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## Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment

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RETAINING MANDATORY SECURITIES DISCLOSURE:  
WHY ISSUER CHOICE IS NOT INVESTOR  
EMPOWERMENT

Merritt B. Fox\*

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## INTRODUCTION

PROFESSOR Roberta Romano proposed recently that the current mandatory system of federal securities law be replaced by a system of issuer choice.<sup>1</sup> A U.S. issuer desiring not to be bound by the existing federal regime would be allowed to select instead the securities law regime of any of the fifty states, the District of Columbia, or any foreign country.<sup>2</sup> This reform, she argues, would empower investors.<sup>3</sup> It would eliminate the federal government's current regulatory monopoly, where officials make the rules to best satisfy their own agendas, and create in its place a market with multiple jurisdictions competing to offer issuers the regulations that maximize share value.<sup>4</sup> Professors Stephen Choi and Andrew Guzman have proposed essentially the same reform.<sup>5</sup> To Choi and Guzman, however, the primary advantage of issuer choice is that it would enable each issuer to choose from among a range of regimes the one best suited to the issuer's particular securities regulation

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<sup>1</sup> See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359, 2361-62 (1998).

<sup>2</sup> See *id.*

<sup>3</sup> See *id.* at 2362.

<sup>4</sup> See *id.*

<sup>5</sup> See Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 *Nw. J. Int'l L. & Bus.* 207, 228-32 (1996) [hereinafter Choi & Guzman, *Dangerous Extraterritoriality*]; Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 *S. Cal. L. Rev.* 903, 907 (1998) [hereinafter Choi & Guzman, *Portable Reciprocity*].

needs.<sup>6</sup> As a result of these proposals, issuer choice is beginning to attract serious attention in policy circles.<sup>7</sup>

This Article argues that, despite these apparent attractions, we should reject issuer choice and retain the current mandatory system. My focus is on the impact of issuer choice on disclosure regulation, the most important component of securities law subject to the proposed reform.<sup>8</sup> Giving U.S. issuers the right to choose their disclosure regime would likely decrease, not increase, U.S. economic welfare. For each U.S. issuer, there is a socially optimal level of disclosure. More information about the issuer and the resulting increase in its share price accuracy produces social benefits in the form of improved selection of new investment projects, improved managerial performance, and reduced investor risk. More information, however, entails additional social costs as well, such as the time and talent of lawyers and accountants as well as the diver-

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<sup>6</sup> See Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 5, at 232; Choi & Guzman, *Portable Reciprocity*, *supra* note 5, at 916-17.

<sup>7</sup> See, e.g., *The Market for Regulation*, *Economist*, Mar. 7, 1998, at 82 (discussing Romano's proposal). On June 12, 1998, the American Enterprise Institute ("AEI") held a seminar in Washington, D.C. entitled "A Market Approach to Securities Regulation" featuring Professor Romano. See AEI Conference Summaries: A Market Approach to Securities Regulation (visited May 19, 1999) <<http://www.aei.org/cs/cs9738.html>>.

<sup>8</sup> In their articles proposing issuer choice, Romano and Choi and Guzman also devote the largest portion of their respective discussions to matters involving disclosure regulation. The other major component of securities regulation concerns fraud: making false or misleading statements in connection with a securities transaction or trading on the basis of inside information. Since both of these activities, like disclosure, involve the quality of information available to the investing public, many of the arguments against issuers choosing their own disclosure regimes translate readily into arguments against issuers choosing their own antifraud regimes as well. In at least one regard, the case against issuer choice in antifraud regulation is even stronger than the case against issuer choice in disclosure regulation. Antifraud regulation applies to face-to-face transactions as well as to impersonal market ones. In a market transaction, the efficient market hypothesis suggests that the effect on share value arising from the issuer's choice of regulatory regime will be reflected in the market price even if any particular buyer is unaware of the choice or its implications. All that the hypothesis requires is that some persons trading in the market be aware of these things. Thus, the buyer, whether aware or not, is, through a lower price, compensated *ex ante* for any inadequacies in the chosen regime regardless of the negative effects these inadequacies may have on the economy as a whole. See *infra* Section I.C.3. In a face-to-face transaction where the buyer may be unaware of the issuer's choice of regime or its implications, there is no assurance of such *ex ante* compensation because there is no opportunity for more informed traders to affect the terms of the transaction.

sions of management and staff time involved in gathering and providing the information.<sup>9</sup> The issuer's socially optimal level of disclosure is reached when the marginal social benefits equal the marginal social costs. Unfortunately, issuer choice would lead U.S. issuers to disclose at a level significantly below this social optimum.

To readers steeped in the history of corporate and securities law scholarship, arguments about mandatory disclosure will have a familiar, if distant, ring. While most commentators took mandatory disclosure's desirability as a given for the first three decades following passage of the Securities Act of 1933 ("Securities Act")<sup>10</sup> and the Securities Exchange Act of 1934 ("Exchange Act"),<sup>11</sup> a heated debate broke out in the mid-1960s.<sup>12</sup> Opponents argued that market forces alone could provide sufficient incentives for issuers to disclose at their socially optimal levels. By the mid-1980s, however, this debate had largely died out. A rough consensus returned, with even most economics-oriented legal academics, ranging from Professor John Coffee to Professors Frank Easterbrook and Daniel Fischel, concluding that, on balance, mandatory disclosure should be retained.<sup>13</sup>

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<sup>9</sup> See *infra* Section I.B for a fuller discussion of the social costs of disclosure.

<sup>10</sup> Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

<sup>11</sup> Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78ll (1994)).

<sup>12</sup> The debate began with empirical work by economists purporting to show that the current mandatory U.S. disclosure regime produces no benefit. See, e.g., George J. Stigler, *Public Regulation of the Securities Markets*, 37 *J. Bus.* 117, 121-24 (1964) [*hereinafter* Stigler, *Public Regulation*]; George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 *Am. Econ. Rev.* 132, 153 (1973). This work and the work of other economists who came to opposing conclusions is discussed *infra* Part II. Signaling—the idea that issuers with good news will want to disclose it and that the market will infer from the silence of the rest that they do not have good news—added a theoretical component to the case against mandatory disclosure. See, e.g., Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in *Issues in Financial Regulation 177*, 183-93 (Franklin R. Edwards ed., 1979). Signaling theory is discussed *infra* Section I.C.2.

<sup>13</sup> See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *Va. L. Rev.* 717, 721-23 (1984) [*hereinafter* Coffee, *Market Failure*]; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 *Va. L. Rev.* 669, 672-73 (1984). Until now, Jonathan Macey was the only prominent dissenter, arguing that the operation of private market forces would lead to a socially efficient level of disclosure: "As markets have become more efficient, society's need to devote resources to support a statutory regime of

The proponents of issuer choice are clearly challenging this consensus. Admittedly, they offer a different alternative to mandatory disclosure from the one presented by its earlier opponents. Mandatory disclosure's early critics would have allowed issuers to be bound by no regime. Romano and Choi and Guzman, on the other hand, would require each issuer to follow some disclosure scheme but would permit the issuer to choose which one. This new alternative to mandatory disclosure, however, shares with the old alternative at least one core feature: Each grants issuers substantial freedom to choose their own disclosure levels. Concern with how issuers would use such freedom<sup>14</sup> is at the heart of the prevailing consensus for retaining mandatory disclosure.

This Article advances the reopened debate over mandatory disclosure in two ways. First, it demonstrates that the proponents of issuer choice have not effectively countered the arguments that have formed the basis of the prevailing consensus for retaining mandatory disclosure. While this consensus was formed when the

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mandatory disclosure designed and enforced by the SEC has disappeared. Any information that was supplied by the force of law now is supplied by the marketplace." Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 *Cardozo L. Rev.* 909, 928 (1994). This dissent is questionable, however, since evidence that markets efficiently impound the information that issuers choose to release in no way shows that issuers will choose to release as much information as is socially optimal.

<sup>14</sup>It is quite possible that issuer choice would grant issuers as much freedom to choose their level of disclosure as would no regulation at all. This result would occur if each jurisdiction, in its effort to attract issuers, chose to appeal to the preferences of a particular niche of issuers. See Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *Fordham L. Rev.* 1855, 1878 (1997) [hereinafter Choi & Guzman, *National Laws*] (referring to this situation as a "separating equilibrium"). Under these circumstances, if a significant number of issuers wanted to disclose at any given level of disclosure (including disclosing essentially nothing), they would be free to do so because one or more jurisdictions would design their regimes to meet this demand. It is also possible, however, that each jurisdiction would try to maximize the number of issuers utilizing its regime by appealing to the broadest segment of the market, i.e., by choosing the level that minimizes the average distance between its requirements and the preferences of each of the world's issuers. See *id.* at 1879-80 (referring to this situation as a "pooling equilibrium"). While this occurrence would result in all jurisdictions offering regimes requiring the same level of disclosure, the level chosen would still raise the same kind of concerns that generated the prevailing consensus against switching from mandatory disclosure to no regulation. After all, the level of disclosure would still be determined by preferences of issuers, and, as we will see *infra* Part I, each issuer would prefer a level of disclosure that is lower than what is socially optimal for it. These points are discussed in greater detail *infra* Section III.A.

alternative to mandatory disclosure was total abandonment of regulation, the proponents of issuer choice have not shown how the arguments that form the basis of this consensus have any less force when applied to the new alternative of issuer choice.<sup>15</sup> Nor have the proponents offered persuasive, more general rebuttals to these arguments. Second, this Article advances the affirmative case for mandatory disclosure by identifying several new and important arguments in favor of retaining the current mandatory disclosure regime.

Part I of this Article presents a theoretical analysis of the kind of disclosure regime that issuers are likely to adopt under a system of issuer choice. An issuer's managers, not its investors, will in the first instance make this choice. I show that disclosure's costs to these managers are greater than its social costs and that disclosure's benefits to them are less than its social benefits. Each issuer will accordingly choose a regime requiring significantly less disclosure than is socially optimal. Part II evaluates the existing empirical literature bearing on the question of whether the current system of mandatory disclosure enhances or diminishes social welfare. I find the results of these empirical studies to be inconclusive. I also show that the question will probably never be empirically resolved one way or the other. Highlighting this difficulty reveals how inappropriate it is for the proponents of issuer choice to try to put the empirical burden on scholars advocating retention of the current system, particularly given the strong theoretical argument that issuer choice would lead to underdisclosure. Part III appraises the argument advanced by Professors Choi and Guzman that issuer

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<sup>15</sup> This is not to say that there are not differences that make issuer choice superior to total abandonment of regulation—there are. Rather, this observation only seeks to point out that issuer choice and total abandonment of regulation share features that make each of them inferior to mandatory disclosure. Compared to total abandonment of regulation, issuer choice has at least two advantages. First, it permits an issuer, at the time of a new issue of securities, to provide assurances to its investors that if its disclosures do not turn out to be a true and complete set of answers to a set of questions provided by the chosen regime, the issuer will face governmental sanctions. In addition, issuer choice also allows the issuer to give a commitment, backed by governmental enforcement and sanctions, to provide an ongoing stream of periodic information at the level required by the chosen regime. In each case, however, since the issuer is free to choose its regime, it is free to choose (1) which information will have government sanction-backed assurances of truthfulness and (2) what level of information the issuer will commit to provide periodically.



choice would better accommodate differences among U.S. issuers in their optimal levels of disclosure. I find that in practice issuer choice would be unlikely to realize this hoped-for result. Part IV examines the transition costs of adopting issuer choice. Part V considers the argument that issuer choice improves capital mobility and reduces costs by permitting foreign issuers to choose their own regime when their shares are offered or traded in the U.S. market. I argue that the same advantages can be obtained with far fewer problems by maintaining the current mandatory U.S. regime but redirecting its reach so that it applies only to U.S. issuers. Part VI concludes.

The new round of debate concerning mandatory disclosure has sharpened our understanding of the role of disclosure regulation, and the proponents of issuer choice deserve credit for initiating this process. But ideas that are good for provoking debate are not necessarily good policy. A switch to issuer choice would result in issuers disclosing significantly less than is socially optimal. This consequence is undesirable unless the existing mandatory regime results in issuer disclosure behavior that deviates even further from what is socially optimal. There is no reason to presume that it does, and to date the proponents of issuer choice have offered no sustained argument, theoretical or empirical, to the contrary.

### I. THE NATURE OF THE DISCLOSURE REGIMES ISSUERS WILL CHOOSE

The obvious starting point for an inquiry into the social welfare effects of adopting issuer choice is to ask what kind of disclosure regime each U.S. issuer would select if given the choice. Fundamental to the stories of both Romano and Choi and Guzman is a belief that the issuer will choose, from the regimes available, the one requiring it to disclose at the most socially beneficial level.<sup>16</sup> In

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<sup>16</sup> Issuer choice will create an incentive for each jurisdiction to shape its requirements to attract as many issuers as possible. Romano sees this effect as a virtue. In her eyes, the incentive created by issuer choice would be a useful antidote to the tendency of the SEC, as a "monopolist" regulator, to adopt the rules that suit its own agenda rather than the rules that would maximize share value. See Romano, *supra* note 1, at 2362. For us to be assured that competition will in fact move requirements in that direction, however, we would need to assume that, when faced with a choice, an issuer will choose the more socially beneficial regime over the less beneficial one.

fact, each issuer will prefer a regime that requires it to disclose substantially less.

*A. The Persons Choosing an Issuer's Regime:  
Private versus Social Optimality*

Under the issuer choice approach, an issuer's managers are the individuals who actually choose the issuer's disclosure regime.<sup>17</sup> Thus, it is on the preferences and incentive structures of the managers that we must initially focus, not on those of the investors. If the choice is to be made at the time of an initial public offering ("IPO"), the managers will themselves be, or be allied with, owners of a substantial portion of the issuer's shares. If the choice is to be made when the corporation is already a large, established pub-

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Similarly, Choi and Guzman see issuer choice and its ensuing jurisdictional competition as making available a range of regimes, each with its own level of required disclosure. See Choi & Guzman, *Portable Reciprocity*, supra note 5, at 916–17. Each issuer, rather than being forced to comply with a purported "one-size-fits-all" mandatory regime, can instead be matched with the regime most suitable for it from a social welfare point of view. Again, there is no assurance that such a matching will occur unless we assume that when faced with a range of choice, the issuer will choose the most socially beneficial regime available.

<sup>17</sup> Professor Romano contemplates a system in which, for any given issuer, one sovereign—the U.S. federal government, a state, the District of Columbia, or a foreign country—would have jurisdiction over all transactions involving the issuer's securities. See Romano, supra note 1, at 2362. She contemplates three possible ways to choose this sovereign: (1) The firm's founders could select the sovereign through a choice of law clause in the firm's articles of incorporation, (2) the founders' choice of the state of incorporation could be deemed the jurisdiction governing securities transactions as well, or (3) the firm's principal place of business could supply the securities regulation regime. See *id.* at 2408–10. Under any of these schemes, management could subsequently change the jurisdiction governing securities transactions, but to do so the managers would need to obtain the approval of the issuer's shareholders. See *id.* at 2415–16. Romano does not explicitly address the question of how existing, publicly traded issuers would be treated at the time that issuer choice is adopted. She presumably intends, however, that these issuers initially would continue to fall under the U.S. federal regime until and unless management decides to switch to some other jurisdiction and obtains the necessary shareholder approval. See *id.* at 2401–02, 2415–18; *infra* Section IV.A. For a discussion of why I believe that shareholder approval is not a meaningful check on a management decision to make such a switch, see *infra* note 69.

Professors Choi and Guzman suggest that at the time of each new issue of securities, an issuer's management would choose the jurisdiction whose rules would govern transactions in securities of that particular issue. See Choi & Guzman, *Portable Reciprocity*, supra note 5, at 922. They propose no exit mechanism once that choice is made.

licly traded corporation, the managers may own only a tiny percentage of the issuer's shares.

Assume that the managers have a range of regimes from which to choose, each requiring a different level of disclosure. A regime requiring greater disclosure involves both added costs to and added benefits for the managers. The marginal cost of additional disclosure tends to rise; the marginal benefit tends to decline.<sup>18</sup> As depicted in Figure 1, the managers will choose the regime that requires the issuer to disclose closest to the level at which the marginal increase in cost to the managers (the private marginal cost) equals the marginal increase in benefit to them (the private marginal benefit). This point, however, will fall below the issuer's socially optimal level of disclosure because, as shown below, over the whole range of levels at which an issuer could disclose, the social marginal cost of an issuer's disclosure is below the private marginal cost to its managers, and the social marginal benefit of its disclosure is above the private marginal benefit to these individuals.<sup>19</sup>

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<sup>18</sup> This somewhat stylized model measures the issuer disclosure level cardinally and, as depicted in Figure 1, shows that the disclosure level has a rising marginal cost curve and a falling marginal benefit curve. This model is a reasonable depiction of the costs and benefits facing managers. The managers first have the issuer release the piece of information that is most beneficial to them relative to its cost, then the piece of information that is next most beneficial relative to its cost, and so on. This behavior corresponds to a situation where the marginal private benefit of disclosure is decreasing and the marginal cost is increasing.

<sup>19</sup> Since there is no reason to believe that the difference between the marginal social benefit and marginal private benefit, or between the marginal social cost and marginal private cost, would increase substantially as an issuer discloses more, the marginal social benefit should, as depicted in Figure 1, also be decreasing and the marginal social cost also be increasing. See *supra* note 18.

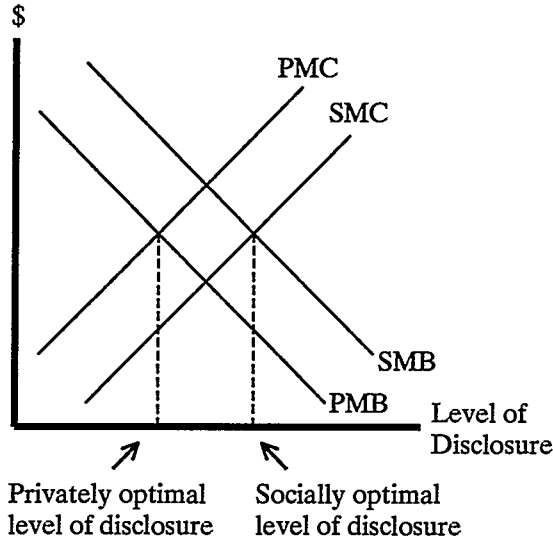


Figure 1.

### B. Costs

#### 1. The Divergence of Private from Social Costs Because of Interfirm Costs

For each *individual* U.S. issuer, a disclosure of information involves two different kinds of costs: “operational” costs and “interfirm” costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the required information. Interfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers. For example, if an issuer discloses that a given line of business is particularly profitable, other firms may be attracted to enter the same market, driving prices, and hence the issuer’s profits, down. At the same time, the issuer’s major suppliers and customers may conclude that in the future they can drive harder bargains with the issuer than they otherwise would have thought possible. Operational costs are costs both to the individual firm and to society as a whole. Interfirm costs, however, are costs only to the individual firm. They are not social costs because the interfirm disadvantages

to the issuer from the disclosure are counterbalanced by the advantages disclosure confers on the other firms.<sup>20</sup> Thus, at all levels of disclosure, an issuer's private marginal costs will exceed its social marginal cost by an amount equal to these interfirm costs. Even managers who completely identify with existing shareholders—managers who seek to maximize share value so that costs to the shareholders are equivalent to costs to them—would therefore choose a regime with a disclosure level below the social optimum.

## *2. Romano's Dismissal of the Importance of the Private/Social Cost Divergence*

This divergence of private from social costs means that issuer choice will lead to market failure and thus presents a serious problem for the proponents of issuer choice. Professor Romano, however, dismisses the importance of the divergence, suggesting that it is "a tenuous rationale for securities regulation."<sup>21</sup> She bases this dismissal on four lines of attack, each of which is unconvincing.

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<sup>20</sup> It can be argued that interfirm costs involve a social aspect as well because the disadvantage to which disclosure puts the issuer relative to its competitors, major suppliers, and major customers leads, as an incidental effect, to a reduction in the issuer's incentives to produce private information in the first place, which hurts the economy's dynamic efficiency. But there are positive incidental effects as well: Increased disclosure enhances competition, and hence static efficiency, by informing competitors where there are profit opportunities, thereby leading to production levels more consistent with marginal cost pricing. Both these incidental effects—negative and positive—are outside the ordinary domain of financial economics, however, and how they balance out is something that the country's governmental authorities should decide. I consider in more detail elsewhere these points and others relating to the private versus social costs of disclosure. See Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 Mich. L. Rev. 2498, 2550–52 (1997) [hereinafter Fox, *Disclosure in a Globalizing Market*]. Other scholars have also commented on the problems for disclosure posed by the existence of interfirm costs. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435, 1490–91 (1992); Coffee, *Market Failure*, supra note 13, at 723–37; Easterbrook & Fischel, supra note 13, at 685–86; Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 Brook. L. Rev. 763, 846–74 (1995).

<sup>21</sup> Romano, supra note 1, at 2426. Professors Choi and Guzman also acknowledge the existence of interfirm costs. See Choi & Guzman, *National Laws*, supra note 14, at 1875. They do not, however, attempt to confront the negative implications of this market failure for the reform they advocate.

*a. The claim that as a matter of theory the divergence of disclosure's social from private cost does not necessarily call for regulation*

Romano's first line of attack is to suggest that even if this divergence between social and private costs exists, the theoretical case for mandatory disclosure is not as clear cut as I suggest:

It can be shown analytically . . . that even in the case of such third-party externalities [i.e., information that would hurt the issuer by helping its competitors], mandatory disclosure is not always optimal compared to voluntary disclosure, and it would in all likelihood be extremely difficult for a regulator to determine when mandatory disclosure is optimal.<sup>22</sup>

She does not explain her assertion, but instead simply cites an article by Ronald Dye.<sup>23</sup> Dye's model, however, applies only in such a restricted range of circumstances as to be essentially useless as a guide to policy.<sup>24</sup> Moreover, when reasonable estimates of the

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<sup>22</sup> Romano, *supra* note 1, at 2368.

<sup>23</sup> See *id.* at 2368 n.23 (citing Ronald A. Dye, *Mandatory Versus Voluntary Disclosures: The Cases of Financial and Real Externalities*, 65 *Acct. Rev.* 1 (1990)).

<sup>24</sup> Ronald Dye contemplates a situation in which an entrepreneur, in advance of a sale of securities to outside investors, commits to providing information that will reduce by some given amount the uncertainty associated with his issuer's future cash flow to shareholders. See Dye, *supra* note 23, at 3–5. Dye compares the amount of disclosure that entrepreneurs can be expected to provide voluntarily with the amount that is socially optimal. Dye considers the consequences of two kinds of third-party effects that can arise from an issuer's disclosure. "Financial externalities," the first kind of third-party effect, occur when an issuer's disclosure reduces uncertainty concerning the future cash flows to shareholders of one or more other issuers but has no effect on the cash flows of these issuers. *Id.* at 2. This "financial externality" effect thus relates to disclosure's "public goods" aspect. See Romano, *supra* note 1, at 2367; *infra* Section I.C.2 (discussing the "public goods" effect as one of the factors causing the social marginal benefit from disclosure to exceed its private marginal benefit). "Real externalities," the second kind of third-party effect, arise when the issuer's disclosure does affect the cash flows of one or more other issuers. Dye, *supra* note 23, at 2. It is this second kind of third-party effect that is the subject of the discussion above and to which Romano refers in the quotation.

Dye concludes that under some circumstances, the voluntary level of disclosure will be at least as great as the socially optimal one, thereby rendering mandatory disclosure unnecessary, while under other circumstances the voluntary level will fall short of that goal. See *id.* at 3. He suggests that in situations where only financial externalities exist, the voluntary level would equal the socially optimal one under a fairly wide range of conditions, but that "where real externalities are present . . . optimal mandatory and equilibrium voluntary disclosure tend to diverge." *Id.* He also suggests that with real externalities, the direction of the divergence—whether voluntary disclosure produces too much information or too little—is unclear in the absence of detailed in-

formation. See *id.* at 19. A number of factors, however, severely limit the generality of Dye's conclusions and render the model relatively useless as a guide to policy.

1. *The empty set of information to which the model applies.* Dye makes two critical assumptions concerning the type of information to which his model applies. One is that management does not know the information that it is committing to provide at the time it makes the commitment. See *id.* at 5. The other is that the information is disclosed prior to sale of the shares. See *id.* at 3-4.

Disclosures made by real-world issuers will almost always fail to conform with one or the other of these assumptions. Before an issuer has public holders of its securities, it has no need to release publicly any information about its financial condition and prospects. When the issuer's entrepreneurs decide to have a public sale of its securities, however, they are likely to decide to release some of this information just before the sale. Strictly speaking, there is no commitment with this release; nothing in advance of the release binds the entrepreneurs to make it. The released information may be accompanied, however, by a pledge that it represents a truthful set of answers to a recognized set of questions. One could characterize certified financials in this fashion, for example. See, e.g., Easterbrook & Fischel, *supra* note 13, at 675. But even if Dye's use of the term "commitment" is stretched to include such a pledge, the commitment is made simultaneously with the release of the information, and so it involves information known to the entrepreneurs. Thus, it does not fit within Dye's model because it violates the model's first assumption.

Something else is likely to happen at the time of the public sale of securities, however. The entrepreneurs are likely to commit to providing additional information periodically in the future. The decision to list on a stock exchange that requires such ongoing disclosure is an example of such a commitment. See Dye, *supra* note 23, at 5. Although an act of this sort does represent a real commitment as the term is generally understood, it does not fit into Dye's model either. While the information ultimately disclosed pursuant to this commitment may not be known by the entrepreneurs at the time they make the commitment, the disclosure will occur after the sale of the securities, thereby violating the second assumption of Dye's model.

Dye's model is thus not useful in comparing voluntary versus mandatory disclosure with regard to either new issue disclosure (currently subject to the mandatory requirements of the Securities Act) or periodic disclosure (currently subject to the mandatory requirements of the Exchange Act), since both kinds of disclosure involve situations violating at least one of his assumptions.

2. *The exclusion of share sales to fund new investment.* The only kind of transaction Dye contemplates in his model is an entrepreneur's sale of his own shares. The issuer involved has already raised its needed capital and made its investment. The sale occurs simply because the entrepreneur wishes to consume before the investment produces its cash flow. See *id.* at 3-5. Thus, the model does not reach disclosure associated with a share sale by an issuer to raise capital to fund a new project, a more common kind of transaction that is probably more vital to the economy.

3. *The misspecification of disclosure's costs and benefits.* The only function for disclosure that Dye identifies in his model is disclosure's potential for altering the allocation of risk between selling entrepreneurs and purchasing outside investors. See *id.* at 3. According to Dye, disclosure that conforms to the model's two assumptions will bring the price that investors will pay for their shares closer, one way or the other, to the discounted present value of the cash flows that they in the end actually receive, thereby reducing the riskiness of their decision to invest. The commitment to provide such disclosure creates a corresponding uncertainty as to the price that the entrepreneur

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neur will receive: He knows that the disclosure will affect the price, but he does not know which way because he does not know its content. Thus, in terms of risk, disclosure benefits risk-averse investors and harms risk-averse entrepreneurs.

This result, however, is an artifact of the model's particular features discussed above, whereby entrepreneurs are the sellers of the shares and commit to provide, before the sale, information not currently known to them. Neither new issue disclosure nor periodic disclosure that issuers provide in the real world will have this risk reallocation effect. Consider first new issue disclosure. For the entrepreneur, the information disclosed is in reality already known to him. Thus, the "commitment" associated with its provision, rather than creating uncertainty as to the price the entrepreneur will receive, has a predictable impact on that price. The information will not, however, be known to the investors prior to disclosure. Its receipt will reduce each investor's uncertainty as to the return on an investment in the issuer's shares. With disclosure, the price she pays will on average be closer, on one side or the other, to the cash flow she will actually receive in the end. This increased accuracy does not necessarily mean that it will reduce her exposure to risk, however. Disclosure by an individual firm concerning its financial condition and prospects relates to uncertainties that are uncorrelated with uncertainty concerning the aggregate cash flows generated by all the firms in the market. To say this in the language of the capital asset pricing model ("CAPM"), disclosure only reduces unsystematic risk. This result can hold even if the firm's disclosure reduces uncertainty concerning the cash flows of certain other firms (for example, ones within the same industry), thereby creating financial externalities, since a whole group of firms would usually not be a big enough factor in the economy as a whole for their results to affect significantly the overall return in the market. Thus, if the investor purchases shares as part of a fully diversified portfolio, the reduction in unsystematic risk will not reduce the riskiness of her overall portfolio, which is all that matters in terms of her exposure to risk. An investor purchasing shares as part of a less than fully diversified portfolio would benefit from the disclosure, but CAPM suggests that, unlike in Dye's model, the entrepreneur will not receive a higher price as a result of providing this benefit. See *infra* Section I.C.1.

Now consider the commitment to provide periodic disclosure. This commitment likewise will not increase risk for the entrepreneurs nor reduce it for investors. The commitment to provide information will not create uncertainty concerning the price that the entrepreneur will receive because the information will not be disclosed until after the sale and therefore cannot affect that sale price. For the same reason, the commitment cannot bring the price that the investor pays closer to the cash flow she will ultimately receive. The fact that with periodic disclosure the investor at some point after the sale will have a more accurate perception of these cash flows is irrelevant to the riskiness of her investment decision, which is determined by how likely it is (based on what is known at the time of the sale) that these cash flows will deviate substantially one way or the other from the price paid for the shares.

Dye's model thus seriously misspecifies disclosure's potential costs and benefits, both private and public. It focuses on a factor on which real world disclosure is likely to have little or no impact—the allocation of risk between entrepreneurs and investors—while ignoring its important effects, discussed below, on capital allocation and the agency costs of management. See *infra* Sections I.C.2–3.



model's parameters are utilized, his model in fact supports the case for mandatory disclosure.<sup>25</sup>

*b. The claim that investors holding diversified portfolios solve the divergence problem*

Romano next argues that the externality producing the divergence between social and private costs does not require mandatory

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<sup>25</sup> In his analysis of real externalities, Dye finds that if an issuer experiences negative private returns from additional disclosures but the disclosures lead to positive market-wide returns, the voluntary level of disclosure will be below the socially optimal level. See Dye, *supra* note 23, at 19. He observes that the opposite would be true if the issuer experiences positive private returns from additional disclosure but the market experiences negative returns. See *id.* He suggests that plausible scenarios can be constructed either way and that "without possessing detailed *a priori* knowledge about the relation between private and market wide returns to additional disclosures for each firm, it is difficult to surmise whether [socially optimal] mandatory disclosures will exceed voluntary disclosures." *Id.*

The signs of the private and market returns to disclosure are not in fact as indeterminate as Dye states. Specifically, I suggest above that there is a wide range of items of information for which one of the private costs of disclosing the item is its harm to the disclosing issuer's competitive or bargaining position vis-à-vis other firms, i.e., the interfirm part of the cost of the item's disclosure. See *supra* Section I.B.1. This part of the private cost of the item's disclosure is counterbalanced by a real externality, the corresponding gains enjoyed by the other firms. Thus, the combined effect on market-wide return of this part of the cost of disclosing this item and the corresponding benefit to other firms is a wash. The other part of the private cost associated with the item's disclosure—the operational costs—has no such corresponding positive external effects, nor do the private benefits to the issuer associated with the item's disclosure have any corresponding negative external effects. Consequently, the social value of the disclosure—what Dye would term its effect on "market-wide returns," Dye, *supra* note 23, at 19—is at least as great as these private benefits from the disclosure minus its operational costs. For all items the release of which would put the issuer's overall disclosure near the socially optimal level, the effect of their disclosure on private returns (private benefits minus total private costs, including both interfirm and operational costs) will be negative, while, by definition, the effect of their disclosure on market-wide returns will be positive. Firms will thus not voluntarily disclose as much as is socially optimal.

More generally, it is hard to imagine how, as an ordinary matter, a disclosure by any one issuer would have a negative effect on the aggregate cash flows of all the other firms in the economy. If such a disclosure affects the aggregate cash flow of these other firms at all (i.e., if a real externality is present), it typically will have a positive effect, since this additional information will allow the other firms to better predict the consequences of their actions. Thus, contrary to Dye's conclusion, there is little possibility that the private returns to disclosure are positive and the market-wide ones negative. Dye's own model, therefore, suggests that real externalities create a divergence between the voluntary level of disclosure and the socially optimal one and that the direction of this divergence is toward too little voluntary disclosure.

disclosure because “[t]he majority of investors hold portfolios . . . and therefore, unlike the issuer, they will internalize the externality if they make the disclosure decision.”<sup>26</sup> The idea here is that if the interfirm costs to an issuer from a disclosure are indeed not social costs because the disadvantages to the issuer are counterbalanced by the advantages the disclosure confers on other firms, the issuer’s investors will not want management to consider these costs in making their disclosure decisions because the investors will own shares in other firms as well.<sup>27</sup> This argument too does not stand scrutiny.

To start, the argument has no applicability to new issue disclosure, which is a large part of the entire scheme of securities regulation.<sup>28</sup> To see this point, consider firm *A*, which is about to engage in an IPO and whose managers are deciding whether to choose a high-disclosure regime or a low-disclosure one, and firm *B*, which is a competitor of *A*. The high-disclosure regime would require a release of information that, by enhancing *B*’s ability to compete with *A*, would benefit *B* but harm *A*. The only way *A* could internalize this externality is if the sale price for *A*’s shares was somehow enhanced because of the benefit that the choice of the high-disclosure regime would confer on *B*. Unfortunately, the sale price will not be enhanced. Potential purchasers of *A* shares fall into two groups: those who currently hold *B* shares and those who do not. Those who do not obviously have no reason to pay more for *A* shares because of the benefit to *B* from *A*’s managers choosing a high-disclosure regime. Potential purchasers who do hold *B* shares have no reason to pay more either. Whether they buy *A* shares or not, they will benefit from *A* choosing the high-disclosure regime and suffer from *A* choosing the low-disclosure one.<sup>29</sup>

Romano’s argument is unpersuasive with respect to periodic disclosure as well. This time, consider firm *C*, an existing publicly held issuer with all of its shares already outstanding and whose managers are deciding whether to choose a regime requiring a high

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<sup>26</sup> Romano, *supra* note 1, at 2368.

<sup>27</sup> See *id.*

<sup>28</sup> The analysis that follows in the text also applies to the choice of a regime to govern an issuer’s ongoing periodic disclosures if it is made at the time of the issuer’s initial public offering.

<sup>29</sup> In a public market for securities, there is no opportunity for bargaining between the holders of *B* shares and the managers of *A* whereby *B* shareholders could condition their purchase of *A* shares upon *A*’s managers choosing the high-disclosure regime.

level of ongoing periodic disclosure or one requiring a low level of such disclosure, and firm *D*, a competitor of *C*. The high-disclosure regime would require the release of information that would, by enhancing *D*'s ability to compete with *C*, benefit *D* but harm *C*. The fact that most *C* shareholders hold diversified portfolios will not eliminate this externality. To start, few of these shareholders are likely to have portfolios that include shares of *D*. This is because of a basic lesson of corporate finance that an investor can enjoy most of the benefits of diversification by holding only a few dozen stocks out of the many thousands available.<sup>30</sup> Thus, in all likelihood, the holders of the majority of *C* shares would have no *D* shares and hence no compensating interest that would counterbalance the competitive disadvantage of the high-disclosure regime.

Even in the unusual situation where the holders of a majority of *C* shares do hold *D* shares as well, they are unlikely, when they vote their shares, to take account of the benefits from *C* choosing the higher disclosure regime. In deciding how to vote, these shareholders are likely to focus only on the cash flows that *C*'s managers can produce. This is because the vast information asymmetries that exist between shareholders and managers, combined with well-known collective action problems, make shareholder influence tenuous enough without the introduction of additional criteria for judging management such as the effect on *D* of *C*'s management's choice of disclosure regime.<sup>31</sup>

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<sup>30</sup> Holding twenty properly chosen stocks achieves 95% of the risk reduction that would be obtained from holding the whole market portfolio and holding 100 such stocks achieves 99% of such reduction. See Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 92 (2d ed. 1995). Only an investor that holds a portfolio consisting of the same percentage of all the stocks available in the market—an index fund—would privately experience costs and benefits from disclosure that parallel its social costs and benefits. Yet index funds are notoriously passive concerning corporate governance. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 *Colum. L. Rev.* 1277, 1339–41 (1991) [hereinafter *Coffee, Liquidity*].

<sup>31</sup> In addition, assuming that fewer than all of *C*'s shareholders hold shares of *D*, it would presumably be a breach of fiduciary duty on the part of the managers of *C* to adopt a disclosure regime sufficiently strict that the private costs to *C* exceeded the private benefits to *C* when their reason for doing so was the benefit that the higher level of disclosure would derivatively confer on the subset of its shareholders who were also holders of *D* shares. See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 143–44 (1991) (noting that equal division of

Finally, if Romano's argument were correct as applied here, the fact that shareholders hold diversified portfolios could also serve as an equally valid argument against having legal sanctions against any type of corporate behavior that negatively affects other corporations, including patent infringement or even breach of contract. Such a result obviously would make no sense.

*c. The claim that proponents of mandatory disclosure have not established the existence of any kind of disclosure having interfirm costs*

Romano also suggests that persons who argue that the divergence of private from social costs justifies mandatory disclosure "have not specified what information requirements the rationale justifies, let alone whether that information is the focus of SEC disclosure requirements."<sup>32</sup> It seems self-evident, however, that almost all potential corporate disclosures have interfirm costs associated with them. The extensive presence of interfirm costs was one of the main factors that drove adoption of mandatory disclosure in the first place.<sup>33</sup> That the interfirm cost problem in fact is

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gains is the general norm in corporate law unless the unequal benefit makes no shareholder worse off).

Moreover, the more reliable devices for helping align management interests with those of shareholders—the hostile takeover threat and share price-based managerial compensation—will be of no help in pushing *C*'s managers to account for the derivative benefit that *C* shareholders who also hold *D* shares would receive from *C*'s choice of the higher disclosure regime. These devices depend on share prices. A firm's share price is a function of the market's perception of the prospective cash flows that managers can produce, see Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 58–62 (5th ed. 1996), not of the advantages it confers on another firm. A shareholder is extremely unlikely to add or subtract *C* shares from her portfolio based on whether management has made a disclosure benefiting *D*.

<sup>32</sup> Romano, *supra* note 1, at 2380.

<sup>33</sup> One of the major categories of information required by the Exchange Act that was not provided by many corporations prior to its enactment in 1934 was sales and cost of sales. See *infra* Section II.A.1. Maurice Kaplan and Daniel Reaugh, in an article surveying, among other things, the annual reports of major corporations in 1930, found that 47% of these firms omitted their net sales figures. See Maurice C. Kaplan & Daniel M. Reaugh, *Accounting, Reports to Stockholders, and the SEC*, 48 *Yale L.J.* 935, 947 (1939). Kaplan and Reaugh suggested that this result could be explained by the existence of interfirm costs:

The usual reason given for refusing to disclose sales and cost of sales figures is the creation of consumer resistance where the gross profit margin is wide and that its publication invites competition or gives an advantage to existing competitors, especially where the competitors' figures remain undisclosed.

the focus of SEC requirements can be confirmed by even a quick review of SEC Regulation S-K,<sup>34</sup> which provides the questions that are incorporated by reference into its Forms 10-K (for periodic disclosure) and S-1 (for IPO disclosure). Regulation S-K calls for a wide variety of information the disclosure of which on the one hand would be useful for predicting an issuer's future cash flows, but on the other hand could seriously hurt the issuer through the advantages it confers on other firms. Examples include profits and sales of each significant individual line of business conducted by the issuer,<sup>35</sup> future capital spending plans,<sup>36</sup> research and development spending,<sup>37</sup> cost ratios,<sup>38</sup> liquidity constraints,<sup>39</sup> and information on backlogs,<sup>40</sup> inventories,<sup>41</sup> and sources of supply.<sup>42</sup>

*d. The claim that issuers will not comply*

Finally, Professor Romano argues that the divergence of private from social cost cannot justify a mandatory disclosure statute because wherever such a divergence is present, issuers will resist providing the required disclosures. Hence the statute is not implementable. Romano gives as her example the SEC requirement, imposed in 1969, that issuers provide line-of-business ("LOB") reporting.<sup>43</sup> She cites a number of studies that she believes prove the ineffectiveness of LOB reporting rules. She bases this conclusion

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Under the Securities Exchange Act . . . corporations . . . are required to list net sales in their . . . periodic reports . . . .

Id. at 946 (citation omitted); see also Twentieth Century Fund, Inc., *The Security Markets* 580-81 (1935) [hereinafter *Twentieth Century Fund, Security Markets*] (listing "advantage to competitors" as a reason for inadequate disclosure).

<sup>34</sup> Regulation S-K, 17 C.F.R. § 229 (1998).

<sup>35</sup> See id. § 229.101(b).

<sup>36</sup> See id. § 229.101(a)(2)(iii)(B)(3).

<sup>37</sup> See id. § 229.101(c)(1)(xi).

<sup>38</sup> See id. § 229.303(a)(3)(ii).

<sup>39</sup> See id. § 229.303(a)(1).

<sup>40</sup> See id. § 229.101(c)(1)(viii).

<sup>41</sup> See id. § 229.101(c)(1)(vi).

<sup>42</sup> See id. § 229.101(c)(1)(iii). There is also anecdotal evidence supporting the existence of significant interfirm costs. My personal experience in legal practice, and that of other securities practitioners with whom I have talked, is that at the margin, where it is not absolutely clear whether the securities laws require disclosure, issuers often resist providing it, giving as their most frequent reason their fear that the information will be used by their competitors.

<sup>43</sup> See Romano, *supra* note 1, at 2380-81. LOB reporting is required by 17 C.F.R. § 229.101(c)(1)(ii).

on the fact that the studies show no statistically significant increase in actual returns after imposition of the requirements.<sup>44</sup> These results are not surprising, however, because LOB disclosure will reveal as many situations in which the market would otherwise overvalue shares as situations in which the market would otherwise undervalue them.<sup>45</sup>

Contrary to her conclusion, the studies cited by Romano in fact provide affirmative evidence that the LOB reporting rules have resulted in issuers providing meaningful new information to the market. If there is meaningful new information in the market, share prices become more accurate.<sup>46</sup> The studies she cites demonstrate that LOB disclosure indeed did lead to an improvement in price accuracy. Their results, showing reduced total variance and price dispersion,<sup>47</sup> provide direct evidence of improved price accuracy. In addition, these studies contain indirect evidence as well: The results show that the accuracy of analysts' forecasts increased,<sup>48</sup> which in turn should lead to improved share price accuracy.

### *3. The Further Divergence of Private from Social Cost Because of Management's Agency Relationship with Shareholders*

The fact that an issuer's managers are in an agency relationship with its shareholders gives rise to an additional source of divergence between the managers' private costs of disclosure and the social costs of that disclosure.<sup>49</sup> Periodic disclosure increases the

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<sup>44</sup> See Romano, *supra* note 1, at 2380–81.

<sup>45</sup> See *infra* Section I.C.3.

<sup>46</sup> The relationship between increased disclosure and price accuracy is discussed *infra* Section I.C.3. The social gains from improved price accuracy are discussed *infra* Section I.C.

<sup>47</sup> See Bipin B. Ajinkya, *An Empirical Evaluation of Line-of-Business Reporting*, 18 *J. Acct. Res.* 343, 359 (1980); Rosanne M. Mohr, *The Segmental Reporting Issue: A Review of Empirical Research*, 2 *J. Acct. Literature* 39, 56–57 (1983) (collecting studies).

<sup>48</sup> See Mohr, *supra* note 47, at 42–55 (collecting studies). For a review of the literature concerning the proposition that mandatory disclosure as a general matter enhances price accuracy, see Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2540 n.80; *infra* Section II.A.1.

<sup>49</sup> In the preceding discussion of the other source of divergence—interfirm costs—it was assumed that managers completely identify with existing shareholders. See *supra* Section I.B.1. This assumption permitted the costs of disclosure to the firm as a whole to be treated as equivalent to disclosure's costs to the managers, the actual disclosure decisionmakers. This is reasonable since firm costs are costs to the managers

effectiveness of a number of devices—the shareholder vote, shareholder enforcement of management’s fiduciary duties, and the hostile takeover threat—that work to limit the ability of managers to deviate from acting in the shareholders’ best interests. This consequence represents a cost to managers, who would prefer to pursue their personal goals under as few constraints as possible.<sup>50</sup>

### C. Benefits

Proponents of issuer choice rely on an unstated premise that the private marginal benefit associated with an issuer’s disclosure equals its social marginal benefit.<sup>51</sup> Such a premise requires two as-

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as well: Disclosure, by damaging the firm, derivatively damages the managers without providing them with any compensating gains. The assumption, however, understates the total cost of disclosure to the managers since it ignores the fact that disclosure can harm their position in their agency relationship with shareholders.

<sup>50</sup> See *infra* Section I.C.3. This increased managerial discipline would have a positive influence on share price from which the managers may gain a derivative benefit. The size of this benefit, however, would in many cases be insufficient to cancel out the personal cost to managers of having to work under greater discipline. See *id.*

<sup>51</sup> See Romano, *supra* note 1, at 2366–67 (asserting that under regulatory competition, managers will have incentives to adopt a disclosure regime that maximizes the joint welfare of managers and investors). Choi and Guzman appear somewhat inconsistent on this matter. On the one hand, in an earlier work proposing a territorial approach to securities choice of law in order to give issuers some degree of choice, they recognize a scenario—a “race to the bottom”—in which managers would choose to bind the issuer to provide a socially suboptimal level of disclosure. See Choi & Guzman, *National Laws*, *supra* note 14, at 1872. Under this scenario, managers gain from engaging in some kind of opportunistic behavior, such as, in Choi and Guzman’s example, insider trading. See *id.* The fact that this behavior is opportunistic implies that the joint wealth of shareholders and managers would be greater if the managers did not engage in such behavior. Greater disclosure would make managers’ opportunistic behavior impossible. A credible promise that such greater disclosure is forthcoming would be reflected in increased proceeds from a share issuance. As Choi and Guzman tell it, the managers’ benefits from the increased proceeds are only indirect, however, and are not as great as the managers’ gains from the opportunistic behavior. See *id.* Managers therefore would choose a lower disclosure regime. See *id.* Thus, while increased disclosure would increase the joint wealth position of the parties and represent a social gain, such disclosure will not occur unless it is mandated because managers do not fully capture disclosure’s social benefits and would therefore select a lower disclosure regime if given the choice.

On the other hand, later in the same article, Choi and Guzman state that a “separating equilibrium” permitting an issuer’s managers to choose a lower disclosure regime would be socially preferable to a regime requiring the issuer to disclose at the higher level. *Id.* at 1877–78. In this section of their article, Choi and Guzman appear not to recognize that they are advocating a reform that, under the circumstances of their earlier race-to-the-bottom scenario, would lead to a decrease in social welfare.

assumptions. The first is that the social benefits of the disclosure level chosen will be fully reflected in the issuer's share price. The second is that the persons making the disclosure choice—the issuer's managers—will fully enjoy this share price improvement. Unfortunately, the proponents of issuer choice do not spell out mechanisms that would generate either of these results. In fact, neither of these assumptions is correct much of the time. Thus, the private marginal benefit associated with an issuer's disclosure is likely to fall below the social marginal benefit, adding to the extent of market failure if the disclosure level is determined by market forces.

An issuer's increased disclosure will result in three kinds of social benefits that will, at least in some situations, not be fully captured by its managers: (1) the reduction in the portfolio risk for the issuer's less than fully diversified shareholders; (2) the improvement in quality of real investment projects chosen to be implemented in our economy; and (3) the reduction in the agency costs of management.

### *1. Reduction in Investor Risk*

When more information is available about an issuer, its share price is likely to be closer, on one side or the other, to actual value.<sup>52</sup> This enhanced accuracy represents a gain to the less than fully diversified investor, because it reduces the risk of holding the issuer's shares in her portfolio. Since the risk that is reduced is unsystematic, however, the issuer's share price will not on average be any higher than it would be absent this disclosure—the fundamental lesson of the capital asset pricing model.<sup>53</sup> Thus, the issuer's

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Moreover, Choi and Guzman do not address this matter at all in their pieces proposing unfettered issuer choice.

<sup>52</sup> See *infra* Section II.A.1.

<sup>53</sup> According to the model, the market does not reward reductions in a share's unsystematic risk because an investor can eliminate unsystematic risk by holding a fully diversified portfolio. See Brealey & Myers, *supra* note 31, at 160–64. The fact that less than fully diversified investors could protect themselves in this fashion suggests that this gain from greater disclosure offers a less compelling reason for mandatory disclosure than the reasons discussed *infra* Sections I.C.2–3. Nevertheless, since less than fully diversified investors exist and will continue to exist irrespective of the government's regulatory choices, the reduction in risk for these investors does represent a social gain.



managers receive no corresponding reward for the benefit enjoyed by the investors.

## 2. *Improved Project Choice*

A second social benefit of disclosure is an improved choice among proposed new investment projects in the economy. One can see this improvement in project selection most easily in a simplified world in which each new investment project is undertaken by a new issuer that raises the necessary funds through an IPO. An issuer's managers will proceed with their proposed project if and only if the issuer's share price is high enough that the issuer can raise the cash necessary to implement the project without having to offer all of its equity to the public. In this situation, the managers can retain the rest of the equity for free. The retained shares constitute an "entrepreneurial surplus" that gives the managers a pro rata claim on the expected positive cash flow generated by the project. Thus, under this scenario, the private benefits from disclosure's improvements in project choice would differ from the social benefits only to the extent that the social benefits of the chosen disclosure level are not fully reflected in price. To the extent the benefits are reflected in price, they will be directly enjoyed by the entrepreneurs making the disclosure decision in the form of a larger entrepreneurial surplus.

Ideally, society would want to implement all proposed projects in rank order of their risk-adjusted expected returns (based on all available information, including what is known by the managers proposing each project). The marginal project that just exhausts society's scarce savings for investment would set the risk-adjusted expected return on capital. Whichever issuer's shares an investor purchases, she would receive a risk-adjusted expected return just equal to that of the marginal project.

This ideal will not be achieved in the real world, however, because some of the information possessed by each proposed project's entrepreneurs will not be public and hence not fully reflected in share price. Some projects inferior to the ideal world's marginal project will be implemented because their issuers' share prices are inaccurately high. Their entrepreneurs will gladly proceed with the project because they can raise all the cash necessary to implement their projects by offering the public less than all of the equity of

their respective firms and keep the rest as entrepreneurial surplus.<sup>54</sup> Likewise, some projects superior to the ideal world's marginal project will not be implemented because their issuers' share prices are inaccurately low. With such a project, a public offering of even all of the issuer's equity would not produce sufficient cash to fund the project.

An increase by all issuers in their level of disclosure would increase the accuracy of the price of every issuer's shares. The resulting reduction in the number of misallocations would be a social benefit that, if greater than the social costs involved, would represent an increase in social welfare (i.e., a net social gain). The question for us, however, is what kind of incentives exist for the managers of each individual issuer voluntarily to produce the level of disclosure that is needed to achieve this social gain. In other words, to what extent would any social gain produced by a single issuer's increased disclosure be reflected in its share price?

*If we were to pick one issuer at random and command an increase in the amount of disclosure it provides, its managers would not on average enjoy any perceptible benefit even if the extra disclosure's cost to them were zero.* This critical point is left out of the existing literature debating the desirability of mandatory disclosure. In an efficient market, the issuer's share price without the increased disclosure would represent an unbiased estimate of the future cash returns to the share's holder discounted to present value and so would the share price with the increased disclosure.<sup>55</sup>

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<sup>54</sup> Such a project has a negative net present value (evaluating its expected future cash flow on the basis of all available information including that available to each of the economy's entrepreneurs, and using the expected return on the marginal project, adjusted for risk, as the discount rate). Nevertheless, if the entrepreneurs go ahead with the project, the shares retained by the entrepreneurs have value because once the investment in the project is made using the proceeds of the share sale, the project will produce an expected positive future cash flow. The retained shares represent a pro-rata claim on this expected positive cash flow.

<sup>55</sup> By "unbiased," I mean that the price is on average equal to the share's actual value, i.e., what the future income stream accruing to the holder of the share—its dividends and other distributions—will turn out to be, discounted to present value. Speculators—the persons whose actions in the market set prices—assess what this future income stream will be based not only on the information that is available about the issuer but also on the information that the issuer chooses not to disclose. The empirical literature testing the efficient market hypothesis suggests that the inferences that speculators draw from issuer disclosures are in fact unbiased. Since there is no reason to believe that inferences from an issuer's absences of comment are any

Each price—the one in the market with less disclosure and the one in the market with more disclosure—is generated by a probability function with a mean equal to the share's actual value. Comparing market pricing with less versus more disclosure is analogous to taking different sample sizes from an urn containing many red and green balls in order to estimate the ratio of the two in the urn. A small sample's ratio, like a price in a market with low disclosure, will be an unbiased estimate of the actual ratio in the urn. In other words, if many such small samples were taken, their average ratio would equal the actual ratio in the urn, but any given sample is likely to be way off, one way or the other. A large sample's ratio, like a price in a market with high disclosure, will also be an unbiased estimate of the actual ratio in the urn. The only difference is that a large sample's ratio will be more accurate in the sense that it will be closer, one way or the other, to the actual ratio in the urn. Thus, on average, the issuer's share price with high disclosure will be the same as with low disclosure.<sup>56</sup>

*If, however, we were to observe an issuer voluntarily picking itself out to provide more disclosure than do other issuers—to choose a stricter regime on its own—we would on average expect the issuer's share price to go up and its managers to enjoy a greater entrepreneurial surplus.* Market participants would reason that because the issuer's entrepreneurs choose to reveal more, the issuer probably has better prospects relative to issuers choosing to disclose less.

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more likely to be biased than inferences from an issuer's disclosures, this literature suggests as well that the inferences speculators draw from an issuer's absences of comment are also unbiased. I discuss these points in considerably more detail elsewhere. See Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2533–39.

<sup>56</sup> The issuer's increased disclosure will on average result in better capital allocation, thereby increasing the overall expected rate of return on capital in the economy. This increase in the overall supply of expected future dollars would lower the rate at which a proposed project's cash flow (and that of all other investment opportunities) is discounted. In a large economy that implements many proposed projects, however, the effect of this single improvement in capital allocation will have only a tiny effect on the discount rate. Thus, the effect of the improvement on the price of the issuer's shares would be imperceptible. See *infra* Section II.A.2.

The increased disclosure will also reduce the overall risk associated with the issuer's shares but not in a way that will enhance share price. Since the information disclosed is firm specific, all of the reduction will be in the share's unsystematic risk. The market, however, does not reward reductions in a share's unsystematic risk with a higher price. See *supra* note 53 and accompanying text.

*Thus it is the fact that an issuer chooses to disclose, not the disclosure itself, that leads to the association between greater disclosure and higher share price.* This concept forms the basis of signaling theory: Issuers that have good news signal this fact by disclosing their news and those that do not have good news signal this fact by their inability to make comparable disclosures.<sup>57</sup>

While the signaling phenomenon means that the market will be better informed in a system of issuer choice than might first appear, it will not be as well informed as it would be if all issuers were compelled to disclose at the higher level that some issuers choose voluntarily. Silence is not a complete substitute for affirmatively disclosing a lack of good news because the market knows that an issuer could choose a low-disclosure regime for reasons other than a lack of good news.<sup>58</sup> As we have seen, an issuer may choose not to disclose because revealing the information might put it in an inferior position vis-à-vis a competitor, major supplier, or major customer.<sup>59</sup>

Projects therefore are not as well chosen in a signaling world—a world where issuers, through choice of regime, are free to choose

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<sup>57</sup> Signaling theory is *the* theory of self-induced disclosure in the context of an IPO. No one has offered any other plausible argument as to why voluntary disclosure alone could produce a sufficient level of information. The classic statement of signaling theory is found in Ross, *supra* note 12.

<sup>58</sup> See Easterbrook & Fischel, *supra* note 13, at 687–88. Commentators have also noted that empirical reality does not conform with signaling theory's prediction that voluntary disclosure will result in the market being informed at the socially optimal level. See Coffee, *Market Failure*, *supra* note 13, at 745; Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1, 7 n.24 (1983). Coffee points out that the market was not able, from the silence of the issuers involved, even to begin to infer in advance that New York City and the Washington Public Power System would experience disastrous defaults. See Coffee, *Market Failure*, *supra* note 13, at 745. These were the two largest defaults in the history of the United States, but the issuers, as municipal entities, were exempt from the mandatory disclosure system. See Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: A Reevaluation*, 36 Buff. L. Rev. 15, 16–21 (1987).

<sup>59</sup> A second reason, other than lack of good news, why an issuer might not disclose is that management is contemplating a management buyout and does not want the good news it possesses to increase the share price. This possibility is particularly damaging to the signaling mechanism since it suggests that silence might in fact indicate highly positive news. See Coffee, *Market Failure*, *supra* note 13, at 740–41. This problem is likely to be relevant, however, only where we are looking to signaling to produce price accuracy in the secondary market, not in the IPO market. It also relates to behavior that is partially constrained by rules against insider trading.

the level at which they bind themselves to disclose and where the market draws negative inferences from the decision of the issuers that choose a low level regime—as they would be in a world where all issuers disclose at a high level. Moving from the signaling world to the mandatory disclosure world would produce social benefits because the list of projects implemented would move closer to the ideal. If these social benefits exceed the social costs, the move represents a net social gain. The entrepreneurs who do not disclose at a high level in the signaling world would not, through higher prices, fully capture this gain from their increased disclosure in the second world. Part of the gain would instead accrue to the entrepreneurs who disclose at a high level in both worlds because the improved allocation of capital would mean a higher percentage of their projects would be implemented. In essence, to price each IPO properly, the market needs information about all potential projects so that it can make the relevant comparisons accurately.

Professor Romano cites a number of studies showing a positive relationship between disclosure and share price as evidence that there are “powerful incentives” for issuers seeking new funds to disclose information and that issuers can hence be trusted to choose for themselves the socially optimal disclosure regime.<sup>60</sup> This relationship, we have just seen, is due to the fact that the issuer chooses to disclose, not to the disclosure itself. It is the pattern we would expect to find under signaling theory. In an issuer choice world where we rely on signaling, issuers will have incentives to choose a regime requiring a level of disclosure greater than zero. But, as we have just seen, these incentives will not be great enough to induce issuers to choose a regime requiring a level as high as is socially optimal, even in the IPO context.

This “public goods” aspect of issuer disclosure does not end here.<sup>61</sup> There are other ways in which information disclosed by one issuer about itself could be useful in analyzing other issuers. It could, for example, reveal something about possible industry-wide

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<sup>60</sup> See Romano, *supra* note 1, at 2374.

<sup>61</sup> A public good is something for which the costs of extending its benefit to an additional person is zero and which it is impractical to exclude that person from enjoying. See Paul A. Samuelson & William D. Nordhaus, *Economics* 32 (15th ed. 1995). The term has been used by many commentators in the disclosure area because disclosure has features of this sort.

trends.<sup>62</sup> Again, these are social benefits that the issuer disclosing the information cannot appropriate through higher share price.

### 3. *Greater Managerial Adherence to Shareholder Interests*

A third social benefit of issuer disclosure is a reduction in the extent to which managers of public corporations place their own interests above those of their shareholders. Here I am talking primarily not about disclosure at the time of an IPO, but about information provided thereafter.<sup>63</sup> Greater ongoing, periodic disclosure increases the effectiveness of a number of devices that work to

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<sup>62</sup> See Easterbrook & Fischel, *supra* note 13, at 685. The model by Ronald Dye, cited by Romano in her effort to dismiss the divergence between private and social costs caused by interfirm costs, is relevant here as well. Dye refers to disclosure that is useful for analyzing another issuer as involving a “financial externality.” Dye, *supra* note 23, at 2. While Dye suggests that voluntary disclosure would be socially optimal under a fairly wide range of circumstances where only financial—not real—externalities are involved, see *id.* at 15, a number of factors significantly limit the model’s usefulness as a guide to policy. See *supra* note 24.

<sup>63</sup> Under the current regime, post-IPO disclosure comes from two sources. One source is the periodic disclosure requirements under §§ 12, 13, and 15(d) of the Exchange Act. See 15 U.S.C. §§ 78l, 78m, 78o(d) (1994). This disclosure is provided on Form 10-K (an annual report requesting much of the same information as is requested on the Securities Act Form S-1 used in connection with IPOs), Form 10-Q (a quarterly report), and Form 8-K. The other source is Section 5 of the Securities Act, which makes no distinction between IPOs and subsequent public offerings and hence requires that post-IPO public offerings of securities be registered as well. See *id.* § 77e. Because the issuer and its directors and officers are much more likely to face substantial liability where there is a materially false or misleading statement or omission in a Securities Act registration statement than in an Exchange Act filing, and because under the Securities Act underwriters face strict liability for such statements or omissions unless they can demonstrate that they engaged in due diligence, issuers provide higher quality disclosure when they engage in subsequent public offerings than when they do not. See Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 *Va. L. Rev.* 1005, 1025–30 (1984) [hereinafter Fox, *Shelf Registration*]; Merritt B. Fox, *Rethinking Disclosure Liability in the Modern Era*, 75 *Wash. U. L.Q.* 903, 903–04 (1997) [hereinafter Fox, *Rethinking Disclosure Liability*]; *infra* note 91. Because, as analyzed below, greater disclosure more effectively constrains managers from engaging in non-share-value-maximizing behavior, firm managers who anticipate making such offerings tend to act more in concert with the interests of shareholders. See Merritt B. Fox, *Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy* 138–39 (1987) [hereinafter Fox, *Finance and Industrial Performance*]; Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 *Am. Econ. Rev.* 650, 654 (1984).

limit such behavior.<sup>64</sup> Disclosure assists in the effective exercise of the shareholder franchise and in shareholder enforcement of management's fiduciary duties.<sup>65</sup> Even more importantly, disclosure increases the threat of hostile takeover when managers engage in non-share-value-maximizing behavior. Disclosure both makes a takeover less risky for potential acquirers and reduces the chance that an inaccurately high share price will deter a value-enhancing acquisition.<sup>66</sup>

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<sup>64</sup>The reduction in managerial discretion is, as discussed above, a direct cost to managers, but this cost is smaller than the social gains resulting from better resource allocation. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. Fin. Econ.* 305, 305-10, 326-28 (1976). The question here is the extent to which managers capture these social gains.

<sup>65</sup>I discuss these points in more detail in Merritt B. Fox, *Required Disclosure and Corporate Governance*, in *Comparative Corporate Governance: The State of the Art and Emerging Research* 701 (Klaus J. Hopt et al. eds., 1998). In the United States, we are so accustomed to a high level of issuer disclosure that we tend not to appreciate its importance with respect to these devices. A comparison with Russia is revealing. The dearth of disclosure there renders the fiduciary duties nominally imposed on management almost useless. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 *Harv. L. Rev.* 1911, 1927-28 (1996). It also makes relatively meaningless disinterested shareholder approval of transactions in which management is interested. See Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons from Russian Economy Fiascos* 17-18 (Mar. 25, 1999) (unpublished paper, on file with the Virginia Law Review Association).

<sup>66</sup>The market for corporate control is a well-recognized device for limiting the agency costs of management where ownership is separated from control, as in the typical publicly held corporation. Greater information disclosure and the resulting increase in price accuracy improves the control market's effectiveness in performing this role. A potential acquirer, in deciding whether it is worth paying what it would need to pay to acquire a target that the acquirer feels is mismanaged, must make an assessment of the target's worth in the acquirer's hands. This assessment is inherently risky and the acquirer's managers, like most persons, are likely to be risk averse. See Brealey & Myers, *supra* note 31, at 13. Greater disclosure, however, reduces the riskiness of this assessment. Hence, with greater disclosure, a smaller apparent deviation between incumbent management's decisionmaking and what would maximize share value is needed to impel a potential acquirer into action, since there would be less risk associated with going ahead.

Also, when share price is inaccurately high, even a potential acquirer certain that it can run the target better than can incumbent management may find the target not worth paying for. The increase in share price accuracy that results from greater disclosure reduces the chance that a socially worthwhile takeover will be thwarted in this fashion.

Greater disclosure thus makes the hostile takeover threat more real. Incumbent managers will be less tempted to implement negative net present value projects in order to maintain or enlarge their empires or to operate existing projects in ways that

In determining the extent to which an issuer's entrepreneurs and managers will be able to capture the social benefits from its ongoing, post-IPO disclosure, we should start by observing that, like IPO disclosure, post-IPO information too has "public goods" aspects.<sup>67</sup> It will aid in the analysis of the prospects of *other* issuers just going public with IPOs. It will also help discipline managers of other established public issuers by assisting the devices that limit the ability of their managers to deviate from their shareholders' best interests. If one has detailed information about one issuer's performance, for example, it is easier to detect shirking by the managers of its competitors, who face a similar external business environment. These public goods type benefits will not be captured in the price of the issuer making the disclosure.

As for the disciplining effect of any given level of periodic disclosure on an issuer's *own* management, there is, in theory, a way for its managers to capture the full social benefit. Managers can internalize the benefit by binding the issuer at the time of its IPO to provide in the future periodic disclosure at a particular level. The higher the promised level, the less the market would expect management decisionmaking to deviate from what is in the shareholders' best interests, and the higher the market price for the issuer's initial offering, net of the prospective costs of this commitment.<sup>68</sup> The entrepreneurs fully capture the increase in firm value since it would be reflected, pro-rata, in the price at which the offered shares are sold and the rest of the shares would continue to belong to the managers.

Reality will be different. This internalization of the benefits from the disciplinary effects of disclosure will not be complete unless the market is confident at the time of the IPO that the issuer is totally bound to disclose at the chosen level for the life of the firm. It is probably impractical, however, to institute an issuer choice regime with such an ironclad guarantee.<sup>69</sup> Yet without it,

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sacrifice profits to satisfy their personal aims. Those managers who nevertheless continue such self-interested behavior are more likely to be replaced. See Fox, *Finance and Industrial Performance*, supra note 63, at 84-91.

<sup>67</sup> See supra note 61 and accompanying text.

<sup>68</sup> See Easterbrook & Fischel, supra note 13, at 684.

<sup>69</sup> Professor Romano suggests as a default rule that management would not be allowed to change disclosure regimes without the approval of a majority of shareholders. See Romano, supra note 1, at 2415-16. She also suggests that any individual



issuer could choose to require a higher, supermajority vote. See *id.* While these suggestions might appear to answer my concern, in reality they pose a dilemma. On the one hand, relying on shareholder voting to protect against managerial opportunism involves the classic free-rider problem. For a shareholder with a small fraction of the shares of a corporation—the type that in aggregate hold the majority of the shares of most corporations—it is not worth acquiring the information necessary to judge the desirability of such a change in regime. After all, there is only a very small chance that her vote will affect the outcome of the elections, and, even if it did, she would experience only a small fraction of the effect of the change in regime. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 526–29 (1990); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549, 1573–77 (1989). On the other hand, if the percentage needed for approval is set very high to help protect against this passivity problem, the arrangement locks the issuer into a disclosure regime that is not likely to adapt to the particular changing needs of firms from the issuer's home jurisdiction. This result presents a contrast to a system of mandatory disclosure based on the issuer's nationality, where the issuer's disclosure would be governed by a regime that is likely to make these adaptations.

Romano also argues that the cost to an institutional investor of informing itself for any given vote is lower than it might first appear, since questions about the effect of a switch to any particular regime on the firm's share value are likely to arise with respect to many of the issuers in which the institution holds shares. See Romano, *supra* note 1, at 2416. This is a fair point. It is limited, however, to the extent that arguments in favor of such a switch differ in their validity from one issuer to the next and do so in ways the determination of which requires information about the particular issuers involved.

There is also an open question as to how representative the preferences of institutional investors are of the preferences of other shareholders with respect to how much an issuer should be required to disclose. On the one hand, it seems clear that institutions have greater skill at and inclination toward obtaining information about an issuer from sources other than the issuer's public disclosures than do small individual investors. Romano argues that studies showing that institutional investors do not outperform the market suggest otherwise, see *id.* at 2416 n.182, but this contention is not correct. Such studies show only that the market reflects new publicly available information so quickly that investors find it hard to make trading profits from possessing it. See *supra* note 55. They do not show that investors of all kinds possess the same amounts of information. If an issuer fails to provide sufficiently high disclosure, institutional investors' greater skill at and inclination toward obtaining information means that their cost of effectively exercising their franchise is smaller than that of the individual investor. Institutions can more easily find substitutes to issuer disclosure for obtaining information, and so their preference for a high level of issuer disclosure will not be as intense. In fairness, it would be easy to exaggerate the importance of this difference, however. The collective action problems for small individual investors may be so great that disclosure is of no direct use to them anyway, since individual investors would not make the effort to process the information even if it were given to them. Disclosure benefits individual investors indirectly instead by making more effective the other constraints on management.

Professors Choi and Guzman propose that an issuer select a securities law regime at the time of each new issue of securities. See Choi & Guzman, *Portable Reciprocity*, *supra* note 5, at 922. Since they propose no exit mechanism, the issuer appears to be bound by that choice—including its ongoing periodic disclosure requirements—for as

the market knows that managers will be subsequently tempted to switch to a lower disclosure regime and thus the market will discount the share price at the time of the IPO to reflect this possibility.

The temptation to switch arises because lower disclosure reduces the effectiveness of the devices that limit managerial discretion and hence provides managers with more room to make decisions that satisfy their own objectives at the expense of the interests of shareholders. Managers who consider switching to a lower disclosure regime know that if they do, the firm's share price in the secondary market will decline because of the expected reduction in managerial discipline. The amount of this decline will not necessarily be as great, however, as the amount by which reduced managerial discipline diminishes the share value. After all, as just noted, the market knows in advance that managers will be tempted to switch to a lower disclosure regime and the discount reflecting this possibility will still be present at the time that any actual switch occurs. In such a situation, the price drop accompanying a switch would be less than the drop in share value. The switch to a lower disclosure regime would therefore be less costly to managers and thus more likely to occur.<sup>70</sup>

Moreover, even if the price decline were as great as the decline in value, the managers would often find that the increased freedom, especially the freedom resulting from the reduced threat of takeovers, would be worth the price decline.<sup>71</sup> After all, managers' biggest concern with secondary market share price is often the

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long as the securities are outstanding. This approach solves the commitment problem in an ironclad way, but it has, in an even more extreme form, the adaptability problems that a high supermajority clause would have under Romano's proposal. See *infra* Part IV.

<sup>70</sup> In other words, the switch is partially paid for in advance, whether or not it is made. As a result, the cost to management of making the decision to switch is lowered, thereby making the switch more probable. This situation is a classic example of a "lemons" problem. See generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 *Q.J. Econ.* 488, 495-96 (1970) (describing representations of quality as an instance of the "lemons" problem).

<sup>71</sup> Managerial share ownership and stock options can ameliorate, but not eliminate, this problem. Such holdings constitute only a fraction of the issuer's outstanding shares—in most cases a small fraction, see 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, 141—and so most of the reduction in share value from non-share-value-maximizing decisions is externalized onto other persons.

takeover threat in the first place.<sup>72</sup> Admittedly, the switch to a lower disclosure regime would also increase the issuer's cost of seeking additional capital through new share issues. Many established firms, however, never raise new capital in this fashion.<sup>73</sup> Even for those firms that do, existing public shareholders, not the managers, will largely or wholly bear the cost of the lower share price.

In sum, the inability of managers to provide an ironclad guarantee of any promise to disclose at a high level, combined with this temptation to switch to a lower disclosure regime, means that when managers, at the time of the IPO, choose the regime under which their issuer will operate, they are not likely to capture fully the beneficial disciplining effects of adhering over the long run to the level of disclosure required by that regime. And if the managers subsequently choose a less rigorous regime, the penalty they incur as a result of any price drop at the time of the switch is not likely to be as great as the decline in share value due to reduced managerial discipline.<sup>74</sup>

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<sup>72</sup> Management's first concern is presumably keeping office. The standard model of how the market for corporate control disciplines management starts with the proposition that there is a high correlation between the efficiency of an issuer's managers and the price of its shares and that potential acquirers look for underpriced shares. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 *J. Pol. Econ.* 110, 112 (1965).

<sup>73</sup> See Fox, *Finance and Industrial Performance*, *supra* note 63, at 233-37 (collecting studies showing the importance of internally generated finance for many firms).

<sup>74</sup> As a result, the argument—based on signaling theory—that issuer choice will lead to socially optimal disclosure is inherently even harder to make for periodic disclosure than for IPO disclosure. Stephen Ross, in his classic exposition of signaling theory, assumes that managers are benefited proportionally to the degree by which they increase the value of the firm. See Ross, *supra* note 12, at 185. Telling a convincing story as to why this assumption might hold in the case of periodic disclosure is much more complicated than in the case of IPO disclosure, since, unlike in an IPO context, entrepreneurs making a periodic disclosure are not in essence selling a portion of the equity of the company previously belonging to them. Professor Coffee, for example, makes the following observation:

[T]he theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions. This theory has far less persuasive force, however, when applied to secondary market trading, which the '34 Act chiefly governs. Here, high agency costs currently exist . . . , thus sheltering opportunistic managerial behavior. A management that will oppose a lucrative takeover offer to its shareholders is also capable of biasing its disclosures . . . .

Coffee, *Market Failure*, *supra* note 13, at 746-47 (footnote omitted).

## II. EMPIRICAL EVIDENCE CONCERNING THE WELFARE EFFECTS OF MANDATORY DISCLOSURE

Under the current system, managers of U.S. issuers are required to disclose at a level prescribed by U.S. authorities.<sup>75</sup> Under issuer choice, managers would be free to bind themselves to the disclosure level of their choosing. Part I of this Article demonstrated that a system of issuer choice would involve substantial market failures. Thus, a switch to issuer choice will decrease social welfare unless the current system of mandatory disclosure involves even larger governmental failures. This observation gives rise to two questions. First, what empirical evidence is available concerning the relative impact on social welfare of the current system versus issuer choice? Second, what are the implications of this evidence for whether the United States should switch to an issuer choice regime?

### *A. Empirical Evidence Concerning the Imposition of Mandatory Disclosure*

There are no empirical studies comparing the current mandatory disclosure system with an issuer choice regime, since issuer choice has never been tried. Studies, however, have compared the current system with the previous world of no federal regulation.

#### *1. Studies of the Effect of New Issue and Periodic Mandatory Disclosure on Price Accuracy*

The efficient market hypothesis suggests that an issuer's share price will be an unbiased estimate of the share's actual value whether there is a lot of publicly available information about the issuer or only a little.<sup>76</sup> More information, however, will increase the expected accuracy of the price, i.e., the likelihood that the price will be relatively close, one way or the other, to the share's actual

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<sup>75</sup> In theory, an issuer whose economic center of gravity as a firm is in the United States could avoid the U.S. disclosure regime if it only offered its shares abroad, only listed its shares for trading abroad, incorporated abroad, and had a majority of its shares held by foreigners. Few, if any, such issuers exist, however. See Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2616-18.

<sup>76</sup> See *supra* Section I.C.2.

value.<sup>77</sup> This result occurs because with more information, speculators—the persons who set an issuer's share price in the market—have a more accurate sense of the issuer's future. Accuracy is revealed empirically by the amount of dispersion in the issuer's share price over time. To quote George Stigler, "Price dispersion is a manifestation—and, indeed, it is the measure—of ignorance in the market."<sup>78</sup> Thus, we would expect that if the imposition of the federal mandatory disclosure system led to an increase in meaningful information being publicly available, mandatory disclosure would have reduced price dispersion. There is considerable evidence that price dispersion did in fact decline after imposition of the federal regime.

*a. Studies by Stigler and Simon of the effect of new issue mandatory disclosure on price accuracy*

George Stigler examined two groups of new share issues, one from the period 1923–28 (prior to the passage of the Securities Act, with its new issue disclosure requirements) and the other from the period 1949–55 (after the Act's passage).<sup>79</sup> For each group, he calculated the average of the price performance of the group members over the five years after issuance relative to the price performance of the market as a whole for the corresponding period (thus controlling for factors affecting the market as a whole).<sup>80</sup> He found that the variance in the relative price performance of individual share issues around the average of the group as a whole declined by almost half between the pre-Act group and the post-Act group.<sup>81</sup> This result is thus consistent with the proposition that the improved disclosure associated with new issuers after adoption of

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<sup>77</sup> See *supra* Section I.C.2. To put this concept of expected accuracy in statistical terms, consider price to be a random variable generated by a distribution function with a mean equal to actual value (reflecting the fact that the price is unbiased). A good measure of the price's expected accuracy would then be the variance of the distribution—the expected value of the square of the deviation from actual value. The greater the variance, the lower the price's expected accuracy. See Robert V. Hogg & Allen T. Craig, *Introduction to Mathematical Statistics* 16–28, 34–40 (2d ed. 1965).

<sup>78</sup> George J. Stigler, *The Economics of Information*, 69 *J. Pol. Econ.* 213, 214 (1961).

<sup>79</sup> See Stigler, *Public Regulation*, *supra* note 12, at 120.

<sup>80</sup> See *id.*

<sup>81</sup> See *id.* at 121 tbl.1, 123 tbl.3.

the Securities Act led to greater price accuracy<sup>82</sup> since, compared to the pre-Act group, the initial price of the typical issuer in the post-Act group (discounted to present value and adjusted to account for the performance of issuers generally) was closer to what the issuer's performance in fact turned out to be.<sup>83</sup>

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<sup>82</sup> This analysis assumes, in accordance with the rational expectations model, that the market for new issues, whether provided with a lot of disclosure or only a little, is efficient in the sense that each issuer's price is an unbiased estimate of its actual value. See *supra* note 55 and accompanying text; *infra* note 94.

<sup>83</sup> Reluctant to attribute Stigler's result to the institution of the federal mandatory disclosure regime, Romano instead attempts to explain away Stigler's finding by first asserting that "the legislation simply forced riskier investments off the market." Romano, *supra* note 1, at 2377 (footnote omitted). Romano admits, however, that this finding "has also been interpreted as indicating that the disclosure mandated by the Act enabled investors to form more accurate price predictions." *Id.* Her first explanation is an idea originally put forward by Stigler. See Stigler, *Public Regulation*, *supra* note 12, at 122 (explaining results by noting "that many more new companies used the market in the 1920's [sic] than in the 1950's [sic]" and consequently concluding that "a major effect of the S.E.C. was to exclude new companies") (footnote omitted).

Romano's and Stigler's account is not the explanation adopted by others who have looked at the data. See Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 *J. Bus.* 382, 390-91 (1964); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 *Am. Econ. Rev.* 295, 311-13 (1989). Presumably everyone, including Stigler and Romano, accepts the theoretical proposition that any information that is of value to investors for predicting the future with greater accuracy will lead to less share price dispersion. The results showing that the post-Act group in fact had less dispersion should therefore logically lead one to the conclusion that the information that the Securities Act prompted to be disclosed was in fact of such value, unless one had affirmative evidence suggesting that some other factor was responsible. The only affirmative evidence Romano offers, however, is a citation to a study showing an increase in the proportion of debt financing after passage of the Act, particularly in the form of privately placed, higher risk debt. See Romano, *supra* note 1, at 2377 & nn.50-51. It is not surprising that this development would occur during the depths of the Great Depression. One suspects that debt financing would have increased regardless of whether mandatory disclosure was imposed on new issues.

Moreover, there is no obvious reason why increased disclosure, which simply reduces information asymmetries between managers and the market, would in fact force riskier investments off the market. To be sure, increased disclosure would hurt the implementation chances of riskier projects that, based on all available information including what is known by the managers proposing each project, should not be pursued. But greater disclosure would also help the chances of riskier projects that, based on the same information, should be implemented. See *supra* Section I.C.2 for a discussion of the relationship between disclosure and project choice.

It may be possible to tell a story about how the liability system that helps enforce the Securities Act disclosure requirements is biased against riskier projects. Presumably, this story would suggest that potential issuers with riskier projects and persons associated with such issuers face a greater risk of liability—even if they make just

In a second, more recent study, Carol Simon makes a similar kind of comparison, using the techniques of modern financial economics.<sup>84</sup> This time the comparison is between a group of pre-Act new share issues and groups of new share issues in each of several post-Act periods.<sup>85</sup> Like Stigler, she finds a lower variance for the share issues made after mandatory disclosure was imposed than for those made in the pre-Act period.<sup>86</sup>

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as great an effort to comply with the disclosure requirements—than potential issuers with less risky projects and their associated persons. Perhaps to suggest just such a story, Romano cites an article by Seha Tinic that argues that after adoption of the Act, underwriters, fearing liability, switched to larger, less risky issuers. See Romano, *supra* note 1, at 2377 (citing Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. Fin. 789, 813 (1988)). Tinic used indirect evidence to support the argument: a finding that the offering price discount relative to initial trading prices was higher in a post-Act 1966–71 sample of IPOs than in a pre-Act 1923–30 sample. See *id.* at 804–05 & tbl.3. The larger discount reduces both the probability of litigation and, if litigation does occur, the amount of damages ultimately recovered. See *id.* at 800–01. Tinic theorizes that the discount therefore constitutes a form of litigation insurance. See *id.* at 797–803. Thus, Tinic’s argument that underwriters have switched to less risky issuers rests on the claim that the increase in the discount represents litigation insurance. A number of factors, however, undermine the force of this explanation of the increased discount and hence its probative value as evidence that underwriters switched to less risky issuers because of fear of litigation. First, the cost of this insurance would be extraordinary—in essence, one gives up a dollar today in order to be sure that one is not sued for that same dollar tomorrow—and so it is hard to believe that rational contracting parties would agree to such an arrangement. Second, there are severe problems in attributing the increase in the discount to this one change between the two sample periods when so many other factors changed as well. Finally, Tinic makes an error in the description of the potential litigation costs created by the Act that diminishes the force of the litigation insurance theory. See Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced*, 41 UCLA L. Rev. 17, 26 n.28 (1993).

Beyond Romano’s citation of Tinic, neither Stigler nor Romano have attempted to tell a story to explain why the Securities Act’s liability system is biased against riskier projects or to suggest why the bias that such a story would predict is a more plausible explanation for the observed reduced price dispersion than the fact that greater disclosure helped investors better predict the issuer’s future.

<sup>84</sup> See Simon, *supra* note 83.

<sup>85</sup> See *id.* at 300, 310.

<sup>86</sup> See *id.* at 309–10 & tbl.7. The use of several post-Act periods rules out the “bull market” explanation of Stigler’s results, *i.e.*, that the greater variance in the pre-Act period was due to the fact that it was a boom period whereas the post-1933 period that Stigler used was not. See *id.* at 308–13.

*b. Benston's study of the effect of periodic mandatory disclosure on price accuracy*

George Benston studied the effect of the periodic disclosure requirements under the Exchange Act.<sup>87</sup> His results are more mixed than the findings of the new issue disclosure studies discussed above. Benston looked at 466 New York Stock Exchange ("NYSE") firms for a period starting prior to the imposition of the Exchange Act regime and running to a point ninety months after its imposition, using the market model to determine the variance of their month-to-month residuals as a measure of price dispersion.<sup>88</sup> Of these, 290 firms disclosed sales data before imposition of the Exchange Act regime and 176 did not.<sup>89</sup> After imposition, all 466 firms were required by law to disclose this sales data. Benston focused on whether the riskiness of the 176 firms that were required by the Act to reveal their sales figures for the first time (the "non-disclosure" firms) declined relative to the riskiness of the firms that had been disclosing sales all along (the "disclosure" firms).<sup>90</sup> To make this comparison, Benston looked to see whether, after the Act was imposed, the average decline in the variance of the residuals of the nondisclosure firms was greater than that of the disclosure firms. Benston found that it was, but only by a very small, statistically insignificant amount, and consequently concluded that the post-Act disclosure of sales data by the nondisclosure firms did not reduce their riskiness.<sup>91</sup>

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<sup>87</sup> See Benston, *supra* note 12.

<sup>88</sup> See *id.* at 138, 141-49. The residual is the difference between the issuer's actual return in a month (price change plus dividends) and the return predicted by the market model. See Gilson & Black, *supra* note 30, at 194. The market model predicts an issuer's return based on the overall market's performance during the month and the issuer's traditional sensitivity to market-wide trends. See *id.* Thus, the variance of an issuer's residuals measures the amount of uncertainty that exists about an issuer with respect to factors specifically affecting the issuer. In other words, variance of residuals is a measure of firm-specific or unsystematic risk. A reduction in the variance of a firm's residuals would suggest an increase in meaningful information in the market about the firm.

<sup>89</sup> See Benston, *supra* note 12, at 143.

<sup>90</sup> See *id.* at 142-43.

<sup>91</sup> See *id.* at 148-49 & tbl.4. This result, of course, does not prove that no such decline occurred. This part of Benston's study looks at a single disclosure item—sales data—among a whole package of new requirements. See *infra* notes 96-105 and accompanying text. The effect of this single requirement on price accuracy may have been positive and large enough relative to its costs to make it economically worth-



while, but not large enough, given the relatively weak statistical powers of Benston's test, to show up as significant. See *infra* Section II.A.3.

There are also some problems with the fundamental design of Benston's test. First, the "control" group—the firms that were already reporting sales before the passage of the Exchange Act—themselves significantly improved the quality of their sales disclosures in response to the regulations. Prior to the passage of the Exchange Act, there was great variation among these firms with respect to how the sales figure was calculated. See Kaplan & Reaugh, *supra* note 33, at 945 n.42, 947; *infra* notes 102–05 and accompanying text. The Exchange Act made these sales disclosures more uniform and standardized. This improvement in the quality of the sales information of the disclosure firms would mute any differences in the price dispersion reactions of the two groups to imposition of the sales disclosure requirement even if the requirement did decrease the dispersion of the nondisclosure firms. It would therefore be less likely that any difference in reaction would show up in the data as statistically significant.

Second, a test looking at the reaction in the 1930s of share price riskiness to the imposition of Exchange Act periodic disclosure requirements is less likely to show the positive effects of mandatory disclosure than a test, such as those discussed in the text above, looking at the reaction of share price riskiness to the imposition of the Securities Act's new issue disclosure requirements. Issuers had fewer incentives in the 1930s to provide accurate information in response to the Exchange Act's requirements than they had in response to those of the Securities Act. The Securities Act had, from the very beginning, extensive civil liability provisions under Section 11, see 15 U.S.C. § 77k (1994) (imposing absolute liability on the issuer and, unless they could affirmatively prove they had performed adequate due diligence, on the directors, key officers, and underwriters as well), and under Section 12(a)(2). See *id.* § 77l(2). There was also regular SEC staff review of S-1 filings. See Byron D. Whiteside, *Development of S.E.C. Practices in Processing Registration Statements and Proxy Statements*, 24 *Bus. Lawyer* 375, 376–78 (1969). The Exchange Act had only Section 18 liability, see 15 U.S.C. § 78r, the insuperable reliance requirements of which have made it a dead letter. See David L. Ratner & Thomas Lee Hazen, *Securities Regulation: Cases and Materials* 328–31 (5th ed. 1996). Moreover, SEC staff review of Exchange Act filings was, compared to its review of S-1 filings, "less thorough and prompt, and generally less effective." Milton H. Cohen, "Truth in Securities" Revisited, 79 *Harv. L. Rev.* 1340, 1362 (1966).

The incentives to comply with Exchange Act periodic disclosure requirements are much greater today than in the 1930s. This increase is due in part to developments under Exchange Act Section 10(b), see 15 U.S.C. § 78j(b), and Rule 10b–5, see 17 C.F.R. § 240.10b–5 (1998). Potential Rule 10b–5 liability for Exchange Act disclosure violations by firms that do not trade in their own securities did not develop until the late 1960s. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 857–62 (2d Cir. 1968), cert. denied sub nom. *Kline v. SEC*, 394 U.S. 976 (1969). This potential liability in turn did not become a serious threat to most issuers until class actions became possible with the development of the fraud on the market theory of reliance, which was first enunciated in the lower courts in the 1970s and was affirmed by the United States Supreme Court only in 1988. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 241–47 (1988). The advent in the early 1980s of integrated disclosure, in which many issuers can incorporate by reference their Exchange Act periodic filings into their new issue Securities Act registration statements, also created an incentive for improving the quality of Exchange Act disclosure since the items incorporated by reference become subject to

Benston's results are also relevant, however, as to the value of the total package of information required to be disclosed under the 1934 Act's regime: The riskiness of both disclosure and nondisclosure firms, as measured by the average standard deviation of the members' residuals, declined by about one-third from the pre-Act period to the post-Act period.<sup>92</sup> This finding would imply that whatever the effect of mandated disclosure of *sales data* on price accuracy, the *total* mandated package *did* substantially increase the supply of meaningful information in the market, and consequently improved price accuracy. Benston, however, ignores the results of his own study.

Why does Benston ignore the fact that the riskiness of each group—the nondisclosure firms and the disclosure firms—appears to have dropped substantially after the imposition of the Act and focus exclusively on the difference in the amount by which each dropped?<sup>93</sup> The reason is that Benston concluded in advance that, aside from sales information, the Act's other disclosure requirements were of no importance, even in the aggregate.<sup>94</sup> In making her argument against mandatory disclosure, Romano adopted Benston's account, citing to his article for the proposition that "the only major mandated item that was not reported by a significant set of firms prior to the 1934 legislation was sales."<sup>95</sup>

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the Securities Act liability scheme. I have explored the shrinking difference in incentives between the Securities Act and the Exchange Act disclosure regimes in greater detail elsewhere. See Fox, *Shelf Registration*, supra note 63, at 1025–32; Fox, *Rethinking Disclosure Liability*, supra note 63, at 903–04.

Thus, given the increase in incentives for issuers to comply with the Exchange Act's periodic disclosure requirements, there is a particular danger in inferring that today the Exchange Act has no impact on price dispersion from a finding that there was no statistically significant extra reduction in price dispersion among the nondisclosure firms back in the 1930s, when the Exchange Act's sales disclosure requirements were first imposed.

<sup>92</sup> See Benston, supra note 12, at 148–49 & tbl.4; see also Irwin Friend & Randolph Westerfield, *Required Disclosure and the Stock Market: Comment*, 65 *Am. Econ. Rev.* 467, 469–70 (1975) (observing this effect in Benston's results).

<sup>93</sup> Benston describes his study as one that tests the benefits of the Act "by examining its differential effect on the securities of corporations that were and were not affected by the legislation [the nondisclosing firms versus the disclosing firms]." Benston, supra note 12, at 142.

<sup>94</sup> See *id.* (describing sales disclosure as "[t]he principal reporting requirement imposed by the '34 Act").

<sup>95</sup> Romano, supra note 1, at 2373.

Benston's and Romano's conclusion that the rest of the Exchange Act's disclosure requirements were of no importance would have come as a real surprise to commentators at the time of the Act's passage. First, Benston's and Romano's conclusion rests on the faulty premise that prior to the Exchange Act's enactment, the exchanges already required that firms make available all of the information—other than sales—that the Act required firms to disclose. Benston's method of researching the exchanges' disclosure requirements in the 1920s and early 1930s was to make inquiries of them. He was apparently informed that during this period the exchanges already "had . . . rules that required listed companies to send certified income statements and balance sheets to stockholders in advance of the annual meeting."<sup>96</sup> In fact, there were no such rules. What regulation there was came from the fact that each issuer, at the time it applied to have its securities listed on the NYSE, was required to enter into a listing agreement with the Exchange.<sup>97</sup> It is true that about the time of the passage of the Exchange Act, the NYSE started to require that each new applicant enter into a listing agreement that provided that a certified income statement and balance sheet be given annually to its shareholders.<sup>98</sup> But the listing agreements entered into by issuers that applied prior to the Act (which would include *all* the firms in Benston's study) did not contain requirements this strict, in some cases not nearly this strict.<sup>99</sup> Indeed, as indicated in a 1934 Senate report,

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<sup>96</sup> Benston, *supra* note 12, at 142.

<sup>97</sup> The standard agreement, at least for issuers that applied in the mid-1920s or later, obligated the issuer to provide certain kinds of information on an ongoing basis. See John Hanna, *The Securities Exchange Act as Supplementary of the Securities Act, 4 Law & Contemp. Probs.* 256, 258–59 (1937) [hereinafter Hanna, *Supplementary*]. For a description of the practice prior to that time, see *infra* note 99.

<sup>98</sup> See Hanna, *Supplementary*, *supra* note 97, at 259.

<sup>99</sup> The New York Stock Exchange's Rules of Listing dated July 1, 1925 (which, since they were included in a 1930 casebook of an eminent scholar, were apparently still in force in 1930) are reproduced in Adolf A. Berle, Jr., *Cases and Materials in the Law of Corporation Finance* 700–13 (1930). The same rules dated September 20, 1938 are reproduced in William Harman Black, *The Law of Stock Exchanges, Stockbrokers & Customers* 997–1027 (1940). The listing agreement required under July 1, 1925 rules did not require that the financial statements be audited nor that nonrecurrent items of income be disclosed as such. See Berle, *supra*.

The earlier that an issuer in Benston's study listed on the NYSE, the less strict were the periodic disclosure requirements under which it was operating during the pre-Act

one of the problems addressed by the Act was the fact that the exchanges felt hampered in their ability to induce firms that had listed earlier to provide more information because the exchanges had "not considered themselves entitled to modify [these agreements] without the consent of such issuers."<sup>100</sup>

Moreover, certain important items of information were not required at all under the listing agreements, even under those of firms listing just before the passage of the Act.<sup>101</sup> More impor-

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test period. The Twentieth Century Fund, in its exhaustive 1935 study of the securities markets, noted that the NYSE's requirements became stricter over time:

It was, however, not until the boom period ending in 1929 was well under way that the Exchange began in earnest to develop the requirements for disclosures that it today imposes upon corporations desiring to list their securities. Since the depression . . . the Exchange authorities have given further attention to this matter.

Twentieth Century Fund, *Security Markets*, supra note 33, at 577. Similarly, Professor John Hanna stated in 1937 that "[l]isting requirements have become progressively more rigorous in recent years." Hanna, *Supplementary*, supra note 97, at 258. There is some reason to believe that issuers that listed prior to the mid-1920s had no obligation at all to provide ongoing periodic information. See Twentieth Century Fund, Inc., *Stock Market Control 133* (1934) [hereinafter *Twentieth Century Fund, Stock Market*].

As evidence of how little bound many firms that listed prior to 1925 apparently were (or, alternatively, how lax the enforcement of the listing agreements generally was), consider the results of a survey conducted by Kaplan and Reaugh. Kaplan and Reaugh made a careful examination of 70 firms' annual financial reports to shareholders for 1930 (a year in the middle of Benston's pre-Act test period). See Kaplan & Reaugh, supra note 33, at 938. Kaplan and Reaugh characterized these 70 firms as representative of the 500 to 600 largest nonutility, nonrailroad, nonfinancial corporations in America. See *id.* at 938 n.16. Four of these 70 did not provide their shareholders with even the simplest form of income statement. See *id.* at 940. A majority of the surveyed firms did not report "cost of goods sold." *Id.* at 948.

<sup>100</sup> S. Rep. No. 73-792, at 5 (1934); see also John E. Tracy & Alfred Brunson MacChesney, *The Securities Exchange Act of 1934*, 32 *Mich. L. Rev.* 1025, 1049 (1934) (noting that "[t]he New York Stock Exchange, through its listing requirements, has made commendable progress in setting higher standards," but that these measures do not "reach securities already issued and listed"). Professors John Tracy and Alfred MacChesney describe the disclosure requirements of the Exchange Act as "fill[ing] in the gap left open by . . . the listing requirements of the exchanges; [they] secure[] similar information [to that required by the Securities Act] regarding securities already outstanding." *Id.* at 1053.

<sup>101</sup> For example, the Exchange Act required information that "differ[s] from the usual stock exchange listing requirements in [its] demand for disclosure of the stock interest and remuneration of officers, directors, ten per cent stockholders and others." Hanna, *Supplementary*, supra note 97, at 261. Also, almost one-third of NYSE companies published financial statements only once a year. See Twentieth Century Fund, *Stock Market*, supra note 99, at 135. The SEC required issuers to provide quarterly financials, pursuant to Form 10-Q under the Exchange Act.

tantly, there were enormous problems with the quality of the financial data that firms provided under the listing agreements.<sup>102</sup> A primary purpose of the Exchange Act was to remedy these problems.<sup>103</sup> One example is sufficient to give a sense of the magnitude of these problems. Kaplan and Reaugh conducted a survey of the 1930 annual reports of a representative sample of the nation's 500 or 600 largest publicly traded industrial corporations.<sup>104</sup> While most firms (though not all) provided some kind of income statement, almost one-third did not reveal how much depreciation, if any, was deducted to arrive at their earnings figures.<sup>105</sup> Without information about depreciation, earnings numbers are virtually meaningless.

Opponents of mandatory disclosure offer, as one of the central exhibits in their case, Benston's finding that there was no significant difference in the reduction in riskiness between firms that previously disclosed sales and firms that did not. Romano, for example, characterizes this study as "important and still underappreciated."<sup>106</sup> But Benston's finding is surely a weak reed on which to lean. It would only take on real substance if his assumption were correct that, aside from sales information, the rest of the Exchange Act's disclosure requirements were of no importance. Benston adopts this assumption on the basis of a superficial and, as it turns out, erroneous examination of the historical state of affairs in the

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<sup>102</sup> See Kaplan & Reaugh, *supra* note 33, at 940 (describing how the 1930 annual income statements of 34 of the 70 large corporations surveyed "were obviously inadequate" and how, as a group, the income statements of all the surveyed corporations displayed "a striking lack of uniformity as to form and content").

<sup>103</sup> See John Hanna, *The Securities Exchange Act of 1934*, 23 Cal. L. Rev. 1, 20 (1934). The SEC, in describing its Exchange Act disclosure requirements, commented specifically on the shortcomings of listing-agreement disclosure:

The outstanding advances which these requirements [under the Exchange Act] represent over reporting practices already in vogue are first, a greater emphasis on the accounting steps involved in income determination, and second, a more complete explanation of the changes which have occurred in balance sheet items during the year under report. . . . The requirements give less attention, on the other hand, to historical information concerning the company, since all companies affected are already listed on the exchanges, and have been reporting consistently, under existing exchange requirements.

Securities Exchange Act Release No. 66, 1934 SEC LEXIS 225, at \*6 (Dec. 21, 1934).

<sup>104</sup> See Kaplan & Reaugh, *supra* note 33, at 938 n.16.

<sup>105</sup> See *id.* at 956.

<sup>106</sup> Romano, *supra* note 1, at 2373.

1920s and 1930s.<sup>107</sup> When his own data suggests that the assumption is incorrect, he ignores the data rather than drop the assumption or provide an alternative explanation.

### *c. Conclusion*

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. The empirical evidence that mandatory disclosure does in fact enhance price accuracy is very important, particularly in light of the discussion in Part I showing that greater information availability and increased share price accuracy produce several social benefits: reduced risk for less than fully diversified investors, improved choice of capital utilizing projects, and reduced agency costs of management.<sup>108</sup> Certainly, these studies are

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<sup>107</sup> A second reason for Benston's focus on sales is that he performed a separate study purporting to show that in 1964, among different types of accounting numbers reported in SEC filings, "sales [were] the only relatively important accounting number." Benston, *supra* note 12, at 142; see also *id.* at 137-38 (summarizing the study). He measured the importance of an accounting number by testing whether an unexpected change in the number from the number previously disclosed led to significant share price reaction. See *id.* at 138-39. A finding that only the sales number qualifies as important by this measure hardly suggests that there is no value in mandating the disclosure of all the other information required by the Exchange Act. It only means that such other items, before their disclosure in an SEC filing, are largely anticipated by the market because of previous information that has become available about the corporation (quite possibly through a press release containing the same information). An issuer that knows it will have to make a formal filing containing certain information at specified dates will most likely disclose more about the same subject outside the formal filings as well, and when it does so, the issuer will be more careful about the accuracy of what it says. To the extent that the filed numbers simply verify the investment community's understanding of the issuer based on this previously released information, there would be no share price reaction to these other items, but the information might very well not have been released previously but for mandatory disclosure.

<sup>108</sup> Romano suggests that an increase in share price accuracy does not produce any social benefits:

Even this alternative explanation [i.e., that mandatory disclosure increases price accuracy] does not, however, demonstrate that the Act benefited investors. A core tenet of modern financial theory is that investors are compensated for bearing market risk, and it was firm-specific risk and not market risk that was measured to have decreased with the 1933 Act. . . . A reduction in own-return variance (that is, more accurate stock prices) is of no value to diversified investors. Consequently, commentators who point to the return variance reduction as evidence affirming

at odds with Professor's Romano's reference to "the near total absence of measurable benefits from the federal regulatory apparatus."<sup>109</sup>

Two caveats are in order, however. First, statistical comparisons between time periods are tricky because other factors change besides the one motivating the inquiry—in our case, imposition of mandatory disclosure—and it may be the changes in these other factors that cause the observed change in outcome. This fact should not pose too great a problem here, however, since in all three studies the measure of riskiness already factored out share price volatility caused by market-wide influences. Second, assuming that the imposition of mandatory disclosure did cause the increase in price accuracy, these studies do not show whether or not the resulting social benefits exceeded the social costs of increased disclosure.

## *2. Studies of the Effect of New Issue Mandatory Disclosure on Rate of Return*

### *a. Results of the existing studies*

The most frequently cited results concerning the impact of the Securities Act's new issue disclosure requirements on rate of return come from the study by George Stigler discussed in Section II.A.1 above.<sup>110</sup> Stigler took two groups of new share issues, one from the period 1923–28 (prior to the passage of the Securities Act) and the other from the period 1949–55 (after the Act's passage), and compared their respective five-year post-issue growth in prices to the growth in prices in the market as a whole.<sup>111</sup> The post-Act group did no better than the pre-Act group.<sup>112</sup> Professor Romano argues that this finding "strongly suggests that the new

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the efficacy of the 1933 Act are mistaken; investors benefit only from reductions in risk that is priced.

Romano, *supra* note 1, at 2377. Romano's statement takes an unduly narrow view of the functions in our economy of the securities markets. It misses the positive effects in the real economy, discussed in Part I, that result from more available information and more accurate share prices. It also ignores the benefit of more accurate prices for less than fully diversified investors, although the ability of such persons to achieve the same welfare gains by diversifying more would make this, standing by itself, a less compelling argument for regulation. See *supra* note 53.

<sup>109</sup> Romano, *supra* note 1, at 2372.

<sup>110</sup> See Stigler, *Public Regulation*, *supra* note 12.

<sup>111</sup> See *id.* at 120.

<sup>112</sup> See *id.* at 121–24.

federal regime had, at best, no effect on investor welfare,"<sup>113</sup> a sentiment shared by Stigler.<sup>114</sup>

At the time Stigler published his results, Professors Irwin Friend and Fred Herman suggested that Stigler's results really showed that new issue mandatory disclosure was worthwhile. They argued that Stigler had made computational errors that understated the performance of the post-Act group.<sup>115</sup> After recalculating, however, Stigler still found that the after-issue price growth for a majority of the five years (including, most importantly, the fifth) was still either not as good as the pre-Act group or not sufficiently better than the pre-Act group to be considered statistically significant.<sup>116</sup>

Commentators such as Professor Gregg Jarrell have also faulted Stigler's study on methodological grounds, criticizing his failure to account for dividends and for differences among stocks in systematic risk.<sup>117</sup> Research, however, reveals no adequately conducted study—including one by Jarrell himself—that does take account of such factors and finds, at least with respect to seasoned issuers, that the post-Act group outperforms the pre-Act group to a statistically significant degree.<sup>118</sup>

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<sup>113</sup> Romano, *supra* note 1, at 2376.

<sup>114</sup> See Stigler, *Public Regulation*, *supra* note 12, at 120–22.

<sup>115</sup> See Friend & Herman, *supra* note 83, at 382–91.

<sup>116</sup> See George J. Stigler, *Comment*, 37 *J. Bus.* 414, 418–19 (1964). In the fourth year, the post-Act group did do better by a statistically significant amount. See *id.* Romano, however, argues that this result does not seriously undermine Stigler's conclusion that Securities Act disclosure was not worthwhile, because Friend and Herman lack a theory as to why the regime should only improve the post-Act group's performance four years after their shares were issued. See Romano, *supra* note 1, at 2376 n.47.

<sup>117</sup> See Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 *J.L. & Econ.* 613, 624–27 (1981); Seligman, *supra* note 58, at 10–11 & n.37.

<sup>118</sup> Gregg Jarrell conducted a study making the same comparison as Stigler but correcting Stigler's methodological shortcomings. See Jarrell, *supra* note 117, at 627. He came to the same conclusion as Stigler. See *id.* at 666–69. Jarrell's study, however, has itself been criticized for its exclusive focus on railroads (railroads were left unregulated in the post-1933 Act period, so they do not really belong in a comparison example) and manufacturing (issues of manufacturing firms were regarded as relatively clean in the pre-Act era, whereas issues of mining and of investment trusts, which were excluded from Jarrell's study, were the issues that gave rise to most of the stories of fraud). See Seligman, *supra* note 58, at 11 n.37; Rodney T. Smith, *Comments on Jarrell*, 24 *J.L. & Econ.* 677, 682 (1981). Simon, in another study again using the techniques of modern financial economics to consider the Stigler comparison, also agrees with Stigler's conclusions with respect to seasoned issuers and initial public is-



*b. Problems with the existing studies*

Stigler's and Jarrell's studies may sound helpful to opponents of mandatory disclosure, but these tests have a fundamental problem in their design that has been missed by the prior literature in the debate. Stigler and Jarrell purport to test whether the social benefits of mandatory disclosure exceed its social costs by comparing, before and after the Act, the rate of return enjoyed by purchasers of newly issued shares *relative* to the rate of return enjoyed by investors in the stock market generally.<sup>119</sup> The assumption is that if the returns enjoyed by the purchasers of newly issued shares improved relative to market returns generally, the Act enhanced net social welfare, and otherwise it did not. The decision to compare *relative* pre-Act and post-Act rates of return, rather than *absolute* ones, was probably made in order to abstract out other factors that affected the market generally between the two periods. Unfortunately, this choice "throws the baby out with the bath water." In a well-functioning capital market, there should be no difference at any point in time between the risk-adjusted expected rate of return enjoyed by new equity purchasers and that enjoyed by purchasers of shares in the secondary market. Both before and after adoption of the Act, the investors who purchased new share issues were free to purchase securities in the secondary market instead, and vice versa.

This connection between the primary and secondary markets for equities means that the ratio of risk-adjusted expected returns in the two markets should always be one-to-one and should be unaffected by the imposition of mandatory disclosure.<sup>120</sup> This fact sug-

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sues of shares to be traded on the NYSE, but finds that the pre-Act issues of shares to be traded on regional exchanges were significantly over-priced while the post-1933 issues were not. See Simon, *supra* note 83, at 304-08, 313. Simon's result suggests some kind of informational inefficiency in these markets that was corrected through time or by imposition of the Securities Act.

<sup>119</sup> See Jarrell, *supra* note 117, at 629; Stigler, *Public Regulation*, *supra* note 12, at 120.

<sup>120</sup> Any differences that do show up between the returns enjoyed by new issue investors and secondary market investors are probably due either to inadequate or inaccurate risk adjustments or to information inefficiencies within the new issue market. In addition, historical returns—the inevitable source of the data in all empirical studies in finance—are only inexact (though unbiased) proxies for expected returns. The reasons why greater disclosure can lead to net social gain—discussed *supra* Part I—in no way depend on eliminating any such inefficiencies. See Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2538-40 n.78 (discussing more extensively the

gests that the heated debate between proponents and opponents of mandatory disclosure as to whether this ratio increased by a statistically significant amount between the pre-Act and post-Act period has been utterly beside the point. In particular, it is invalid for Romano and Stigler to conclude that the Act did not enhance social welfare from the fact that the studies did not find a statistically significant improvement in the rate of return enjoyed by the purchasers of newly issued shares relative to the rate enjoyed by share purchasers generally.

*c. The difficulty in conducting a properly designed rate of return study*

These problems with the existing studies raise an important question: What would be the proper way to design a test of whether imposition of new issue mandatory disclosure increased net social welfare? To answer this question, start by recalling from Part I that a disclosure-induced increase in the accuracy with which new share issues are priced will improve project choice in the economy.<sup>121</sup> The market will therefore better allocate scarce capital. Recall also that in choosing among all the proposed new real investment projects in the economy, society ideally would want to implement them in rank order of their risk-adjusted expected returns (based on all available information including what is known by the managers making each project proposal), with the marginal project just exhausting society's scarce savings for investment. Because of information asymmetries between each proposed project's managers and the market, the ideal will not be reached. With more accurate prices, however, fewer projects with risk-adjusted expected returns below this marginal project will be implemented and fewer projects with risk-adjusted expected returns above this marginal project will be foregone. As a result, there will be an increase in the number of dollars of expected future cash flow generated by projects funded by a given amount of savings through new issues of equity. If this increase, discounted to present value, exceeds the cost of the extra disclosure, society will experience a net social gain.

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literature concerning the possibility of such inefficiencies in the new issue market and the role, if any, that greater disclosure can play in reducing them).

<sup>121</sup> See *supra* Section I.C.2.

Assume for a moment that greater disclosure does lead to such a net social gain. Consider the effect of this gain on the market for capital—the market for expected future dollars. The same number of dollars invested today through the purchase of newly issued equity will, with greater disclosure, generate an increased number of expected future dollars. This increased supply will drive down the price today of an expected future dollar, whether the source of that expected future dollar is newly issued equity or any other investment vehicle. Stated more conventionally, if greater disclosure leads to a net social gain, it will also lead to an increase in the economy-wide risk-adjusted expected rate of return on investment.

This analysis suggests that the only way to determine empirically whether the Securities Act's new issue mandatory disclosure has led to a net social gain is to see whether the overall risk-adjusted rate of return increased after the Act's adoption. In theory we could perform this test. The practical problem, however, is that new stock offerings have represented only a small fraction of the total amount of real investment occurring in the corporate sector each year.<sup>122</sup> Suppose that greater disclosure sufficiently improves the choice of real investment projects funded by new issues of equity so that, after accounting for the costs of disclosure, the number of future dollars expected to be generated by the projects so chosen substantially increases. In absolute dollar terms, this increase would represent an important net social gain. In relative terms, however, it will represent only a small percentage increase in the number of expected future dollars from all real investment projects, because most real investment projects are funded in other ways. Thus, the price of a future dollar will go down only slightly, or, again to state the result more conventionally, the expected rate of return on investment, including investment in newly issued equity, will go up only slightly.<sup>123</sup>

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<sup>122</sup> Stigler's study, for example, looked at new issues during the period 1949–55 to see if their purchasers did better than did purchasers of new issues during the pre-Act period of 1923–28. See Stigler, *Public Regulation*, *supra* note 12, at 120. For the period 1949–55, the proceeds from new stock issues constituted only 10.7% of the amount spent by U.S. corporations on new plant and equipment. See Bureau of the Census, U.S. Dep't of Commerce, *Statistical Abstract of the United States* 493 tbl.602 (1957).

<sup>123</sup> Put another way, if increased new issue disclosure produces a net social gain, purchasers of new equity issues will enjoy only a small portion of that gain. Three other

In sum, the proper way to design a study of the net welfare effects arising from imposition of the Act would be to see whether there was a change in the overall rate of return on investment in the economy. Such a study would likely not provide meaningful answers, however, because the statistical power of the tests available to us is not great enough to pick up the impact of the Act on the economy-wide rate of return. Even if the Act's requirements, by improving allocation of funds raised by new equity issues, led to a welfare gain that substantially exceeded disclosure's costs in absolute dollar terms, the Act's disclosure regime would probably have only a very small effect on the economy-wide risk-adjusted expected rate of return on investment. Investors in new equity issues would enjoy no greater improvement in their expected rate of return than would any other investors. Given the simultaneous changes in all the other factors that affect this rate of return—from Federal Reserve policy to trends in the international economy—the gain that occurs as the result of imposing new issue mandatory disclosure would almost certainly be lost in the background noise and would not show up as statistically significant.

### *3. Studies of the Effect of Periodic Mandatory Disclosure on Rate of Return*

The only systematic inquiry into the impact of mandatory periodic disclosure on shareholder returns is contained in the study by Benston discussed in Section II.A.1.b. above.<sup>124</sup> Benston's study is different from the studies measuring the returns to the imposition of mandatory new issue disclosure. The new issue studies, as we have just seen, are fundamentally misdesigned because the index they use as the measure of the reform's impact—the ratio of the expected rate of return of the particular securities involved to that of the market as a whole—will remain unchanged regardless of the size and direction of the reform's net impact on social welfare. Benston's study is not vulnerable to this criticism. It compares the

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groups will enjoy the rest: (1) the sellers of the shares, since the increased cash flows produced as a result of better capital allocation will be discounted at an only slightly higher rate; (2) investors in all the other available investment vehicles; and (3) suppliers of all other factors of production in the economy. See Fox, *Disclosure in a Globalizing Market*, supra note 20, at 2556.

<sup>124</sup> See Benston, supra note 12; supra Section II.A.1.b.

market valuation of the already outstanding shares of two sets of firms, one that would be expected to be more affected by the Exchange Act reform than the other if in fact the higher required level of disclosure, as a general matter, enhanced net social welfare by reducing the agency costs of management.<sup>125</sup> The power of the statistical tests that Benston uses, however, is weak, probably unavoidably so. Moreover, Benston's study also has its own basic design problems. Ultimately, as with the new issue studies, Benston's periodic disclosure work reveals little one way or the other about the reform's impact on social welfare.

*a. Benston's results*

Recall that Benston looked at the returns of 466 NYSE firms, 290 of which had disclosed sales data before imposition of the Exchange Act regime (the "disclosure" firms) and 176 that did not (the "nondisclosure" firms).<sup>126</sup> He used the market model to calculate each group's cumulative average residual for the period between February 1934 and June 1935, a period during which the Exchange Act's mandatory disclosure requirements were initially imposed.<sup>127</sup> The market model is used in this fashion to control for factors that affect returns in the market generally, thereby making it easier to isolate and identify the effect, if any, of the particular event under study—in this case, imposition of mandatory periodic disclosure. Benston found that the cumulative residuals were +.10% for the disclosure group compared with +.72% for the nondisclosure firms,<sup>128</sup> thus suggesting that the requirements increased each group's value. Neither figure, however, was significantly different from zero statistically.<sup>129</sup> This result leads Benston to con-

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<sup>125</sup> See *supra* Section I.C.3.

<sup>126</sup> See Benston, *supra* note 12, at 138, 141–49.

<sup>127</sup> See *id.* at 146. The cumulative residual is a measure of how well, over a period of time surrounding the event in question (in this case imposition of the Exchange Act), the stock outperformed (or, if negative, underperformed) its expected return given general trends in the market. See Gilson & Black, *supra* note 30, at 193–204; *supra* note 88. Thus, if the cumulative residuals were positive for the nondisclosure firms, this result would provide affirmative evidence that the firms were made more valuable by being forced to disclose sales, presumably because the gains from increased managerial discipline exceeded the costs of disclosure.

<sup>128</sup> See Benston, *supra* note 12, at 147 n.22.

<sup>129</sup> See *id.* at 147–48.

clude that “the disclosure provisions of the ‘34 Act were of no apparent value to investors.”<sup>130</sup>

*b. Problems with the statistical power of Benston’s tests*

Benston is overly hasty in his conclusion. The fact that the cumulative residual for the *disclosure* firms is not significantly different from zero means nothing. The Act was imposed on all NYSE companies, and thus any effect that it would have on the disclosure firms would be completely absorbed by the market-wide return that the market model abstracts out of the cumulative residual. Benston appears to have already made up his mind about these firms anyway. Benston starts with the assumption that imposition of the Act on the disclosure firms will have no effect because he considers sales to be the only important accounting number not already disclosed by all NYSE firms, and the disclosure firms were already providing sales figures.<sup>131</sup>

The fact that the cumulative residual for the *nondisclosure* firms is not significantly different from zero does not mean a great deal more. The statistical power of the test that Benston uses is sufficiently weak that it would not pick up any plausibly sized increase in value from imposition of the sales requirement. An example will illustrate the point. Suppose that requiring firms to disclose their sales figures had a sufficiently great positive impact on the devices that limit managerial discretion that, despite the costs of the requirement, it increased the value of the firms not previously disclosing this information by 0.5%. Putting this figure in the context of today’s market, a 0.5% increase would represent a net social gain of about \$19 billion.<sup>132</sup> This amount obviously represents a huge social gain and would make the disclosure requirement highly worthwhile. Yet, due to background noise, this gain would not be

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<sup>130</sup> Id. at 149.

<sup>131</sup> See id. at 142; *supra* notes 92–107 and accompanying text (discussing this extremely dubious assumption).

<sup>132</sup> The market capitalization of all NYSE listed companies at the end of 1997 was approximately \$10 trillion. See NYSE, *Fact Book for the Year 1997*, at 40 (1998). Therefore, if firms representing 38% of this capitalization increased in value by 0.5% as a result of imposition of the disclosure requirement, this increase would represent a gain of \$19 billion.

large enough, in all likelihood, to have associated with it a price change that is statistically significant.

To see this point, start by noting that in an efficient market, the share price of nondisclosure firms would have risen commensurately with the hypothetical 0.5% increase in value when the Act was imposed. Other chance factors occurring simultaneously, however, would almost certainly also have affected the prices of the nondisclosure firms' shares so that the effect of the sales disclosure requirement on share price could not be ascertained with certainty. Due to these other factors, the observed changes in share prices at the time that the sales disclosure requirement is imposed, even after adjustment by the market model, would likely differ substantially from that 0.5% increase.<sup>133</sup>

For the price change that accompanies imposition of the sales disclosure requirement to be considered statistically significant, the change must be sufficiently different from zero that one can, with reasonable confidence, reject the "null hypothesis" that the true effect of imposing the requirement is zero and that the observed price change results solely from the other chance factors. The "standard error" is a statistically derived estimate of the tendency of these other factors to cause the *observed* price changes to deviate from the *actual* effect of the imposition of the requirement on prices. The standard error in Benston's study was 3.07%.<sup>134</sup> As a result, the observed adjusted price change would have to be at least 5.53% before we could reject the null hypothesis with 95% confidence, the usual standard for deeming a result statistically significant.<sup>135</sup> In other words, the observed change would have to be that large in order for us to say with 95% confidence that imposition of the sales requirement had any positive effect. There is a *less than one in twenty-five chance* that an increase of 0.5% in the actual value of the nondisclosure firms—a \$19 billion gain—will be ac-

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<sup>133</sup> The expected value of the effect of these other factors on share price is zero, but this only means that these factors are as likely to add to the effect on share price of the imposition of the sales disclosure requirement as to subtract from it.

<sup>134</sup> See Benston, *supra* note 12, at 147 n.22.

<sup>135</sup> 5.53% represents 1.96 standard deviations. If the change in value were in fact zero and the adjusted price change was normally distributed, 95% of the time the adjusted price change would be within  $\pm 5.53\%$ . See Hogg & Craig, *supra* note 77, at 96-101, 370.

compared by an observed change in share prices sufficiently large—at least 5.53%—to meet this standard.<sup>136</sup>

This example demonstrates two things. First, it shows the danger of confusing statistical significance with economic significance, as Benston obviously did in concluding that his study showed that the disclosure provisions of the Exchange Act were of no apparent value to investors.<sup>137</sup> Second, it illustrates the extraordinary, and unwarranted, burden that Romano puts on those who doubt the wisdom of her proposed changes. She cites to the Benston article as her prime exhibit for the proposition that the empirical burden is on the doubters, stating that “[t]here is little tangible proof of the claim that corporate information is ‘underproduced’ in the absence of mandatory disclosure”<sup>138</sup> and suggesting that Benston’s finding “surely undermines blind adherence to the status quo.”<sup>139</sup> In reality, Benston’s findings are not capable of undermining much. *Mandatory disclosure was bound to fail the test Benston set up for it. Whatever the value to investors of the sales disclosure requirement, it was almost certainly going to appear statistically insignificant.*

As with new issue disclosure, it is unlikely that the impact of mandatory periodic disclosure on net social welfare will ever be resolved empirically. Increased periodic disclosure and its consequent increase in secondary market price accuracy can, as discussed in Part I, reduce the extent to which managers of public corporations place their own interests above those of their share-

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<sup>136</sup> This calculation involves the distribution of possible observed values of the price change if the true value of the price change that results from imposition of the sales disclosure requirement is an increase of 0.5%. Since the observed change in prices will be considered statistically significant at the 95% level and have the right sign only if it is an increase or decrease of greater than 5.53%, the question becomes: What are the chances that the observed change after imposition of the requirement will be of that magnitude? Because of the number of observations, the distribution of possible observed changes will approximate a normal distribution with a mean of 0.5% and a standard deviation equal to the standard error of 3.07%. The required positive change, 5.53%, is 1.80 standard deviations above 0.5%, and so, based on standard statistical tables for the normal distribution, there is a 3.6% chance that the observed change in prices will be an increase of greater than 5.53%. Thus, the chance that the observed change will be considered statistically significant and have the correct sign is 3.6%.

<sup>137</sup> To be precise, Benston said the data is “consistent” with this hypothesis. See Benston, *supra* note 12, at 149. The example shows that the data is equally consistent with the hypothesis that the disclosure provisions were of value to investors.

<sup>138</sup> Romano, *supra* note 1, at 2373.

<sup>139</sup> *Id.* at 2372.



holders. If the value of the resulting improvement in the agency relationship exceeds the cost of the disclosure, society will experience a net social gain. Again, this gain would increase the number of dollars of expected future cash flow generated by existing projects and hence increase the overall rate of return on investment. Thus, in theory, we could also determine whether the Exchange Act's mandatory periodic disclosure requirements have led to a net social gain by testing whether the overall rate of return increased after the initial imposition of the Act's requirements on issuers. We have the same problem, however, as with new issue disclosure—even a substantial improvement in absolute dollar terms would be nearly impossible to detect.

*c. Design problems in Benston's study*

There are also three fundamental design problems with Benston's use of the nondisclosure firms' average cumulative residuals as a measure of the social welfare effect of the sales disclosure requirements. The first difficulty arises from the fact that a full 38% of the firms traded on the NYSE did not disclose sales prior to the imposition of the Exchange Act.<sup>140</sup> Any impact that the Act's sales disclosure requirement had on the value of these firms would therefore have a significant effect on the market-wide return. The market model, however, abstracts the market-wide return out of the cumulative residuals.<sup>141</sup> Thus, the cumulative average residual of the nondisclosure firms will significantly understate the effect of the sales requirement on these firms and, as a consequence, will aggravate the weakness of the statistical power of the available tests.

The second design problem comes from the fact that the Act not only forced the nondisclosure firms to begin providing their sales figures, it also required the disclosure firms significantly to improve the quality of the sales figures they were already providing. Prior to the imposition of the Act, there was great variation among these firms with respect to how the sales figure was reported.<sup>142</sup> After the Act's adoption, sales figures were reported in a more uniform and standardized fashion, making the information more accessible to

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<sup>140</sup> See Benston, *supra* note 12, at 142.

<sup>141</sup> See *supra* note 127 and accompanying text.

<sup>142</sup> See *supra* note 91.

investors.<sup>143</sup> Thus, if the Exchange Act's sales disclosure requirement increased the value of the nondisclosure firms, it should also have increased the value of the disclosure firms, though perhaps by a smaller amount. This increase in the returns of the disclosure firms would increase the average market-wide return. Again, the market model abstracts out the market-wide return from each firm's residuals, including those of the nondisclosure firms. Thus, average cumulative residuals of the nondisclosure firms would further understate the effect of the sales requirement on these firms and hence even further aggravate the weakness of the available statistical tests.

The third design problem arises from the fact that the sales disclosures by each nondisclosure firm, as discussed in Part I, produce positive externalities that are enjoyed by the firm's competitors, customers, and suppliers.<sup>144</sup> Many of the firms benefiting from these externalities were disclosure firms, which, after all, constituted 62% of the firms in Benston's study.<sup>145</sup> The externalities enjoyed by the disclosure firms are part of the social benefits produced by imposition of the Act, but they were not captured by the average cumulative residuals of the nondisclosure firms since the returns of the nondisclosure firms did not reflect these benefits. Indeed, the residuals of the nondisclosure firms will instead reflect the counterbalancing negative effects on them resulting from their competitors, customers, and suppliers starting to know the nondisclosure firm's sales figures. Thus, the interfirm costs associated with the nondisclosure firms beginning to disclose their firm's sales figures would have a negative effect on the average cumulative residuals of the nondisclosure firms even though these interfirm costs are not social costs. As a result, Benston uses the wrong baseline for measuring whether requiring the nondisclosure firms to start disclosing their sales figures leads to a positive net social gain. If the requirement had a zero net social gain, the residuals of the nondisclosure firms would be expected to be negative. If the average residuals of the nondisclosure firms is zero, this would suggest the requirement led to a positive net social gain.

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<sup>143</sup> See *id.*

<sup>144</sup> See *supra* notes 91, 102–05 and accompanying text.

<sup>145</sup> See Benston, *supra* note 12, at 142.

*B. The State Corporate Law Competition Literature*

Professor Romano believes that the literature concerning the social welfare effects of competition among the states in the area of corporate law strongly supports her issuer choice proposal.<sup>146</sup> Corporate law competition develops because, under existing choice of law rules, U.S. corporations are free to select their state of incorporation regardless of their physical location and where they do business.<sup>147</sup> Romano characterizes this arrangement as “a responsive legal regime that has tended to maximize share value.”<sup>148</sup>

The proposition that state competition for corporate charters enhances U.S. economic welfare is in fact a controversial one and has been the subject of one of corporate law's most intense debates in the last twenty years. The opening salvo in the debate was fired by William Cary in an article finding this competition to be a harmful “race for the bottom.”<sup>149</sup> Cary believed that states cater to the self-interested desires of corporate managers for minimal regulation.<sup>150</sup> Ralph Winter responded with an argument that competition leads to a “race to the top,” since the state offering the corporate law rules that maximize share value will be offering firms the lowest cost of capital.<sup>151</sup> He suggested that managers are compelled to seek a low cost of capital by forces in both the market for corporate control and in the market for their products.<sup>152</sup> A number of commentators have offered a more mixed evaluation of charter competition as well. After considering the theoretical arguments and reviewing the empirical evidence, these studies view charter competition neither as so broadly helpful as do Winter and

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<sup>146</sup> See Romano, *supra* note 1, at 2383–88.

<sup>147</sup> Under the “internal affairs” doctrine in conflict of laws jurisprudence, if a corporation located or doing business in State A is incorporated under the laws of State B, State A will apply State B's corporate law to the corporation. See Restatement (Second) of Conflict of Laws §§ 301–02 (1971).

<sup>148</sup> Romano, *supra* note 1, at 2362; see also Roberta Romano, *The Genius of American Corporate Law* 1–31 (1993) (arguing that the existing choice of law system, in which U.S. corporations can select their state of incorporation, promotes the maximization of share value).

<sup>149</sup> William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *Yale L.J.* 663, 666, 705 (1974).

<sup>150</sup> See *id.* at 666.

<sup>151</sup> See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251, 256 (1977).

<sup>152</sup> See *id.* at 264–66.

Romano nor as so broadly harmful as does Cary.<sup>153</sup> If these more mixed evaluations are correct, state charter competition has not been share value maximizing in many regards and our experience with it provides little basis for the proposition that issuer choice would be superior to the current mandatory system of disclosure regulation.

Even if Romano is correct that state competition for corporate charters is share value maximizing, Romano overstates her case when she says that “[t]here is no reason to expect state competition to operate differently for securities law than it does for corporate law.”<sup>154</sup> Unlike a firm’s decision to include—through its choice of where to incorporate—certain corporate governance terms in its charter, a firm’s decision to commit—through a choice of securities regime—to a higher level of disclosure has positive externalities.<sup>155</sup> As we have seen, this fact can have a crucial effect on the workings of regulatory competition since it induces issuers to demand securities regimes requiring them to disclose at levels below what is socially optimal.<sup>156</sup>

### *C. Implications of the Available Empirical Studies for Whether Reform Should be Undertaken*

The following picture emerges from the foregoing review of the available empirical studies. There is affirmative evidence for the proposition that mandatory disclosure has increased the amount of meaningful information in the market and has improved price accuracy. Everything else being equal, these benefits will lead to in-

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<sup>153</sup> See William L. Cary & Melvin Aron Eisenberg, *Cases and Materials on Corporations* 125–32 (7th ed. 1995); Bebchuk, *supra* note 20, at 1455–58; Black & Kraakman, *supra* note 65, at 1974–77; Merritt B. Fox, *The Role of the Market Model in Corporate Law Analysis: A Comment on Weiss and White*, 76 Cal. L. Rev. 1015, 1035–44 (1988); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Colum. L. Rev. 1908, 1909–10 (1998).

<sup>154</sup> Romano, *supra* note 1, at 2385.

<sup>155</sup> See *supra* Section I.C.

<sup>156</sup> See *supra* Part I. Lucian Bebchuk makes the point that it is precisely because disclosure involves these positive externalities that disclosure is more suitably regulated at the federal level than under a system subject to competitive pressures. See Bebchuk, *supra* note 20, at 1490–91. He contrasts disclosure regulation with other areas of corporate law not involving positive externalities and concludes that these other areas would be better regulated primarily at the state level specifically because of the potential for jurisdictional competition. See *id.* at 1485–95.

creased social welfare. Mandatory disclosure, however, involves costs as well. Affirmative evidence is lacking for the proposition that the benefits are greater than the costs. Affirmative evidence is also lacking for the proposition that the costs are greater than the benefits. Given the limited power of the statistical tests available to test these latter two propositions, the imposition of mandatory disclosure would have to have had an extraordinarily large positive or negative net effect on social welfare in order to make its effects detectable.

The empirical evidence concerning the social welfare effects of competition in the state corporate law area is mixed. In any event, the evidence is not really relevant to the issuer choice debate because the behavior regulated by corporate law does not involve significant third-party effects while securities disclosure does. Indeed, as we have seen in Part I of this Article, these third-party effects are a primary reason for the existence of mandatory disclosure regulation in the first place.

This picture of the available empirical studies argues against undertaking the radical reform of issuer choice for two reasons. First, as laid out in Part I, theoretical analysis suggests that there will be a substantial market failure if an issuer choice regime is adopted. We know that at least for some additional increase in the level of disclosure above the amount that issuers will provide under issuer choice, the increased benefits will exceed the increased costs. This is because under an issuer choice system, each issuer will choose a regime requiring a sufficiently low level of disclosure that the marginal social benefit of additional disclosure exceeds its marginal social cost. Thus, mandatory disclosure, by requiring a higher level of disclosure, has the unquestionable potential to increase social welfare. The proponents of issuer choice have presented no theory as to why government is so disabled that its attempts to correct this market failure are likely to be more damaging than the market failure itself.

Given that empirical studies have not resolved the issue one way or the other, the preponderance of our understanding of the subject is theoretical. Theory points toward retaining mandatory disclosure rather than toward adopting issuer choice. Under these circumstances, it is inappropriate for the proponents of issuer

choice to argue that a lack of affirmative empirical evidence showing that the benefits of mandatory disclosure exceed its costs means that we should abandon mandatory disclosure, particularly given how unlikely it is that the matter will ever be capable of empirical resolution.

The second reason why this picture of the existing empirical studies argues against adopting issuer choice rests on the prudential maxim that persons advocating change have the burden of proof.<sup>157</sup> Mandatory disclosure has been in effect for over sixty years and is a generally well-regarded government program. To the extent that empirical studies should play a role in deciding whether to change, it is the proponents of issuer choice that need to show empirically that mandatory disclosure causes harm, not the proponents of retaining the current system that need to demonstrate that it leads to a net social gain.

### III. THE CAPACITY OF ISSUER CHOICE TO ACCOMMODATE DIFFERENCES AMONG U.S. ISSUERS IN THEIR SOCIALLY OPTIMAL LEVELS OF DISCLOSURE

Each U.S. issuer has a socially optimal level of disclosure, where the social marginal benefit of the issuer's disclosure just equals its social marginal cost.<sup>158</sup> One issuer's socially optimal level may well differ from another's. Professors Choi and Guzman argue that issuer choice is desirable because it better accommodates these differences.<sup>159</sup> According to them, the competition among jurisdictions engendered by issuer choice would lead to a range of different regimes corresponding to these differing issuer needs. Each issuer would then choose the regime most suitable for it.<sup>160</sup>

This Part appraises their argument and finds three problems. First, issuer choice may not in fact give rise to a set of regimes requiring disclosure levels corresponding to these differing issuer needs. All the world's major jurisdictions may in the end require

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<sup>157</sup> See Easterbrook & Fischel, *supra* note 13, at 714–15 (applying this maxim to the same issue).

<sup>158</sup> See *supra* Section I.A.

<sup>159</sup> See Choi & Guzman, *National Laws*, *supra* note 14, at 1874–83.

<sup>160</sup> See *id.* at 1878.

approximately the same level of disclosure. Second, even if issuer choice does give rise to a differentiated set of regimes, the potential that this range of regimes affords for better accommodating issuer needs will not be realized. As demonstrated in Part I, each issuer is unlikely to choose the regime requiring it to disclose at its socially optimal level. Rather, it will choose one requiring significantly less disclosure. Finally, Choi and Guzman offer no account of why, to the extent that significant differences do exist among U.S. issuers in their respective socially optimal levels of disclosure, the federal mandatory regime cannot provide different rules for different issuers. To some extent, it does so even today.

These three problems suggest that concern about accommodating differences among U.S. issuers is a poor reason to adopt issuer choice. Compared to the alternatives, issuer choice is likely to lead to a greater, not smaller, average deviation between the level at which each U.S. issuer is required to disclose and the issuer's socially optimal disclosure level.

*A. The Range of Regimes Offered to U.S. Issuers  
Under Regulatory Competition*

*1. The Need to Establish that Regulatory Competition Will Lead to an Appropriately Differentiated Set of Regimes*

An essential first step in showing that regulatory competition will enhance, rather than harm, social welfare is to establish that it will give rise to a set of choices that are better tailored to the particular needs of individual U.S. issuers than is the current mandatory regime.<sup>161</sup> The proponents of issuer choice have not demonstrated convincingly that it will.

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<sup>161</sup> A more elaborate statement of this criterion follows. Regulatory competition would give rise to some given set of regimes from among which U.S. issuers would choose. For each issuer, this set will include some regime with requirements closer to the issuer's particular socially optimal level of disclosure than the requirements of any other regime. Compared to the level currently required by the U.S. system, the alternative level required by this regime may be closer to, or further from, this issuer's socially optimal level of disclosure. If, on average, it is further from the socially optimal level, we can confidently say, without knowing more, that issuer choice would harm social welfare. If on average it is closer, a necessary but not sufficient condition has been met for showing that issuer choice improves social welfare. The inquiry then

It is easy to imagine, like Choi and Guzman do, that regulatory competition would indeed lead to a range of disclosure choices.<sup>162</sup> In this story, each jurisdiction would try to maximize the number of issuers utilizing its regime by tailoring its requirements to appeal to a different niche in the market.<sup>163</sup> It is just as easy to imagine, however, that each major jurisdiction would instead try to maximize its number of issuers by appealing to the broadest possible segment of the market, the approach that the large television networks traditionally have followed with respect to broadcast programming.<sup>164</sup> In that event, each such jurisdiction would offer a regime that minimizes the average distance between its requirements and the preferences of each of the world's issuers. In this second story, all these regimes would have essentially the same disclosure requirements.<sup>165</sup> U.S. issuers would move from being regulated by a standard designed for the average U.S. issuer to being regulated by one designed for the average issuer worldwide. This result would reduce, not enhance, U.S. welfare because the only effective choices then available to U.S. issuers would likely have requirements further from these issuers' socially optimal level of disclosure than are the requirements of the current U.S. mandatory regime.<sup>166</sup>

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would go on, as in Sections III.B–C of this Article, *infra*, to consider whether, for each issuer, this alternative is the regime that the issuer would in fact choose, and whether refining the current mandatory system to take better account of the differences among U.S. issuers presents a better course of action for reform.

<sup>162</sup> See Choi & Guzman, *National Laws*, *supra* note 14, at 1874–75.

<sup>163</sup> Choi and Guzman refer to this situation as a “separating equilibrium.” *Id.* at 1878.

<sup>164</sup> See Newton N. Minow, *Address to the National Association of Broadcasters*, May 9, 1961, in *Newton N. Minow & Craig L. LaMay, Abandoned in the Wasteland: Children, Television, and the First Amendment 185, 190–91* (1995).

<sup>165</sup> Choi and Guzman refer to this situation as a “pooling equilibrium.” Choi & Guzman, *National Laws*, *supra* note 14, at 1879–80.

<sup>166</sup> Most of the factors that determine an individual issuer's socially optimal level of disclosure are ones that U.S. issuers share more in common with each other than they do with issuers from other countries, a point acknowledged by Choi and Guzman. See *id.* at 1882–83. Thus, the individual levels for most U.S. issuers will be much closer to the U.S. average than to the world average. See *infra* Section III.B. Suppose that issuer choice results in an undifferentiated set of regimes, as this text suggests is quite possible. See *infra* Section III.A.3. Then, assuming that the current U.S. regime at least roughly reflects this U.S. average, U.S. issuers would be better governed by it than by the regimes that would be made available under issuer choice by the major jurisdictions (including the United States), which would instead reflect the world average. U.S. issuers that are not trying to avoid disclosure altogether will



The proponents of issuer choice see their reform as creating a market in which jurisdictions compete to sell a product—disclosure regulation. The question raised by these two alternative scenarios is whether this market would or would not in fact make available an efficiently differentiated range of this product. Product differentiation is the subject of an extensive literature in industrial organization economics.<sup>167</sup> This literature suggests that there is no reliable correspondence, as a general matter, between the pattern of differentiation that results from market competition and the pattern of differentiation that is socially optimal.<sup>168</sup> Some models suggest there will be too little differentiation, with each producer seeking to offer a product close to the preferences of the average consumer.<sup>169</sup> Other models suggest that there will be too much differentiation, with each producer trying to soften price competition by differentiating itself from its competitors.<sup>170</sup>

The literature on product differentiation is thus at odds with Choi and Guzman's general suggestion that we can count on the competitive market to get right the level of differentiation:

[W]e argue that the global securities market should be free to determine for itself—through a market-based competitive process between regimes—the amount of diversity in regimes. The market will then balance the benefit to issuers and investors from multiple regimes against the cost to different countries of maintaining a completely different level of regulation.<sup>171</sup>

More is needed than this simple appeal to the general efficiency of market processes if the proponents of issuer choice are to provide any assurance that the set of regimes resulting from regulatory

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probably feel bound to choose only from among the jurisdictions of the major capitalist countries. Only those countries can probably provide regimes with a credible promise of expert administrative and enforcement processes.

<sup>167</sup> The seminal work in this area is Harold Hotelling, *Stability in Competition*, 39 *Econ. J.* 41 (1929). The modern literature in the area is surveyed in Jean Tirole, *The Theory of Industrial Organization* 277–303 (John Bonin & H el ene Bonin trans., 1994).

<sup>168</sup> See Tirole, *supra* note 167, at 279–87.

<sup>169</sup> See, e.g., Hotelling, *supra* note 167, at 56–57.

<sup>170</sup> See C. d'Aspremont et al., *On Hotelling's "Stability in Competition,"* 47 *Econometrica* 1145 (1979).

<sup>171</sup> Choi & Guzman, *National Laws*, *supra* note 14, at 1883.

competition will in fact improve the possible choices available to U.S. issuers.

## 2. *Choi and Guzman's Approach*

Choi and Guzman claim that significant differentiation among regulatory regimes is "likely."<sup>172</sup> While they do not lay out an explicit model on which they base this prediction, they provide a story about how a differentiated set of regimes might well arise.<sup>173</sup> They imagine a world with two types of issuers, *A* and *B*, and two

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<sup>172</sup> Choi & Guzman, *Portable Reciprocity*, supra note 5, at 906.

<sup>173</sup> See *id.* at 917; Choi & Guzman, *National Laws*, supra note 14, at 1874–82. Reconstructing Choi and Guzman's reasoning as to why they believe that a significantly differentiated set of choices is likely to arise from issuer choice requires putting the articles "Portable Reciprocity: Rethinking the International Reach of Securities Regulation" and "National Laws, International Money: Regulation in a Global Capital Market" together. The result is not entirely satisfactory. Their more recent piece, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation," contains the conclusion that significant differentiation is "likely." Choi & Guzman, *Portable Reciprocity*, supra note 5, at 906. The rationale they give for this conclusion, however, is simply the idea that each jurisdiction will seek to appeal to a different niche of issuers:

[D]ifferent issuers and investors will prefer different regimes. If there is sufficient capital mobility, competition for issues is likely to lead to more than one regime. Countries will find themselves unable to attract all types of issuers and investors, because these securities market participants will not all seek the same regulatory regime. In response, countries will target only a part of the overall market.

*Id.* at 917.

Choi and Guzman do not explain in this recent piece, however, why this result is more likely than each jurisdiction seeking to appeal to the broadest segment of investors. They instead cite to their earlier piece, "National Laws, International Money: Regulation in a Global Capital Market," for "[a] detailed discussion of how such a diversity of regimes may come about . . ." Choi & Guzman, *Portable Reciprocity*, supra note 5, at 917 n.58 (citing Choi & Guzman, *National Laws*, supra note 14, at 1874–82). The review of their analysis in Section III.A.2 *infra* is based on that earlier, more detailed discussion. It should be noted that in the earlier discussion, however, Choi and Guzman take no position as to whether jurisdictional competition is more likely to lead to a differentiated or undifferentiated set of regimes. They simply note that the undifferentiated outcome would be unstable in the absence of each jurisdiction possessing some kind of natural advantage over certain issuers. See Choi & Guzman, *National Laws*, supra note 14, at 1880. Since each major jurisdiction almost certainly does have such a natural advantage today, see *infra* note 182, Choi and Guzman then suggest various factors that might—but might not—be sufficient to counteract such a natural advantage. See Choi & Guzman, *National Laws*, supra note 14, at 1881.

countries, 1 and 2.<sup>174</sup> *A* issuers want a high level of disclosure and *B* issuers want a low one. Each country has both types of issuers. Country 1 is large and has relatively more *A* issuers. Country 2 is small and has relatively more *B* issuers.<sup>175</sup> Initially each country is isolated. Country 1's regime, reflecting the preponderance of *A* issuers, requires a level of disclosure closer to *A*'s ideal, and Country 2's a level closer to *B*'s ideal.<sup>176</sup> International capital mobility and jurisdictional competition are then introduced.<sup>177</sup> Country 2, Choi and Guzman suggest, may seek to expand the volume of issuers covered by its regime by moving its regime even closer to *B*'s ideal level. While this shift may result in the loss of some *A* issuers, it would be more than counterbalanced by the gain in *B* issuers. In response, Country 1 may resign itself to the loss of *B* issuers and move even closer to *A*'s ideal level of required disclosure. The final result would be a significantly differentiated set of choices that are closer to each type of issuer's private optimum than prevailed on average before.<sup>178</sup>

Choi and Guzman, however, acknowledge that jurisdictional competition could result in an undifferentiated set of choices instead. They can see this result occurring if Country 1 responds to Country 2's action by itself moving more toward *B*'s ideal level in order to retain those of its *B* issuers that would otherwise defect to Country 2.<sup>179</sup> Through a path they do not fully describe, each country's regime would then end up requiring the same disclosure level. They argue, however, that unless each country has some "natural" advantage for retaining its own issuers, this result would be unstable.<sup>180</sup> Country 2, seeing that Country 1's abandoned *A* issuers are ripe for the picking, would reverse strategy and move towards *A*'s ideal level of required disclosure, again creating a significantly differentiated set of regimes.<sup>181</sup> Choi and Guzman go on to explore the

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<sup>174</sup> See Choi & Guzman, *National Laws*, supra note 14, at 1876–81.

<sup>175</sup> See id. at 1877.

<sup>176</sup> See id.

<sup>177</sup> See id.

<sup>178</sup> See id. at 1877–78.

<sup>179</sup> See id. at 1879–80.

<sup>180</sup> See id. at 1880.

<sup>181</sup> See id.

extent to which each country might in fact have such a natural advantage and the factors that would chip away at these advantages thereby making any temporary lack of differentiation unstable.<sup>182</sup>

### 3. An Alternative Approach

Consider, however, an alternative scenario that uses Choi and Guzman's same simple assumptions and is at least as plausible. In this scenario, jurisdictional competition leads to an undifferentiated set of regimes and the result *is* stable. The starting point is the same, with the same two countries, each initially isolated, and the same two types of issuers. Again, international capital mobility and jurisdictional competition are then introduced. Assume that neither country has any natural advantage with respect to any of the issuers—the very condition that Choi and Guzman suggest would make the undifferentiated result they conjure up unstable. Each issuer will thus choose its regime entirely on the basis of how close each regime comes to the issuer's privately optimal level of required disclosure. Either country can move first in response to this change in circumstances. Whichever country does take the first step will adopt requirements equal to *A*'s privately optimal

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<sup>182</sup> See *id.* at 1880–81. Choi and Guzman's own approach suggests a significant likelihood that an undifferentiated set of choices would in fact be stable. The United States and the other major capitalist countries almost certainly have, and are likely to retain for some time, a natural advantage with issuers of their own nationality. As long as financial information is not fully globalized, U.S. investors, for example, will continue to exhibit their very substantial bias toward investing in U.S. issuers. See Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2512–15, 2523–29. Given the strong bias of U.S. investors for U.S. issuers, U.S. investors are likely to have a strong bias toward the U.S. disclosure regime as well. Most U.S. issuers, wanting to satisfy their most natural group of investors, are therefore likely to choose the U.S. regime. One can tell the same story about issuers and investors in each of the small number of other large capitalist countries with established regulatory regimes.

Under these circumstances, the United States and the few other large capitalist countries will, according to mechanisms identified by Choi and Guzman, each seek to attract the minority of issuers of the world that do not have a strong affinity for their home country's regime. See Choi & Guzman, *National Laws*, *supra* note 14, at 1880. These jurisdictions will do so by offering such issuers a disclosure regime reflecting the lowest common denominator, the way the large television networks traditionally competed for viewers in the United States. See Minow, *supra* note 164, at 190–91. This process will require each of the countries to move their regimes toward some world-average required level of disclosure.

level since, worldwide, there are more *A* firms than *B* firms.<sup>183</sup> The other country responds by adopting the same standards. This response is based on an expectation, standard in models of this type, that if two producers offer the identical product at the same price, they would then divide equally the available customers. In this case, Country 1 and Country 2 would divide equally both the *A* issuers (who would be fully satisfied and indifferent as to which country to choose) and the *B* issuers (who would be less than fully satisfied but also indifferent between the two countries). The result is a stable equilibrium. Requiring *A*'s privately optimal disclosure level, compared to requiring any other level of disclosure, would make each country better off given at least one of the choices that the other country might make, and at least as well off given any other choice the other country might make. In game theory terms, requiring *A*'s privately optimal level of disclosure is thus the dominant strategy for both countries.<sup>184</sup>

<sup>183</sup> Under Choi and Guzman's assumptions, *A* is the preponderant kind of firm in the larger country. See Choi & Guzman, *National Laws*, *supra* note 14, at 1877. If there were more *B* firms than *A* firms worldwide, the same scenario would play out, but with each jurisdiction adopting requirements equal to *B*'s privately optimal level.

<sup>184</sup> Consider a model of this situation based on game theory. The first mover can choose between (1) requiring *A*'s privately optimal level of disclosure, and (2) requiring something less. There would be no reason to require more disclosure than *A*'s privately optimal level since that would be less appealing to all issuers. The second mover can choose among (1) requiring more than the first mover chose to require (but, for the same reasons, not more than *A*'s privately optimal level), (2) requiring the same level as the first mover chose, and (3) requiring less than the level the first mover chose. If the first mover chose *A*'s privately optimal level, the second mover's choices (1) and (2) are the same.

Consider how this game would play out. Assume arbitrarily that there are 70 *A* issuers in the world and 30 *B* issuers. If there is a difference in the regimes' required disclosure levels, the *A* issuers choose the regime with a required level closer to their private optimum and the *B* issuers choose the regime closer to their private optimum. If both regimes require the same level, both types of issuers divide evenly between the two regimes since the issuers are indifferent between the regimes. The payoff diagram in terms of the number of issuers adopting each regime would be as follows:

		Second Mover		
		(1)	(2)	(3)
First Mover	(1)	50,50	50,50	70,30
	(2)	30,70	50,50	70,30

The real world, of course, is more complicated than the simple assumptions on which any of these scenarios is based. The supply of each kind of issuer, for example, may be influenced over time by the particular level or levels of disclosure required by the available regimes. And each jurisdiction may be motivated in its choice of required level by more than the number of issuers it can attract to adopt its regime. As suggested by the brief discussion above concerning product differentiation generally, the amount of differentiation (if any) in any given market is determined by a number of factors that pull in different directions. Pulling in favor of differentiation is intense price competition, since differentiation tends to soften such competition.<sup>185</sup> Pulling in favor of nondifferentiation is a desire to maximize unit sales, which means choosing characteristics that minimize the average distance between what is offered and what each individual consumer wants.<sup>186</sup> Nondifferentiation is also more likely where a producer's consumers gain some benefit from the mere similarity of its product to that of another producer.<sup>187</sup> The literature offers no intuition suggesting that one set of factors or the other should dominate as a general matter.<sup>188</sup> In the real world we observe both markets with a great deal of product differentiation and markets with almost none.

As for the particular market we are concerned with—the market for disclosure regimes—forces for nondifferentiation would, if anything, be particularly strong. For one thing, proximity produces a clear benefit. Consider the later of two jurisdictions to choose the requirements constituting its disclosure regime. If the later-choosing regime selects requirements close to, rather than far from, those of the earlier-choosing jurisdiction, it helps investors—who have learned to interpret the meaning of the disclosures under the earlier-choosing jurisdiction's regime—to interpret the disclo-

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The dominant strategy for each jurisdiction is its choice (1). That decision would make it better off than it would be under any other choice it might make given at least one of the choices of the other party, and at least as well off as it would be under any other choice it might make given any other choices of the other party.

<sup>185</sup> See Tirole, *supra* note 167, at 286.

<sup>186</sup> See *id.*

<sup>187</sup> See *id.* (discussing nondifferentiation as a method for lowering consumers' search costs).

<sup>188</sup> See *id.*

asures required under the later-choosing jurisdiction's regime as well. Also, price competition is likely to be limited in this market. According to Choi and Guzman's own description, unit sales maximization, not revenue maximization, appears to be the main force driving the behavior of jurisdictions in their choice of a required level.<sup>189</sup> As Choi and Guzman see it, the larger the number of issuers choosing a jurisdiction's regime, the greater the size and importance of the regulating agency, the more transactions effected on the markets located in the jurisdiction, and the greater the agency's economies of scale.<sup>190</sup>

#### 4. Conclusion

In sum, Choi and Guzman overstate things when they conclude that a differentiated set of regimes is a "likely" result of jurisdictional competition. A more appropriate conclusion would be that we have very little idea about what such competition would bring. Indeed, based on what we do know, an undifferentiated set of regimes seems the more likely result.<sup>191</sup> Thus, Choi and Guzman have not achieved an essential first step in demonstrating that issuer choice will match disclosure regimes with issuers in a way that enhances, rather than harms, social welfare.

*B. Even if a Differentiated Set of Regimes Does Develop,  
Issuer Choice's Capacity to Customize is Not Worth  
its Bias Toward Underdisclosure*

Suppose that jurisdictional competition does lead to an appropriately differentiated set of regimes, as Choi and Guzman hope. Thus, for each U.S. issuer, there is some jurisdiction that will offer a required disclosure level approximately equal to the issuer's social optimum. Choi and Guzman assume that the issuer will select

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<sup>189</sup> In explaining disclosure choice, Choi and Guzman barely give mention to revenue considerations. See Choi & Guzman, *Portable Reciprocity*, supra note 5, at 923.

<sup>190</sup> See *id.* Based on a review of the literature on product differentiation, Tirole states that "[i]t is, thus, clear that the incentive to differentiate products decreases when firms do not compete in prices. Indeed, Hotelling (1929) enunciated the principle of *minimal differentiation* in such circumstances." Tirole, supra note 167, at 287.

<sup>191</sup> It is also possible that a differentiated set of regimes will result, but that the regimes will be too differentiated from a social welfare point of view.

this jurisdiction. Choi and Guzman's assumption is incorrect. As discussed in Part I, the persons who will choose each issuer's disclosure regime will be its managers. They have a preference for choosing a regime with a level of required disclosure substantially lower than the issuer's socially optimal disclosure level.

This fact raises the question of whether the cure—issuer choice with its tendency toward underdisclosure—is worse than the disease—the lack of accommodation to individual differences among U.S. issuers under the supposedly “one-size fits-all” federal mandatory disclosure regime. There are good reasons to believe that the cure is worse than the disease. In other words, even if issuer choice results in an appropriately differentiated set of regimes—a dubious proposition in and of itself—it may still increase the average deviation between each U.S. issuer's actual level of disclosure and its socially optimal one. After all, as discussed below, the differences in socially optimal disclosure levels among U.S. issuers (at least among issuers that represent the bulk of capital in the United States) are small relative to differences between U.S. issuers and the major issuers of other countries. Thus, on the one hand, the cost of imposing a uniform U.S. system of mandatory disclosure on U.S. issuers is not necessarily very great in terms of its lack of customization. On the other hand, under issuer choice, issuers will have a strong tendency, as we have seen, to select regimes requiring them to disclose at a level substantially below their social optimums.

The effectiveness of disclosure in helping to reduce the agency costs of management and in assuring the best choice of real investment projects in the economy depends on an issuer's internal decision structure and the corporate finance environment in which the issuer operates.<sup>192</sup> Studies in comparative corporate govern-

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<sup>192</sup> The internal decisionmaking structure arises out of a combination of the law of the jurisdiction of incorporation and the issuer country's traditional business customs and practices. Custom and practice include both the typical terms of the firm's articles of incorporation and the manner in which people typically behave within a given set of publicly and privately imposed legal constraints. The corporate finance environment is determined by a number of factors, including the degree of concentration of share ownership, the nature of the holders of any such concentrated blocks, the rules and practices under which these holders use their voting power singly and in cooperation with others, the extent to which the legal system and suppliers of finance facilitate or hinder hostile takeovers, and the relative availability of financing in dif-



ance show significant contrasts among countries in both internal decision structures and corporate finance environments.<sup>193</sup> Publicly traded issuers from a given country are likely to have much more in common with each other than with issuers from other countries with respect to these factors and therefore with respect to the effectiveness of disclosure as well. Controlling for costs, the more effective disclosure is, the higher the socially optimal level of disclosure. Unlike effectiveness, there is no reason to expect major variations in the costs of disclosure across countries. Thus, issuers from any given country will tend to have optimal levels of disclosure that are closer to each other than they are to those of issuers from other countries.

By way of illustration, one can make a set of rough contrasts between the United States (and Canada, and, to a lesser extent, the U.K.) on the one hand, and Germany and Japan on the other. These contrasts suggest significant differences in the value of disclosure. Voting power in U.S. issuers is less concentrated and institutional investors in U.S. issuers are less inclined, separately or together, to exercise their voting power to influence corporate decisions.<sup>194</sup> Debt/equity ratios are lower,<sup>195</sup> and there is more use of publicly offered equity as a source of finance,<sup>196</sup> particularly by relatively new companies financing major projects. Hostile tender offers are more frequent, as are solicitations of public shareholders in proxy fights.<sup>197</sup> In contrast, in Germany and Japan, institutional in-

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ferent forms (equity versus debt) and from different sources (private versus public markets).

<sup>193</sup> See, e.g., Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994); Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 *Mich. L. Rev.* 1997 (1994).

<sup>194</sup> See, e.g., Roe, *supra* note 193, at 169–70.

<sup>195</sup> See, e.g., F.X. Browne, *Corporate finance: stylized facts and tentative explanations*, 26 *Applied Econ.* 485, 488 (1994) (“[Non-financial firms in securities-based financial systems (the United States, the United Kingdom and Canada) have quite low debt/equity ratios compared to those in the bank-based systems of Japan, Germany and France.”).

<sup>196</sup> See, e.g., *id.* at 494 (stating that internal funding is significantly greater in the United States, the United Kingdom, and Canada than in Japan and continental Europe).

<sup>197</sup> See Roe, *supra* note 193, at 172 (Germany); Coffee, *Liquidity*, *supra* note 30, at 1299–1300 (comparing the U.S. to Japan).

vestors play a larger role both in monitoring managerial behavior and in supplying finance, mostly debt.<sup>198</sup>

The picture painted here suggests that the optimal level of disclosure for U.S. issuers would be higher than for German and Japanese ones. Compared to their foreign counterparts, U.S. institutional investors do less monitoring of the way issuers' managers make both operating and project choice decisions. U.S. institutional investors collect, analyze, and act on less information (both public and nonpublic) concerning these matters. Thus, more of the work of aligning managerial and shareholder interests with respect to these decisions falls to devices—such as the hostile takeover threat—that are assisted in their effectiveness by greater public disclosure. Greater disclosure and its enhancement of share price accuracy also does more to promote good project choice in the United States because of the greater reliance placed by U.S. start-up companies on the public equity markets as a source of capital.<sup>199</sup>

It is thus apparent that among issuers worldwide, a major portion of the dispersion in their socially optimal levels of disclosure is explained by their nationalities. This reality argues for an approach that applies to each issuer a regime requiring the level of disclosure that is socially optimal for the typical issuer of its nationality. There is certainly variation in optimal disclosure levels among U.S. issuers. This variation, however, is insufficiently great, particularly for those issuers representing the bulk of U.S. corporate capital, to justify trying to accommodate it by a method—issuer choice—that would introduce a substantial bias toward under-disclosure.

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<sup>198</sup> Japanese firms borrow \$5.33 from banks for every dollar they raise in the capital markets, German firms \$4.20, and American firms \$0.85. See Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 *Stan. L. Rev.* 73, 81–89 (1995).

<sup>199</sup> Ronald Gilson and Bernard Black show that the prospect of a vibrant initial public offering market for issuers that have shown a certain degree of success greatly facilitates the earlier provision of venture capital to get them off the ground in the first place and explains why there is so much more venture capital available in the United States than in other industrialized countries. See Ronald J. Gilson & Bernard S. Black, *Venture capital and the structure of capital markets: banks versus stock markets*, 47 *J. Fin. Econ.* 243 (1998).

*C. The Possibility of Providing Different Rules for Different Issuers  
Within a Mandatory Disclosure Regime*

The argument that issuer choice is needed to accommodate differences among U.S. issuers is further undermined by the fact that an alternative exists for accomplishing the same result without creating a risk of a globally undifferentiated set of regimes or introducing a substantial bias toward underdisclosure. This alternative would be for the U.S. mandatory disclosure regime to provide different rules for different issuers. Less would be required of those issuers with indices suggesting that their socially optimal level of disclosure is relatively low. To some extent, the U.S. regime provides this kind of differentiated treatment of issuers already. Small issuers, for example, can register a public offering of new shares under Regulation A, which requires less detailed disclosure.<sup>200</sup> This rule appears to reflect the economies of scale involved in disclosure: The social benefits from disclosure rise proportionately with the size of the issue, but the social costs do not. Similarly, issuers with fewer than 500 shareholders who do not trade on a national stock exchange and have not engaged in a public offering need not provide periodic disclosure at all, even if they are very large firms.<sup>201</sup> This exception appears to reflect the idea that less substantial agency costs of management exist in firms that have relatively few shareholders.

Choi and Guzman need to explain why this less radical reform is not an adequate response to their problem with the mandatory system—its insufficient accommodation of differences among U.S. issuers with respect to their socially optimal levels of disclosure. The closest Choi and Guzman come to offering such an explanation is to suggest that issuer choice will “affect[] the incentives of domestic lawmakers to fashion regimes designed to maximize the welfare of securities market participants.”<sup>202</sup> This Article, however, shows that the results of jurisdictional competition are likely to fall well short of such welfare maximization. One could argue, of course,

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<sup>200</sup> See 17 C.F.R. §§ 230.251–230.263 (1999); Small Business Initiatives, 57 Fed. Reg. 36,442, 36,442–49 (1992).

<sup>201</sup> See 15 U.S.C. §§ 78l(a), (g) (1994).

<sup>202</sup> Choi & Guzman, *Portable Reciprocity*, *supra* note 5, at 923.

that the incentives of regulators in a mandatory disclosure system are so perverse that the rules they produce would fall even farther short, but the proponents of issuer choice do not seriously attempt such an argument.<sup>203</sup>

Choi and Guzman also suggest that issuer choice would provide issuers the opportunity to signal their "quality" by their choice of regime, asserting that "[w]hen a firm issues in a high quality regime, investors know there is relatively little risk even without examining the disclosures made under that regime. Therefore, the advantages of disclosure are supplemented by the signal provided by the regime choice."<sup>204</sup> If this signaling effect were indeed an advantage of issuer choice, it is not an advantage that could be supplied by a mandatory disclosure regime, even one that attempts to differentiate among issuers. Close examination, however, suggests that it is not such an advantage. Choi and Guzman's application of the signaling concept in this particular context simply does not make much sense. As the foregoing quotation shows, what Choi and Guzman claim an issuer can signal by choice of regime is its level of riskiness. The only kind of risk that they could be talking about here is firm specific (i.e., unsystematic) risk, since that is what issuer disclosure is all about. Yet the fundamental lesson of portfolio theory is that diversified investors care only about the systematic risk associated with an issuer, something about which the choice of regime signals nothing.<sup>205</sup> Moreover, even if "quality" covers additional firm attributes about which investors in fact would care, there is no special advantage in being able to ascertain these attributes by simply examining the issuer's choice of regime rather than by investigating all the issuer's underlying disclosures. In an efficient market, the investor has no need to examine either, since these attributes would already be reflected in the issuer's share price.

In sum, concern about accommodating the differing disclosure needs of U.S. issuers is a poor reason for abandoning mandatory disclosure and adopt issuer choice. Indeed, there is a serious

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<sup>203</sup> See *infra* Part VI.

<sup>204</sup> Choi & Guzman, *Portable Reciprocity*, *supra* note 5, at 924.

<sup>205</sup> See *supra* Section I.C.1.

risk that, compared to the alternatives, issuer choice will lead to a greater, not smaller, divergence between the level at which each U.S. issuer is required to disclose and the issuer's socially optimal disclosure level. Issuer choice has three problems in this regard. First, it may not in fact give rise to a set of regimes requiring disclosure levels corresponding to the differing needs of U.S. issuers. Second, even if it does, each issuer is likely to choose a regime requiring a level of disclosure well below what is socially optimal for it. Finally, a mandatory system itself can be designed to provide considerable accommodation to the different needs of different issuers.

#### IV. THE COSTS OF TRANSITION TO ISSUER CHOICE

Determining the desirability of a proposed reform requires consideration of the transition costs associated with its implementation, not mere contemplation of how the reform would work in equilibrium once it has been up and running for some time. The specific concern here relates to currently existing, publicly traded U.S. issuers. The firms currently belonging to this group represent the bulk of productive capacity in this country today.<sup>206</sup> In the aggregate, these particular firms are likely to continue to be a major, if diminishing, factor in the economy for several decades into the future. The efficient operation of these enterprises is thus a matter of vital national concern, as is the fair distribution of the wealth they generate. Currently, these issuers have both their new issue and periodic disclosures regulated by the U.S. federal regime. Professor Romano and Professors Choi and Guzman differ in how to deal with these issuers upon adoption of an issuer choice regime, but the approach of each raises serious problems with their overall plan.

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<sup>206</sup> Historical statistics give a sense of the importance to the U.S. economy of corporations that are publicly held and hence subject to the Exchange Act's periodic disclosure requirements. Consider just the largest 200 nonfinancial corporations. Edward Herman estimated that 83% of these were management controlled (a conclusion that requires that they have dispersed public ownership). See Edward S. Herman, *Corporate Control, Corporate Power* 54 (1981). At the time of that estimate, the 200 largest manufacturing corporations held 60% of all manufacturing assets in the country. See *Mergers and Industrial Concentration: Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 95th Cong.* 155 (1978) (statement of Michael Perschuk, Chairman of the Federal Trade Commission).

*A. Romano's Approach*

Professor Romano does not explicitly address the question of what would happen to existing issuers at the time that issuer choice is adopted. She presumably intends that these issuers would initially continue to be subject to the current U.S. federal regime. Management, however, would be allowed at any point thereafter to change regimes with the approval of a majority of the shareholders.<sup>207</sup>

If Romano's issuer choice plan is implemented, the managers of each existing issuer will switch their firm to a regime requiring an inefficiently low level of disclosure unless the checks against such self-serving action prove strong enough to prevent it. Everything else being equal, managers prefer as low a level of periodic disclosure as possible. Low disclosure reduces the effectiveness of devices that limit managerial discretion and hence provides managers with more room to satisfy their own objectives at the expense of shareholders.<sup>208</sup> This preference will exist even when the gains to the managers are smaller than the losses to the shareholders.

In many cases, the checks against managers' self-interested behavior will indeed be insufficiently strong to prevent a switch to a regime with socially suboptimal requirements. The reasons for this weakness are the same as the reasons—discussed in Part I—that the market, at the time of an IPO, will fear that an issuer's initial choice of a regime with an efficiently high level of disclosure will not endure over the whole life of the firm.<sup>209</sup> In brief, collective action problems make the requirement of a shareholder vote a notoriously poor check on managerial preferences of this sort.<sup>210</sup> While the switch to a regime with an inefficiently low level of disclosure will depress share prices in the secondary market and reduce the attractiveness of any future use of equity financing, these results do not impact managers directly. And to the extent that they impact managers indirectly, their effects are often attenuated.<sup>211</sup>

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<sup>207</sup> See Romano, *supra* note 1, at 2415–18.

<sup>208</sup> See *supra* Section I.C.3.

<sup>209</sup> See *id.* Every firm that engages in an IPO becomes a publicly traded issuer with its existing capital managed indefinitely under the discretion of management.

<sup>210</sup> See *id.*

<sup>211</sup> See *id.*

The prospect of such switches to regimes requiring lesser disclosure is troubling for two reasons. First, it suggests that adoption of issuer choice is likely to lead to significant new inefficiencies involving firms that currently control the bulk of the economy's productive capital. Eventually, less disciplined management combined with the inevitable turnover in the ranks of major firms generally will cause such firms to fade in importance, but the costs during the decades-long period of transition are potentially huge. This concern is independent of many of the problems with issuer choice identified in Parts I and II. It does not depend, for example, on the existence of third-party effects arising from the fact that an issuer's disclosures are useful to other issuers and their investors. Nor is it related to the risk that a globally undifferentiated set of regimes would develop, with each regime requiring a level of disclosure that on average is further from the socially optimal disclosure level of each U.S. issuer than is the level required by the current U.S. mandatory regime. Thus, even if the problems identified in Parts I and II were to prove unfounded, issuer choice's potentially huge transition costs make it a questionable reform.

Second, adoption of the reform could significantly redistribute wealth from the investors who hold the outstanding shares of existing issuers to the managers of these issuers. These shares were initially issued and traded during a period in which investors assumed that the managers would be bound for the life of the firm by the disciplining effects of the current, federally mandated level of disclosure. Issuer choice would permit the switch to a disclosure regime in which managers could act more to their own benefit at the expense of shareholders. Although every legal reform alters expectations in ways that arbitrarily redistribute wealth, we should be cautious about ones that involve potentially major redistributions while offering at best only speculative net gains to society. At a minimum, realizing that this redistribution will occur illuminates the large private interest in implementing issuer choice possessed by some of its corporate management advocates.

### *B. Choi and Guzman's Approach*

Under Professors Choi and Guzman's version of issuer choice, an issuer would select a securities law regime at the time of each

new issue of securities.<sup>212</sup> Unlike Romano, Choi and Guzman propose no exit mechanism. Thus, if their version of issuer choice were adopted, existing public U.S. issuers would presumably be deemed to have chosen the federal disclosure regime for their outstanding shares. They would thus continue to be bound by its periodic disclosure requirements for the duration of their corporate lives.

Choi and Guzman's approach thus avoids the transition costs involved in Romano's approach. By the same token, however, their approach greatly reduces the significance of the overall reform since, for perhaps decades, the majority of U.S. issuers would continue to be bound by the U.S. federal system for periodic disclosure. Moreover, for any issuer so bound, the advantages of choosing a foreign regime for a new issue of securities are diminished as well. While a foreign jurisdiction's new issue regime might not require disclosure of certain items that the U.S. regime does require, the issuer is generally bound in due course to provide these items under the U.S. periodic requirements anyway.<sup>213</sup> Thus, choosing a foreign regime to govern a new issue of securities at best provides just a bit of a delay in having to make public the items of information required by the U.S. new issue regime.<sup>214</sup>

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<sup>212</sup> See Choi & Guzman, *Portable Reciprocity*, *supra* note 5, at 922.

<sup>213</sup> If the U.S. issuer did choose the U.S. regime for its new issue of securities, it would, pursuant to Section 5 of the Securities Act, need to register these securities on Form S-1, S-2, or S-3. The questions concerning the issuer that each of these Forms asks come from cross-references to certain items in Regulation S-K. See 17 C.F.R. §§ 229.10-229.915 (1998). The information concerning the issuer that it is in any event bound to produce annually pursuant to the periodic disclosure system is set out in Form 10-K, information that is solicited by questions that also come from cross-references to certain items in Regulation S-K. A quick review of the list of items cross-referenced by each shows a high degree of overlap. Indeed, the fact that the traditional S-1 registration statement was simply asking the same information that the issuer needed to produce anyway under its Exchange Act periodic disclosure obligations was a major premise behind the SEC's adoption of integrated disclosure in the early 1980s, with its provisions for short-form registration of established issuers and liberalized rules for shelf registration. See Fox, *Shelf Registration*, *supra* note 63, at 1007-08.

<sup>214</sup> There is, however, greater potential liability associated with providing inadequate answers to the new issue disclosure requirements than to the periodic ones. See *supra* note 63. This greater potential liability may be a reason for an issuer to choose another jurisdiction's regime. It also means, as a practical matter, that under the U.S. regime an issuer is likely to disclose more in response to the same questions when it is bound by the new issue requirements rather than by just the periodic requirements.



Also, for most existing U.S. issuers of any significance, the effort involved in complying with the U.S. new issue requirements may actually be lower than the effort involved with a foreign regime. Even though foreign jurisdictions require a lower overall level of disclosure than does the U.S. regime and little of the information asked for by them is substantially different from anything asked for under the U.S. regime, the questions—and hence their appropriate answers—are somewhat different in form. In contrast, an issuer already bound by the U.S. periodic regime that chooses the U.S. regime to govern its new issue of securities can, in most cases, meet its requirements simply by incorporating by reference its answers in the periodic reports it has already filed.<sup>215</sup>

If Choi and Guzman are serious about the benefits they believe can be achieved from a system of issuer choice, they are going to need to modify their proposal to resemble more closely Romano's suggestion. In making this alteration, however, Choi and Guzman will have to face the objection raised here to Romano's approach, namely that the transition costs associated with a switch to an issuer choice system will be enormous.

## V. FOREIGN ISSUERS

Currently, a foreign issuer wishing to offer its shares or to have them traded in the United States must generally comply with the requirements of the U.S. disclosure regime.<sup>216</sup> Under an issuer choice system, a foreign issuer would be able to choose its own country's regime instead. The proponents of issuer choice argue that this regime would improve international capital mobility and reduce costs because foreign issuers no longer would be deterred

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<sup>215</sup> Under Securities Act Form S-3, the issuer only has to provide information about the terms of the securities and the way the offering will be underwritten. Information about the business of the issuer may be incorporated by reference from previous Exchange Act periodic disclosure filings. To qualify to use a Form S-3, an issuer must have provided periodic disclosure pursuant to Exchange Act requirements for at least one year and have equity outstanding with a market value of at least \$75 million. Since the bulk of industrial capital in the United States is controlled by the largest 500 corporations, see Fox, *Finance and Industrial Performance*, *supra* note 63, at 117, 414–15, it is controlled by issuers that more than easily meet these requirements.

<sup>216</sup> See Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2610–17.

by the U.S. regime's high-disclosure requirements from entering U.S. markets or seeking U.S. investors.<sup>217</sup> These are indeed valuable benefits, but obtaining them does not require adoption of issuer choice with all of its associated problems. The same benefits can be secured by maintaining the current U.S. mandatory regime but by redirecting its reach so that it applies to all U.S. issuers and to no foreign issuers (with nationality determined by an issuer's economic center of gravity).

I have argued elsewhere that redirecting the reach of the U.S. regime in this fashion is a desirable reform.<sup>218</sup> Briefly, my reasons are as follows. The efficient market hypothesis assures us that an issuer's share price will be discounted in the market to reflect the investor welfare effects of its applicable disclosure regime.<sup>219</sup> This fact means that the primary function of disclosure is promotion of efficiency in the real economy, not investor protection. As discussed in Part I, an appropriate level of disclosure by a country's issuers can, through its positive effects on managerial motivation and the choice of real investment projects, increase the returns

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<sup>217</sup> See Choi & Guzman, *Portable Reciprocity*, supra note 5, at 922–23; Romano, supra note 1, at 2419–20.

<sup>218</sup> See Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 Mich. L. Rev. 696 (1998) [hereinafter Fox, *Political Economy*]; Fox, *Disclosure in a Globalizing Market*, supra note 20, at 2618–19. Nothing in my proposal is intended to prevent a foreign issuer from electing to bind itself to the U.S. regime on an ongoing basis; I only suggest that the U.S. regime not be mandatorily imposed on foreign issuers.

<sup>219</sup> See Fox, *Disclosure in a Globalizing Market*, supra note 20, at 2533–39, 2554–61. The concept that prices are discounted to reflect the investor welfare effects of the applicable regime is also a cornerstone of the case for issuer choice. See Choi & Guzman, *Portable Reciprocity*, supra note 5, at 925; Romano, supra note 1, at 2366–67. This concept has its limits, however. My proposal to exempt foreign issuers from the U.S. regime does not apply, at least when the proposal is first implemented, to foreign issuers engaging in IPOs in the United States and ones whose shares trade primarily in poorly developed securities markets such as those that exist in many of the emerging markets countries. See Fox, *Political Economy*, supra note 218, at 739–41. The reason for this restriction is doubts about the efficiency of the markets in which these securities are sold or traded, because with no assurance about the efficiency of these markets there is no assurance that the prices of the securities trading in them are properly discounted to reflect the welfare effects of the applicable disclosure regime. See *id.* The willingness of the proponents of issuer choice to allow such transactions without the issuers providing U.S. level disclosure is another danger of their proposal.

generated by capital-utilizing enterprises.<sup>220</sup> A competitive market in disclosure regimes, however, will lead a country's issuers to disclose at below that socially efficient level.<sup>221</sup> The chief losers from suboptimal disclosure are the *country's* entrepreneurial talent and labor, not the *issuer's* investors, since competitive forces push capital, with its greater international mobility, toward receiving a single global expected rate of return (adjusted for risk) regardless of the disclosure practices of a given country's issuers.<sup>222</sup>

The United States thus has a strong interest in the disclosure level of all U.S. issuers. Because of the market failures involved, we would want this level determined under a system of mandatory disclosure, not one of issuer choice. By the same token, the United States has little interest in the disclosure behavior of foreign issuers, even those issuers whose shares are sold to or traded among U.S. residents.<sup>223</sup> There is thus no reason to mandate that foreign issuers comply with the U.S. system. The right response to the globalizing market for securities is not to abandon the U.S. system of mandatory disclosure, but to refocus its application to where it is needed. Such a response would be just as effective at improving international capital mobility and reducing costs as would adopting issuer choice, but would create none of the problems associated with issuer choice.

## VI. CONCLUSION

Issuer disclosure serves several social functions. It improves the selection of proposed real investment projects in the economy, enhances the effectiveness of the mechanisms that help align the interests of managers and shareholders, and reduces the risk for less than fully diversified investors. Because disclosure involves social costs as well, however, there are limits on how much of this good thing we want. Thus, each U.S. issuer has an optimal level of dis-

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<sup>220</sup> See *supra* Sections I.C.2-3.

<sup>221</sup> See *supra* Parts I, II.

<sup>222</sup> See Fox, *Political Economy*, *supra* note 218, at 732-33; Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2561-69.

<sup>223</sup> See Fox, *Political Economy*, *supra* note 218, at 736-41; Fox, *Disclosure in a Globalizing Market*, *supra* note 20, at 2554-61.

closure. The fundamental policy question is how to get each issuer to disclose at a level as close to this social optimum as possible.

One approach, tried in the United States until the Great Depression, is total nonregulation. Each issuer is completely free to determine how much information it will disclose. There are a number of market failures associated with this approach that are likely to result in most issuers significantly underdisclosing. These failures arise from a number of sources. An issuer's disclosures are useful to its competitors, suppliers, and customers, but the issuer receives no reward in return. The disclosures are useful as well to investors in assessing the value of the securities of other issuers, but again the issuer captures none of that benefit. This second set of benefits is important because it improves both the process by which the interests of the shareholders and managers of other issuers are aligned and the process by which real investment projects associated with other issuers are selected. Finally, without regulation, issuer managers have trouble vouching for the accuracy of their disclosures or credibly committing to provide an optimal level of periodic disclosure over time.

A second approach, used by the United States for the last sixty years, is mandatory regulation. The function of mandatory disclosure is to correct for the market failures identified above. This second approach relies on political processes, combined with bureaucratic expertise, to identify and enforce the socially optimal level of issuer disclosure.

Issuer choice represents a third approach. While it does, to some extent, improve the ability of issuer managers to vouch for the accuracy of their disclosures and to commit credibly to an optimal level of periodic disclosure over time, it does nothing to correct the other two market failures associated with total nonregulation. Issuer choice also creates the danger that each major jurisdiction, in an attempt to appeal to the broadest possible segment of a global set of issuers, will adopt the same, lowest-common-denominator required level of disclosure. This result would be less well suited to the needs of U.S. issuers than is the current mandatory regime. Finally, issuer choice may involve huge transition costs, as the managers of many existing, publicly traded

issuers may find it worthwhile to switch to inefficiently low disclosure levels.

This Article makes out a strong case for mandatory disclosure as the best approach for getting issuers to disclose at the socially optimal level. To overcome this case, the proponents of issuer choice would need to show that the governmental failures associated with regulation exceed the market failures likely to be associated with issuer choice. To date, issuer choice's supporters have not done so. For the most part, these proponents assume governmental failure and ignore market failure. The crux of their argument for issuer choice rests on the belief that competition among regulators will create positive incentive effects. This is not a persuasive argument for change absent a showing that these possible incentive effects are worth their cost in terms of the market failures that issuer choice will bring.

Where might such a showing come from? It is unlikely that it will come from empirical studies of the effects of the imposition of the Securities Act and the Exchange Act in the 1930s. Certainly, no study to date comes close to showing that the governmental failures associated with these regulations were more damaging to our economic welfare than the market failures in the period of total nonregulation preceding these Acts. The nature of the data strongly suggests that future empirical studies also are unlikely to resolve the issue of whether the governmental failure associated with mandatory disclosure is greater than the market failure associated with issuer choice.

If a showing is to be made that the governmental failure is the larger of the two, it likely will have to be made on the basis of theory. Yet, this avenue of attack is not so promising, either. Because the market failures associated with issuer choice assure us that issuers will disclose too little, an increase in disclosure will, over some range, increase social welfare. The proponents of issuer choice need to provide a theory as to why government is so disabled that its attempts to correct this shortfall will result in a required level of disclosure falling outside of this range.

The literature on public choice is a possible foundation for such a theory. Indeed, some commentators have argued on just this basis that mandatory disclosure represents overregulation at the be-

hest of the securities industry.<sup>224</sup> There are a number of reasons to be skeptical that a successful theoretical argument in favor of issuer choice can be built on this basis, however. To start, there is debate about the effectiveness of public choice theory in explaining regulation generally. There is hardly a consensus that most political action consists of self-interested rent-seeking.<sup>225</sup> Even if one believes that public choice theory has considerable explanatory value generally, a story that the influence of concentrated interests has led to too high a level of mandated disclosure may err in not correctly identifying all of the concentrated interests involved. Some members of the securities industry may well desire a high level of mandatory disclosure in order to reduce the costs of collecting information. Others, however, may prefer a low level. For example, if only a low level is required, more firms would be willing to become public companies, thereby resulting in more fee-generating initial public offerings and secondary trades. The story also omits consideration of the managements of established public corporations, whose interests are likely to favor low levels of required disclosure.<sup>226</sup> It also does not account for the possibility that the interests of those pushing for higher disclosure may coincide serendipitously with correction of the market failures that would occur under issuer choice.

This discussion suggests that mandatory disclosure is the best of the three approaches for getting issuers to disclose near their optimal levels. The proponents of issuer choice have yet to make a persuasive case that their approach would work better, and their prospects for doing so seem dim.

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<sup>224</sup> See Macey, *supra* note 13, at 922 (1994); Susan M. Phillips & J. Richard Zecher, *The SEC and the Public Interest* 22–23 (1981). But see Easterbrook & Fischel, *supra* note 13, at 670–73, 714–15 (considering the application of public choice theory to this problem but concluding that mandatory disclosure should be retained).

<sup>225</sup> For critical reactions to public choice theory, see Dorothy A. Brown, *The Invisibility Factor: The Limits of Public Choice Theory and Public Institutions*, 74 *Wash. U. L.Q.* 179 (1996); Richard H. Pildes & Elizabeth S. Anderson, *Slingshot Arrows at Democracy: Social Choice Theory, Value Pluralism, and Democratic Politics*, 90 *Colum. L. Rev.* 2121 (1990); Cass R. Sunstein, *Interest Groups in American Public Law*, 38 *Stan. L. Rev.* 29 (1985).

<sup>226</sup> See *supra* Part I.