirit that discourage asking the hard questions,<sup>50</sup> deference to the CEO’s authority,<sup>51</sup> and the directors’ desire

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<sup>43</sup> FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* 188–89 (2003). When officers were controlling shareholders, things could get even worse, as in the Hollinger International, Inc. case, in which controlling shareholders looted \$400 million. See *Hollinger Inc. Says S.E.C. May Bring a Civil Lawsuit Against It*, N.Y. TIMES, Aug. 31, 2004, at C2.

<sup>44</sup> See William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

<sup>45</sup> See Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance*, J. CORP. FIN. (forthcoming 2006).

<sup>46</sup> See Gretchen Morgenson, *Are Options Seducing Directors, Too?*, N.Y. TIMES, Dec. 12, 2004, at BU1.

<sup>47</sup> Jensen et al., *supra* note 41, at 29.

<sup>48</sup> LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 31–34 (2004).

<sup>49</sup> See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 613 (1982); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 726–27 (2005).

<sup>50</sup> See BEBCHUK & FRIED, *supra* note 48, at 32.

<sup>51</sup> People have a natural tendency to defer to those they perceive to be in positions of authority. See Stanley Milgram, *Behavioral Study of Obedience*, 67 J. ABNORMAL & SOC. PSYCHOL. 371 (1963).

not to monitor others more strictly than they would like to be monitored themselves.<sup>52</sup>

Eugene Fama and Jensen suggest that the reputational constraint should sufficiently induce independent directors to do their job properly,<sup>53</sup> but experience indicates otherwise. A more realistic assessment, in light of the facts, is that directors' reputational constraints are pretty loose.<sup>54</sup> Even if directors vote for extremely high pay for executives or themselves, they likely will suffer little reputational damage unless they go so far that the shareholder "outrage" factor is triggered.<sup>55</sup>

The long-term impact of Sarbanes-Oxley's reforms is still unknown.<sup>56</sup> Reputational sanctions always have more bite, however, when it is clear that conduct violates legal standards.<sup>57</sup>

## B. The Gatekeepers

If issuing companies engage in financial shenanigans driven by their managers and unconstrained by their directors, outside gatekeepers including auditors, attorneys, stockbrokers, and stock analysts are the next place to look for investor protection. They are, however, too often inadequate for such a task.

### 1. Auditors

Auditors are the primary gatekeepers for investors in public companies. Such investors reasonably assume that the financial statements filed by public companies fairly represent the financial condition of those companies.<sup>58</sup> Many suggest that because of the reputational

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<sup>52</sup> See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 875 (1991).

<sup>53</sup> See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

<sup>54</sup> See BEBCHUK & FRIED, *supra* note 48, at 36.

<sup>55</sup> See *id.*

<sup>56</sup> The short-term signs are good. For example, since Sarbanes-Oxley's promulgation, public company boards are spending more time on their duties. See Brian Louis, *Stiffer Boards: Corporate Scandals Have Prompted Rule Changes that Have Put More Work in the Laps of Directors*, WINSTON-SALEM J., Jan. 2, 2005, at 1 (noting the 75% increase in the frequency of audit committee meetings). They are meeting more often without the CEO present. See Lina Saigol, *Fewer Willing to Take Director Risk*, FIN. TIMES, Nov. 24, 2004, at 22 (noting that the percentage of boards holding sessions without the CEO's presence had risen from 41% in 2002 to 93% in 2003).

<sup>57</sup> See Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 446-47 (2005) ("In fact, it was not until our legal and political system openly condemned Enron officials that their reputations began to suffer.").

<sup>58</sup> Enron's shareholders certainly relied at least partially on Arthur Andersen. See, e.g., Stephen L. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 273 (2003).

constraint, it would be irrational for auditors to act improperly.<sup>59</sup> Yet empirical evidence indicates that when treatment of a transaction is less than certain, accountants often succumb to their clients' wishes, even when those wishes contradict the auditors' best judgment, and even in settings in which the auditors could build a reputation for reliability.<sup>60</sup>

Thirty years of accounting research using the tenets of behavioral psychology and related fields demonstrates that auditors scarcely resemble the "Chicago man,"<sup>61</sup> the model of the law and economics literature who is thought to rationally protect his reputation by acting in an upstanding fashion. Instead, the literature shows that decision-making biases and heuristics easily precipitate audit failures by causing auditors to act in a less than fully rational fashion.<sup>62</sup> It also may be rational, in the short term, for individual accountants to disregard their clients' fraud in order to cultivate client relationships critical to their careers.<sup>63</sup> Reputational constraints fail to restrain large accounting firms, both because large firms have a huge competitive advantage over second-tier firms that is difficult to squander and because as a group, large firms are lumped together such that one firm does not profit much from behaving better than its competitors.<sup>64</sup>

Substantial evidence indicates that the accounting scandals of the past few years resulted partly because consulting fees were just too easy to sell to audit clients, and no accounting firm could comfortably displease its clients by being a stickler about accounting rules with so much consulting money at risk. Consulting fees rose from seventeen percent of audit fees in 1990 to sixty-seven percent in 1999.<sup>65</sup> Studies also show that the firms that bought more consulting services were

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<sup>59</sup> See, e.g., *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (Easterbrook, J.).

<sup>60</sup> See Brian W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, 20 *AUDITING*, Sept. 2001, at 49, 66.

<sup>61</sup> Cf. Daniel McFadden, *Rationality for Economists?*, 19 *J. RISK & UNCERTAINTY* 73, 76 (1999) ("However, there is overwhelming behavior evidence against a literal interpretation of Chicago man as a universal model of choice behavior.").

<sup>62</sup> See, e.g., 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).

<sup>63</sup> See *id.* at 187-89.

<sup>64</sup> See Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients*, 1 *J. EMPIRICAL LEGAL STUD.* 263, 297-98 (2004) (finding no major distinctions among the Big Six in terms of quality); cf. Rajib Doogar et al., *The Impairment of Auditor Credibility: Stock Market Evidence from the Enron-Andersen Saga* (December 2003) (unnumbered working paper), available at <http://ssrn.com/abstract=479941> (finding "auditor credibility spillovers" in that the emerging news of Arthur Andersen shredding documents hurt the reputation of all large auditors).

<sup>65</sup> *PANEL ON AUDIT EFFECTIVENESS, REPORT AND RECOMMENDATIONS* 112 (2000), available at <http://www.pobauditpanel.org/downloads/chapter5.pdf>.

more likely to fit the profile of firms that engaged in earnings management.<sup>66</sup>

The Enron-Arthur Andersen scandal devastated the theory of reputational constraint of auditors.<sup>67</sup> Even Larry Ribstein, generally a strong opponent of aggressive regulation, recognizes the necessity of drastic reform because “auditing firms have proven willing to cast aside valuable reputations for short-term profits. Notably, a \$7 million fine levied against Arthur Andersen because of its mishandling of Waste Management a few months before the Enron scandal broke did not provoke Arthur Andersen to significantly change its ways.”<sup>68</sup>

## 2. Attorneys

In theory, the reputational constraint also applies to attorneys. In reality, the restraint is not sufficient. Indeed, Donald Langevoort suspects that many clients are drawn to attorneys who have a reputation for helping clients pull shenanigans.<sup>69</sup> Evidence shows that during the 1990s many attorneys were more “aiders and abettors” of client fraud than gatekeepers against it.<sup>70</sup>

For example, Enron was the largest client of Vinson & Elkins, paying fees of \$35 million a year.<sup>71</sup> Vinson & Elkins’s attorneys, who were up to their elbows in structuring questionable deals,<sup>72</sup> did not listen to warnings about those deals. Instead, they found ways for Enron to avoid disclosing incriminating information.<sup>73</sup> When they did question Enron CFO Andy Fastow, he rebuffed them, and the lawyers never went to the board with their concerns.<sup>74</sup> Financial columnist Roger

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<sup>66</sup> See Richard M. Frankel et al., *The Relation Between Auditors’ Fees for Non-Audit Services and Earnings Management*, 77 ACCT. REV. (SUPP.) 71, 89 (2002).

<sup>67</sup> See Choi & Fisch, *supra* note 58, at 293–94.

<sup>68</sup> Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 30 (2002) (footnotes omitted).

<sup>69</sup> See Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers’ Responsibility for Clients’ Fraud*, 46 VAND. L. REV. 75, 112 (1993).

<sup>70</sup> See Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 353–54 (2003); John C. Coffee, Jr., *Proposed Sec. 307 Rules*, NAT’L L.J., Dec. 2, 2002, at B8.

<sup>71</sup> BETHANY McLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 357 (2003).

<sup>72</sup> See *id.* at 305 (noting that many of Enron’s most questionable deals were the product of brainstorming among its employees, Arthur Andersen accountants, and Vinson & Elkins attorneys).

<sup>73</sup> See *id.* at 328 (explaining how Vinson & Elkins attorneys helped Enron attorneys find loopholes for not disclosing Fastow’s compensation for running Enron’s special purpose entities).

<sup>74</sup> Ellen Joan Pollock, *Lawyers for Enron Faulted Its Deals, Didn’t Force Issue*, WALL ST. J., May 22, 2002, at A1 (“Vinson & Elkins lawyers sometimes objected, saying the deals posed conflicts of interest or weren’t in Enron’s best interests. But Vinson & Elkins didn’t blow the whistle. Again and again, its lawyers backed down when rebuffed by Mr. Fastow or his lieutenants, expressing their unease to Enron’s in-house attorneys but not to its most senior executives or to its board.”).

Lowenstein was largely right when he concluded that attorneys for firms such as Enron “were less professionals than mercenaries,” and that “[t]he long hours these professionals for hire spent with executives, and also the professionals’ more-than-ample fees, forged an identity of interest, a society of mutual co-conspiracy.”<sup>75</sup>

The same self-serving bias that colors auditors’ judgments affects attorneys as well.<sup>76</sup> No attorney believes disbarment or civil liability for securities fraud is in her long-term interest, but overconfidence, undue optimism, the illusion of control, and related decision-making errors can cause attorneys to jeopardize their long-term reputational interest by taking unwise risks. When it comes to attorney misbehavior, “[r]eputation . . . is not a cure-all.”<sup>77</sup>

### 3. Stockbrokers

Most stock brokerage advertising stresses reputation, yet the securities industry is a “bundle of conflicts of interest”<sup>78</sup> that constantly endangers the reputational constraint. Stockbrokers make money by inducing clients to engage in transactions that will generate commissions, though a “buy and hold” strategy is more profitable.<sup>79</sup> These stockbrokers often work for Merrill Lynch, Morgan Stanley, Citigroup, or other firms. These firms also have investment banking arms that seek to sell their issuer clients’ stocks high, though stockbrokers ostensibly work to help investor clients buy the stock low.<sup>80</sup>

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<sup>75</sup> LOWENSTEIN, *supra* note 31, at 162.

<sup>76</sup> See, e.g., George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 145–53 (1993) (noting that in one set of experiments, law students were given basic information about a tort case and asked to play the role of counsel for the plaintiff or defendant while negotiating a settlement; in the short time it took to read the packet, students began to identify with their assigned roles, which substantially biased their judgments as to what would constitute a fair settlement).

<sup>77</sup> Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 410 (1997) (addressing the motivations of attorneys).

<sup>78</sup> Robert Kuttner, *The Big Board: Crying Out for Regulation*, BUS. WK., Oct. 13, 2003, at 26, 26.

<sup>79</sup> See Brad M. Barber & Terrance Odean, *All that Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors* 25 (Jan. 2005) (unnumbered working paper), available at <http://ssrn.com/abstract=460660> (“Previous work has shown that most investors do not benefit from active trading. On average, the stocks they buy subsequently underperform those they sell and the most active traders underperform those who trade less. The attention-based buying patterns we document here do not generate superior returns. We believe that most investors will benefit from a strategy of buying and holding a well-diversified portfolio. Investors who insist on hunting for the next brilliant stock would be well advised to remember what California prospectors discovered ages ago: All that glitters is not gold.” (internal citations omitted)).

<sup>80</sup> See James Surowiecki, *In Wall Street We Trust*, NEW YORKER, May 26, 2003, at 40 (explaining the conflict and noting that various cognitive biases lead many investors to stay with their brokers even after evidence emerges that the brokers have been involved in fraud).

While one may fault investors for not being sufficiently wary, courts have properly held that “[t]hough the law of fraud does not endorse a hear no evil, see no evil approach, neither does it require that an aggrieved party . . . proceed[ ] from the outset as if he were dealing with thieves.”<sup>81</sup> Yet in recent years, rampant fraud has victimized those investors who did not proceed in this manner.

In the past few years, violations have been widespread. In 2003, investors filed nearly 9,000 arbitration claims with the National Association of Securities Dealers (NASD).<sup>82</sup> Moreover, the NASD itself, which does not have a reputation as a particularly vigorous enforcer of its own standards,<sup>83</sup> filed 1,352 enforcement actions against its members.<sup>84</sup> This evidence strongly indicates that the reputational constraint is insufficient to properly minimize broker misconduct.<sup>85</sup> There are many behavioral reasons that explain this phenomenon.<sup>86</sup> Among the most important, however, are the facts that most brokers are under high pressure to produce results in the short term and that they know they are unlikely to be in the business in the long term.<sup>87</sup>

#### 4. *Securities Analysts*

Opponents of strong securities regulation often contend that, although there may have been a time of rampant fraud and no disclosure, the high level of sophistication of institutional investors who dominate the market today renders regulation unnecessary.<sup>88</sup> Sophisticated investors can protect themselves (and, indirectly, other investors) by demanding efficient disclosure and suitable antifraud incentives. The securities professional’s rational interest in protecting

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<sup>81</sup> *Hudak v. Econ. Research Analysts, Inc.*, 499 F.2d 996, 1002 (5th Cir. 1974).

<sup>82</sup> Press Release, Nat’l Ass’n Sec. Dealers (NASD), NASD: 2003 in Review (Dec. 30, 2003), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_002808](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002808). The NASD handles approximately ninety percent of securities arbitration claims. Ben White, *NASD Sees Arbitration Problems: Letter Rebukes Firms for Document Delays*, WASH. POST, Nov. 7, 2003, at E1.

<sup>83</sup> See *S.E.C. Proposes N.A.S.D. Censure to Settle Rules Inquiry*, N.Y. TIMES, June 19, 1996, at D3 (noting NASD failings and SEC pressure for improvement).

<sup>84</sup> Press Release, NASD, *supra* note 82.

<sup>85</sup> See Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1427, 1429–34 (2002) (providing six reasons why the reputational constraint is inadequate, especially noting that “the reputational constraint is often insufficient to prompt managers and issuers to disclose optimal amounts of accurate information to investors”).

<sup>86</sup> See *id.* at 1426–34.

<sup>87</sup> See PETER D. SPENCER, *THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS* 33 (2000) (“[I]n financial industries, short-term incentives to cheat or defraud are typically high compared to long-term incentives to remain in the industry.”).

<sup>88</sup> See BENJAMIN MARK COLE, *THE PIED PIPERS OF WALL STREET: HOW ANALYSTS SELL YOU DOWN THE RIVER* 120–21 (2001) (quoting two portfolio managers as not worried that Salomon Smith Barney analyst Jack Grubman was “unduly influenced” by conflicts of interest.).



her long-term reputational capital theoretically will provide sufficient protection from abuse, thereby rendering governmental regulation unnecessary.<sup>89</sup>

Securities analysts provide a small, slightly impure laboratory experiment for this theory. For various reasons, courts and commentators were hostile to SEC regulation of securities analysts,<sup>90</sup> who remained relatively unregulated until recently.<sup>91</sup> Theoretically, a rational securities analyst would burnish her reputation by arranging to be compensated only by the quality of her picks, disclosing the method of her compensation, and swearing that she truly believed in her ratings. Sophisticated investors theoretically would demand these measures. The unregulated market, however, did not function in that manner.

Prior to Sarbanes-Oxley, the law and many investors assumed that analysts were reasonably objective researchers, while they were actually financially " beholden to their employers and their [employers'] largest clients."<sup>92</sup> Perhaps once upon a time securities analysts recommended only stocks they believed in and did, by dint of diligent research, uncover financial frauds.<sup>93</sup> Before Congress passed Sarbanes-Oxley, however, the chasm between investor perception of the stock analysts' role and their actual practice was alarmingly wide. The system of compensating analysts not on the accuracy of their calls but on how much investment banking business they could generate by flacking for potential clients contributed mightily to the existence of such a gulf.<sup>94</sup>

Although sophisticated investors recognized the potential conflict of interest, they likely believed that analysts would not totally prostitute themselves in order to gain investment banking business for their firms.<sup>95</sup> The investors were wrong. For example, at least some analysts, many working for investment banks seeking Enron's underwriting business, "ignored serious indications of financial problems and

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<sup>89</sup> See *id.*

<sup>90</sup> See, e.g., *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983) (recognizing value of analysts and rejecting an SEC attempt to punish an analyst for insider trading); Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*, 41 VA. J. INT'L. L. 653, 662 (2001) (noting that after commentators' criticism of a 1991 SEC action against a CEO for selectively disclosing information to an analyst, the SEC stopped bringing such actions).

<sup>91</sup> See Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1038 (2003) (noting that in spring 2002, the SEC approved standards aimed at analyst disclosure and trading practices that were adopted by the NYSE and NASD in response to Sarbanes-Oxley).

<sup>92</sup> COLE, *supra* note 88, at xiii.

<sup>93</sup> See PARTNOY, *supra* note 43, at 285 ("Today, business journalists uncover most financial fraud; ten years ago, that was the job of securities analysts.").

<sup>94</sup> *Id.* at 285–86.

<sup>95</sup> See, e.g., COLE, *supra* note 88, at 120–21.

continued to recommend Enron as an investment long after the company entered its death spiral."<sup>96</sup> The inherent conflict of interest for sell-side analysts helps explain such conduct. The analysts sought rewards based primarily on whether their recommendations allowed their firms to obtain or retain investment banking business;<sup>97</sup> meanwhile, firms did not base analyst salaries on accuracy.<sup>98</sup> Because "[a]nalysts were not rewarded for being right[,] . . . few tried to be."<sup>99</sup>

Academic studies fortify the colorful anecdotes about analysts Jack Grubman and Henry Blodget. The studies indicate the following: that analysts' recommendations are consistent with the interests of their firms but not with the interests of investors who follow the recommendations,<sup>100</sup> that higher investment banking fees generally lead to more positive analyst ratings,<sup>101</sup> that before Sarbanes-Oxley, analysts' professional rewards depended more on their being persistently optimistic than their being accurate,<sup>102</sup> and that independent analysts tend to be more accurate than analysts associated with investment banks.<sup>103</sup>

The presence of a few bad apples does not explain this pattern. "Of 33,169 'buy,' 'sell' or 'hold' recommendations . . . in 1999, only 125 [0.3%] were pure sells."<sup>104</sup> Alarming, "sixteen out of the seventeen securities analysts covering Enron maintained 'buy' or 'strong buy' recommendations" right up until its bankruptcy; the only

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<sup>96</sup> Choi & Fisch, *supra* note 58, at 273.

<sup>97</sup> See *id.* ("Analyst reports are often influenced by a brokerage firm's desire to attract or retain investment banking business."); Fisch & Sale, *supra* note 91, at 1039, 1040-56 (providing substantial evidence that analysts are "essentially salespeople, serving the interests of their firm's investment banking clients").

<sup>98</sup> See Fisch & Sale, *supra* note 91, at 1052.

<sup>99</sup> LOWENSTEIN, *supra* note 31, at 85.

<sup>100</sup> Narasimhan Jegadeesh et al., *Analyzing the Analysts: When Do Recommendations Add Value?* 3 (May 16, 2002) (unnumbered working paper), available at <http://ssrn.com/abstract=291241>.

<sup>101</sup> See Hsiou-wei Lin & Maureen F. McNichols, *Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations*, 25 J. ACCT. & ECON. 101, 124-25 (1998) (finding that analysts' biased and overly optimistic investment recommendations regarding their firms' clients' stocks are worse than unaffiliated analysts' recommendations); Patricia M. Dechow et al., *The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings* 3-4 (June 1999) (unnumbered working paper), available at <http://ssrn.com/abstract=168488> (finding that sell-side analysts' forecasts are systematically overoptimistic regarding equity offerings due to the positive relationship between fees paid to investment banks and analysts' optimism).

<sup>102</sup> See Harrison Hong & Jeffrey D. Kubik, *Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts*, 58 J. FIN. 313, 341, 345-46 (2003).

<sup>103</sup> See Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 683 (1999).

<sup>104</sup> COLE, *supra* note 88, at 97.

holdout was the analyst for Prudential Securities, a firm which, not coincidentally, did not then engage in investment banking.<sup>105</sup>

There is no way to overstate the greed, dishonesty, and treachery of many securities analysts during the dot-com boom. Furthermore, no evidence suggests that even the most sophisticated investors did or could have adequately discounted share prices to account for this treachery. The “brazenness of the conduct of the analysts” illustrates the inadequacy of the reputational constraint.<sup>106</sup>

### 5. *Investment Banks*

Securities analysts were only one part, albeit an important one, of the overall problem with investment banks during the dot-com bust.<sup>107</sup> The Glass-Steagall Act, which long separated investment banking activities from those of commercial banking due to perceived conflicts of interest, was repealed based on the assumption that investment bankers would not risk their long-term reputation by acting imprudently.<sup>108</sup> James Fanto makes the case, however, that many investment banking employees, not just securities analysts, psychologically became part of their clients’ inner circle.<sup>109</sup> The investment bankers then assisted their clients’ financial shenanigans using special purpose entities, fake assets sales, and the like.<sup>110</sup> In pursuing the short-term lucre from such clients as Enron and WorldCom, invest-

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<sup>105</sup> John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 316 (2004).

<sup>106</sup> Thad A. Davis, *A New Model of Securities Law Enforcement*, 32 CUMB. L. REV. 69, 118 (2001); see David J. Labhart, Note, *Securities Analysts: Why These Gatekeepers Abandoned Their Post*, 79 IND. L.J. 1037, 1047–48 (2004) (discussing why the reputational constraint failed to deter analysts’ biased Enron recommendations).

<sup>107</sup> As Hillary Sale has pointed out, the problem with investment banks went well beyond the blatant fraud of their stock analysts. They wore numerous “conflicting hats” and repeatedly colluded with fraudulent clients, including Adelphia and Enron. See Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 410–12 (2003).

<sup>108</sup> See, e.g., James A. Fanto, *Subtle Hazards Revisited: The Corruption of a Financial Holding Company by a Corporate Client’s Inner Circle*, 70 BROOK. L. REV. 7, 13–14 (2004) (laying out the arguments for banks to exercise care in protecting their reputations, which would eliminate the need to keep the commercial and investment banking functions separate and distinct).

<sup>109</sup> See *id.* at 15–17.

<sup>110</sup> See *id.* In terms of the mechanism behind this seemingly irrational behavior by investment bankers, Fanto suggests:

Considerable social psychological evidence shows that members of excessively cohesive groups often act for the group’s sole benefit despite an explicit mission to do otherwise (e.g., to act on behalf of a larger organization, such as a corporation, of which the group is an important part). A group can transform its members so that they adopt uniform views and become hostile to dissenters and outsiders. . . . Social psychologists who study the formation of these unnaturally cohesive groups explain this behavior in terms of a perversion of the natural and ordinary search by individuals for social identity and for certainty in unsettling environments.

*Id.* at 16–17 (footnotes omitted).

ment bankers acted in a manner ultimately extremely destructive to their firms' reputations. Thanks to Eliot Spitzer and the SEC, the investment bankers' actions injured their own pocketbooks as well.<sup>111</sup> Citigroup, Merrill Lynch, and CS First Boston all enjoyed relatively good reputations, but risked those reputations for substantial investment banking fees.<sup>112</sup>

#### 6. *Mutual Funds*

During the initial phase of the recent financial scandals, many took consolation in the fact that mutual funds supposedly remained the small investor's friend and safe haven. Indeed, even those who would eliminate government regulation of securities are forced to concede that unsophisticated investors might suffer perilously under such a regime and have suggested that such investors could take safe haven in mutual funds, which would place them on an equal footing with market professionals.<sup>113</sup>

Mutual fund abuses of average investors, however, have been widespread. The benefits of maintaining a good reputation have not sufficiently constrained mutual fund managers who seek short-term gain. Stephen Choi and Jill Fisch have noted, in an understated but accurate phrase, that "interests of the [mutual fund] manager . . . may diverge from those of fund investors."<sup>114</sup> This divergence leads fund managers to gouge investors and subordinate investor interests for monetary gain. Many mutual funds have engaged in the following mischief: raising charges and fees to investors though fund costs have declined,<sup>115</sup> subordinating investor interests by allowing late trading and market-timing trades that could cost investors as much as \$4 billion per year,<sup>116</sup> imposing so-called 12b-1 fees primarily to enrich

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<sup>111</sup> See Matt Krantz, *Analysts Deliver Better Advice*, USA TODAY, Feb. 10, 2005, at 1B (noting that New York Attorney General Eliot Spitzer imposed a \$1.4 billion fine on big Wall Street firms, and noting a new study finding that if investors listened to analysts post-Sarbanes-Oxley they would actually have made money as opposed to losing money by following the advice pre-Sarbanes-Oxley).

<sup>112</sup> See, e.g., PARTNOY, *supra* note 43, at 277-85 (noting that by charging excess commissions, a blatant form of extortion, CS First Boston raised the normal 7% commission for underwriting an IPO to a 65% commission).

<sup>113</sup> See Choi, *supra* note 14, at 300-02; see also Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 929 (1994) (discussing the ability of uninformed investors to neutralize information asymmetries by hiring a professional to invest on their behalf).

<sup>114</sup> See Choi & Fisch, *supra* note 58, at 280.

<sup>115</sup> See Aldo Svaldi, *Hidden Costs Can Gouge Mutual Funds*, DENVER POST, Oct. 5, 2003, at 1K (noting that "hidden" expenses cost investors \$40 billion per year and that "critics argue [that mutual funds] didn't pass enough [economies of scale] on to their clients").

<sup>116</sup> See Diana B. Henriques, *Spitzer Casting a Very Wide Net*, N.Y. TIMES, Oct. 12, 2003, § 3, at 1 (noting that "market-timing" trades involve "rapid in-and-out trading which can be a drag on a fund's long-term performance" and are normally prohibited by fund rules, and noting that "late trading" involves trading after the official trading day is closed based on

themselves,<sup>117</sup> accepting lavish gifts from brokers in order to steer business their way,<sup>118</sup> and engaging in other creative forms of wrongdoing.<sup>119</sup>

Former SEC head Arthur Levitt termed the abuses “the most egregious violation of the public trust of any of the events of recent years.”<sup>120</sup> Substantial evidence exists both that market-timing abuses were systemic<sup>121</sup> and that industry professionals knew about the abuses and did nothing.<sup>122</sup> In short, ample evidence supports the proposition that the reputational constraint has not prevented mutual funds from frequently and flagrantly placing their own short-term financial interests ahead of investor interests.<sup>123</sup>

### 7. Rating Agencies

Opponents of securities regulation rely heavily upon the ability of contracting parties to hire reputational intermediaries, such as Standard & Poor’s, to vouch for important financial information. Theoretically, ratings agencies should seek to uphold their own reputations. As Partnoy points out, however, those agencies per-

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market-moving information from after the 4 p.m. trading deadline); James Surowiecki, *Right Trade, Wrong Time*, NEW YORKER, Oct. 20, 2003, at 74 (explaining further the concepts of market timing and late trading, and citing a Stanford Business School study that this behavior “could be robbing investors of more than four billion dollars a year”).

<sup>117</sup> See Tom Lauricella, *Mutual-Funds Sales Fees Just Enrich Firms, SEC Study Says*, WALL ST. J., May 13, 2004, at C1 (explaining a recent SEC study that concluded that 12b-1 fees, used by funds for marketing, cost investors ten billion dollars a year with little compensating benefit).

<sup>118</sup> See Andrew Parker, *Watchdogs Probe Broker Gifts*, FIN. TIMES, Nov. 24, 2004, at 17 (describing SEC and NASD inquiries into allegations that brokerage firms gave away such things as tickets to exclusive sporting events and expensive wine to employees of mutual funds); James Politi, *Lazard Caught Up in US Inquiry into Gifts for Trades*, FIN. TIMES, Feb. 12–13, 2005, at 8 (describing the regulatory inquiry into allegations of improper gift-giving by the investment bank).

<sup>119</sup> See, e.g., Adrian Michaels et al., *Comment & Analysis: The Mutual Fund Industry Knows Its Fate Is Based on Public Confidence. It Will Do Anything to Restore That*, FIN. TIMES, Oct. 31, 2003, at 17 (noting that while recent investigations have focused on late trading and market timing, “complaints against the industry also encompass allegations of illegal personal enrichment, side deals with brokers involving undisclosed commissions, the mis-selling of inappropriate products to customers, and the withholding of discounts”).

<sup>120</sup> Tom Lauricella, *For Staid Mutual-Fund Industry, Growing Probe Signals Shake-Up*, WALL ST. J., Oct. 20, 2003, at A1.

<sup>121</sup> Simon Targett, *Comment & Analysis: Market Timing Is Systemic*, FIN. TIMES, Nov. 24, 2003, at 1 (citing a survey regarding the opinions of executives running U.S. pension funds).

<sup>122</sup> See Judith Burns, *SEC Fund Watcher Blasts Industry*, WALL ST. J., Mar. 23, 2004, at D7 (quoting Paul Royce, head of the SEC’s investment-management division, as saying that fund industry insiders knew about abuses but “turned a blind eye” to them).

<sup>123</sup> See Usha Rodrigues, *Let the Money Do the Governing: The Case for Reuniting Ownership and Control*, 9 STAN. J. L. BUS. & FIN. 254, 278 (2004) (“Recent settlements suggest that mutual funds are willing to put their own interests ahead of investors.”).

formed abysmally in the 1990s.<sup>124</sup> He notes that they “downgraded companies only after all the bad news was in, frequently just days before a bankruptcy filing. Nevertheless, investors continued to trust the credit-rating agencies, and regulators continued to rely on them.”<sup>125</sup>

Jonathan Macey points out that credit rating agencies are essentially “captured” by the firms they rate.<sup>126</sup> Since the ratings can have such an extremely significant negative impact upon the rated companies, agencies are extremely reluctant to downgrade credit ratings, which would essentially detonate a corporate “nuclear bomb.”<sup>127</sup> Whatever the cause, rating agencies utterly failed as gatekeepers during recent market turmoil.<sup>128</sup> The strong chance that their reputations would take a hit in the wake of poor performance was clearly insufficient to turn them into effective gatekeepers.

### 8. Stock Exchanges

In the recent dot-com disaster, stock markets were more effective than most other gatekeepers, though SEC oversight likely accounts for this anomaly. Even with such oversight, significant problems ensued. For one thing, the NYSE did not stop widespread illegal trading by floor brokers.<sup>129</sup> The exchange failed “to police its elite floor-trading firms and . . . ignor[ed] blatant violations in which investors were shortchanged on trades totaling roughly two billion shares over three years.”<sup>130</sup>

Problems of this type arise from a fundamental misalignment of incentives between the owners of the NYSE and their customers.<sup>131</sup>

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<sup>124</sup> See PARTNOY, *supra* note 43, at 171, 250–51.

<sup>125</sup> *Id.* at 352; see also Richard A. Oppel, Jr., *Credit Agencies Say Enron Dishonesty Mislabeled Them*, N.Y. TIMES, Mar. 21, 2002, at C1 (discussing the Senate Governmental Affairs Committee’s criticism of credit rating agencies for failing to discover and warn investors about Enron earlier).

<sup>126</sup> See Macey, *supra* note 70, at 342 (explaining that if a rating agency decides to downgrade a corporation’s score based on perceived financial difficulties, the act of the downgrade itself will prevent the corporation from raising the funds necessary to continue operating, thus forcing the corporation into bankruptcy).

<sup>127</sup> *Id.*

<sup>128</sup> See Coffee, *supra* note 105, at 318 (noting that along with other gatekeepers, debt rating agencies that should have provided early warning of trouble did not awake before the “penultimate moment” preceding the collapses of Enron, WorldCom, and similar companies).

<sup>129</sup> Gary Weiss, *Can the Big Board Police Itself?*, BUS. WK., Nov. 8, 1999, at 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.”).

<sup>130</sup> Susanne Craig & Laurie P. Cohen, *SEC Takes Another Look at Grasso*, WALL ST. J., Nov. 3, 2003, at C11.

<sup>131</sup> For example, until 1975, when the SEC passed rules to prohibit fixed commissions, the NYSE maintained them to benefit its members at the direct expense of its customers. See SELIGMAN, *supra* note 1, at 404–05 & n.\*.

Even Pritchard, an advocate of increased reliance on exchanges as a substitute for governmental regulation, concedes that exchanges have little incentive to retard stock manipulation because such activity increases trading volume and, consequently, profits.<sup>132</sup> Pritchard asserts that substantial incentives compel exchanges to prevent nonmanipulative fraud.<sup>133</sup> The stronger impetus, however, is to hide fraud by exchange members for as long as possible, as exchanges often do.<sup>134</sup> Before Congress empowered the SEC to oversee the exchanges, they were rife with fraud.<sup>135</sup> Notwithstanding increased regulation, the NYSE still hesitates to punish member fraud.<sup>136</sup>

Direct SEC pressure and the incentive of avoiding more aggressive regulation drove most pro-investor reforms by the NYSE over the

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<sup>132</sup> Pritchard, *supra* note 11, at 1002–03; *see also* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1463 (1997) (conceding that exchanges have little incentive to stop manipulation, but arguing nonetheless that self-regulation is preferable to government regulation because the actual consequences of government intervention on the market are unclear); Stephen Craig Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J. LAW & ECON. 141, 141 (1995) (“An 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.”).

<sup>133</sup> Pritchard, *supra* note 11, at 982.

<sup>134</sup> *See* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1518 (1997) (“[T]o the extent that an exchange believes that, absent policing, certain violations are likely to remain undiscovered, its incentives to engage in such policing are substantially reduced.”); *see also* John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 32 (1999) (“Exchanges do not have ideal incentives, however, for the task of enforcement.”).

<sup>135</sup> *See* 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”); FRASER, *supra* note 19, at 387–88, 393–94 (describing various fraudulent activities occurring on the exchanges in the 1920s, including pools and secretly paying radio and print journalists to tout stocks); JOHN STEELE GORDON, *THE GREAT GAME: THE EMERGENCE OF WALL STREET AS A WORLD POWER, 1653–2000*, at 215 (1999) (noting that 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.”).

<sup>136</sup> John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 68 n.254 (2001) (noting that “the NYSE seldom, if ever enforced its own disciplinary rules” before the SEC’s creation (citing Stuart Banner, *The Origin of the New York Stock Exchange, 1791–1860*, 27 J. LEGAL STUD. 113, 138–39 (1998))).

years.<sup>137</sup> Recent scandals involving securities analysts provide a salient example.<sup>138</sup>

In sum, Enron and related scandals have demonstrated clearly that the reputational constraint does not hold up against naked self-interest as perceived (often irrationally) by economic actors, or against institutional pressures that cause economic actors to make decisions they would never make outside the institutional context.<sup>139</sup> “The bottom line is that reputation alone does not constrain the behavior of gatekeepers.”<sup>140</sup>

### C. The Reputational Constraint Under a Behavioral Microscope

The reputational constraint has proven insufficient to restrain issuers, their officers and directors, and a variety of gatekeepers.<sup>141</sup> Because incentives are often misaligned and huge amounts of money hang in the balance, it is often exceedingly rational, at least in the short term, for the Andy Fastows, Jack Grubmans, and David Duncans of the world to utterly ignore their long-term reputations. This short-term greed by primary actors and gatekeepers helps explain why private contracting, self-regulation, and third-party intermediaries are in-

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<sup>137</sup> Prentice, *supra* note 85, at 1438–39. For example, proponents of exchange self-regulation have often noted that the NYSE attempted to require some disclosure by its listed companies even before the passage of the 1933 Securities Act. See, e.g., Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 326–27 (2001). But, as has been pointed out, the NYSE viewed such requirements primarily as a means of preempting government regulation. See, e.g., *id.* at 327 (“Historically, listing standards were seen as a substitute for government regulation. The NYSE argued that if its listing standards for securities offered for sale adequately protected the investing public, then government regulation would be unnecessary.”).

<sup>138</sup> Professors Fisch and Sale point out that SROs such as the NYSE and the NASD have proved themselves to be unable or unwilling to impose and enforce meaningful restrictions on analyst conflicts and self-dealing. The NYSE and the NASD are run by, and primarily are accountable to, their members, the brokerage firms. Given the importance of investment banking business for member firms, it is unrealistic to expect the SROs actively to curtail a structure that promotes these operations. . . . [B]rokerage firms often benefit more directly from analysts’ work through proprietary trading in covered securities. It is not surprising, then, that the scope of the regulatory response by the SROs has been limited and that the SROs have failed effectively to enforce even the monitoring functions that they self-prescribed. The SROs have little reason to disturb the status quo.

Fisch & Sale, *supra* note 91, at 1096 (footnote omitted).

<sup>139</sup> See John M. Darley, *How Organizations Socialize Individuals into Evildoing*, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 13, 13 (David M. Messick & Ann E. Tenbrunsel eds., 1996) (“[M]ost harmful actions are not committed by palpably evil actors carrying out solitary actions . . . [but] by individuals acting within an organizational context.”).

<sup>140</sup> PARTNOY, *supra* note 43, at 404.

<sup>141</sup> See, e.g., *id.* at 403 (“Put simply, gatekeepers do not have proper incentives to police corporate managers, because they do not suffer sufficient reputational consequences even when they do a poor job of monitoring.”).



adequate to protect investors and preserve healthy securities markets. The reputational constraint usually runs into a “backward recursion” problem

where the future benefits from being honest are eventually dwarfed by the potential return from being self-dealing or negligent. This can include endgame situations (where, for example, the individual is at the end of his career or assignment or a firm faces imminent closure), scenarios where the reputational loss accrues mainly to the firm but not to the manager (an internal principal agent problem), situations where the returns to the individual from noncontractual activities outweigh any expected future losses (a rational argument for deception), and misinterpretations of the risk from such actions or their expected penalties (an individual may not be aware of the magnitude of the risks, or might rationalize this to a minimum).<sup>142</sup>

Additionally, cognitive limitations and behavioral biases often combine to prevent managers,<sup>143</sup> attorneys,<sup>144</sup> auditors,<sup>145</sup> securities industry professionals,<sup>146</sup> and others from acting rationally to preserve long-term reputational capital.<sup>147</sup>

Among these behavioral factors is the “time delay trap.”<sup>148</sup> One can only build a reputation over time; it involves delayed gratification. However, many people overvalue short-term gratification<sup>149</sup> and dis-

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<sup>142</sup> Oliver Marnet, *Behaviour and Rationality in Corporate Governance*, 39 J. ECON. ISSUES 613, 625 (2005).

<sup>143</sup> See Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417 (2003) (offering a behavioral explanation for the Enron debacle); 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) (“For example, 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.”).

<sup>144</sup> See Langevoort, *supra* note 69 (offering a behavioral explanation of attorneys’ roles in their clients’ frauds).

<sup>145</sup> See Prentice, *supra* note 62 (offering a behavioral explanation for reckless auditing).

<sup>146</sup> See Prentice, *supra* note 85, at 1426–34 (offering a behavioral explanation of securities industry professionals’ actions).

<sup>147</sup> See Sale, *supra* note 107, at 407 (noting that the assumption that gatekeepers such as lawyers, accountants, and investment bankers are largely self-regulated by reputation constraints turns out to be wrong).

<sup>148</sup> See JOHN G. CROSS & MELVIN J. GUYER, SOCIAL TRAPS 19–22, 39–62 (1980); SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 242 (1993).

<sup>149</sup> See CROSS & GUYER, *supra* note 148, at 19 (“The immediately desirable consequence reinforces the wrong action, and since the undesirable consequence occurs only after a considerable time lag, it has little effect on inhibiting a future recurrence of the same trap.”); Samuel Issacharoff, *Can There be a Behavioral Law and Economics?*, 51 VAND. L. REV. 1729, 1732 (1998) (summarizing studies suggesting that “the ability to engage in precise Bayesian comparisons of likely returns to alternative courses of conduct, particularly over time, are deeply suspect, if not preposterously naive”).

proportionately discount future consequences.<sup>150</sup> They are thus likely to commit more crime (which involves short-term gains and long-term costs)<sup>151</sup> and accrue less reputational capital than would be perfectly rational. The time delay trap surely played a role in the actions of the perpetrators of the Enron and other scandals.

A second key behavioral factor stems from the strong tendency of people to gather, weigh, process, and even remember information in ways that serve their personal interests.<sup>152</sup> The greater the motivation, the stronger the influence of the self-serving bias:

Consider Enron, which was largely involved in creating new businesses involving deal terms, derivative structures and unusual commodities without clearly established values. When Enron employees valued these terms, derivatives, and commodities, the decision determined the numbers Enron would put in its financial statements which, in turn, determined whether hundreds of millions of dollars of bonuses would be paid to the very employees who were making the valuations. No wonder those valuations frequently showed enormous profits when it later turned out that Enron lost money on the deals. No surprise, then, that in retrospect these judgments appear to have been unethical.<sup>153</sup>

Thus, a rational interest in building a long-term reputation is often short-circuited by a decision to enjoy more immediate rewards, and the self-serving bias often warps judgments regarding the consequences of that decision.

## II

### THE CASE FOR A STRONG SEC

Edward Glaeser writes that “the case for laissez-faire is based more on the fallibility of the state than on the perfection of markets.”<sup>154</sup> Conversely, proponents of a strong SEC point to the weaknesses of the alternatives to regulation. It is not that the SEC will regulate perfectly. It surely will not. The point is that the alternatives, including private

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<sup>150</sup> See MARGERY FRY, *ARMS OF THE LAW* 82–84 (1951) (finding that some people worry less about future punishment than others because they irrationally discount the future).

<sup>151</sup> See Travis Hirschi, *On the Compatibility of Rational Choice and Social Control Theories of Crime*, in *THE REASONING CRIMINAL: RATIONAL CHOICE PERSPECTIVES ON OFFENDING* 105, 114 (Derek B. Cornish & Ronald V. Clarke eds., 1986) (“[Criminal offenders’] general tendency is toward short-term, immediate pleasure without undue concern for how such pleasure is obtained or for long-range consequences.”).

<sup>152</sup> See generally Robert Prentice, *Teaching Ethics, Heuristics, and Biases*, 1 *J. BUS. ETHICS EDUC.* 57, 58–67 (2004) (discussing the implications of heuristics and biases on ethical decision making).

<sup>153</sup> *Id.* at 63; see also Prentice, *supra* note 143 (viewing the Enron scandal through a behavioral lens).

<sup>154</sup> Edward L. Glaeser, *Psychology and the Market*, 94 *AM. ECON. REV. PAPERS & PROCEEDINGS* 408, 412 (2004).

contracting, self-regulation, and regulatory competition buoyed by the reputational constraint, are demonstrably less effective.

Limitations on the reputational constraint explain the infamous agency problem. Every advanced economy in the world has a body of law to mitigate the effects of the agency problem. Regimes of private contracting or issuer choice assume away the agency problem by supposing that managers will sacrifice their own personal interests in order to advance their principals' best interests. The evidence in Part I demonstrates that the agency problem will not disappear so easily.

The intractability of the agency problem means that the case for a strong-SEC model of securities regulation rests on more than just the weaknesses of competing models. This Part makes that case. Although overregulation is a constant worry, the targets of regulation are generally extremely wealthy and powerful commercial entities able to advocate strongly on their own behalf in Congress, with the press, and to the SEC directly. Indeed, the more immediate concern is that such political pressure can stymie effective regulation. Although the SEC, among others, failed to prevent Enron and related scandals, a key explanation is that "[t]he United States has under-funded the hard work of investor protection, holding back from the system the resources it would take"<sup>155</sup> to prevent fraud more effectively. Arthur Levitt's stories from the 1990s vividly demonstrate how political pressure blocked his instinctive responses that might have averted or at least minimized the Enron-era scandals.<sup>156</sup>

Despite such political pressure, most commentators consider the SEC an extremely successful regulator.<sup>157</sup> The U.S. securities markets are the world's most efficient and liquid, and inspire a high level of investor confidence. The SEC has received repeated praise throughout its almost seventy-year history as a "model agency."<sup>158</sup> It has not acted like the stereotypical regulatory monolith.<sup>159</sup> Defying some ad-

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<sup>155</sup> See Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1140 (2003).

<sup>156</sup> See ARTHUR LEVITT & PAULA DWYER, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW; WHAT YOU CAN DO TO FIGHT BACK (2002).

<sup>157</sup> Archon Fung and colleagues recently noted:

The U.S. system of corporate financial reporting has proven highly effective in reducing hidden risks to investors and improving corporate governance. . . . Over time, the United States has developed the world's most exacting and most studied system of mandatory financial reporting.

Archon Fung et al., *The Political Economy of Transparency: What Makes Disclosure Policies Effective?* 19–20 (Ash Inst. for Democratic Governance and Innovation, Harvard Univ., Working Paper No. OP-03-04, 2004), available at <http://ssrn.com/abstract=766287>.

<sup>158</sup> See Eric J. Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a Single European Securities Regulator*, 34 LAW & POL'Y INT'L BUS. 499, 527 (2003).

<sup>159</sup> See 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); Pan, *supra* note 158, at 527

ministrative theorists, the SEC typically does not blindly seek its own aggrandizement, often ceding substantial regulatory control when doing so serves the best interests of investors and the markets.<sup>160</sup>

But the Commission is seldom an industry lapdog. To the extent that some are still concerned about regulatory capture,<sup>161</sup> the SEC has successfully avoided it.<sup>162</sup> John Coates notes that the SEC has established a record of responsiveness and resistance to bureaucratic inertia such that it “remains a highly respected government agency, even among political constituencies otherwise inclined to doubt the value or abilities of government regulators.”<sup>163</sup> Lawyers who deal with the SEC, both in the United States and abroad, indicated in a recent study that they view the agency as both effective and responsive.<sup>164</sup>

How has the SEC fared so well?

#### A. Decision-Making Process

Critics note that human decision makers run the SEC, as they do issuing companies, accounting firms, and other economic actors. Thus, the same behavioral biases and cognitive limitations that neutralize the effectiveness of the reputational constraint among those economic actors might also undermine the efficient decision-making processes of the SEC.<sup>165</sup> Although this is true, the SEC does have the benefit of a process that effectively gathers information from all points of view. The Commission has significant formal and informal avenues

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(“[T]hough the SEC has a regulatory monopoly over the U.S. securities market, the SEC does not behave like a monopoly.”).

<sup>160</sup> See Coates, *supra* note 159, at 549 (citing as an example the SEC’s promulgation of Rule 144A).

<sup>161</sup> See generally Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 LAW & SOC. INQUIRY 435, 436 (1991) (“[C]apture has not seemed to be theoretically or empirically fertile to many sociologists and political scientists working in the regulation literature.”); David B. Spence, *The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Environmental Law*, 89 CAL. L. REV. 917, 961 (2001) (“The most important defect of capture theory is that it is unsupported by the evidence.”).

<sup>162</sup> See SELIGMAN, *supra* note 1, at xv (“Few have suggested seriously that the SEC has been a ‘captive’ of the industry it regulates . . . [S]uch a suggestion cannot be sustained by a reasonable reading of the Commission’s history.”); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 745 (2002) (noting that the SEC has maintained a pro-investor outlook and that “it does not appear that the SEC has so far been captured by the managers of public corporations”).

Because of its need to preserve franchise and related revenue, Delaware is more subject to corporate pressure than is the SEC. Therefore, substantive corporate law in the United States has been much more subject to capture than securities law. See Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 121 (2004).

<sup>163</sup> Coates, *supra* note 159, at 543–44.

<sup>164</sup> See Pan, *supra* note 158, at 529.

<sup>165</sup> See, e.g., Choi & Pritchard, *supra* note 19; Glaeser, *supra* note 154, at 412 (“We cannot admit the manifold errors that human beings make in their private lives and then assume that the state will get things right.”).

of communication with the securities industry, thereby ensuring that it has the input and often the support of the market professionals it seeks to regulate.<sup>166</sup> Furthermore, the Commission's staff<sup>167</sup> generally keeps in close contact with the regulated entities via informal meetings with securities professionals.<sup>168</sup>

When the SEC considers new rules, it uses a process that guarantees that it will receive information and arguments from all points of view, unlike an individual decision maker prone to seeking out only information to support preexisting views.<sup>169</sup> The Commission publishes proposed rules, entertains a lengthy comment period, examines the comments, and responds to them. If the SEC proposes a controversial rule, advocates, opponents, investors, securities professionals, academics, and others lodge thousands of comments. The process often results in the Commission substantially adjusting, amending, or even scrapping its original proposals.<sup>170</sup>

Although neutralizing cognitive biases often fails,<sup>171</sup> experimental evidence indicates that "asking or directing experimental subjects to consider alternative or opposing arguments, positions, or evidence has been found to ameliorate the adverse effects of several biases, including the primacy or anchoring effect, biased assimilation of new evidence, biased hypothesis testing, the overconfidence phenomenon, the explanation bias, the self-serving bias, and the hindsight bias."<sup>172</sup> The SEC's rule promulgation process forces the Commission to do exactly this—consider alternatives and arguments on both sides of the issue in order to improve the final output of the decision-making process.

Negative feedback is a similarly important neutralizing technique also ensured by the comment process.<sup>173</sup> Furthermore, the Commis-

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<sup>166</sup> See Pan, *supra* note 158, at 530 (noting that when the SEC makes rules, the securities industry is able to give "strong input" through the formal notice and comment process).

<sup>167</sup> See *id.* (noting that the Commission's staff is "competent and professional," and that "[t]he SEC consistently attracts some of the best lawyers in the United States, most of whom are experienced securities lawyers").

<sup>168</sup> See *id.*

<sup>169</sup> See, e.g., MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 34–35 (5th ed. 2002) (noting several studies finding confirmation bias among lay people and even statisticians).

<sup>170</sup> For example, a few years ago the SEC proposed the largest ever revision of the 1933 Act's rules, a rewriting so large it was termed the "aircraft carrier." Criticism from public companies and the private bar convinced the Commission to scrap the plan, however. See Stephen Labaton, *S.E.C. Nominee Says Rules Need a Review*, N.Y. TIMES, July 20, 2001, at C1.

<sup>171</sup> See Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 VAND. L. REV. 1663, 1747 n.447 (2003).

<sup>172</sup> Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 133 (2002).

<sup>173</sup> See Paredes, *supra* note 49, at 740–41 (noting the usefulness of both a requirement that decision-makers explicitly consider both sides of the issue and of negative feedback).

sion makeup of members from both major political parties helps to foster the give and take that improves the decision-making process.<sup>174</sup> Furthermore, SEC employees lack any dramatic conflict of interest. The millions of dollars that clouded the judgment of Jeff Skilling, Bernie Ebbers, Henry Blodget, and other major actors in recent scandals are not a factor for SEC employees. More importantly, SEC decision makers generally operate under two helpful, congressionally mandated heuristics.

## B. Effective Heuristics

Individual decision makers develop heuristics to help them make decisions when overwhelmed with information. Some of these heuristics are “fast and frugal,” and lead to quick and effective decisions in some contexts.<sup>175</sup> After the Great Crash of 1929, Congress attempted to restore investor confidence in the nation’s markets. Its two primary tools, embodied in the Securities Act of 1933 and the Securities Exchange Act of 1934, were mandatory disclosure<sup>176</sup> and punishment for fraudulent disclosures.<sup>177</sup> Thus, two very simple heuristics emerged: Disclosure is good and fraud is bad.

Obviously, these heuristics do not produce perfect results. Ben Franklin advised, “All things in moderation.” Too much disclosure can be unduly burdensome to issuers and confusing to investors. Overly aggressive fraud fighting can be inefficient. Generally speaking, however, these two heuristics have well served the SEC, the invest-

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<sup>174</sup> Mahoney contends that “a government regulator that sets out to determine optimal exchange rules starts from a substantial disadvantage in information, experience, and incentives compared to an exchange.” Mahoney, *supra* note 132, at 1462. Through its rule-making process, however, the SEC can take full advantage of the exchange’s information and experience, as well as information from other relevant parties. In terms of incentives, the SEC’s relative lack of self-interest renders it better positioned to make rules.

<sup>175</sup> See, e.g., Peter M. Todd, *Fast and Frugal Heuristics for Environmentally Bounded Minds*, in *BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX* 51 (Gerd Gigerenzer & Reinhard Selten eds., 2001). It is also true that some of those same heuristics can, in other contexts, lead decision makers to err substantially. See Russell Korobkin & Chris Guthrie, *Heuristics and Biases at the Bargaining Table*, 87 MARQ. L. REV. 795, 798–99 (2004) (noting that “fast and frugal” heuristics can work well in some settings but “prove to be poor substitutes for more complex reasoning” on other occasions).

<sup>176</sup> Drafters of these laws were influenced by Justice Brandeis’s statement that “[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 62 (Harper Torchbooks 1967) (1914).

<sup>177</sup> See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 103 (7th ed. 1992) (“The Securities Act of 1933 has two basic objectives: (1) to provide investors with material financial . . . information concerning new issues of securities . . . ; and (2) to prohibit fraudulent sale of securities.”).

ing public,<sup>178</sup> and perhaps most importantly, the American capital markets.<sup>179</sup> The rest of this section focuses on these heuristics.

1. *Disclosure Is Good*

a. *The Benefits of Disclosure*

Empirical evidence overwhelmingly indicates that companies and markets operating under an effective regime of mandatory disclosure fare better than companies and markets in regimes of voluntary disclosure.<sup>180</sup> Markets thrive on information. Behavioral finance research indicates that modern securities markets are not as efficient as many economists have suggested.<sup>181</sup> There is no doubt that the less accurate information market participants have ready access to, the less efficient markets tend to become.<sup>182</sup>

All market participants will prefer more information to less and reliable information to unreliable information. Even sophisticated investors are not skilled at obtaining private information possessed by firms.<sup>183</sup> This is why ratings agencies, stock analysts, stockbrokers, and auditors exist, whatever their limitations and faults. To eliminate these intermediaries would spell disaster; to improve their performance would be a boon. Furthermore, mandatory disclosure does improve performance because an issuer "is typically the least cost

<sup>178</sup> Although the SEC's two primary heuristics are that disclosure is good and fraud is bad, arguments can be made for more substantive regulation. For example, Shlomo Benartzi et al. recently suggested that because employees pervasively underestimate the risk of owning their own employers' stock and their employers tend to overestimate the benefits associated with employee stock ownership relative to its costs, reforms are justified. See Shlomo Benartzi et al., *Company Stock, Market Rationality, and Legal Reform*, J.L. & ECON. (forthcoming). A mixture of ignorance and excessive optimism put employee savings at excessive risk that is inconsistent with any rational assessment of the situation. *Id.*

<sup>179</sup> Investor protection is a means to an end—the goal of helping markets by solidifying investor trust in them so that they may thrive. See Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 545 (2003) ("The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s.").

<sup>180</sup> See *infra* notes 265–78 and accompanying text.

<sup>181</sup> Michael Jensen's declaration that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis," Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978), turns out to have been somewhat premature. There is now a mountain of behavioral finance literature that calls this conclusion into serious question. See, e.g., *ADVANCES IN BEHAVIORAL FINANCE* (Richard H. Thaler ed., 1993); HERSH SHEFRIN, *BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING* (2000); ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000); ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000).

<sup>182</sup> See Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 404 (1980) (indicating that when research is expensive, capital markets cannot be informationally efficient).

<sup>183</sup> See SPENCER, *supra* note 87, at 77.

provider of such information . . . [and] at the same time, mandatory disclosure reduces the incentive for wasteful and duplicative research by outsiders.”<sup>184</sup>

Securities markets are by no means the only markets that benefit from adequate information.<sup>185</sup> When one governmental agency began requiring restaurants to display hygiene quality grade cards, restaurants quickly improved cleanliness and customers paid more attention to hygiene quality.<sup>186</sup> These improvements decreased the number of hospitalizations caused by food-borne illness.<sup>187</sup> Information is more important for securities markets than for any other kind of market. The buyer of a car, for example, can kick its tires and look under the hood before deciding what to pay. Investors in securities can look only at the piece of paper that is the metaphorical stock share or at other pieces of paper containing the seller’s financial statements. The accuracy of those financial statements is more difficult for an investor to verify than are claims about an automobile made by a used car salesperson.

Not only does information assist investors in deciding when to buy or sell, and for how much, it also assists them in exercising their shareholder right to vote<sup>188</sup> and enforcing managers’ fiduciary responsibilities.<sup>189</sup> Adequate disclosure can also improve managerial performance by facilitating the market for corporate control.<sup>190</sup> Dis-

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<sup>184</sup> See Choi & Fisch, *supra* note 58, at 308 n.177.

<sup>185</sup> Fung and colleagues have noted that “transparency systems” have emerged around the world as a regulatory tool for implementing social policy that works by requiring corporations to disclose information about their products and practices. Fung et al., *supra* note 157, at 1–2. They note:

Government-mandated disclosure plays a unique role in supplementing and correcting the private provision of socially relevant information. First, only government can *compel disclosure* by restaurants, factories, or schools. Second, only government can *require comparable metrics, format, and timing*. Third, only government can *create systems backed by deliberative democratic processes*.

*Id.*

<sup>186</sup> See Ginger Zhe Jin & Phillip Leslie, *The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards*, 118 Q. J. ECON. 409 (2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=322883](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=322883).

<sup>187</sup> See *id.*

<sup>188</sup> Without mandatory federal disclosure, shareholders would often be very much in the dark when exercising their franchise because state corporate law has never required much disclosure. See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 583, 611–626 (2004) (noting these and other problems with state corporate law).

<sup>189</sup> See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1364 (1999).

<sup>190</sup> See Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 135 (2004) (stating that additional disclosure requirements imposed on oil and gas companies in the late 1970s led to a takeover boom in the industry in the early 1980s).



closure also discourages litigation.<sup>191</sup> Federal securities law, not state corporate law, plays the most important role in corporate governance in America today, primarily because “disclosure has become the most important method to regulate corporate managers and disclosure has been predominantly a federal, rather than a state, methodology.”<sup>192</sup>

Even advocates of drastic reductions in federal securities regulation agree that information is important to markets. Opponents of regulation believe, however, that unregulated firms will voluntarily disclose adequate, accurate information.<sup>193</sup> The next section addresses the accuracy of that belief.

b. *The Improbability of Adequate Voluntary Disclosure*

Companies with histories of timely disclosure of accurate information can generally raise more money cheaper and faster than other companies.<sup>194</sup> Based on this fact, some assume that in the absence of disclosure requirements, investors will demand and companies will voluntarily disclose optimal amounts of information. This theory has not proven accurate for product disclosure,<sup>195</sup> environmental disclo-

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<sup>191</sup> See Laura Field et al., *Does Disclosure Deter or Trigger Litigation?*, 39 J. ACCT. & ECON. 487, 506 (2005).

<sup>192</sup> See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 861 (2003).

Some major transnational studies have demonstrated that corporate law protections of investors from the depredations of managers and majority shareholders are relatively unimportant, by themselves, in promoting capital markets. This finding may reflect the fact that, absent adequate disclosure, these protections cannot truly be enforced or enjoyed. See Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. (forthcoming 2006).

<sup>193</sup> See, e.g., S. J. Grossman & O.D. Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. (PAPERS & PROC.) 323, 323–27 (1980) (asserting that disclosure is privately optimal); Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in ISSUES IN FINANCIAL REGULATION 177, 183–88 (Franklin R. Edwards ed., 1979) (suggesting that market pressures will induce managers to voluntarily disclose efficient amounts of information).

<sup>194</sup> See Mark H. Lang & Russell J. Lundholm, *Corporate Disclosure Policy and Analyst Behavior*, 71 ACCT. REV. 467, 490 (1996) (noting that firms that disclose more information have larger analyst followings, which leads to various benefits).

<sup>195</sup> See, e.g., Alan D. Mathios, *The Impact of Mandatory Disclosure Laws on Product Choices: An Analysis of the Salad Dressing Market*, 43 J. L. & ECON. 651, 672–74 (2000) (noting that when nutrition labels were voluntary, makers of high-fat salad dressings tended not to disclose fat content and that mandatory labeling affected consumer behavior); see also Oliver J. Board, *Competition and Disclosure 1* (Jan. 12, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=652541> (providing economic theory explaining this persistent underdisclosure, and concluding that “mandatory disclosure laws can promote competition and raise consumer surplus at the expense of firm profits, potentially increasing the efficiency of the market”).

sure,<sup>196</sup> or corporate social reporting.<sup>197</sup> Voluntary corporate reporting has been strategic, not optimal, in each of these areas.

Furthermore, history demonstrates that voluntary disclosure has not worked in securities markets either. For example, nineteenth-century England saw that "the lack of reliable and timely information inhibited the formation of broad and anonymous markets for corporate securities."<sup>198</sup> After a wave of fraud involving unregulated joint stock companies, Parliament passed various mandatory disclosure laws in 1844 and 1845.<sup>199</sup> Parliament subsequently repealed the requirements in order to experiment with a return to voluntary disclosure.<sup>200</sup> The voluntary disclosure regime failed again,<sup>201</sup> and over time Parliament extended mandatory disclosure to railroads (in 1868), utilities (in 1871 and 1882), and banks (in 1878).<sup>202</sup> Parliament finally mandated disclosure for all types of registered companies in the Companies Act of 1900.<sup>203</sup>

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<sup>196</sup> More than 80% of investors want environmental disclosures from issuers. See Marc J. Epstein & Martin Freedman, *Social Disclosure and the Individual Investor*, ACCT., AUDITING & ACCOUNTABILITY J., Dec. 1994, at 94, 106. Yet when corporations do disclose environmental matters, they disclose strategically, often with the purpose of fending off calls for mandatory disclosure or some other form of regulation. See James Guthrie & Lee D. Parker, *Corporate Social Disclosure Practice: A Comparative International Analysis*, in 3 ADVANCES IN PUB. INTEREST ACCT. 159 (1990); see also Timothy N. Cason & Lata Gangadharan, *Environmental Labeling and Incomplete Consumer Information in Laboratory Markets*, 43 J. ENV. ECON. & MGMT. 113, 116 (2002) (finding in environmental disclosure that "reputations alone are not sufficient to eliminate this problem"); W. Darrell Walden & Bill N. Schwartz, *Environmental Disclosures and Public Policy Pressure*, 16 J. ACCT. & PUB. POL'Y 125, 146 (1997) ("[I]t is doubtful that substantive environmental information adversely affecting future earnings and potential cash flows will be reported voluntarily.").

<sup>197</sup> A recent survey found that 86% of Americans believe that corporations should disclose their support for social issues. *New National Cone Survey Finds Americans Intend to Punish and Reward Companies Based on Their Corporate Citizenship Practices*, BUS. WIRE, Oct. 2, 2002. It seems, therefore, that in theory companies could burnish their reputations by developing a reputation for accurate disclosure of their corporate social responsibility information. In practice, however, reputation does not suffice. See David Hess & Thomas W. Dunfee, *The Kasky-Nike Threat to Corporate Social Reporting: Implementing a Standard of Optimal Truthful Disclosure as a Solution*, BUS. ETHICS Q. (forthcoming) (manuscript at 9, on file with author) (noting that in both environmental disclosure and corporate social reporting, firms' motivations for disclosure are "strategic, and not in furtherance of the goal of accountability to stakeholders").

<sup>198</sup> BASKIN & MIRANTI, *supra* note 19, at 136.

<sup>199</sup> See *id.* at 140 (describing the Joint-Stock Companies Registration, Incorporation, and Regulation Act of 1844 and the Companies Clauses Consolidations Act of 1845).

<sup>200</sup> See *id.*

<sup>201</sup> See *id.* ("This system of voluntary disclosure was eventually found to be wanting in the protection it afforded investors.").

<sup>202</sup> See Coffee, *supra* note 134, at 8 n.26 (noting that the Securities Act of 1933 was modeled upon the Companies Act of 1900).

<sup>203</sup> This law became the model for American disclosure provisions. See *id.*

Corporate disclosure in the United States was also unreliable and lacked uniformity before federal regulation.<sup>204</sup> The NYSE began requiring annual reports from listed companies by 1895 and later required even more documents, but “while these financials were better than nothing, they were hardly of the type that would be particularly meaningful to the public or stockholders, [who didn’t get to see them anyway.]”<sup>205</sup> When the American Institute of Accountants approached the NYSE in 1927 to suggest improvements in financial disclosure by NYSE-listed companies, the NYSE showed no interest.<sup>206</sup>

Just before the Great Crash of 1929, Laurence Sloan conducted an exhaustive study of the financial disclosures of major American corporations.<sup>207</sup> He discovered that industrial financial reports were “woefully inadequate,” lacking uniformity and meaningful explanation.<sup>208</sup> Sloan concluded that “[i]n several important respects, no criticism of the abuses that exist can be too harsh.”<sup>209</sup> Others noted “the atmosphere of secrecy which prevails so widely in corporate circles.”<sup>210</sup> Opaque financial disclosures often forced investors “to read between the lines.”<sup>211</sup> Because companies were free to choose among several different accounting formats, they could mask the unreliability of their reports.<sup>212</sup>

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<sup>204</sup> See, e.g., BERLE & MEANS, *supra* note 20, at 318 (noting the inadequacy of corporate disclosure at the passage of the first federal securities laws); GARY JOHN PREVITS & BARBARA DUBIS MERINO, *A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING* 103–74 (1998) (noting the inadequacy of disclosure in the “Gilded Age”); Maurice C. Kaplan & Daniel M. Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 *YALE L. J.* 935, 978 (1939) (noting that even after the SEC began mandating various disclosures, companies were loath to present important information beyond minimum requirements).

<sup>205</sup> Lawrence E. Mitchell, *The Creation of American Corporate Capitalism: The First Public Response—The Seeds of a Legislative Solution* 18 (George Washington Univ. Law Sch., Pub. Law & Legal Theory, Research Paper No. 105, 2004), available at <http://ssrn.com/abstract=586184> (alteration in original).

<sup>206</sup> See 1 JOHN L. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION* 163–64 (1969).

<sup>207</sup> LAURENCE H. SLOAN, *CORPORATION PROFITS* (1929).

<sup>208</sup> *Id.* at 334.

<sup>209</sup> *Id.*

<sup>210</sup> Matthew Josephson, *Infrequent Corporation Reports Keep Investors in Dark*, 36 *MAG. OF WALL STREET* 302, 374 (1925).

<sup>211</sup> Max Rolnik, *Stock Buyers Search for Hidden Profits*, 44 *MAG. OF WALL STREET* 582, 583 (1929) (“There is no established uniformity in the way published [financial] reports are prepared and we have to read between the lines, so to speak, to learn more than is disclosed”).

The Twentieth Century Fund agreed, concluding that the information contained in periodic reports by NYSE companies contained information “so meager as to be almost useless to the stockholder. In numerous instances, indeed, instead of disclosing the report succeeds in concealing the real conditions.” TWENTIETH CENTURY FUND, *THE SECURITIES MARKETS* 580 (1931), cited in LOUIS LOSS & JOEL SELIGMAN, 1 *SECURITIES REGULATION* 205 (3d ed. 1998).

<sup>212</sup> See SELIGMAN, *supra* note 1, at 48 (giving examples).

Deregulation apologists have argued that the NYSE began to impose meaningful disclosure requirements on its listed companies before Congress passed the federal securities laws,<sup>213</sup> thereby conceding that companies themselves were not voluntarily disclosing adequate information.<sup>214</sup> Furthermore, the disclosure requirements the NYSE imposed were primarily an attempt to forestall regulation in response to a long series of state and federal investigations into abuses.<sup>215</sup> Many companies were able to evade the NYSE disclosure requirements because other exchanges permitted trading on an unlisted basis,<sup>216</sup> while the Enrons of their day simply flouted the disclosure requirements,<sup>217</sup> including infamous figures such as Ivar (the “Match King”) Kreuger and Samuel Insull.<sup>218</sup>

Deregulation supporters argue that the rise of institutional investors since 1930 has eliminated the need to require disclosure.<sup>219</sup> Again, the historical record does not support this conclusion. Just as most NYSE-listed companies disclosed only when the exchange forced them to do so, the companies not covered by the 1934 Exchange Act did not voluntarily improve their disclosures substantially in succeeding years.<sup>220</sup> Companies did not volunteer the information and sophisticated investors did not demand it with sufficient vigor. The SEC reported in 1963 that many over-the-counter (OTC) companies “either make no reports to shareholders at all or their reports are

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<sup>213</sup> See ROMANO, *supra* note 9, at 16.

<sup>214</sup> The little disclosure companies did engage in was for the purpose of fending off regulation. See Sean M. O’Connor, *Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 780 (2004) (noting that proposals of the Industrial Commission around 1900 made the biggest companies feel “it was in their best interest to begin disclosing information on their own terms, rather than wait for state or federal regulation”).

<sup>215</sup> See Robert A. Prentice, *Regulatory Competition: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1186–87 (2005). The NYSE’s important reforms all occurred in an atmosphere where “demand for reform and government supervision of the securities industry was incessant.” CAROSSO, *supra* note 135, at 155.

<sup>216</sup> See SELIGMAN, *supra* note 1, at 47 & n.\*.

<sup>217</sup> See *id.* at 47–48 (noting that NYSE enforcement was no better than the exception-riddled state blue sky laws).

<sup>218</sup> See generally GALBRAITH, *supra* note 19, at 82 (quoting Ivar Kreuger as saying that 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”); PREVITS & MERINO, *supra* note 204, at 267 (noting that Kreuger, Insull, and others had no fear that authorities would bring in independent auditors).

<sup>219</sup> See, e.g., ROMANO, *supra* note 9, at 12.

<sup>220</sup> LOSS & SELIGMAN, *supra* note 211, at 207.

meager and inadequate.”<sup>221</sup> Only the SEC’s mandate changed that situation.<sup>222</sup>

The general failure of companies to disclose any adverse information that the law does not require persists today. For example, the NYSE imposes an obligation upon listed companies “to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities.”<sup>223</sup> This obligation extends beyond current SEC requirements; neither companies nor the NYSE, however, are too concerned with this requirement, which “is more often honored in the breach, as companies choose when it is in their interest to make disclosure of events that are not *required* to be disclosed.”<sup>224</sup>

This hesitation to disclose does not exist only in the United Kingdom and the United States. Innumerable advisors have told Russian companies of the potential benefits of cultivating a reputation for full and accurate voluntary disclosure.<sup>225</sup> Yet in Russia today, as in the United Kingdom and the United States before regulation, “[e]ven the largest companies refuse to publish meaningful accounts or to be audited. Fleecing shareholders is the norm.”<sup>226</sup>

Not only do firms consistently and naturally withhold bad information when they can, but they also often withhold good news, even when there is no obvious cost of disclosure.<sup>227</sup> So the question arises: Why does experience with issuer disclosure differ from theories of market deregulation? The next two subsections explore that question.

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<sup>221</sup> U.S. SEC. & EXCH. COMM’N, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, pt. 3, at 10 (1963).

<sup>222</sup> See Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 54–55 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 492, 2004), available at <http://ssrn.com/abstract=631221>.

<sup>223</sup> NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 202.05, quoted in Allan Horwich, *New Form 8-K and Real-Time Disclosure*, 37 REV. SEC. & COMMODITIES REG. 109, 109 (2004).

<sup>224</sup> Horwich, *supra* note 223; see also Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: “Are We There Yet?”*, 20 CARDOZO L. REV. 135, 163–65 (1998) (noting that the NYSE seems never to enforce this requirement).

<sup>225</sup> See Leonid Rozhetskin, *Shareholders Should Demand an End to Company Secrecy*, MOSCOW TIMES, Mar. 14, 1995 (corporate attorney noting the necessity of public disclosure by new Russian companies); Dmitry Vasilyev, *Financial Disclosure: What Is to Be Done?*, MOSCOW TIMES, Mar. 5, 2002 (former chair of the Russian Federal Securities Commission urging more and better disclosure).

<sup>226</sup> JOHN McMILLAN, *REINVENTING THE BAZAAR: A NATURAL HISTORY OF MARKETS* 180 (2002).

<sup>227</sup> See Ranga Narayanan, *Insider Trading and the Voluntary Disclosure of Information by Firms*, 24 J. BANKING & FIN. 395, 396 (2000).

i. *Issuer Choice*

Most scholars believe today that public companies, absent legal requirements, will underproduce information.<sup>228</sup> They have not had difficulty providing theories to explain the historical record. For example, even if managers' interests are completely aligned with those of their firms—an assumption questioned in the next subsection—managers often decide that full disclosure is not in the firm's best interest.

Merritt Fox argues that companies left to their own devices will underdisclose due to two types of proprietary costs.<sup>229</sup> First, operational costs, such as out-of-pocket expenses and diversion of staff time, will deter socially optimal disclosure.<sup>230</sup> Companies that do not intend to access the capital markets any time soon are particularly susceptible to the influence of operational costs.<sup>231</sup> And, most companies tap the equity markets only infrequently.<sup>232</sup> If a company is already cash rich, why would it disclose information that would not put more cash in the corporate till?

A second impediment comes in the form of interfirm costs that put a disclosing firm at a disadvantage relative to its competitors.<sup>233</sup>

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<sup>228</sup> See Gerard Hertig et al., *Issuers and Investor Protection*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 193, 204 (Reinier Kraakman et al. eds., 2004) [hereinafter *ANATOMY OF CORPORATE LAW*].

<sup>229</sup> See Fox, *supra* note 189, at 1339 (“[I]ssuer choice would lead U.S. issuers to disclose at a level significantly below [the] social optimum.”). Fox argues that even most economists admit that firms 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, e.g., SELIGMAN, *supra* note 1, at 566–67 (giving reasons to “doubt[ ] that market forces alone would result in the publication of sufficient, reliable, and timely data.”); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 745 (1984) (providing evidence that firms do not generally voluntarily disclose socially optimal amounts of information). There exists substantial evidence that firms do not generally voluntarily disclose socially optimal financial information to signal the market that they are good investments. See Hess & Dunfee, *supra* note 197, at 8–9 (citing several studies regarding how proprietary information costs may depress voluntary disclosure).

<sup>230</sup> See Merritt B. Fox, *Optimal Regulatory Areas for Securities Disclosure*, 81 WASH. U. L. Q. 1017, 1023 (2003).

<sup>231</sup> See Ferrell, *supra* note 222, at 22–23 (noting that it is not in the best interests of a mature, low-growth firm that does not rely on the markets to raise funds to encourage a full-disclosure regime, which would primarily benefit potential competitors).

<sup>232</sup> See Paredes, *supra* note 49, at 696 (“[T]he reality is that many companies need to raise capital relatively infrequently . . . [and] even a poorly performing company will almost always be able to raise funds if needed.”).

<sup>233</sup> See Fox, *supra* note 189, at 1345–46 (noting that even managers identifying completely with shareholders will not disclose optimally); Guttentag, *supra* note 190 (reaching a similar conclusion based on additional and different reasons); Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 424 (2001) (citing studies indicating that firms have an incentive not to disclose information that will reduce their competitive position, even if it makes it more costly to raise additional equity).

Efficient managers may choose not to disclose voluntarily if disclosure would give an advantage to competitors, even if the benefit to investors from disclosure is greater than the harm the firm would sustain at the hands of its competitor.<sup>234</sup>

Competitors aside, firms can clearly benefit in the short run, even in an efficient stock market, by massaging their financial numbers to look better than they are or by hiding numbers to prevent investors from perceiving the sad truth.<sup>235</sup> A central premise of disclosure theory is that "any entity contemplating making a disclosure will disclose information that is favorable to the entity, and will not disclose information unfavorable to the entity."<sup>236</sup>

A firm on the brink of bankruptcy<sup>237</sup> has a "last period" incentive not to disclose that is rational at least in the short term.<sup>238</sup> Langevoort argues persuasively that trading credibility with investors is rational in a much broader range of scenarios than just the last period.<sup>239</sup> Examples include situations in which firms need to encourage external investment,<sup>240</sup> minimize external financing costs in the short term,<sup>241</sup> or increase the stock price for a contemplated IPO.<sup>242</sup> If firms lie outright for these reasons, as many do from time to time, then they will certainly avoid full disclosure for similar reasons. They will feel partic-

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<sup>234</sup> See Oesterle, *supra* note 224, at 200.

<sup>235</sup> 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 (1997).

<sup>236</sup> Ronald A. Dye, *An Evaluation of "Essays on Disclosure" and the Disclosure Literature in Accounting*, 32 J. ACCT. & ECON. 181, 184 (2001).

<sup>237</sup> See Kenneth B. Schwartz, *Accounting Changes by Corporations Facing Possible Insolvency*, 6 J. ACCT., AUDITING, & FIN. 32, 40-41 (1982) (finding that companies on the brink of bankruptcy are much more likely to change accounting methods to increase earnings per share).

<sup>238</sup> Jennifer Arlen and William 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. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 694.

<sup>239</sup> 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).

<sup>240</sup> See 1 IRVING KELLOGG & LOREN B. KELLOGG, *FRAUD, WINDOW DRESSING, AND NEGLIGENCE IN FINANCIAL STATEMENTS* § 5.02 (1991); Videotape: *Cooking the Books: What Every Accountant Should Know About Fraud* (Nat'l Ass'n of Certified Fraud Examiners 1991) (on file with author) (concluding that financial manipulation occurs in part "to encourage investment through the sale of stock").

<sup>241</sup> See Dechow et al., *supra* note 33, 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.").

<sup>242</sup> 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").

ular pressure to avoid disclosure if their managers believe that their competitors also engage in “financial statement beautification.”<sup>243</sup>

ii. *Managerial Discretion*

Although evidence indicates that it is in the long-term best interests of most companies to disclose fully and thereby signal their economic strength to the market, most firms seldom disclose more than the law requires. Before outside forces imposed mandatory disclosure on firms, corporate managers did not voluntarily disclose much, and certainly not an optimal amount of, 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 stock holders to know even the barest details of their financial affairs was unthinkable . . . .”<sup>244</sup> Today, although cross-listing on U.S. markets sends a positive signal to investors and creditors, less than ten percent of eligible companies cross-list.<sup>245</sup>

Again, why does practice not accord with laissez-faire theory? Issuer self-interest, as noted in the previous subsection, is one factor. A more prevalent factor is manager self-interest. The mismatch between the best interests of the managers who make the decisions about disclosure and the best interests of the shareholders who own the company creates an agency problem.<sup>246</sup>

Calculated self-interest contributes to this mismatch. A manager makes a disclosure decision “with an eye . . . towards the impact of that decision on the manager’s own utility function.”<sup>247</sup> Managers have a natural tendency to harbor information that gives them an advantage.<sup>248</sup> Obviously, the same incentives that motivate competent and efficient managers to voluntarily disclose have the effect of discouraging incompetent and inefficient managers from disclosing accurately

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<sup>243</sup> Hill, *supra* note 235, at 145 n.10.

<sup>244</sup> GEORGE L. LEFFLER, *THE STOCK MARKET* 452 (2d ed. 1957).

<sup>245</sup> See Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?*, 71 J. FIN. ECON. 205, 216 (2004).

<sup>246</sup> This is the biggest problem in U.S. public companies, in which ownership is widely dispersed. In closely held U.S. companies and in most companies around the world, the bigger problem is the mismatch between the interests of controlling shareholders and minority shareholders. See Ferrell, *supra* note 222, at 11–12.

<sup>247</sup> James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1236 (1999).

<sup>248</sup> See McMILLAN, *supra* note 226, at 172 (“‘People are reluctant to share their information,’ observed the head of a large French Company. ‘Managers in particular seem to think it gives them extra power.’”); Fox, *supra* note 189, at 1411 (“Everything else being equal, managers prefer as low a level of periodic disclosure as possible[,] . . . even when the gains to the managers are smaller than the losses to the shareholders.”).



and thereby courting discipline or termination.<sup>249</sup> Managers can and do profit by using private information to trade their companies' shares. They profit more and therefore will disclose less in a regime of voluntary disclosure.<sup>250</sup> Perhaps they are looting the company.<sup>251</sup> Perhaps they wish to hide their excessive compensation.<sup>252</sup> Perhaps they wish to hide bad news.<sup>253</sup> Finally, perhaps they are successfully pursuing the interests of the company, but not well enough to trigger the desired bonuses, and therefore need to hide earnings management.<sup>254</sup> Given that managers often have bonuses and other incentives tied to their firms' reported financial success, studies indicate that they aggressively lobby for favorable accounting standards.<sup>255</sup> Managers then use those accounting standards to advance their own best interests.<sup>256</sup> Several empirical studies indicate that the more closely managers' compensation is tied to stock price, the more likely

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<sup>249</sup> See Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, J. LAW & CONT. PROBS., Summer 2000, at 45 (noting that if managers sense a risk of being fired for inadequate performance, they will "buy[ ] time by hiding . . . deficiencies"); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, DUKE L.J. (forthcoming) (noting that not all companies should be expected to voluntarily disclose optimal amounts of information because mandatory disclosure will "reflect inefficient management in lower stock prices and thereby render the corporation a more likely target for takeovers; expose inefficient management to claims of breach of fiduciary duties; expose inefficient management to proxy fights; limit management ability to consume and expropriate value from shareholders; and increase pressure from the board of directors" (footnotes omitted)).

<sup>250</sup> See Narayanan, *supra* note 227, at 398 ("[S]tricter enforcement of insider trading laws and/or larger penalties for violating these laws will move managers towards full disclosure because expected insider trading profits will decline.").

<sup>251</sup> See 1 KELLOGG & KELLOGG, *supra* note 240, § 1.03 ("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.").

<sup>252</sup> See Bethany McLean, *Why Enron Went Bust*, FORTUNE, Dec. 24, 2001, at 58, 61.

<sup>253</sup> See Hertig et al., *supra* note 228, at 204 ("[B]ad news hurts managers by reducing their compensation and diminishing their job security. Thus, the worse news becomes, the less likely managers are to disclose it voluntarily.").

<sup>254</sup> See Flora Guidry et al., *Earnings-Based Bonus Plans and Earnings Management by Business-Unit Managers*, 26 J. ACCT. & ECON. 113, 140 (1999) (reporting an empirical study finding "evidence consistent with business-unit managers manipulating earnings to maximize their short-term bonus plans").

<sup>255</sup> See Lawrence Revsine, *The Selective Financial Misrepresentation Hypothesis*, ACCT. HORIZONS, Dec. 1991, at 16, 21 (citing studies indicating 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).

<sup>256</sup> 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 that managerial compensation is 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) ("[M]anagement controlled firms are more likely than owner controlled firms to adopt accounting methods which result in increased or early reported earnings.").

managers are to manipulate earnings.<sup>257</sup> There is similar empirical evidence that managers engage in earnings overstatement so that they may profit from insider trading.<sup>258</sup>

Another recent study shows that firms that restated their financials following SEC allegations of accounting fraud from 1996 to 2002 paid \$320 million in income taxes “as a result of overstating their earnings by approximately \$3.36 billion.”<sup>259</sup> Thus, in order to earn bonuses, managers are often willing to waste corporate assets by paying taxes that are not owed on profits that were not earned.<sup>260</sup>

Given these incentives, if disclosure is voluntary, “managers will focus on improving the limited set of their performance indicators that are observable by investors, even when improving these measures does not increase the value of the firm.”<sup>261</sup> The more discretion managers have to make disclosure decisions, the more strategically they can manipulate the timing, amount, quality, and fact of disclosure. When managers have more discretion, they have more opportunity to profit from insider trading.<sup>262</sup>

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<sup>257</sup> See, e.g., Daniel B. Bergstresser & Thomas Philippon, *CEO Incentives and Earnings Management*, J. FIN. ECON. (forthcoming), available at <http://ssrn.com/abstract=640585> (providing empirical evidence indicating that the use of discretionary accruals to manipulate reported earnings is more pronounced at firms where the CEO's potential total compensation is more closely tied to the value of stock and option holdings); Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 63 (2006) (finding that “CEOs with option portfolios that are more sensitive to the stock price are significantly more likely to misreport”).

<sup>258</sup> See, e.g., Messod D. Beneish, *Incentives and Penalties Related to Earnings Overstatements that Violate GAAP*, 74 ACCT. REV. 425 (1999) (finding that executives of firms managing earnings are more likely to engage in insider trading than managers of firms not overstating earnings); cf. Shane A. Johnson et al., *Executive Compensation and Corporate Fraud* 3 (Apr. 16, 2003) (unpublished manuscript), available at <http://ssrn.com/abstract=395960> (finding that “executives at fraud firms have significantly larger equity-based compensation and greater financial incentives to commit fraud than do executives at . . . control firms,” and that they “earn significantly more total compensation by exercising significantly larger fractions of their vested options . . . during the fraud years”).

<sup>259</sup> See Merle Erickson et al., *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 389 (2004).

<sup>260</sup> The evidence of managers forfeiting shareholder interests is ubiquitous. See, e.g., Michael D. Klausner & Robert Daines, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs* (Stanford Law Sch., John M. Olin Program in Law & Econ., Working Paper No. 299, 2004), available at <http://ssrn.com/abstract=637001> (finding that when parent corporation managers stand to benefit from entrenching spinoff company managers, they are more likely to set up a spinoff governance structure containing antitakeover provisions, even though it reduces parent share value).

<sup>261</sup> Guttentag, *supra* note 190, at 133.

<sup>262</sup> See Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 S. CAL. L. REV. 303, 357–59 (1998) (arguing that requiring pretrading disclosure would create disincentives from engaging in insider trading); H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions*, 35 J.L. & ECON. 149, 158–67 (1992) (finding, among other things, that insiders generate abnormal profits when trading their own firm's stock).

In addition to these short-term, rational reasons for faulty disclosure, managers also have numerous irrational motivations to minimize disclosure. Most managers, like most people, tend to be both overconfident in their own abilities and unduly optimistic about their own and their firms' future performance.<sup>263</sup> Therefore, managers often conclude that disclosure leads to unnecessary, and perhaps counterproductive, meddling or supervision. The self-serving bias drives managers to believe that they caused their companies' successes while circumstances beyond their control caused the companies' failures. These factors can lead managers to underdisclose even as they try to act in the company's best interests. In the end, voluntary full disclosure seldom occurs in the real world.<sup>264</sup>

c. *Mandatory Disclosure as a Solution*

The variety of firm-oriented and self-interested motivations of managers justify mandatory disclosure. Mandatory disclosure is, however, an admittedly costly and somewhat blunt instrument. Although regulators can tailor disclosure for differently sized firms and a variety of transactions, the exceptions and exemptions are still not as specific as stipulations reached by sophisticated parties who engaged in extensive negotiation. Nonetheless, mandatory disclosure has numerous advantages over a voluntary system.

i. *Benefits for Issuers*

First, mandatory disclosure may be cheaper for issuers than voluntary disclosure. Mandatory disclosure relieves issuers from negotiating individually tailored disclosure packages with a variety of investors and lenders.<sup>265</sup> Mandatory, uniform rules can therefore save, as well as cause, transaction costs.

More importantly, mandatory disclosure allows quality firms to signal the market effectively, thus benefiting issuers. Absent costly information searches, investors typically have difficulty distinguishing honest from dishonest, prosperous from destitute, and reliable from

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<sup>263</sup> See generally Paredes, *supra* note 49 (discussing possible sources of CEO overconfidence).

<sup>264</sup> See Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. FIN. STUD. 479, 480 ("Full voluntary disclosure . . . rarely seems to occur in reality, and firms typically do not disclose more than regulation requires.").

<sup>265</sup> Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1092 (1995) (noting that mandatory regimes can "save [ ] parties from negotiating over the content of disclosure where the outcome is not likely to vary among firms, and thus the costs of complying with the one-size-fits-all rule are less than the costs of negotiating individual levels of disclosure").

shaky firms.<sup>266</sup> Any firm can claim current profits and favorable long-term prospects. Furthermore, many firms can fool both sophisticated investors and the entire market, as the dot-com bubble vividly illustrated. Without a meaningful antifraud penalty, firms can lie with relative impunity. Even with a meaningful antifraud penalty, firms in a voluntary disclosure regime can easily disclose selectively. Firms may disclose good numbers in one quarter, but not in the next quarter when the numbers are not as favorable, or they may disclose the numbers in a particular format in one quarter, but in a different format in the next quarter in order to hide unfavorable developments.

In markets that allow such “cheap talk,”<sup>267</sup> actors are often unable to signal quality. Strategic disclosure is relatively easy, and it therefore forces investors to discount the price of the shares of *all* issuers.<sup>268</sup> Even in today’s economy, voluntary disclosures send few meaningful signals absent a requirement that the firm will also disclose tomorrow, and that governmental sanctions will result from either a failure to disclose *or* from affirmative deception.<sup>269</sup> Crooks can easily mimic the candid disclosure of an honest firm, and, absent required disclosure, current candid disclosure may degrade in the future.<sup>270</sup>

Evidence indicates that in situations in which consumers care about the environment and would like to purchase “green goods,” third-party certification is needed, at a minimum, to give credence to claims made by sellers.<sup>271</sup> Another study indicates that when auditors cannot clearly signal their professional quality, those who attempt to

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<sup>266</sup> This is an example of Akerlof’s famous “lemon problem,” the problem of adverse selection resulting from information asymmetries. See George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

<sup>267</sup> See Jordi Brandts & Gary Charness, *Truth or Consequences: An Experiment*, 49 MGMT. SCI. 116, 120 (2003) (noting that cheap talk is not necessarily effective when the parties’ interests are not aligned). See generally Vincent Crawford, *A Survey of Experiments on Communication via Cheap Talk*, 78 J. ECON. THEORY 286 (1998) (surveying empirical studies on cheap talk).

<sup>268</sup> Voluntary disclosure depends crucially upon its credibility because the market realizes the possibility of managers’ self-serving motivations. One major method of quality assurance is comparison of the voluntarily disclosed information to disclosure of later-required information. If, for example, voluntarily disclosed projections are not later realized, litigation may result, and the system of required disclosure, backed up by the legal system, has then played an important role in providing credibility for voluntary disclosures. See Healy & Palepu, *supra* note 233, at 425.

<sup>269</sup> See RAGHURAM G. RAJAN & LUIGI ZINGALES, *SAVING CAPITALISM FROM THE CAPITALISTS* 161 (2003); Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 244 (“Absent regulation, issuers control not only access to, but the accuracy and timing of, firm-specific disclosure.”).

<sup>270</sup> Franco, *supra* note 269, at 306.

<sup>271</sup> See Timothy N. Cason & Lata Gangadharan, *Environmental Labeling and Incomplete Consumer Information in Laboratory Markets*, 43 J. ENVTL. ECON. & MGMT. 113, 115 (2002) (finding that cheap talk in the form of unregulated claims “often fails to generate the efficient delivery of clean products”).

enhance their reputation cannot charge significantly higher prices, therefore lowering their profits.<sup>272</sup>

Mandatory disclosure allows issuers to raise external funds because lower adverse selection costs allow investors to assume something other than that the issuer is low value.<sup>273</sup> By significantly constraining the ability of an issuer to strategically withhold information,<sup>274</sup> mandatory disclosure greatly increases investor confidence in the information disclosed.<sup>275</sup>

Mandatory disclosure also minimizes the opportunities of insiders to engage in insider trading or otherwise defalcate.<sup>276</sup> Issuers can not only signal the value of their shares with reasonable assurance, but can commit credibly to a lower level of asset diversion.<sup>277</sup> In regimes with widely dispersed shareholders, who worry about mistreatment by managers, and in regimes with concentrated ownership, in which shareholders worry about exploitation by controlling shareholders, investors are more willing to invest and creditors more willing to loan if future disclosure is mandated.<sup>278</sup>

<sup>272</sup> See generally J. A. Brozovsky & F. M. Richardson, *The Effects of Information Availability on the Benefits Accrued from Enhancing Audit-Firm Reputation*, 23 ACCT., ORGS. & SOC'Y 767 (1998) (examining the effect of reputation on prices and profits).

<sup>273</sup> See Ferrell, *supra* note 222, at 19–20. For this reason, firms tend to voluntarily disclose more information just before they attempt to access the markets than they do at other times. See 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*, 38 J. ACCT. RES. (SUPP.) 91, 121 (2000) (finding in a study of German firms that a switch from the German to a fuller reporting regime, such as a U.S.-style regime, appeared via indirect measures to allow them to “garner economically and statistically significant benefits”).

<sup>274</sup> See Franco, *supra* note 269, at 289.

<sup>275</sup> As Franco notes:

Mandatory disclosure addresses the problem of informational asymmetry in two ways. It increases (at least in the United States) the amount of firm-specific disclosure provided by issuers. In this sense, it redresses the chronic incentives that lead issuers to provide less than adequate disclosure. . . . It also significantly constrains issuer discretion to withhold information strategically. This latter purpose gives rise to a signaling effect. Mandatory disclosure enables investors to make better inferences about material non-public information held by issuers.

*Id.*

<sup>276</sup> See Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1339 (1996) (“[Mandatory disclosure] 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.”).

<sup>277</sup> See Ferrell, *supra* note 222, at 20.

<sup>278</sup> *Id.* at 6–8.

ii. *Benefits for Investors*

Mandatory disclosure requirements create more useful public information than was ever the case under previous voluntary systems.<sup>279</sup> The history of voluntary disclosure establishes that fact. Mandatory disclosure protects lay investors who lack the wherewithal to bargain for optimal disclosure.<sup>280</sup> Even institutional investors “do not possess private information or great skill at obtaining such information, and they would accordingly not benefit from a regime that minimizes firms’ public disclosures.”<sup>281</sup> Mandatory disclosure benefits all investors, because it provides them with roughly the same information they would bargain for if they were rational. The investors save, however, the time and expense of bargaining with each and every firm in which they wish to invest, and therefore can more easily diversify their portfolios.

Mandatory disclosure reduces search and information processing costs for investors by requiring cheap,<sup>282</sup> readily available,<sup>283</sup> standardized,<sup>284</sup> and relatively reliable<sup>285</sup> disclosure of information. Required

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<sup>279</sup> See Franco, *supra* note 269, at 322–23 (explaining why issuer-choice standards will lead to disclosure that is both quantitatively and qualitatively inferior).

<sup>280</sup> It is often argued that mandatory disclosure does not benefit lay investors because they generally do not read the information that the SEC requires firms to disclose. However, Franco aptly points out that the fact that investors “seldom take the time to study issuers’ disclosure materials . . . is a product of the success of mandatory disclosure rather than evidence of its marginal value.” *Id.* at 296.

<sup>281</sup> Romano, *supra* note 12, at 2416.

<sup>282</sup> Mandatory disclosure reduces overall search costs because companies can obviously disclose information within their possession more cheaply than investors and analysts can uncover it through investigation. See Goshen & Parchomovsky, *supra* note 249, at 24–27. Indeed, some inside information would not be available even if investors and analysts were to spend excessive sums in search costs. See *id.*

<sup>283</sup> Absent mandatory disclosure, analysts, institutional investors, and others must engage in costly, repetitive searches of information. See Coffee, *supra* note 229, at 733–34.

<sup>284</sup> See RAJAN & ZINGALES, *supra* note 269, at 161 (“If each firm chose its own idiosyncratic method of disclosure, comparability across firms would be lost—a problem that is apparent among the private equity funds, where investors complain about the difficulty of comparing fund performance when each fund can choose the method of disclosing performance that it prefers.”); Michael J. Fishman & Kathleen M. Hagerty, *The Optimal Amount of Discretion to Allocate in Disclosure*, 105 Q.J. ECON. 427, 440 (1990) (showing that standardizing disclosure requirements “makes it easier to filter out the common noise[, which] allows the market to more efficiently price projects and increases the efficiency of the flow of capital”).

<sup>285</sup> As Rock points out, it is highly problematic for issuers to voluntarily bond themselves to provide credible and accurate financial information into the future. See Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 685–86 (2002). The SEC’s disclosure system solves this contracting problem by (a) serving a standardizing function regarding the form and quality of disclosure, (b) providing a mechanism for adjusting to the evolving needs regarding reporting obligations, (c) providing a credible and specialized enforcement mechanism, and (d) limiting exit by corporations. *Id.* at 686–87.

disclosure reduces both private transaction costs<sup>286</sup> and public transaction costs<sup>287</sup> in capital and other markets,<sup>288</sup> and is needed to help defeat strategic disclosure.<sup>289</sup>

### iii. *Theory and Evidence*

Despite the obvious theoretical advantages of regularly disclosing comparable and accurate information, critics claim that there is no proof that SEC disclosure requirements have actually been beneficial.<sup>290</sup> Although evidence regarding the 1933 and 1934 Acts remains mixed in light of the potential methodological shortcomings of early and conflicting studies,<sup>291</sup> several more recent and sophisticated stud-

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<sup>286</sup> John A. Hepp & Brian W. Mayhew, *Audits of Public Companies 19–20* (June 29, 2004) (unpublished manuscript), available at <http://ssrn.com/abstract=564266> (noting that mandated disclosure minimizes costs of sharing information because issuers and investors need learn only one accounting and auditing language, reduces negotiations costs because investors and issuers need not negotiate the criteria and scope of information sharing, and ensures that all firms accessing public capital markets bear the same costs).

<sup>287</sup> *Id.* at 20 (noting that the “costs of public monitoring of corporate activities would be much higher in the absence of publicly mandated audited financial statements, as would the costs of collecting information for public policy decisions,” and offering as an example tax collection, in which correspondence between audited financial statements and corporate tax returns is used by the IRS as a preliminary screen for tax code compliance).

<sup>288</sup> *Id.* at 19 (“A mandated audit conducted by an independent auditor based on public auditing standards (i.e. GAAS) with criteria specified by public accounting standards (i.e. GAAP) greatly reduces private transaction costs in comparison to private transaction costs without mandated auditing and standards.”).

<sup>289</sup> Hess & Dunfee, *supra* note 197, at 34 (noting that “[s]tandardization is necessary to overcome the problem of strategic disclosure”).

<sup>290</sup> See, e.g., ROMANO, *supra* note 9, at 16–26 (citing studies of the 1933 and 1934 Acts in support of the claim that SEC-mandated disclosure was not necessarily more efficient than voluntary disclosure).

<sup>291</sup> Several early studies produced conflicting results. See George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (finding “no measurable positive effect” resulting from the disclosure requirements of the 1934 Act); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 313 (1989) (finding lower issue-specific risk after the 1933 Act); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) (finding that once regulatory costs are taken into consideration, the 1933 Act most likely did not save investors any money).

These early studies do not settle the debate. However, many have concluded that these early studies do, in fact, indicate that greater pricing accuracy resulted from the disclosure requirements. See John C. Coffee Jr., *Convergence and Its Critics: What Are the Preconditions to the Separation of Ownership and Control?* 48 (Columbia Univ. Ctr. for Law & Econ. Studies, Working Paper No. 179, 2000), available at <http://ssrn.com/abstract=241782> (“[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 189, at 1379 (“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.”).

It is no wonder that these studies remain controversial, given the confounding events taking place at the time, most particularly the Great Depression. See Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market* 7 (Harvard John

ies provide empirical evidence for the logical proposition that more information creates more accurate stock prices and, ultimately, more efficient securities markets.<sup>292</sup> For example, recent empirical studies indicate the market-enhancing benefits of numerous SEC disclosure requirements, such as the 1964 requirement that OTC companies come within the 1934 periodic disclosure system,<sup>293</sup> the 1980 requirement that every issuer's filing contain a management discussion and analysis section wherein management discusses and analyzes the issuer's financial situation,<sup>294</sup> the 1999 requirement that OTC Bulletin Board (OTCBB) companies comply with 1934 Act reporting requirements,<sup>295</sup> the Regulation Fair Disclosure (FD) promulgated in 2000,<sup>296</sup> and the November 2000 requirement that issuers disclose

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M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 453, 2003), available at <http://ssrn.com/abstract=500123> (noting that with regard to the conflicting findings of the Simon, Benston, and Stigler studies that "[i]t is extraordinarily difficult to adjudicate this debate convincingly given the econometric evidence indicating that the Great Depression did have a profound effect on the capital markets").

<sup>292</sup> See Goshen & Parchomovsky, *supra* note 249, at 40 (noting the traditional arguments supporting mandatory disclosure, namely that absent required disclosure, there will be both too much and too little investment in securities research).

<sup>293</sup> Ferrell, *supra* note 222, at 54 (finding a "substantial reduction" in the volatility of OTC stock returns and price movement more in parallel with the listed market, both indicating increased pricing accuracy); Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Act Amendments*, Q. J. ECON. (forthcoming 2006) (finding evidence that the 1964 amendments created \$3.2 to \$6.2 billion in value for shareholders of the OTC firms in the study sample).

<sup>294</sup> Merritt B. Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331 (2003) (finding that the new requirement made share prices more accurate, and producing evidence that greater share price accuracy makes capital allocation more efficient).

<sup>295</sup> See, e.g., Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 261 (2005) (finding that firms following the new OTCBB rules exhibited significant increases in market liquidity, that those firms already in compliance SEC regulations also exhibited positive increases in liquidity, and that the requirement directly helped previously noncompliant firms).

<sup>296</sup> See, e.g., Markus K. Brunnermeier, *Information Leakage and Market Efficiency*, 18 REV. FIN. STUD. 417, 420 (2005) (arguing that Regulation FD increases informational efficiency, at least to the extent that it suppresses information leaks); Brian J. Bushee et al., *Managerial and Investor Responses to Disclosure Regulation: The Case of Reg FD and Conference Calls*, 79 ACCT. REV. 617, 619 (2004) (finding that Regulation FD did not decrease the amount of information disclosed during investor conference calls, that other predicted disadvantages of the rule had not materialized, and that small investors were now able to capitalize on disclosed information in the same way as large investors); Venkat Eleswarapu et al., *The Impact of Regulation Fair Disclosure: Trading Costs and Information Asymmetry*, 39 J. FIN. & QUANT. ANALYSIS 209, 209 (2004) (finding that through Regulation FD "the SEC appears to have diminished the advantage of informed investors, without increasing volatility"); Ronen Feldman et al., *Earnings Guidance After Regulation FD*, J. INVESTING, Winter 2003, at 31, 40 ("[I]nvestors can process the information companies disclose in their earnings guidance, and react to it in the proper manner, as regulators envisioned in passage of Regulation FD."); Andreas Gintschel & Stanimir Markov, *The Effectiveness of Regulation FD*, 37 J. ACCT. & ECON. 293 (2004) (finding that Regulation FD has been effective in curtailing selective disclosure); Frank Hefflin et al., *Regulation FD and the Financial Information Environment: Early*



fees paid to auditors.<sup>297</sup> Other domestic studies are similarly supportive.<sup>298</sup>

Empirical evidence also supports the theory that mandatory disclosure improves the monitoring capability of third parties, reduces the costs for investors, and thereby lowers the price for firms that raise

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*Evidence*, 78 ACCT. REV. 1 (2003) (finding that Regulation FD led to improved informational efficiency and a substantial increase in the disclosure of forward-looking information, and no reliable evidence of impairment of analysts' forecasts); Afshad J. Irani, *The Effect of Regulation Fair Disclosure on the Relevance of Conference Calls to Financial Analysts*, 22 REV. QUANTITATIVE FIN. & ACCT. 15, 15–16 (2004) (presenting empirical evidence that Regulation FD improved analysts' forecast accuracy); Chun I. Lee et al., *Effect of Regulation FD on Asymmetric Information*, FIN. ANALYSTS J., May/June 2004, at 79, 87 (finding little support for critics of Regulation FD who claimed that it would increase volatility and reduce the quantity of information introduced into the market); Ori E. Barron et al., *Leveling the Informational Playing Field*, 3 REV. ACCT. & FIN. 21 (2004) (concluding that "in affording nonprofessionals access to higher levels of disclosure, Regulation FD could result in more informationally diverse sets of investors, and hence more efficient, share prices"); Partha Mohanram & Shyam V. Sunder, *How has Regulation Fair Disclosure Affected the Functioning of Financial Analysts?* 29–30 (Dec. 2003) (unnumbered working paper), available at <http://ssrn.com/abstract=297933> (finding that in the post-Regulation FD period, the best analysts continued to distinguish themselves, while all analysts' incentives to gather private information and perform independent analysis were enhanced); Philip Shane et al., *Earnings and Price Discovery in the Post-Reg. FD Information Environment: A Preliminary Analysis* (Nov. 15, 2001) (unnumbered working paper), available at <http://leeds-faculty.colorado.edu/shanep/research/regfdpaper.pdf> (finding that price discovery improved and price volatility decreased after Regulation FD); Shyam V. Sunder, *Investor Access to Conference Call Disclosures: Impact of Regulation Fair Disclosure on Information Asymmetry* 34 (Apr. 2002) (unpublished manuscript), available at [http://icf.som.yale.edu/pdf/yale\\_seminar\\_shyam.pdf](http://icf.som.yale.edu/pdf/yale_seminar_shyam.pdf) (finding that Regulation FD had not caused firms to disclose less information voluntarily and that the bid-ask price spread had decreased). *But see, e.g.*, Afshad J. Irani & Irene Karamanou, *Regulation Fair Disclosure, Analyst Following, and Analyst Forecast Dispersion*, 17 ACCT. HORIZONS 15, 15 (finding that Regulation FD "led to a decrease in analyst following and an increase in forecast dispersion"); Warren Bailey et al., *Regulation FD and Market Behavior around Earnings Announcements: Is the Cure Worse than the Disease?* 16–18 (July 2, 2002) (unnumbered working paper), available at <http://ssrn.com/abstract=311364> (finding that Regulation FD seems to impair the ability of analysts to reach a consensus); Armando R. Gomes et al., *SEC Regulation Fair Disclosure, Information, and the Cost of Capital*, (July 8, 2004) (unnumbered working paper), available at <http://ssrn.com/abstract=529162> (finding that the adoption of Regulation FD caused a reallocation of information-producing resources, raising the cost of capital for some small firms).

<sup>297</sup> See Jere R. Francis & Bin Ke, *Disclosure of Fees Paid to Auditors and the Market Valuation of Earnings Surprises* 3 (Jan. 5, 2006) (unnumbered working paper), available at <http://ssrn.com/abstract=487463> ("We conclude . . . that the SEC's mandatory disclosure of audit and nonaudit fees provides new information that investors could not obtain from other sources, and that investors perceived high nonaudit fees negatively after their disclosure.").

<sup>298</sup> Healy and Palepu have examined the capital markets research studies and note that "[t]he most significant conclusion is that regulated financial reports provide new and relevant information to investors." Healy & Palepu, *supra* note 233, at 413. Healy and Palepu expressly note, however, that this research does not necessarily prove that regulated disclosure is preferable to voluntary disclosure because "it does not compare the relative informativeness of regulated and unregulated financial information." *Id.*

capital.<sup>299</sup> Higher disclosure requirements can even lead to increased venture capital financing, given that venture capitalists can foresee their ability to cash out of prudent investments on more favorable terms under such a regime.<sup>300</sup>

Transnational empirical research similarly supports mandatory disclosure, as it indicates that countries that require disclosure enable their companies to attract investors and therefore have deeper and broader capital markets.<sup>301</sup> Similarly, companies from low-disclosure jurisdictions that list on exchanges with higher disclosure requirements tend to benefit substantially.<sup>302</sup>

These empirical studies strongly suggest that mandatory disclosure works, both because it is mandatory and because it generally results in increased disclosure. As Rock points out:

The lesson here is that one cannot neglect the extent to which mandatory disclosure regulation helps issuers and investors contract for capital. . . . [T]he problem of contracting for a given level, quality, and permanence of disclosure is not trivial and one should not ignore the extent to which the current system succeeds. Investment

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<sup>299</sup> See Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, 72 ACCT. REV. 323, 346–47 (1997) (finding that more disclosure in SEC annual reports reduces the cost of equity capital for firms not closely followed by analysts); M. Gietzman & J. Ireland, *Cost of Capital, Strategic Disclosures and Accounting Choice*, 32 J. BUS. FIN. & ACCT. 599, 631–32 (2005) (finding that U.K. companies that disclose more have lower capital costs).

<sup>300</sup> See RAJAN & ZINGALES, *supra* note 269, at 254–55.

<sup>301</sup> See CROSS & PRENTICE, *supra* note 15, at 47 (finding that mandatory securities laws correlate to stronger and more efficient stock markets); Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, J. ACCT. RES. (forthcoming June 2006), available at <http://ssrn.com/abstract=641981> (finding that countries with extensive securities regulation and strong enforcement mechanisms exhibit lower cost of capital levels than nations with weak legal institutions, even when other factors are controlled); Ole-Kristian Hope, *Disclosure Practices, Enforcement of Accounting Standards, and Analysts' Forecast Accuracy: An International Study*, 41 J. ACCT. RES. 235, 264–65 (2003) (“Controlling for firm- and country-level factors, . . . firm-level annual report disclosure level is positively associated with forecast accuracy, [suggesting] that firm-level disclosures provide useful information to analysts.”); Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 33 (1999) (“Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable.”); Hazem Daouk et al., *Capital Market Governance: How Do Security Laws Affect Market Performance?*, J. CORP. FIN. (forthcoming) (finding that better capital market governance features, including earnings disclosure and enforcement of insider trading laws, are linked to a decrease in the cost of equity and increases in market liquidity and pricing efficiency); Fung et al., *supra* note 157, at 21 (finding that international investment funds prefer to hold assets in countries with greater disclosure and that during crises funds tend to flee more opaque markets); La Porta et al., *supra* note 192 (finding that disclosure and liability rules benefit stock markets).

<sup>302</sup> See, e.g., Mark H. Lang et al., *ADRs, Analysts, and Accuracy: Does Cross Listing in the United States Improve a Firm's Information Environment and Increase Market Value?*, 41 J. ACCT. RES. 317, 342 (2003) (finding that firms that cross list on U.S. exchanges have greater analyst coverage and increased forecast accuracy and that those translate into higher valuations).

capital is available all over the world, yet it is the U.S. capital markets, under the SEC disclosure system, that are without peer in the public financing of new enterprises, high tech and otherwise, domestic and foreign.<sup>303</sup>

The benefits of mandatory, uniform, comparable disclosure are obvious.<sup>304</sup> Critics and supporters of mandatory disclosure may have countervailing theories, but strong empirical evidence supports mandatory disclosure.

## 2. *Fraud Is Bad*

The benefits of requiring disclosure outlined above cannot be realized without some reasonable assurance that the information that is disclosed is reasonably accurate. If companies must disclose certain information but can lie about it, investors will sensibly avoid the markets. Therefore, the second heuristic that guides SEC policy making is: Fraud is bad. Pretty much everyone, communitarians and contractarians, liberals and conservatives, can agree with this broad conclusion (though perhaps not its policy implications).

### a. *The Inefficiency of Fraud*

Fraud is not only unfair, but also inefficient. Securities fraud imposes substantial costs upon an economy, primarily in the form of distortion of investment decisions.<sup>305</sup> Securities fraud reduces managerial accountability, increases verification costs for analysts and others, raises liquidity costs, and distorts capital allocation.<sup>306</sup> Ultimately, “[i]nvestors will be reluctant to invest and trade if they believe

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<sup>303</sup> Rock, *supra* note 285, at 693–94. As Coffee notes, “the cost of capital appears to be lower for firms that make fuller disclosure.” John C. Coffee Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1811 (2002).

<sup>304</sup> See, e.g., Cox, *supra* note 247, at 1234 (“Certainly the evidence amassed by researchers suggesting that capital markets are noisy markets, i.e. that stock prices do not on average reflect a security’s intrinsic value, does not support subjecting investors to multiple disclosure standards.”); Prentice, *supra* note 85, at 1445 (noting that a regulatory regime lacking uniform disclosure gives rise to a “Tower of Babel”); David S. Ruder, *Reconciling U.S. Disclosure Policy with International Accounting and Disclosure Standards*, 17 NW. J. INT’L L. & BUS. 1, 10 (1996) (“It is difficult to imagine how an investor would be able to judge the effectiveness of different regulatory regimes, much less quantify that knowledge in a manner allowing the investor to change the purchasing or selling price of a particular security.”).

There is a balance to be struck because disclosure is expensive. The SEC does not always get it right, of course. See, e.g., Randolph Beatty & Padma Kadiyala, *Impact of the Penny Stock Reform Act of 1990 on the Initial Public Offering Market*, 46 J.L. & ECON. 517, 538 (2003) (finding that the Penny Stock Reform Act of 1990’s attempt to curb fraud in the IPO market did not significantly improve issuer quality).

<sup>305</sup> See, e.g., Tracy Yue Wang, *Securities Fraud: An Economic Analysis 1* (Nov. 2004) (unnumbered working paper), available at <http://ssrn.com/abstract=500562>.

<sup>306</sup> See Pritchard, *supra* note 11, at 937–45.

that the markets are stacked against them.”<sup>307</sup> When investors refuse to invest because they believe the markets are rigged, economic damage occurs. Many proponents of market deregulation assume that investors will reduce the price they pay for securities to adjust for the risk of being defrauded. This is not optimal either.

First, deflation of securities to account for the risk of fraud harms firms trying to raise money. The firms cannot raise as much money, or on as favorable terms, as they could if investors did not fear fraud. In Russia, where meaningful securities regulation is nonexistent, investor fears that insiders will loot oil companies cause stocks to trade at one one-hundredth of their potential value in the United States.<sup>308</sup>

Second, deregulation harms investors because they cannot accurately discount the securities they purchase to account for fraud risk. Opponents of full disclosure suggest that investors can adjust the price of securities based on the relative level of fraud protection in the contract signed by the parties in a regime of private contracting, or based on the securities laws of the state or nation where the company has opted into a regulatory competition regime. Certainly sophisticated investors may take these factors into account. Even sophisticated investors may have difficulty accurately and efficiently pricing securities in light of these signals, however.<sup>309</sup>

There are several reasons why it is difficult for investors to adjust the price they pay for shares to account accurately for the risk of fraud. First, undisclosed management information is generally not part of stock market prices.<sup>310</sup> Furthermore, no ready formulae exist to discount the stock of companies that sell their shares under contracts that disclaim liability for fraud, or that choose regulation by a fraud-friendly jurisdiction. Investors and others are not sensitive to when they are being misled.<sup>311</sup> Psychological evidence indicates people are generally insensitive to the source of information.<sup>312</sup> People have difficulty disregarding information, even when they learn it is

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<sup>307</sup> A. C. Pritchard, *Self-Regulation and Securities Markets*, REGULATION, Spring 2003, at 32, 33.

<sup>308</sup> See RAJAN & ZINGALES, *supra* note 269, at 57.

<sup>309</sup> See Prentice, *supra* note 215, at 1216.

<sup>310</sup> The strong form of the efficient capital markets hypothesis (ECMH) assumes that such information is incorporated in the stock price, but most evidence is inconsistent with this version of the ECMH. See Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 417 (2004) (“Virtually no support exists for the ‘strong’ form of the . . . ECMH.”).

<sup>311</sup> See, e.g., M. HIRSH GOLDBERG, *THE BOOK OF LIES* 233–36 (1990); Bella M. DePaulo et al., *Deceiving and Detecting Deceit*, in *THE SELF AND SOCIAL LIFE* 323, 343–44 (Barry R. Schlenker ed., 1985).

<sup>312</sup> See, e.g., DePaulo et al., *supra* note 311, at 327 (“[People] tend to believe whatever affect or disposition the [communicator] is claiming, even when they know that the [communicator] may be deceiving.”).

from an unreliable source.<sup>313</sup> Judgments often move in the right direction, but usually not far enough. Studies in accounting show that trained auditors tend to overweight explanations for accounting anomalies provided by their clients, even though the auditors recognize their clients' incentive to mislead.<sup>314</sup> Other studies demonstrate that when people know of their advisors' conflicts of interest, they insufficiently discount that information.<sup>315</sup> Nicholas DiFonzo and Prashant Bordia point out that when people recognize that the sources of rumors about the stock market are not credible, they claim that they are not influenced by discredited rumors, but their actual trading activity clearly indicates that they are.<sup>316</sup>

It is therefore likely that investors who know an issuer has chosen a low-disclosure or no-fraud-protection regime will not adjust the stock price sufficiently to account for the likelihood of fraud. Studies show that people use information in the form provided to them; therefore, they place more weight on express disclosures than on implicit information.<sup>317</sup> When evaluating one-sided disclosures of uncertain prospects, decision makers weigh the side that is disclosed more than the side that must be inferred.<sup>318</sup> They therefore bid higher when the best possible outcome is disclosed, but they must infer the

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<sup>313</sup> See generally Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in *JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 3, 8 (Daniel Kahneman et al. eds., 1982) (noting people's insensitivity to reliability; 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 they know that the information is reliable or unreliable).

<sup>314</sup> See Urton Anderson & Lisa Koonce, *Explanation as a Method for Evaluating Client-Suggested Causes in Analytical Procedures*, *AUDITING*, Fall 1995, at 124, 130 (finding that auditors tend to find evidence supporting causes of unexpected financial 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 an explanation may not be valid.").

<sup>315</sup> See Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 *J. LEGAL STUD.* 1, 6 (2005). Disclosure of conflicts can also increase bias in advice because it causes the advisors to feel morally licensed and strategically encouraged to exaggerate their advice even more. See *id.* at 13–14.

<sup>316</sup> See Nicholas DiFonzo & Prashant Bordia, *Rumor and Prediction: Making Sense (but Losing Dollars) in the Stock Market*, 71 *ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES* 329, 346 (1997) ("[R]umors do not have to be believed or trusted in order to powerfully affect trading, they simply have to make sense.").

<sup>317</sup> See JOHN W. PAYNE ET AL., *THE ADAPTIVE DECISION MAKER* 48, 50–52 (1993).

<sup>318</sup> See J. Richard Dietrich et al., *Market Efficiency, Bounded Rationality, and Supplemental Business Reporting Disclosures*, 39 *J. ACCT. RES.* 243, 244 (2001) (finding that disclosure of expected reserves by an oil company "leads to market prices that better reflect that information as compared to situations where the same information must be inferred"); Jessen L. Hobson & Steven J. Kachelmeier, *Strategic Disclosure of Risky Prospects: A Laboratory Experiment*, 80 *ACCT. REV.* 825 (2005).

lowest possible outcome, than when the lowest possible outcome is disclosed, but they must infer the best possible outcome.<sup>319</sup>

Investor reaction to securities analysts' recommendations illustrates these tendencies. While securities analysts clearly suffer conflicts of interest that render their predictions overly optimistic, empirical studies indicate that investors do not adequately discount for this effect.<sup>320</sup> There are "uncountable cases in which analyst hype alone seems to have resulted in significant stock price movements."<sup>321</sup> During the dot-com bubble, substantial, visible evidence indicated that stock analysts were issuing false reports, but the markets did not adequately discount their advice.<sup>322</sup> Certainly unsophisticated investors would not be able to value different protective devices that issuers might adopt.<sup>323</sup>

Issuers may strategically manipulate investors in this manner, for it works even when bidders know that disclosures are opportunistic rather than random.<sup>324</sup> Therefore, when they receive an express representation of securities' values and must infer the implications of a decision to register in a low-disclosure or no-fraud-protection regime, investors tend to adjust the stock price in a downward direction, but not enough.<sup>325</sup>

While investors can certainly draw inferences from an issuer's decision not to disclose earnings, they can draw more certain and accurate inferences from actual disclosure of earnings, whether positive or negative. Empirical studies indicate that "explicit disclosures lead to more efficient market reactions, even when the same information can be inferred . . . ."<sup>326</sup>

Furthermore, it is extremely difficult for investors to discount share prices to account for the risk of insider trading.<sup>327</sup> Because insider trading is by nature secret, with unknown volume and occurrence, "in actual practice, [investors] may not be able to set any discount."<sup>328</sup>

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<sup>319</sup> See Hobson & Kachelmeier, *supra* note 318, at 844.

<sup>320</sup> See Michaely & Womack, *supra* note 103, at 677-78.

<sup>321</sup> Fisch & Sale, *supra* note 91, at 1078.

<sup>322</sup> See Sale, *supra* note 107, at 406 (noting that the market did not adequately discount even for fully disclosed risks).

<sup>323</sup> See Stephen J. Choi, *Promoting Issuer Choice in Securities Regulation*, 41 VA. J. INT'L L. 815, 824-26 (2001).

<sup>324</sup> See generally Hobson & Kachelmeier, *supra* note 318 (finding that users place higher values on risky prospects when a maximum, rather than a minimum, potential outcome is disclosed, and that the biasing effect of such one-sided disclosures is equally pronounced when users know that the issuers are making either strategic or random disclosures).

<sup>325</sup> See *id.*

<sup>326</sup> Dietrich et al., *supra* note 318, at 265.

<sup>327</sup> William K.S. Wang, *Selective Disclosure by Issuers, Its Legality and Ex Ante Harm: Some Observations in Response to Professor Fox*, 42 VA. J. INT'L L. 869, 878 (2002).

<sup>328</sup> *Id.* at 878-79.

Ultimately, fraud is inefficient. Investors cannot adequately protect themselves by paying less for securities based on fuzzy signals sent by companies that opt into no-liability or low-liability antifraud regimes. The availability of such regimes imperils market efficiency.

b. *The Improbability of Adequate Voluntary Compliance*

Ideally, managers would refrain from committing fraud because of the long-term benefits of a reputation for honesty. Unfortunately, the same factors that often cause managers of public companies to disclose information strategically also cause them to disclose false information. Competition for resources means that “unlawful business conduct is a natural accompaniment of modern life.”<sup>329</sup>

Any hope that individual investors could adequately police securities fraud is naive. Individual investors, even sophisticated ones, cannot sufficiently monitor, detect, and then remedy fraud with common law claims for fraud or breach of contract.<sup>330</sup> Rather, detecting many types of fraud, such as wash sales and matched orders, “requires a central organized detection and enforcement system such as the SEC.”<sup>331</sup> McMillan agrees, noting that

[s]tock prices can be manipulated in subtle ways that would easily escape legal prosecution but that might be controlled by a regulator. Only an expert could detect insider trading carried out via layer upon layer of transactions. A focused regulatory agency provides a more credible deterrent to financial misleading than can overstretched courts.<sup>332</sup>

c. *Strong SEC Enforcement as a Solution*

A strong central agency can deter and punish fraud better than individual investors, who are largely at the mercy of fraudsters. Since fraud victimizes even the most sophisticated investors, deregulation seriously jeopardizes the interests of lay investors. In an unregulated environment, gatekeepers are unreliable, and exchanges both suffer serious conflicts of interest and lack viable enforcement mechanisms to prevent most types of securities fraud.<sup>333</sup>

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<sup>329</sup> Diane Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 MICH. L. REV. 1377, 1401 (1982).

<sup>330</sup> See Goshen & Parchomovsky, *supra* note 249, at 27.

<sup>331</sup> *Id.* at 28.

<sup>332</sup> McMILLAN, *supra* note 226, at 177–78.

<sup>333</sup> See Peter M. DeMarzo et al., *Self-Regulation and Government Oversight*, 72 REV. ECON. STUD. 687, 702 (2005) (concluding that stock exchanges will choose less fraud enforcement than customers would prefer and that the government can benefit customers by causing exchanges to enforce more aggressively); see also RAJAN & ZINGALES, *supra* note 269, at 160 (“[A]nother argument for why the Securities Act of 1933 ‘worked’ is that enforcement by the federal government was seen as more credible because it may have been seen as less subject to capture by insiders on exchanges.”).

A strong central agency is preferable to state regulation alone. The SEC offers a large, coordinated antifraud enforcement organization that is more efficient and effective than the fifty states.<sup>334</sup> Just as the Delaware courts are advantageous for corporate law cases because they handle more of them than do courts in other states, the greater experience of the federal government makes it the preferred enforcer of securities law. Empirical studies show that a proactive agency that can demand additional disclosure, investigate wrongdoing, and enjoin bad actions facilitates development of financial markets.<sup>335</sup>

Although critics may justly fault the SEC for failing to eliminate securities fraud completely, no sensible person believes there would be less securities fraud without the SEC. Before federal securities laws were passed, securities fraud was widespread. Virtually every state blue sky administrator supported federal laws to thwart that fraud.<sup>336</sup> The rigorous disclosure requirements of the 1933 and 1934 Acts helped retard fraud,<sup>337</sup> as did civil and criminal punishments imposed for deceitful activity. Today, no state blue sky regulator would support elimination of the SEC.

The current strong-SEC securities regulatory system, even with its flaws, provides more protection for investors than any other regulatory regime in the world.<sup>338</sup> This protection induces investors to “play the game,”<sup>339</sup> thereby promoting capital market development and en-

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<sup>334</sup> See Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 178–79 (1997).

<sup>335</sup> See Chenggang Xu & Katharina Pistor, *Law Enforcement Under Incomplete Law: Theory and Evidence from Financial Market Regulation* 36 (Columbia Univ. Ctr. for Law & Econ. Studies, Working Paper No. 222, 2002), available at <http://ssrn.com/abstract=396141>.

<sup>336</sup> See I LOSS & SELIGMAN, *supra* note 211, at 194–200; see also Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35, 93 (2005) (noting that before the federal securities laws were enacted, companies could easily evade state blue sky laws by making offers across state boundaries).

<sup>337</sup> See Cox, *supra* note 247, at 1235 (“[E]ven . . . neoclassical economists . . . acknowledge that one of the consequences of the enactment of the Securities Act of 1933 was a great reduction in the number of risky or fraudulent public offerings.”); see also SELIGMAN, *supra* note 1, at 562 (noting evidence that the 1933 and 1934 Acts reduced securities fraud).

<sup>338</sup> See Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT’L L.J. S77, S82 (1994) (“[No] other major securities commission in the world has the power, on its own, to enforce disclosure rules and to seek judicial sanctions against those who disobey the rules. The U.S. success rate in bringing to justice companies that have chosen to ignore the requirements is dramatically better than that of other markets around the world, and that I think contributes to [public confidence in the market].”).

<sup>339</sup> See *id.* (noting that when investors “decide the game is rigged, they will simply choose to go and play a different game”).



abling economic growth.<sup>340</sup> This is particularly important in times of crisis, when panic can cause extreme, long-lasting damage.<sup>341</sup>

Furthermore, stringent securities laws shape morals and behavior.<sup>342</sup> By promulgating and enforcing antifraud rules, the SEC establishes societal standards for market actors. If the SEC prohibits insider trading, people will view it as unacceptable behavior.<sup>343</sup> If the SEC punishes earnings management, economic actors cannot rationalize it as ethically defensible.

Similarly, enforcing securities laws enhances trust among market participants. Critics suggest that law undermines trust, but evidence indicates that, among strangers, law can enhance trust. Would *A* trust *B* more if *B* made a legally unenforceable promise or if *B* made a promise and *A* could sue him if he lied? The best evidence points to the latter.<sup>344</sup>

Goshen and Parchomovsky point out:

Like mandatory disclosure duties, restrictions on fraud and manipulation also create a virtuous cycle. By reducing information traders'

<sup>340</sup> See McMILLAN, *supra* note 226, at 179 ("Where shareholder safeguards are less strict, there is a dampening of willingness to invest. . . . [Empirical studies show that c]ountries with strong investor protections have bigger capital markets. The efficacy of the stock market varies with how activist the government is in setting the platform.").

<sup>341</sup> See Karmel, *supra* note 179, at 544–45 ("The theory that regulatory competition produces the most efficient regulatory structure is based on principles of economics that fail to sufficiently take into account the psychological factors affecting investor confidence. . . . The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s."); Cindy Skrzycki, *Collapse Shakes Core of Confidence in Economy*, WASH. POST, Oct. 25, 1987, at A18 ("Business historian Thomas K. McCraw of the Harvard Business School pointed out that the underpinnings of the economy in 1929 were in some ways stronger than they are today: New industries were taking hold and growing and the government was running a surplus. The depression that followed the crash came because the institutional and regulatory safety net that exists today was not in place to avoid a panic.").

<sup>342</sup> See THOMAS DONALDSON & THOMAS W. DUNFEE, *TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS* 95 (1999) ("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."); Fairfax, *supra* note 57, at 445 (noting that legal opinions define acceptable conduct and thereby help set norms for behavior); Richard H. Pildes, *The Unintended Cultural Consequences of Public Policy: A Comment on the Symposium*, 89 MICH. L. REV. 936, 938–39 (1991) (noting that 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 . . ."); Steven Shavell, *Law Versus Morality as Regulators of Conduct* 64 (Harvard John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 340, 2001), available at <http://papers.ssrn.com/abstract=293905> (noting that "legal rules can affect our moral beliefs as well as the operation of the moral sanctions").

<sup>343</sup> See Prentice, *supra* note 85, at 1503 ("When the SEC bans manipulation and insider trading, 'financial morality' similarly evolves.").

<sup>344</sup> See Angela L. Coletti et al., *The Effect of Control Systems on Trust and Cooperation in Collaborative Environments*, 80 ACCT. REV. 477, 478 (2004) (finding that control systems induce cooperation which, in turn, positively affects trust, rather than undermining it as has been argued).

precaution costs, restrictions on fraud and manipulation facilitate entry into the information traders market and thus increase competition among information traders. The enhanced competition will, in turn, increase the probability of detecting misstatements and fraud, and thereby reduce the incentive for corporations to engage in fraud or manipulation. The reduced incentive to release misleading information to the market will further decrease information traders' precaution costs, and so on.<sup>345</sup>

Empirical evidence thus supports mandatory disclosure rules. It also indicates that antifraud rules,<sup>346</sup> insider trading prohibitions,<sup>347</sup> private antifraud enforcement,<sup>348</sup> and even corporate governance pro-

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<sup>345</sup> Goshen & Parchomovsky, *supra* note 249, at 29. Goshen and Parchomovsky emphasize the role that securities analysts play in our markets, noting that "by protecting information traders, securities regulation represents the highest form of market integrity, which ensures accurate pricing . . . to all investors. In this way, securities regulation improves the allocation of resources in the economy." *Id.* at 6.

<sup>346</sup> See D. Paul Newman et al., *The Role of Auditing in Investor Protection*, 80 ACCT. REV. 289, 300 (2005) indicating that "in markets that provide greater investor protections through [auditor and insider] penalties, total investment levels in new ventures are greater and firm ownership is less concentrated").

<sup>347</sup> See Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 144 (2005) ("[C]ountries with more prohibitive insider trading laws have *more diffuse* equity ownership, *more accurate* stock prices, and *more liquid* stock markets."); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 75 (2002) ("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."); Robert M. Bushman et al., *Insider Trading Restrictions and Analysts' Incentives to Follow Firms*, 60 J. FIN. 35, 35 (2005) (finding that analyst coverage of firms increases following enforcement of insider trading laws, especially in developing countries); Laura N. Beny, *Do Shareholders Value Insider Trading Laws? International Evidence* 34 (Harvard John M. Olin Ctr. for Law Econ. & Bus., Discussion Paper No. 345, 2001), available at <http://papers.ssrnh.com/abstract=296111> (finding that investors do value insider trading legislation, especially when ownership and control are separated); Coffee, *supra* note 303, at 1828 ("The available empirical evidence suggests that adopting and enforcing a prohibition against insider trading significantly reduces the cost of capital. Such a finding is consistent with [substantial empirical evidence adduced by La Porta and his colleagues, as well as others,] that strong laws protecting minority investors are a precondition to financial development.").

<sup>348</sup> See La Porta et al., *supra* note 192 (finding that effective private securities litigation enforcement is positively correlated with more developed capital markets). Indeed, La Porta et al.'s study found that private litigation enforcement was more important than public enforcement, particularly in less-developed nations unlikely to have a strong central agency. See *id.* Even in the United States, the number of private actions exceeds the number of SEC actions. See, e.g., Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience* 31 (European Corporate Governance Inst., Law Working Paper No. 41/2005, 2005; Georgetown Univ. Law Ctr., Pub. Law Research Paper No. 624582, 2005), available at <http://ssrn.com/abstract=624582>. Nevertheless, "the two forms of enforcement often complement each other." Erik Berglöf & Stijn Claessens, *Corporate Governance and Enforcement* 41 (World Bank Policy Research, Working Paper No. 3409, 2004), available at <http://ssrn.com/abstract=625286>.

visions protecting minority shareholders from exploitation<sup>349</sup> serve to strengthen capital markets and encourage economic development.

In sum, share price accuracy and financial liquidity determine market efficiency. Mandatory disclosure and antifraud provisions both contribute to share price accuracy and because both decrease costs and increase fairness for parties participating in capital markets, they also improve liquidity. As Black notes, "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."<sup>350</sup>

### 3. *Global Emulation*

The strong-SEC model works. There is a consensus among state and federal regulators, legitimate issuers, and respected members of the securities industry regarding the desirability of the "disclosure good and fraud bad" meta-script.<sup>351</sup> Legitimate issuers and honest securities professionals do not wish to be deregulated, except at the margin.<sup>352</sup>

The same empirical evidence that emphatically supports mandatory full disclosure, antifraud enforcement, insider trading prohibition, and corporate governance reform has helped the American theory of regulation spread around the world. Although the heavy-

<sup>349</sup> See Jere R. Francis et al., *The Role of Accounting and Auditing in Corporate Governance and the Development of Financial Markets Around the World*, 10 ASIA-PAC. J. ACCT. & ECON. 1, 3 (2003) (finding that accounting standards are more transparent and disclosures more timely in countries with strong protections for minority investors); Simon Johnson et al., *Tunneling*, 90 AM. ECON. REV. (PAPERS & PROC.) 22, 26 (2000) (finding that legal protection of minority shareholders promotes overall economic development); Bernard S. Black et al., *Does Corporate Governance Affect Firm Value?: Evidence from Korea*, 22 J.L. ECON. & ORG. (forthcoming 2006) (finding that higher levels of corporate governance protection among South Korean firms increased their valuation); Rafael La Porta et al., *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002) (finding that common law jurisdictions' legal protections for minority shareholders increase firms' valuations); Christian Leuz et al., *Investor Protection and Earnings Management: An International Comparison* (MIT Sloan Sch. Of Mgmt., Working Paper No. 4225-01, 2002), available at <http://ssrn.com/abstract=281832>.

<sup>350</sup> Bernard S. Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 J. SMALL & EMERGING BUS. L. 91, 92-93 (1998); see also Berglöf & Claessens, *supra* note 348, at 29 (surveying the empirical literature and concluding that "[o]nly a combination of strong investor rights and an efficient judicial system leads to well-developed financial markets").

<sup>351</sup> See Langevoort, *supra* note 348, at 10. Ronald Chen and Jon Hanson use the term "meta-script" in referring to the structure underlying policymaking. Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1 (2004).

<sup>352</sup> Langevoort explains:

After all, most securities regulation is just a solution to the economists' lemons problem, and firms (both issuers and those in the securities industry) on the more legitimate end of the scale appreciate a mechanism that helps separates [sic] out the lemons from the rest of the fruit. Investor confidence generates wealth for those who supply the relevant goods.

Langevoort, *supra* note 348, at 10-11.

handed extraterritorial application of Sarbanes-Oxley causes European and Asian companies and countries to grouse about American securities law, those companies and countries have for years been moving toward the American strong-SEC model. Although the convergence will likely never be complete because of cultural differences and path dependence, the trend will inevitably continue.<sup>353</sup>

a. *A Central Agency*

In recent years, every EU member has created its own version of the SEC, not because of requirements, but because of the obvious success of American capital markets operating under the SEC's protective umbrella.<sup>354</sup> The United Kingdom has created the Financial Services Authority (FSA),<sup>355</sup> Germany the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin),<sup>356</sup> France the Autorité des Marchés Financiers (AMF),<sup>357</sup> and Spain the Comisión Nacional del Mercado de Valores (CNMV).<sup>358</sup> Asian nations have followed suit. For example, China

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<sup>353</sup> Even the most controversial provision of Sarbanes-Oxley, section 404's expensive rules on internal financial controls, were serving as the model for contemplated Japanese reform in December 2004, after that country's version of the SEC found that one in ten listed companies had provided false financial statements. See David Ivison & Barney Jopson, *Deceit Revealed in Japanese Companies*, FIN. TIMES, Dec. 21, 2004, at 12. Furthermore, anticipating section 404, the U.K.'s Hampel Committee and Cadbury Committee both suggested that boards of directors should evaluate their firms' systems of internal control and risk management. See Cynthia A. Williams & John M. Conley, *An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493 (2005); see also Peggy Hollinger, *French Call for Common Standards Governance*, FIN. TIMES, Jan. 14, 2005, at 16 (noting that the French stock market regulator recently advocated a common European internal control standard); Bruce Zagaris, *European Commission Proposal on Corporate and Financial Malpractice*, INT'L ENFORCEMENT L. REP., Jan. 2005, at 6 (noting that in response to the Parmalat and other scandals, the Commission of the European Communities recommended new initiatives to strengthen internal financial controls along the lines of section 404).

<sup>354</sup> See 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.").

<sup>355</sup> See SPENCER, *supra* note 87, at 40 (noting that the British system is similar to the U.S. regulatory regime); Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319 (2003) (comparing and contrasting strong regulators).

<sup>356</sup> See Rosa M. Lastra, *The Governance Structure for Financial Regulation and Supervision in Europe*, 10 COLUM. J. EUR. L. 49, 51 (2003) (discussing the creation of BaFin).

<sup>357</sup> See W Paul Bishop, *Recent Developments in Corporate Governance Practices in France*, in INT'L FIN. L. REV., CORPORATE GOVERNANCE 97, 97-101 (describing the circumstances of AMF's creation); Samer Iskandar, *FN Financial Profile: Michel Prada, AMF Chairman, Keeps France on the Road to Radical Reform*, FIN. NEWS ONLINE, Oct. 25, 2004 (noting that AMF's chair believes its structure is most similar to that of the United States' SEC).

<sup>358</sup> See Samuel Wolff, *Implementation of International Disclosure Standards*, 22 U. PA. J. INT'L ECON. L., 91, 98 n.39 (2001).

has created the China Securities Regulatory Commission (CSRC),<sup>359</sup> Japan the Financial Services Agency (FSA),<sup>360</sup> and South Korea the Financial Supervisory Commission (FSC).<sup>361</sup>

The world investor community has found persuasive evidence that a central authority, such as the SEC, reduces financing costs for issuers by providing more credibility to a market than could exist if private parties negotiated disclosure or securities exchanges alone regulated it. Central agencies are particularly important outside the United States because other nations' private enforcement mechanisms are not as effective as the United States'.<sup>362</sup> Additionally, European regulators and the SEC are working together to further the convergence of European and U.S. securities regulation.<sup>363</sup>

#### b. *Mandatory Disclosure*

The United States and the United Kingdom have long required full disclosure because share ownership of public companies is more widely dispersed<sup>364</sup> than in other nations. Nonetheless, even in nations with more concentrated ownership structures, lawmakers value mandatory disclosure because it minimizes the illicit diversion of corporate assets by controlling shareholders and promotes competition against established firms.<sup>365</sup>

Even before Sarbanes-Oxley, the Organisation for Economic Co-operation and Development (OECD) studied corporate governance issues.<sup>366</sup> In 1999, the OECD adopted principles that recommended U.S.-style mandatory corporate disclosure.<sup>367</sup> The EU nations realize

<sup>359</sup> See Jiangyu Wang, *Dancing with Wolves: Regulation and Deregulation of Foreign Investment in China's Stock Market*, 5 *ASIAN-PAC. L. & POL'Y J.* 1, 8-9 (2004), <http://www.hawaii.edu/aplpj/pdfs/v5-01-Wang.pdf> (discussing the CSRC and the issues it faces).

<sup>360</sup> See Markham, *supra* note 355, at 320.

<sup>361</sup> See Karen Harris, *Anticipatory Regulation for the Management of Banking Crises*, 38 *COLUM. J. L. & SOC. PROBS.*, 251, 271 (2005).

<sup>362</sup> See Gerard Hertig, *Convergence of Substantive Law and Convergence of Enforcement, A Comparison*, in *CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE* 328, 332 (Jeffrey N. Gordon & Mark J. Roe eds., 2004) (noting that Japan and the EU nations are emulating a strong-SEC model "because mandating transparency is considered to be ineffective if enforcement is left to private parties").

<sup>363</sup> See Ian Bickerton, *SEC and CESR to Work Together*, *FIN. TIMES*, June 5, 2004, at 8.

<sup>364</sup> See Ferrell, *supra* note 222, at 11.

<sup>365</sup> See *id.* at 19-25.

<sup>366</sup> See Organisation for Economic Co-operation and Development, <http://www.oecd.org/home> (last visited Feb. 19, 2006).

<sup>367</sup> See *ORG. FOR ECON. CO-OPERATION & DEV., AD HOC TASK FORCE ON CORPORATE GOVERNANCE, OECD PRINCIPLES OF CORPORATE GOVERNANCE* (April 16, 1999), <http://www1.worldbank.org/publicsector/legal/OECD%20Corporate%20Governance%20Principles.pdf>.

that “[r]obust, comparable and transparent financial information is fundamental to the successful operation” of EU markets.<sup>368</sup>

Although some important differences remain in the details, there has been a convergence in recent years, and “it seems that the capital markets and regulation are inexorably pressing European and Japanese companies toward the U.S.-U.K. model of financial reporting.”<sup>369</sup> Both the reach and the scope of mandatory disclosure requirements in primary and secondary markets around the world are already broadly similar to the U.S. model.<sup>370</sup> This is true not only of initial and continuous reporting, but also of reporting in extraordinary transactions, such as tender offers.<sup>371</sup>

Traditionally, significant accounting differences among jurisdictions have dramatically affected the accuracy and reliability of required financial reporting.<sup>372</sup> While meaningful accounting differences remain, all major jurisdictions are moving toward the Anglo-Saxon accounting model to provide improved accuracy, comparability, and meaningfulness to investors and creditors.<sup>373</sup>

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<sup>368</sup> Ian P. Dewing & Peter O. Russell, *Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Developments Before and After Enron*, 42 J. COMMON MKT. STUD. 289, 289 (2004).

<sup>369</sup> Gerard Hertig & Hideki Kanda, *Creditor Protection*, in ANATOMY OF CORPORATE LAW, *supra* note 228, at 71, 82; *see also* Manuel P Barrocas, *Portugal's Answer to Sarbanes-Oxley*, INT'L FIN. L. REV., May 2003, at 57, 57 (noting Portugal's 1999 Capital Market Act that imposed new disclosure requirements with attendant penalties for disobedience).

<sup>370</sup> *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, in CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, *supra* note 362, at 33, 53 (noting that “major jurisdictions outside of the US are reinforcing their disclosure systems” and that “the subject matter of mandatory disclosure for public companies is startlingly similar across the major commercial jurisdictions today”); Hertig, *supra* note 362, at 332 (“There is now an EU law framework with transparency requirements that are becoming increasingly similar to those in the US—a trend that should be reinforced by post-Enron regulatory reforms.”).

<sup>371</sup> *See* Paul Davies & Klaus Hopt, *Control Transactions*, in ANATOMY OF CORPORATE LAW, *supra* note 228, at 157, 175 (“[A] centerpiece of all takeover regulation [in major nations] . . . is an elaborate set of provisions mandating disclosure by both the target board and the acquirer for the benefit of target shareholders.”).

<sup>372</sup> Rajan and Zingales note that in Germany, until at least recently, “misleading investors is not an aberration but a tenet of policy.” RAJAN & ZINGALES, *supra* note 269, at 250. They provide the well-known example of Daimler-Benz, which in 1998 merged with Chrysler Corporation to form DaimlerChrysler. In 1993, Daimler-Benz showed a half-year profit of DM 168 million according to German accounting standards; that profit changed to a DM 949 million loss when the company had to conform to GAAP in order to list with the NYSE. *See id.* at 250–51.

<sup>373</sup> *See* Hansmann & Kraakman, *supra* note 370, at 53 (noting that “uniform accounting standards are rapidly crystallizing” into two sets of well-defined standards, American GAAP and the International Accounting Standards (IAS) and that these two standards will probably converge further “if only because of the economic savings that would result from a single set of global accounting standards”); Hertig et al., *supra* note 228, at 201–02. Although EU and Japanese accounting remains slightly more opaque than U.S.-U.K. standards, “pressure from the international capital market, and the desire to access the U.S.

c. *Strong Antifraud Rules*

Most developed nations have recently adopted new or stronger antifraud rules and have strengthened means of enforcement.<sup>374</sup> For example, the EC Public Offer Prospectus Directive of 1989 required member nations to adopt a system of mandatory disclosure for public offerings and punishment for misrepresentations analogous to those that the Securities Act of 1933 addressed in the United States.<sup>375</sup> In the last decade or so, Germany has expanded regulators' authority and reduced impediments to misled investors bringing lawsuits.<sup>376</sup> Several European nations have begun studying American-style class actions as a means to protect shareholders and consumers.<sup>377</sup> Japan, China, Korea, and other Asian nations have also adopted U.S.-style securities fraud statutes and strengthened shareholder rights.<sup>378</sup> Similarly, all major nations regulate their capital markets and attendant institutions, such as stock exchanges and stock brokerage firms.<sup>379</sup> EU nations are even considering strengthening private enforcement in order to support the centralized agencies they have established.<sup>380</sup>

Overall, transnational studies indicate a strong correlation between the maturity and size of capital markets and the aggressiveness with which they protect investors. Therefore, as EU and other markets evolve they will most likely emulate the U.S. fraud-fighting model even more closely.<sup>381</sup>

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equity market in particular, have forced the largest EU and Japanese firms to adopt accounting practices that are comparable to those used by U.S. firms." *Id.* at 202.

<sup>374</sup> Hertig et al., *supra* note 228, at 211 (noting that negligence and antifraud "[s]tandards backed by the potential for large damage awards are important in every regime of securities regulation").

<sup>375</sup> David B. Guenther, Note, *The Limited Public Offer in German and U.S. Securities Law: A Comparative Analysis of Prospectus Act Section 2(2) and Rule 505 of Regulation D*, 20 MICH. J. INT'L L. 871, 927-28 (1999) (noting the "fundamental commonalities" between the 1933 Securities Act and Germany's Prospectus Act passed in response to the EC's Public Offer Prospectus Directive).

<sup>376</sup> See Peter M. Memminger, *The New German Insider Law: Introduction and Discussion in Relation to United States Securities Law*, 11 FLA. J. INT'L L. 189, 193-94 (1996).

<sup>377</sup> See Brendan Malkin, *UK Firms Gear Up as Class Action Culture Hits Europe*, THE LAWYER, Feb. 7, 2005, at 72, 72 (noting that Sweden, Germany, France, and the Netherlands are all studying class actions, and Russia and the Ukraine are "getting their first taste of multi-party disputes").

<sup>378</sup> See, e.g., Bernard S. Black et al., *Shareholder Suits and Outside Director Liability: The Case of Korea* (Stanford Law Sch., John M. Olin Program in Law & Econ., Working Paper No. 47/2005, 2005), available at <http://ssrn.com/abstract=628223> (detailing South Korea's reforms, including the facilitation of securities class action lawsuits).

<sup>379</sup> See Hertig et al., *supra* note 228, at 193.

<sup>380</sup> See Hertig, *supra* note 362, at 332-33.

<sup>381</sup> See Hertig et al., *supra* note 228, at 213 (noting that "[s]trikingly, the aggressiveness of the legal regimes of investor protection seems roughly to match the size and maturity of national capital markets.").

d. *Insider Trading Prohibitions*

Within roughly the past fifteen years, EU members, Japan, China, and other countries have prohibited insider trading in similar circumstances and on substantially the same grounds as the United States.<sup>382</sup> As arguments favoring the efficiency of insider trading rang increasingly hollow,<sup>383</sup> appeals to fairness sharpened,<sup>384</sup> and empirical evidence demonstrated that bans on insider trading strengthened the performance of capital markets,<sup>385</sup> international acceptance of insider trading waned. There is a burgeoning international consensus that the inherent unfairness of insider trading undermines the integrity of securities markets and discourages regular investors from playing what they perceive as a loaded game.<sup>386</sup>

A key development evidencing this emerging consensus was the 1989 EU Council Directive mandating that member states enact specific rules to curb insider trading activities.<sup>387</sup> Germany, desiring to improve its securities markets and make them more inviting to lay investors, drove this change.<sup>388</sup> Among EU nations, only France and the United Kingdom had preexisting insider trading regimes of any significance.<sup>389</sup> The Directive was patterned, however, more on American law than on either the French or British rules. By the turn of the millennium, virtually all developed nations had enacted U.S.-style insider trading laws and enforcement actions in the United Kingdom, France, Germany, China, Japan, South Korea, and elsewhere were no longer rare.<sup>390</sup>

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<sup>382</sup> See Gerard Hertig & Hideki Kanda, *Related Party Transactions*, in ANATOMY OF CORPORATE LAW, *supra* note 228, at 101, 113 (“[A]ll major jurisdictions now impose some kind of direct ban on insider trading on the basis of non-public information about the value of issuer securities.”); Amir N. Licht, *International Diversity in Securities Regulation: Roadblocks on the Way to Convergence*, 20 CARDOZO L. REV. 227, 233 (1998) (noting that the SEC and the International Organization of Securities Commissions have brought about a convergence of insider trading regulation based on the U.S. model).

<sup>383</sup> See, e.g., Mark Klock, *Are Wastefulness and Flamboyance Really Virtues? Uses and Abuse of Economic Analysis*, 71 U. CIN. L. REV. 181, 247–48 (2002) (refuting arguments that insider trading is efficient and beneficial).

<sup>384</sup> See Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119 (arguing that economic rationales for insider trading have not successfully refuted the importance of fairness arguments); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375 (1999) (providing a rational justification for banning insider trading based on a deontological moral principle).

<sup>385</sup> See *supra* note 347.

<sup>386</sup> See SHEN-SHIN LU, INSIDER TRADING AND THE TWENTY-FOUR HOUR SECURITIES MARKET: A CASE STUDY OF LEGAL REGULATION IN THE EMERGING GLOBAL ECONOMY 17–21 (1999) (noting the unfair advantage insider trading provides insiders).

<sup>387</sup> See Memminger, *supra* note 376, at 193–94.

<sup>388</sup> See *id.*

<sup>389</sup> See *id.*

<sup>390</sup> See, e.g., *German Authorities Suspect Insider Trading of Medion Shares*, BORSEN-ZEITUNG, Dec. 24, 2004 (noting a new German investigation into insider trading); *Messier in Jail for Vivendi Fraud Probe*, TAIWAN NEWS, June 23, 2004 (noting that former high-flying French



Without question, nations around the world are moving inexorably toward the American strong-SEC model.<sup>391</sup> For political reasons, they cannot appear happy about it. They must grumble about American legal imperialism.<sup>392</sup> Yet the strong-SEC system works, as the United States' economy demonstrates. Because these nations wish to attract capital, develop their securities markets, and strengthen their economies, they must emulate the United States,<sup>393</sup> and to a lesser degree, the United Kingdom.<sup>394</sup> While, for reasons of path dependence and cultural diversity, the convergence will never be complete, the convergence is already quite substantial.

### CONCLUSION

In the end, the key question is not whether the government is preferable to the market as an allocator of capital and resources. In that contest, the market easily wins. The relevant question is whether the government can, with the right tools, make securities markets more efficient than they would be without governmental assistance.

Two competing theories address this question. One vision relies on market participants, including issuing companies, managers, directors, auditors, stockbrokers, stock analysts, and others, to advance

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businessman Jean-Marie Messier was in jail under suspicion of insider trading in Vivendi stock); *Spanish Regulator Opens Inquiry into Insider Trading in Adeasa Prior to Autogrill Takeover Bid*, *IL SOLE*, Feb. 3, 2005 (noting a new Spanish investigation into insider trading); Mariko Sanchanta, *Tsutsumi Faces Tough Sentence*, *FIN. TIMES*, Sept. 12, 2005, at 28 (noting that Yoshiaki Tsutsumi, formerly the world's richest man, had pled guilty to insider trading charges in Japan). This is not to say that such prosecutions are yet commonplace in these nations. They are not.

<sup>391</sup> This discussion should make clear that the convergence is not entirely one-way. For example, the SEC is seriously considering moving toward the principles-based accounting system more popular in the EU and away from the rules-based system currently used in the United States.

More importantly, at the big-picture level it is very likely that the United States will move more toward the EU model in the area of corporate social reporting (CSR). Because investors as well as others are taking an increasingly broader view of the responsibilities of corporations, American firms will have to catch up to European firms in CSR. See Cynthia A. Williams and John M. Conley, *An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct* (UNC Legal Studies, Research Paper No. 04-09, 2004), available at <http://ssrn.com/abstract=632347> (making this argument and showing that the United Kingdom may be setting the new trend).

<sup>392</sup> Karmel notes: "It would appear that the reaction of foreign issuers to Sarbanes-Oxley is following a familiar pattern—vigorous protest by foreign issuers to being subjected to new SEC regulations, followed by responsive actions by foreign regulators to impose some of the new standards, likely to lead to accommodations by both the foreign issuer community and the SEC to a new regime." Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 *STETSON L. REV.* 849 (2004).

<sup>393</sup> See Ehud Kamar, *Beyond Competition for Incorporations*, 94 *GEO. L.J.* (forthcoming 2006) (noting that competition for investment is forcing European nations to reform their corporate governance along lines consistent with the U.S. system).

<sup>394</sup> See *id.* at 51 (noting that EU nations are using "Anglo-American corporate law as a reference point").

their long-term reputational interests by acting rationally. In this vision, managers voluntarily bond themselves to the market by disclosing optimal amounts of information, subjecting themselves to securities fraud and insider trading liability, and embracing corporate governance best practices. Auditors seldom act recklessly. Stock analysts burnish their reputations by recommending only the stocks they believe in and forfeiting any opportunity to garner investment banking revenue for their employers, even if it would mean greater gain in the short run.

The other story recognizes the unavoidable agency problem and addresses the problem with two simple rules: Mandatory disclosure is good and fraud is bad. Required disclosure produces more information than voluntary disclosure ever has or would. The mandatory feature allows quality firms to signal their quality and avoid the “market for lemons” problem. Punishing fraud promotes both fairness and efficiency values. Investors therefore feel confident investing.

The best empirical evidence strongly supports the second theory. Around the world, governments interested in enlarging their economies and strengthening their capital markets embrace the strong-SEC model by creating central securities agencies. These governments both charge such agencies with enforcing mandatory disclosure rules, antifraud proscriptions, and insider trading prohibitions, and supplement the agencies’ resources with private enforcement provisions. The best evidence available indicates that this is the future of securities regulation.

