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MANDATORY DISCLOSURE AND THE PROTECTION OF INVESTORS

Frank H. Easterbrook and Daniel R. Fischel***

THE Securities Act of 1933 and the Securities Exchange Act of 1934 have escaped the fate of many other early New Deal programs. Some of their companions, such as the National Industrial Recovery Act, were declared unconstitutional; others such as the Robinson-Patman Act, have fallen into desuetude; still others, such as Social Security, have been so changed that they would be unrecognizable to their creators. Many of the New Deal programs of regulation lost their political support and were replaced by deregulation; communications and transportation are prime examples.

The securities laws, however, have retained not only their support but also their structure. They had and still have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter. The notorious complexities of securities practice arise from defining the details of disclosure and ascertaining which transactions are covered by the disclosure requirements. There is very little substantive regulation of investments.

To be sure, the Securities and Exchange Commission (SEC) occasionally uses the rubric of disclosure to affect substance, as when it demands that insiders not trade without making "disclosures" that would make trading pointless, when it requires that a going private deal "disclose" that the price is "fair," and when it insists that the price of accelerated registration of a prospectus is "disclosure" that directors will not be indemnified for certain wrongs.

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Too, some amendments, such as the Williams Act provisions on tender offers, have substantive consequences. Although several of these refinements are important,[1] they are not the principal components of regulation. The dominating principle of securities regulation is that anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain.

Why have the laws survived? Those who enacted these statutes asserted that they were necessary to eliminate fraud from the market and ensure that investors would receive the returns they expected; otherwise, the argument ran, people would withdraw their capital and the economy would staguate.[2] This explanation seemed especially pressing in 1933, for there had been frauds preceding the Depression and much disinvestment during. On this public interest story, the interests served by the laws are the same now as they were then, and so the laws have retained their beneficial structure.

No scholar should be comfortable with this simple tale. Fraud was unlawful in every state in 1933; we did not need a federal law to penalize lying and deceit. Fraud in the sale of education is more important to most people of moderate means (the supposed beneficiaries of the securities acts) than fraud in the sale of securities; these people have a much greater portion of their wealth invested in human capital than in the stock market. Yet there are no federal laws addressing these other assets. There were many securities frauds before 1933, and there have been many since. The Investors Overseas Services, National Student Marketing, Equity Funding, and OPM Leasing frauds of the last decade are every bit as spectacular as the frauds of the 1920s.

The modern recognition, backed up by evidence, that much leg-

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[1] We have criticized parts of this regulation elsewhere. See, e.g., Carlton & Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857 (1983); Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L.J. 698, 728-31 & n.83 (1982); Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982); Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395, 418-26 (1983); Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Tex. L. Rev. 1 (1978). See also Easterbrook & Jarrell, Separate Statement *in* SEC Advisory Committee of Tender Offers, Report of Recommendations 70-106 (1983). But see Easterbrook, Insider Trading as an Agency Problem, *in* The Agency Relationship ___ (J. Pratt & R. Zeckhauser eds. 1984) (forthcoming) (disagreeing with Carlton & Fischel, supra).

[2] For a recounting of the public statements of those who lobbied for and enacted the laws, and of the events they cited as establishing the need for legislation, see J. Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporato Finance (1982).

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islation is the outcome of the interplay of pressure groups—and that only hy accident will interest group laws serve the hroader public interest—suggests another hypothesis.[3] The securities laws may be designed to protect special interests at the expense of investors.

The securities laws possess many of the characteristics of classic interest group legislation. Existing rules give larger issuers an edge, because many of the costs of disclosure are the same regardless of the size of the firm or the offering. Thus larger or older firms face lower flotation costs per dollar than do smaller issuers. The rules also help existing investment banks and auditing firms obtain an advantage because they acquire expertise and because rivals cannot compete by offering differentiated products.[4] The securities laws' routinization of disclosure reduces the number of paths to the marketplace and insists that all firms give investors "the best," just as airline regulation stifled the high-density, low-fare strategies that have flourished recently.

Many lawyers are specialized in securities work, and other market professionals depend on the intricacies of the law for much revenue. Although there may be too many members of these favored groups (larger issuers, investment banks, the securities bar) for them to charge monopoly prices, the members would suffer windfall losses if existing regulations were repealed. Thus they have every incentive to support the status quo on an interest-group ba-

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[3] The general statements of the interest group approach, are Peltzman, Toward a More General Theory of Regulation, 19 J.L. & Econ. 211 (1976); Posner, Taxation by Regulation, 2 Bell J. Econ. & Mgt. Sci. 22 (1971); Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. & Mgt. Sci. 3 (1971), revised and reprinted in G. Stigler, The Citizen and the State: Essays on Regulation (1975). See also Becker, A Theory of Competition Among Pressure Groups for Political Influence, 98 Q.J. Econ. 371 (1983) (a formal analysis of political equilibria with multiple interest groups).

[4] Henry Manne emphasized both of these points in what is surely the most comprehensive and thoughtful legal critique of the securities laws from an economic perspective. See Manne, Economic Aspects of Required Disclosure under Federal Securities Laws, *in* Wall Street in Transition 23, 31-40 (H. Manne & E. Solomon eds. 1974). See also H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose (1979); Benston, The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements, *in* Economic Policy and the Regulation of Corporate Securities 23 (H. Manne ed. 1969); Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Sigualling Theory, *in* Issues in Financial Regulation 177 (F. Edwards ed. 1979); Wolfson, A Critique of the Securities and Exchange Commission, 30 Emory L.J. 119 (1981).

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sis.[5] And if the losses from existing laws are spread across a large number of people (individual investors), each of whom would benefit only slightly from abolition, the current regulation could survive even if it reduces social welfare.

Unfortunately, no one knows why some pieces of legislation are enacted and survive while others do not. The interest group explanation that might account for securities legislation also could explain airline and trucking regulation, yet these systems have been almost obliterated. Perhaps securities laws have survived because they are not predominantly interest-group legislation. But it is parlous to equate survival of legislation with public interest. Tobacco, milk, and farm price supports, for example, have survived despite the recent emphasis on deregulation. Few would seriously argue that these laws are anything other than the most naked forms of interest-group legislation.

The survival of securities regulation thus is consistent with either the interest-group or the public interest perspective. Distinguishing between the two explanations is difficult. To be sure, the dominant theme of the recent avalanche of literature in the economics of regulation is that few if any regulatory schemes can be explained as pure public interest responses to market failure. And we have no doubt that support by benefited interest groups explains much of the continued support for securities regulation. We are less confident, however, that interest-group support is the *sole* explanation for securities regulation. We think it appropriate, therefore, to search for the "public interest" justifications of those laws.

We examine in this essay the functions of legal rules against fraud and rules compelling disclosure promulgated by the national government. Our principal conclusion is that neither the supporters nor the opponents of the fraud and disclosure rules have made a very good case. Those who portray the laws as classic public-

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[5] Some parts of the securities laws had obvious interest-group support. The foremost of these is the regulation of the exchanges, which until 1975 permitted the SEC to shore up a price-fixing cartel of brokers. We do not study these parts here, although it is conceivable that the regulation of the securities business is related to the regulation of investments in the sense that SEC enforcement of the cartel was the political price of obtaining regulation of investment. See Jarrell, Change at the Exchange: The Causes and Effects of Deregulation, 27 J.L. & Econ. ___ (1984) (forthcoming), for a careful exposition of the way regulation affected the price of exchange services.

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interest legislation systematically overlook how markets protect investors. Those who emphasize the power of markets often understate the costs of using markets and compare the real securities laws against hypothetical markets. The appropriate comparision is not regulation against market but one kind of regulation against another. But for the national securities laws, the regulation of securities would be in the hands of states and judges. We offer some reasons to believe that regulation in this alternative mode might be less satisfactory than the regulation we have now. Thus we are unable to reject either the interest-group or the public interest explanation of securities regulation.

I. The Federal Prohibition Against Fraud

A. The Market Without Legal Intervention

Fraud reduces allocative efficiency. So too does any deficiency of information. Accurate information is necessary to ensure that money moves to those who can use it most effectively and that investors make optimal choices about the contents of their portfolios. A world with fraud, or without adequate truthful information, is a world with too little investment, and in the wrong things to boot.

Securities are claims to the future income of firms. The problem in selling securities is that this income is subject to many risks, and no entrepreneur can make a binding promise about the amount of income the firm will yield in all possible circumstances. The entrepreneur or managerial team, however, has better information than the prospective investor about both the nature of these contingencies and how the firm will fare under them. Some business prospects have higher expected returns than others; some managers will produce more than others out of any given business prospect. The market is inefficient unless it matches projects, managers, and funds until, at the margin, the returns are equal. The better prospect-manager combinations should attract more funds until this equality condition is satisfied.

Yet how does an investor recognize the better combinations? Unless people who offer the "better securities" (those representing claims in the superior combinations) can distinguish themselves from others, investors will view all securities as average. Higher quality securities will sell at prices lower than they would if infor-

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mation were available costlessly, and there will be too little investment in good ventures. Meanwhile, low-quality securities will attract too much money. It will be cheap to offer a low-quality security; such offerings will be overcompensated. "Lemons" will dominate the market as the quality of investments offered deteriorates.[6] No firm could recover the costs of offering high-quality securities. Investors and society both lose. This is roughly the picture painted by many proponents of the securities laws.

One cannot leap from the difficulties of a market with asymmetric information to the conclusion that there is need for regulation—even such mild regulation as a prohibition of fraud. There are ways by which the sellers of high quality securities can identify themselves. One is to disclose information demonstrating quality. The buyer can verify some of this information, and this verification will lend credence to the rest. Verification will not work perfectly, though. Sometimes a firm must withhold information in order to avoid giving commercially valuable secrets to rivals. A firm thus will be hard pressed to convince buyers of the value of some secret production process or new but unreleased product. The other problem is that low quality sellers can mimic the disclosure of ascertainable facts while making bogus statements about things buyers cannot verify. The low quality firms erode the informational content of the disclosures of other firms, and again consumers cannot identify the high quality investments.[7]

Indeed, in securities markets only a limited amount of information can be verified at all. Investors cannot "inspect" a business venture in a way that enables them to deduce future profits and

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[6] See Ackerlof, The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970).

[7] This problem is more serious for securities than for most physical goods because of the difficulty of verification. A seller of a house must expect many buyers to verify statements about square footage, termites, and structural flaws. A seller of charcoal does not expect the buyer to test on the spot whether the charcoal will ignite without lighter fluid, but any misstatement will affect the probability of repeat purchases, and so the seller has little incentive to misrepresent. Many sellers have competitiors anxious to expose misstatements. All of these are effective in controlling the release of information no matter what the law does about fraud. See R. Posner, The Regulation of Advertising by the FTC (1973); Darby & Karni, Free Competition and the Optimal Amount of Fraud, 16 J.L. & Econ. 67 (1973); Nelson, Advertising as Information, 82 J. Pol. Econ. 729 (1974). But because each security is an interest in a unique project, neither competitors' statements nor the prospect of repeat purchases will impose restraints, and it is very hard for a buyer to verify statements before the sale.

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risks. Investors do not even want to inspect; they seek to be passive recipients of an income stream, not to be private investigators. When investors spend time and resources inspecting, each one's effort will duplicate another's. A system of inspection by buyers would forfeit much of the benefit of the division of labor.

Even after the business has been in operation for some time, it is hard to tell whether an unexpected outcome was attributable to changed conditions or luck rather than to a misdescription of the prospects. True, information about how a whole industry is doing will provide a basis for comparison so that claims of a member of the industry can be checked. Some of the firms' managers and promoters are "repeat players," so they will seek to preserve their reputations by telling the truth. Even so, it is possible that promoters may find the gains from one-shot deception greater than the reputational loss. It follows that some firms will find fraud to be the project with the highest net present value.

High quality firms must take additional steps to convince investors of their quality. One traditional step is to allow outsiders to review the books and records and to have these outsiders certify the accuracy of the firms' representations. The accountant who certifies the books of many firms has a reputational interest—and thus a possible loss—much larger than the gains to be made from slipshod or false certification of a particular firm.[8] Similarly, firms may sell their securities through investment bankers who inspect the firm's prospects, put their money on the line in buying the stock for resale, and put their reputations on the line in making representations to customers.[9] The larger the auditor or investment banker relative to an issuer, the more effective these methods of verification are. This suggests why investment bankers form syndicates to distribute securities even though any one could handle them alone. Syndication increases the amount of reputational capital put behind the offering.

The firms themselves can take actions that render their disclo-

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[8] See Benston, Security for Investors, *in* Instead of Regulation 169, 172 (R. Poole ed. 1981); DeAngelo, Auditor Size and Audit Quality, 3 J. Acct. & Econ. 183 (1981).

[9] See G. Benston, Corporate Financial Disclosure in the UK and the USA (1976); Fischel, Insider Trading & Investment Analysts: An Economic Analysis of *Dirks v. Securities and Exchange Commission*, 3 Sup. Ct. Econ. Rev. ___ (1984) (forthcoming); Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549 (1984); Smith, Comments on Jarrell, 24 J.L. & Econ. 677, 678 (1981).

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sures more believable. One such action is to ensure that their managers hold substantial quantities of their stock. This can be accomplished by stock options or by "cheap stock" when the firm goes public, as well as by inducing managers to buy stock in the market. Then if the firm does poorly, the managers lose with the other investors. The higher the quality of the stock, the more of it managers will be willing to hold in undiversified portfolios; the more managers hold, the more willing other investors will be to believe the firm's statements.[10] Another action open to the firm is to issue debt, which could lead to bankruptcy. This strategy might seem implausible, but consider that bankruptcy imposes very high costs on managers' portfolios and careers. By using leverage to increase the risk of bankruptcy, the firms with the best prospects and thus the lowest bankruptcy costs can certify themselves to investors.[11] Managers can establish a certification method by promising a high-payout policy too. This is attractive to investors because the consistent payment of dividends forces managers to return to the capital markets repeatedly in order to continue operations, and on the return visits the firm must again undergo careful scrutiny by the new investors.[12] Finally, managers could warrant their statements in the traditional way: They could make legally enforceable promises (perhaps backed up by insurers) to pay the investors if the firm does worse than promised (perhaps, say, in a comparison against a market index). The person vouching for the payment obligation would look very carefully at the firm's claims, so that only high-quality firms could find solvent guarantors, and the investors would be protected.

Even in a market without a rule against fraud, these methods of verification would offer investors substantial protection and make it possible for high quality firms to raise money. Investors, after all, need not donate cash to new firms. They can put their money in government securities or bank accounts with no risk; they can

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[10] See Stiglitz, Information and Capital Markets, *in* Financial Economics: Theory and Application 118, 120 (1982).

[11] See Grossman & Hart, Corporate Financial Structure and Managerial Incentives, *in* The Economics of Information and Uncertainty 107 (J. McCall ed. 1982); Ross, The Determination of Financial Structure: The Incentive-Signalling Approach, 8 Bell J. Econ. 23 (1977).

[12] See Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650 (1984).

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invest in regulated public utilities that have very little risk; they can purchase land or other productive assets. New or less known firms can obtain money only if they offer packages more attractive than those already existing.

B. The Effects of a Rule Against Fraud

For the reasons we have spelled out, a rule against fraud is not an essential ingredient of securities markets. Each of these certification methods is costly, however. Auditing, investment banking, and underwriting firms are very expensive to establish and operate; debt and dividend strategies entail transaction costs; managers must be paid extra to induce them to hold undiversified portfolios, and their risky position may lead them to make inferior investment decisions later on; direct verification of claims by thousands of buyers may be the most expensive of all.

A rule against fraud can reduce these costs, especially for new firms. The penalty for fraud makes it more costly for low-quality firms to mimic high-quality ones by making false disclosures. An antifraud rule imposes low or no costs on honest, high quality firms. Thus it makes it possible for high quality firms to offer warranties at lower cost.[13] The informational warranty, if enforced, makes it unnecessary for buyers to verify information or for sellers to undertake expensive certification.[14] The expenses of offering high quality securities go down while the expenses of passing off low quality securities rise.

The rule against fraud will not drive the costs of the high-quality firms to zero, however, because the rule may be underenforced. Firms still will use some additional certification devices. Moreover, a fraud rule does not have much effect when a firm is silent. The silence of a firm whose securities are trading in secondary markets could mean no news, bad news, or good news that cannot be disclosed because disclosure would benefit rivals. Investors have incentives to investigate to find the meaning of the silence, and firms will incur costs either to preserve secrecy or to communicate the tenor of the news without saying too much. The fraud rule and

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[13] For a similar analysis see Beaver, The Nature of Mandated Disclosure, *in* SEC Advisory Committee on Corporate Disclosure, Report of Recommendations 618, 637-39 (1977).

[14] See Grossman, The Informational Role of Warranties and Private Disclosure About Product Quality, 24 J.L. & Econ. 461 (1981).

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other verification methods are complements in some respects, substitutes in others.

Antifraud rules also impose costs of their own. Enforcement costs (investigative, prosecutorial, and judicial staffs) are obvious. The costs of overenforcement or inaccurate enforcement are harder to see but no less real. Start with an extreme case of inaccurate enforcement. Suppose that the probability of being prosecuted for any given statement is .55 if the statement is false, .45 if the statement is true. This could come about if, for example, the prosecutors and courts adopt a theory of "strict liability" and penalize all firms whose projections of profit turned out poorly. Because market conditions cause many plans, even those well laid and truthfully described, to fail, while firms that tell lies could succeed, prosecutions would be brought against honest firms, and many dishonest would escape.

The deterrent force of any rule is the *difference* between how the rule treats those who obey and how it treats those who disobey. If the difference is small—if, for example, a person driving at fifty-five miles per hour is only a little less likely to be charged with speeding than a person driving at eighty-five—then the rule does not deter. If there are gains from violating the rule, one may as well violate it. The world of inaccurate enforcement is similar to the world of no enforcement. Statements are no longer trustworthy unless the firm undertakes the costly certification and verification methods described in the previous section, and even truth-tellers will say as little as possible in order to avoid paying the penalty for lying. The higher the penalty for the offense, the more discriminating the enforcement must be in order to prevent both deterring appropriate behavior and stimulating undesired behavior. This is one reason why the procedures used in criminal law require a higher degree of proof.

Overenforcement is similar to undiscriminating enforcement. For any offense, there is an optimal level of enforcement at which the costs of expending an additional enforcement dollar equal the gains from reducing the incidence of the offense. The optimal level of enforcement allows some violations to occur because the costs of stamping out these violations exceed the costs of the violations themselves. Excessive penalties for fraud—especially if these penalties are available in actions brought by private plaintiffs—can

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lead both to overenforcement and to excessive deterrence of truthful statements.[15]

The rule against fraud, then, is most beneficial when enforcement costs are low and when it is possible to separate untruths from statements that, although true, do not accurately predict the future. Enforcement costs are least, and the chance of error lowest, when prosecutions are concentrated on verifiable statements of fact rather than on predictions. The SEC's administration of the securities laws has emphasized the making of accurate historical statements rather than projections, which are not required and are sheltered from prosecution by a "safe harbor." This approach is consistent with one in which fraud rules are used where they yield maximum net benefits.[16]

C. Why is the Rule Against Fraud National?

In 1933 every state had a rule against fraud. What, then, was the point of the many new rules contained in the '33 and '34 Acts? The Acts' supporters usually say that the national rules were necessary because the state rules were "ineffective" (witness the discovery of frauds), but this is not a good explanation. The existence or even increase of reported frauds no more proves that the state laws against fraud were "ineffective" than the existence of murder shows that state criminal law is "ineffective" and should be replaced with a national murder statute enforced by a Federal Homicide Commission.

The justification of federal legislation lies, rather, in the efficiency of enforcing in one case all claims that arise out of a single transaction. Many new issues of securities are sold to purchasers in several states; even issues initially sold within a single state ultimately find their way into the hands of out-of-state owners, if only because the owners move. Thus almost all substantial firms' securities sell in interstate markets. If claims arising out of these securities were litigated where plaintiffs resided, there would be multiple

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[15] See Easterbrook, Detrebling Antitrust Damages, 28 J.L. & Econ. ___ (June 1985) (forthcoming); Landes & Posner, The Private Enforcement of Law, 4 J. Legal Stud. 1 (1975).

[16] There has been criticism of the SEC from all quarters concerning its emphasis on historical fact. Our discussion of the costs and benefits of fraud rules suggests that prosecutions are appropriately focused on statements of "hard" fact, while private certification and verification mechanisms deal with matters of projection and opinion.

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cases for every security, with the possibility of inconsistent decisions and inconsistent legal standards. Claims of fraud usually involve written documents, and there is good reason to have the identical claim litigated in multiple forums.

The securities laws create nationwide service of process and have a liberal venue rule that permits litigation to consolidate all defendants and all claims in a single forum.[17] The class action device created by Rule 23 of the Rules of Civil Procedure makes it easy to bring all plaintiffs together. We discuss in Part III some of the reasons why a single rule of law about what must and cannot be disclosed may be beneficial. For now it is enough to note that the federal prohibition of fraud would be beneficial even if the single federal suit enforced multiple rules based on state law.

II. Mandatory Disclosure

A. Disclosure and the Public Goods Aspect of Information

In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity.[18] If they disclosed, they could do so in any way they wished, provided they did not lie. They could attempt to sell securities with ads in glossy magazines and on television featuring sexy models or herds of bulls, as sellers of other products (including brokerage services) do.

A mandatory disclosure system substantially limits firms' ability to remain silent. Just as importantly, it controls the time, place, and manner of disclosure. Firms must wait until they file a registration statement before saying anything that may be construed as touting (the "gun jumping" rule); they must wait until the registration statement is effective and a prospectus has been delivered before putting anything else in writing (the "free writing" rule); they must mail prospectuses and proxy statements at designated times but may not resort to ads on television.

What does a mandatory disclosure system add to the prohibition

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[17] 15 U.S.C. § 78aa (1982). See Leroy v. Great W. United Corp., 443 U.S. 173, 178-79 (1979).

[18] This is something of an overstatement, because the distinction between failure to inform and misrepresentation is not always clear. Failure to speak may be viewed as an implied representation that "nothing has changed." The securities laws recognize this by penalizing the omission of material facts necessary to make the actual disclosures not misleading. We return to this in Part III.

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of fraud? The implicit public-interest justification for disclosure rules is that markets produce "too little" information about securities when the only rule is one against fraud. One often hears the assertion that information is a "public good," meaning that it can be used without being used up and that the producer of information cannot exclude others from receiving the benefits. If the producer of information cannot obtain all of its value, too little will be produced. It seems to follow that there are virtues in a rule requiring production of all information that would be forthcoming were gains fully appropriable.

This rationale gets us only so far. For one thing, it proves too much. No one can fully appropriate the value of information about toothpaste, but there is no federal rule about disclosing the efficacy of toothpaste in preventing cavities. Why are securities different? We leave the other products to competitive markets because of a conclusion that people who make or use a product (or test it as Consumers' Union does) will obtain enough of the gains from information to make the markets reasonably efficient.

Similarly, those who learn about a security may profit from their information. They cannot obtain all of the benefits, because others in the market will infer the news, and the price of the securities will adjust. The new price will "contain" the news, preventing the person who first learned it from taking further gains. This also means, however, that the value of news decays very quickly in securities markets; the information is "used up" as subsequent people see things, and these people then have their own incentives to go out and find information.[19]

The more sophisticated version of the public goods explanation is that although investors produce information, they produce both too much and too little. They produce too little because the benefits are imperfectly appropriable. If information is worth one hundred dollars to investors as a group, but no one can capture more than ten dollars of gains, then no one will obtain more than ten dollars worth of information. Investors produce too much information, though, if several create the *same* ten dollars bit of informa-

[19] See Manne, supra note 4, at 42-43. The dynamic process by which stock markets impound information in prices, extinguishing the value of "old news" while creating incentives to find "new news," is described in Grossman & Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 Am. Econ. Rev. 383 (1980).

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tion (redundant production). Mandatory disclosure will prevent redundant production of information, the argument concludes.

The other source of excessive production is the gain available from forecasting the future. Some information, such as the quarterly earnings of a firm, offers opportunities for trading gains; the person who learns the news first can make great profits. In one important sense, though, the information is worthless. Trading on news that is bound to come out anyway does not change the future or lead to better investment in new securities. The price will ultimately change to reflect the true earnings. That it changes a day or so quicker is not of much moment for allocative efficiency. The lure of trading profits may induce people to spend a lot of effort and other resources "beating the market." Much of this is waste because the profit opportunity is larger than the efficiency gains from expediting the transition of prices.[20] The argument concludes by observing that the prompt disclosure of information by the affected firm will extinguish the trading opportunity. When everyone knows the truth, no one can speculate on it. Investors as a group would pay to have these trading gains (and the costly search for information) eliminated.[21] What better way to do this then mandatory disclosure by the firm that knows the truth?

These arguments have a common problem: they do not link the benefit of disclosure and the benefit of *mandatory* disclosure. If disclosure is worthwhile to investors, the firm can profit by providing it. The firm is in privity with its investors, and the Coase The-

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[20] See Hirshleifer, The Private and Social Value of Information and the Reward to Inventive Activity, 61 Am. Econ. Rev. 561 (1971). There has been a substantial dispute about the interpretation and magnitude of this effect, but we need not enter that debate here.

[21] This is a commonplace observation in the literature on rent seeking. Imagine 10 equally qualified firms competing for a radio license worth $1,000. Each one's chance to obtain that license is worth $100, and each will spend up to $100 in promotional and lobbying expenses to seek the license. The net value to each firm is $100 less the expenses. So long as one firm lobbies, the others must do so too. The firms would pay for someone to stop all of them from engaging in the lobbying; if no firm expended resources the opportunity would have an expected value of $100 for each firm. The same is true in securities markets. Each investor may try to get an edge on the others, but so long as these efforts just anticipate the future and do not yield better investments initially, they are waste and everyone gains if they are eliminated. See Tullock, Efficient Rent Seeking, *in* Towards a Theory of the Rent-Seeking Society 97 (J. Buchanan, R. Tollison & G. Tullock eds. 1980). See also Barzel, Some Fallacies in the Interpretation of Information Costs, 20 J.L. & Econ. 291 (1977) (showing how markets develop solutions to problems of inefficient search); Kenney & Klein, The Economics of Block Booking, 27 J.L. & Econ. 497 (1983) (showing the same).

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orem suggests that firm and investors can strike a mutually beneficial bargain.[22] A decision by the firm effectively "coordinates" the acts of many investors who could not bargain directly.

To see how this works, take a simple example of a firm that wants to issue new securities.[23] The firm has a project (say, the manufacture of a new computer) that it expects to be profitable. If the firm simply asked for money without disclosing the project and managers involved, however, it would get nothing. Investors would assume the worst, because, they would reason that if the firm had anything good to say for itself it would do so. Silence means bad news. A firm with a good project, seeking to distinguish itself from a firm with a mediocre project (or no project at all), would disclose the optimal amount of information. That is, it would disclose more and more so long as the cost of disclosure (both direct costs of dissemination and indirect costs of giving information to rivals) was worthwhile to investors as a whole.

The firm deals with all actual and prospective investors. Unlike an investor who deals only in a portion of a firm's stock, and thus cannot capture the full value of information, the firm controls all of its investments and can appropriate the full value of information. The firm that discloses more can sell its stock for more, indeed for as much more as the full value of all information.

The process works for bad news as well as for good. Once the firm starts disclosing it cannot stop short of making any critical revelation, because investors always assume the worst. It must disclose the bad with the good, lest investors assume that the bad is even worse than it is. And the firm cannot stand on its say-so alone. Mere disclosure would be enough if the rule against fraud were perfectly enforced, but it is not. Thus the firm uses the verification and certification devices described in Part I. Given these devices, a rule compelling disclosure seems redundant, and if the fraud penalty and verification devices do not work, a rule compelling disclosure is not apt to be enforceable either.

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[22] Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960).

[23] The economics of this have been formalized by Grossman, supra note 14, and Grossman & Hart, Disclosure Laws and Takeover Bids, 35 J. Fin. 323 (1980). Although the formal models assume that the cost of transmitting information is zero and that a prohibition of fraud is perfectly enforced, we show in the text that the broad outlines of the argument do not depend on these assumptions. See also Benston, Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code, 33 U. Miami L. Rev. 1471 (1979), for a similar exposition.

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The principle of self-induced disclosure as a solution to the lack of property rights in information applies to trading in the secondary market as well as to the initial issuance of stock. The firm's investors always want to be able to sell their stock in the aftermarket for the highest price. Their ability to do so depends on a flow of believable information (otherwise potential buyers reduce the bid prices, assuming the worst). For most information about a firm, the firm itself can create and distribute the knowledge at less cost than the shareholders, and the firm's decision, because it reflects the value to all shareholders, will be correct at the margin. A firm that wants the highest possible price when it issues stock must take all cost-justified steps to make the stock valuable in the aftermarket, so it must make a believable pledge to continue disclosing.[24]

The evidence bears this out. Firms have been disclosing the most important facts about themselves—and certifying these facts through third parties—as long as there have been firms. It is possible to trace the use of auditors back to the beginning of the corporation, and at the time the '34 Act, which created the requirement of annual disclosure by listed companies, became law, every firm traded on the national markets made voluminous public disclosures certified by independent auditors.[25] Between 1934 and 1964, annual disclosure was required only of those firms traded on national exchanges. (In 1964 the statute was amended to cover all firms with more than a specified number of investors.) Firms could avoid disclosure by delisting or not listing initially. Nonetheless, firms eagerly listed themselves on an exchange and disclosed; firms that were not listed also disclosed substantial amounts of data, following the pattern set by those covered by the statute. Even today, the securities of state and local governments are exempt from the

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[24] This follows from the agency literature, which shows that managers bear the costs if they fail to take any cost-justified steps to reduce the net costs of management. Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

[25] On the history, see Watts & Zimmerman, Agency Problems, Auditing, and the Theory of the Firm, 26 J.L. & Econ. 613 (1983). On the state of affairs in 1934, see Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132 (1973). Not all firms disclosed the same things, which creates problems to which we return.

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mandatory disclosure rules, yet these issuers routinely supply voluminous information to purchasers.

Disclosure for the purpose of stilling investors' doubts also reduces (to the appropriate degree) investors' incentives to search too much for trading information. The problem, as we described it above, is that knowing the future creates profit opportunities without making investors as a group better off. Because searching out such information is costly, investors as a group gain if firms disclose so as to minimize the opportunities and thus the incentives to search. The net return on a security is its gross return (dividends plus any liquidating distribution) less the cost of information and transactions in holding the security. A firm can increase this net return as easily by reducing the cost of holding the stock as well as by increasing its business profits. Firms that promise to make disclosures for this purpose will prosper relative to others, because their investors incur relatively lower costs and can be more passive with safety. The more convincing the promise, the more investors will pay for the stock.

B. Limitations on the Self-Interest Model of Disclosure

That information is a "public good" means that investors acting independently do the wrong amount of information-gathering, but for reasons we have explained, the self-interest of firms' managers lead them to supply roughly the amount of information investors as a group desire. This amount is "rough," however, because of the certification and verification costs in the supply of information. If disclosure rules, like fraud rules, could reduce the costs, then firms' disclosure would be improved. We return to this in Part III. There is one other reason why firms' disclosures may not be optimal: third party effects.

The information produced by one firm for its investors may be valuable to investors in other firms. Firm A's statements may reveal something about the industry in which Firm A operates—if only the size of Firm A's anticipated production—that other participants in the industry can use in planning their own operations. There may be other collateral benefits to investors in rival firms. Yet Firm A cannot charge the investors in these other firms for the benefits, although they would be willing to pay for them. Because they cannot be charged, the information will be underproduced.

The problem is related to the prisoners' dilemma. The firms and

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investors, acting as a group, would want the firms to disclose information with both firm and industry-specific components. Each firm acting individually will not do so, in part because the others would get a free ride and in part because some of the information (such as that pertaining to new products) may give a competitive advantage to rivals. Each firm would be willing to disclose, but only if all others were required to do likewise. Then the costs and any business risks would be distributed more evenly. In the absence of some requirement or strong inducement to disclose, each firm will want to be a holdout.

There is a similar free riding problem in the disclosure of information that facilitates comparisons among firms. Firm C may know something that makes it attractive relative to D. It cannot convey this information effectively, however, without conveying information about D's plans and prospects. The information about D will redound partly to the benefit of present or prospective investors in D, and Firm C cannot obtain compensation. Firm C could appropriate part of the gain by buying or selling D's stock, but this is a costly transaction, and Firm C could not appropriate the full gain without owning D, E, F, G, and so on, outright. An increase in the size of firms to allow greater internalization of information has other costs, including monopoly and a reduction in investors' ability to diversify their holdings.

Firm C also encounters difficulty in appropriating the value of information affecting risk-return characteristics. The less the degree of difference among firms, the more spillover the disclosures of one firm will have, and the poorer this firm's incentives to disclose. Many firms will have similar risk-return characteristics. Some form of collective action (whether or not through the government) could be beneficial in principle here. Which method of tackling the collective action problem has the lowest net costs is an empirical problem.

Or suppose there is an optimal format for communicating information to investors. Some disclosures are easier to understand, verify, etc., than others, while some disclosures tend more to hide than to reveal information. If contracts among all investors in society could be written costlessly, the investors would require all firms to identify and use the optimal format of disclosure. The costs may be too high, though, for one firm acting on its own. The optimal form of disclosure may entail use of some specialized lan-

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guage (one can think of accounting principles, with their detailed definitions, as a specialized disclosure language), yet no one firm can obtain a large share of the benefits of inventing and employing this language; others will be able to use the format without charge. Sometimes, too, the ease of using a given method of disclosure will depend on other firms adopting the same format, so as to facilitate comparisons across investments. Other firms may not be anxious to cooperate.

Mandatory disclosure rules promulgated by the government are one means to achieve standardization, but it does not follow that mandatory disclosure is necessary. Markets frequently devise ingenious solutions to problems of information. Indeed, the problems faced by sellers of securities are not much different from those involved in bringing new products to market. Mass sale of records and stereo systems was facilitated by the development of standard record speeds. Color television was not feasible until manufacturers and broadcasters agreed on a standard method of transmission. The new laser compact disk players are greatly aided in competing against tapes and records by the standard promulgated by Phillips, the holder of an important patent. Sometimes trade associations may devise such standards, as the electronics industry and, in part, the accounting industry have done. Whether standardization may be achieved more cheaply by private or governmental responses is an empirical question.

C. Private or Competitive Methods of Creating Optimal Disclosure

1. Informational Intermediaries

We have assumed so far that firms essentially act on their own in creating and communicating information to investors. Sometimes firms will not disclose because the costs of this self-help exceed the value of the information. Sometimes they will not disclose because the information would decrease rather than increase the firms' value, even though investors would gain from having the knowledge; information about a new product or a new technology may be in this category. Because of these "good" reasons for nondisclosure, investors cannot infer unambiguously that no news is bad news; the power of the self-interest model of disclosure is re-

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duced, and high-quality firms will have trouble distinguishing their offerings from those of low-quality firms.

Informational intermediaries are a partial solution to these difficulties. Consider the case of a firm that wants to raise money to take advantage of a technological breakthrough, the details of which it cannot disclose. This firm may disclose the information to an underwriter, which will price the securities appropriately. Investors realize that underwriters may have information that is not disclosed to the public and that they have strong reputational interests in not deceiving customers. Investors then pay more for these securities than they would for those of similar firms that had not made such breakthroughs. Firms also can spread the news indirectly—although not as well, because of the weaker reputational interests of the intermediaries—by disclosing portions to investment analysts or other intermediaries, who communicate to the public by making recommendations rather than by setting out details.[26]

Accountants also serve as intermediaries. We have emphasized before that accountants reduce the cost of verifying information because they put their reputations behind the accuracy of a firm's disclosures. Moreover, to the extent accountants agree on a common language, they serve the function of standardizing (reducing the costs of) any amount of disclosure. Accountants spread over all firms the costs of creating and maintaining the standard language. Of course accountants may face pressures from individual firms to misuse their language, or they may be unable to agree on a common language at all; governmental intervention may reduce these costs of agreement and enforcement.

Informational intermediaries obviously cannot ensure accuracy or completeness of information. Their employees may be incompetent or deceived; they review events periodically rather than continuously, so the situation may change between their inspection and the time any investor acts in reliance. But any other disclosure

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[26] For a similar analysis of financial (rather than informational) intermediaries, firms that invest in other firms, see Campbell & Kracaw, Information Production, Market Signalling, and the Theory of Financial Intermediation, 35 J. Fin. 863 (1980). See also Benston, Accounting Standards in the United States and the United Kingdom: Their Nature, Causes, and Consequences, 28 Vand. L. Rev. 235 (1975); Benston, The Market for Public Accounting Services: Demand, Supply, and Regulation, 2 Acct. J. 2 (1979), for a treatment very close to the one we offer below.

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device has these problems as well. The relevant point is that the informational intermediaries increase the amount of accurate information about firms that can be conveyed to investors.

2. *Informed Traders*

Some traders know more than others. Insiders and those who receive information from insiders, brokers, those who search out tidbits and draw inferences, and those who purchase information from the better informed (such as analysts and money managers) are informed traders. People become informed to "beat the market" and earn superior returns. Their ability to earn these returns is limited, though, by the fact that other investors follow the same strategy and trade on what they learn. Other traders become informed, and the very act of trading—moving the price of the stock toward the one the informed traders think is "right"—causes the price of the stock to impound the value of the information these traders possess. When the price reaches a level at which informed traders are indifferent between being buyers and being sellers, the price conveys the information about the firm more effectively and cheaply than direct disclosure. Trading will never be completely revealing; uninformed traders may not be able to tell whether particular trades are motivated by new information or by portfolio adjustments. Nonetheless, trading and not trading by informed parties supplies other investors with a great deal of information.[27]

3. *Stock Exchange*

Organized exchanges reduce the costs of transacting.[28] By making it easier for parties with different beliefs about the future to transact, organized exchanges increase liquidity and reduce the unnecessary risk of investing. The greater the liquidity of the secondary market, the more successful the exchange. Because the success of an exchange depends on the amount of trading, exchanges have incentives to adopt rules governing trade that operate to the benefit of investors. Such rules attract more trades, reducing the cost

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[27] On the role of informed traders in communicating information, see Grossman & Stiglitz, Information and Competitive Price Systems, 66 Am. Econ. Rev. 246 (1976); Manne, supra note 4. See also R. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983) (collecting empirical studies); Gilson & Kraakman, supra note 9.

[28] See Telser, Why There are Organized Futures Markets, 24 J.L. & Econ. 1 (1981).

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and increasing the profits of those who run the exchanges.

Exchanges gain, for example, by adopting rules that minimize the amount of deceit committed by listed firms, because investors who are misled are less likely to be repeat players. For the same reason, exchanges have an incentive to adopt rules that require listed firms to disclose the amount and type of information that investors demand. Competition among organized exchanges for both the listing of firms and the business of investors, as well as competition between exchanges and other methods of investing, increases the incentives of the exchanges to adopt beneficial rules.

Firms, in turn, have incentives to list their securities on exchanges the rules of which maximize the benefits of investors. To see this, assume for the moment that firms acting by themselves would disclose less (or different) information than that demanded by investors as a class, and that the social loss from this inappropriate level of disclosure is less than the costs to these individual firms of contracting to produce the right amount of information. This might occur, for example, because of the third-party effects discussed in Part II.B. Organized exchanges offer the firms a way to cope with the collective action problem. The firms can agree to be bound by the rules set by the exchange, and these rules can come closer to requiring optimal disclosure because they will "internalize" many of the third-party effects. Firms that bind themselves to follow the exchange's rules will have a competitive advantage in attracting capital. This sort of process is at work in the rivalry among exchanges, with the New York Stock Exchange, which sets rules governing disclosure of information and the issuance of new stock by listed firms, attracting business at the expense of other methods of trading.

Our analysis implies that firms listed on national exchanges systematically disclose more information than firms not so listed, both before and after the securities acts. We have not conducted a survey to confirm this implication, but it is consistent with casual impressions.

4. States

Competition among state for corporate charters, like competition among exchanges for business, ameliorates the collective action problem. There is a growing literature on the conditions under which competition among jurisdictions will tend to produce benefi-

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cial rules.[29] This competition is never more powerful than in the market for corporate charters. Because investors can shift their investments almost at will, and with close to no cost, among firms chartered in different states, and because firms have the ability to select and move the place of incorporation at almost no cost, the jurisdictions that select rules most beneficial to investors will attract and hold the most capital.

The economics of federalism have implications for many issues of corporate law. The power of interstate competition strongly suggests that any aspects of corporate law that survive across jurisdictions and over time are likely to benefit investors. It means that the states that have attracted the largest sums of investment are most likely to have adopted efficient rules. It suggests that rules produced by this inter-jurisdictional competition are more likely to assist investors than are rules promulgated by a nationwide regulatory bureaucracy, which can stifle this competition.[30] If compulsory disclosure of certain matters is optimal, we would expect to see state law require such disclosures, because the requirement would make the state more attractive to investors (and thus to firms).

One interesting implication of these principles is that investors probably gain from the evolutionary trend in corporate law toward treating the legal rules as a set of off-the-rack understandings subject to variation by specification in the articles and bylaws. In Delaware and most other states today, firms may choose almost any set of organizing principles they desire.[31] These statutes typically require little or no ongoing disclosure by operating firms, although state "blue sky" laws customarily require substantial disclosures

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[29] See, e.g., D. Mueller, Public Choice 125-45 (1979) (collecting sources); Easterbrook, Antitrust and the Economics of Federalism, 26 J.L. & Econ. 23 (1983); Epple & Zelenitz, The Implications of Competition Among Jurisdictions: Does Tiebout Need Politics?, 89 J. Pol. Econ. 1197 (1981); Rose-Ackerman, Does Federalism Matter?: Political Choice in a Federal Republic, 89 J. Pol. Econ. 152 (1981). See generally Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956) (describing a model that yields a solution for the level of expenditures for local public goods as compared with national goods).

[30] For an application of these principles see Easterbrook & Fischel, Voting in Corporate Law, 26 J.L. & Econ. 395 (1983). There are limits, though, on the reach of any suvivorship argument. For a debate on the location of these limits in dealing with insider trading, compare Carlton & Fischel, supra note 1, with Easterbrook, supra note 1.

[31] See R. Winter, Government and the Corporation (1978) (the pioneering discussion of federalism and corporate law). See also Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982).

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when stock is issued. This suggests that legal requirements to disclose information about existing firms may well be unnecessary, unless there are problems, such as multi-state third-party effects, that could prevent interjurisdictional competition from coming to the "right" set of requirements.

D. Some Poorly Supported Rationales of Mandatory Disclosure

The existence of self-induced disclosure by firms, in addition to the variety of competitive mechanisms external to firms for acquiring, disseminating, and requiring the disclosure of information, gives investors much information. Is this "enough" knowledge? One market may suffer "market failure," but there are at least five markets that extract information from corporations. If there is to be a good argument for the national government's compelling disclosure, it must establish why all of the other mechanisms fail. Several of the arguments offered in favor of mandatory disclosure conspicuously fall short when measured by that standard.

1. Increasing Public Confidence in the Markets

The justification most commonly offered for mandatory disclosure rules is that they are necessary to "preserve confidence" in the capital markets. It is said that investors, especially small and unsophisticated ones, withdraw their capital to the detriment of the markets and the economy as a whole when they fear that they may be exploited by the firms or better-informed traders. Disclosure rules both deter fraud and equalize "access" to information, restoring the necessary confidence.

This argument is not surprising; between 1929 and 1934 the securities markets suffered great outflows of capital, which could be attributed to "lack of confidence" among other sources, and during the next fifty years investors appear to have had "confidence." Unless we are satisfied with *post hoc ergo propter hoc* reasoning, however, we cannot stop here. There were extended periods of "confidence" before 1934. A greater percentage of the public invested in equities in the 1920s than at any time since (although indirect investments through mutual funds and pension trusts make investment more widespread now). Why would federal disclosure rules breed necessary confidence?

The explanation cannot be that fraud reigns supreme in the ab-

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sence of mandatory disclosure. We have shown above that it does not, and the proponents of mandatory disclosure have not established that there is lesser incidence of fraud with disclosure rules than with anti-fraud legislation alone. To show one, ten, or hundreds of frauds in the 1920s just does not fulfill the obligation; we can point to an equal number of contemporary frauds, from Equity Funding to Penn Central to OPM. Just as we do not say that recent frauds show that the securities laws are ineffective or undesirable, so the proponents cannot rely on the bare existence of fraud in the 1920s.

This is not to say that confidence is unimportant. An investor who believes the market is a fair game puts more in equities and spends less investigating. Both are sources of economic gain. But to make such a confidence argument, one would need to show that any reduction in fraud attributable to the disclosure rules was more valuable than the costs of administering those rules. No regulation can be justified satisfactorily without such analysis: arguing that disclosure reduces fraud without toting up the cost makes as much sense as arguing for the reduction of auto fatalities by requiring all automobiles to be built with five-inch steel plate. Because there is no good evidence that mandatory disclosure rules reduce the incidence of fraud, the cost-benefit analysis cannot show benefits in excess of costs.

Even if there were better evidence on the quantum of fraud, we would need to analyze the costs of mandatory disclosure at the margin, "unbundling" the different routes (such as the registration, prospectus, form 10-K, proxy, and other disclosure devices) and looking at the disclosure required by each. It may be, for example, that a streamlined registration disclosure requirement has benefits exceeding costs but that the proxy disclosure system has net costs. We cannot know at the level of theory. All we can say is that after fifty years, the proponents of regulation have *no* scientifically-acceptable evidence of a favorable cost-benefit ratio for any disclosure rule that rests on the benefits of reducing fraud or increasing confidence.

2. *Protecting Unsophisticated Investors*

The companion to the "fraud" argument is that unsophisticated investors need particular protection. Some say that uninformed investors are exploited investors; whoever knows less will get a raw

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deal. Others maintain that fear of such exploitation erodes confidence whether or not these investors lose out. Disclosure rules equalizing access and simplifying the presentation of information, so all can understand it, overcome the problem, whichever way it is put.

This argument is as unsophisticated as the investors it is supposed to protect. It disregards the role of markets in impounding information in prices. So long as informed traders engage in a sufficient amount of searching for information and bargains, market prices will reflect all publicly available information.[32] The actions of informed traders influence the price until these traders are satisfied with it on the basis of information; the price cannot be "improved" until new information comes along. The uninformed traders can take a free ride on the information impounded by the market: they get the same price received by the professional traders without having to do any of the work of learning information. These traders are simply made worse off if information is foisted on them: they have to read it or throw it away, yet it does them no good because it is all old hat to professional traders and so cannot influence prices.[33] The informed traders also get rewarded for their news by being slightly ahead of the rest of the market. Such rewards do not come "at the expense" of the less informed; they are compensation for effort that benefits all traders. No matter what the disclosure laws say, the "average investor" who gets disclosure statements through the mail will always be too late to take advantage of any bargains available to those who use information first.

The "confidence" part of the argument is no stronger than the contention that the uninformed are exploited in fact. If they are not so exploited, they do not logically fear exploitation and so do

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[32] An enormous literature now exists on the extent to which prices efficiently reflect available information. See, e.g., Banoff, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 Va. L. Rev. 135 (1984); Fox, Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis, 70 Va. L. Rev. ___ (June 1984) (forthcoming). For a summary, see Gilson & Kraakman, supra note 9. For a more technical discussion, see E. Fama, Foundations of Finance 133-68 (1976).

[33] See Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1 (1982) (contains a fuller discussion of this argument). For a general discussion of how non-shoppers benefit from the actions of shoppers in competitive markets, see Schwartz & Wilde, Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis, 127 Pa. L. Rev. 630 (1979).

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not lack confidence. True, one can *say* that the investors irrationally lack confidence, so that mandatory disclosure is necessary, but this comes close to being a tautology. How could it be proved or refuted? We are willing to concede that there are illogical investors who always suspect that the informed traders are getting secret advantages, but where does this lead us? These paranoid traders can protect themselves at minimal cost. They can, for example, put their money in the hands of professional advisers or managers of mutual funds, thus getting for themselves whatever advantage accrues to the insiders.[34] The existence of informational inequalities—real or imagined—is therefore an inadequate basis of mandatory disclosure.

3. *Increasing the Supply of Truthful Information*

A third common justification for mandatory disclosure is the need to provide investors, especially sophisticated investors, with valuable information to make decisions. Under this justification, it is unimportant whether the average investor has equal access or can understand the information. The focus is on getting the information to the market, with little concern about who gets it first.[35] This argument, in other words, assumes that prices will reflect information efficiently; it justifies disclosure on account of its beneficial effect on the accuracy of prices.

There may well be gains to be had from additional disclosure to the market. We have discussed the reasons why private incentives to disclose, even in connection with competition among markets and states, will not produce all information and may not produce the right amount. If federal disclosure laws reduce the costs of investors' becoming informed, they will increase investors' net returns, and capital markets will be able to allocate funds to higher valuing users.

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[34] Data strongly suggest that market insiders—professional traders and money managers—get no advantage. See, e.g., J. Cragg & B. Malkiel, Expectations and the Structure of Share Price (1982). There are so many well-informed traders that competition among them prevents them from realizing advantages. Nonetheless, the "protection of the uniformed" argument is weak even if there are hidden advantages. An elaboration of the argument in the text appears in Easterbrook & Jarrell, supra note 1, at 79-83. See also Fischel, supra note 9.

[35] Implementation of this goal frequently conflicts with the goal of ensuring that the information be accessible to unsophisticated investors. See Anderson, The Disclosure Process in Federal Securities Regulation, 25 Hastings L.J. 311 (1974).

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One must be careful, though, about committing the fallacy of thinking that if some information is good, more is better. It is not enough to show that the disclosure rules have led corporations to disclose more information now than they did before 1933. Information is costly, and the costs are borne in large part by investors. Whether investors benefit by more information depends on whether the marginal benefits of increments to knowledge exceed the marginal costs. No one would argue that investors would gain on net if Chrysler "disclosed" the contents of its corporate files, down to the purchase price of each conveyor belt and the details of its bargaining strategy for the next round of negotiations with employees. Thus the observation that more information is released now than fifty years ago may show that there is excessive disclosure now and the right amount fifty years ago, or it may show that conditions have changed over time, and that investors now demand more information. If this is true, the amount of disclosure would have increased with or without a statute.

There is some irony in the argument that disclosure rules bring valuable information to market. Many of the "disclosure" rules *prohibit* the transmission of information at certain times and in certain forms. The gun-jumping and touting rules restrict predistribution statements. The information most important to the market concerns the future; what's past is already reflected in prices. Yet for more than forty-five years the SEC discouraged firms from making any projections of profits or other forward-looking disclosures, on the ground that this information was inherently misleading. Rule 175, issued in 1979 after long study, permits the disclosure of projections and forecasts, provided they are adequately supported (that is, still tied to yesterday's facts). To understand the disclosure rules as they are or were, one must explain these restrictions and omissions of information along with the mandatory disclosures.

III. The Disclosure Rules as a Response to Third Party Effects, Legal Error, and Rent Seeking

Although the rationales usually advanced for the disclosure provisions of the securities acts are unconvincing, we believe that there is a more plausible line of argument, which (to our knowledge) has not previously been advanced. We sketch this argument below.

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A. The Objectives of Disclosure Requirements

1. Controlling Third-Party Effects

We discussed in Part II.B. three reasons why the self-interest model of disclosure might not lead to optimal release of information: (1) some data would concern the industry as well as the firm, and firms would underproduce this data both because they could not charge for benefits conferred on others and because they would want to learn the plans of others without disclosing their own; (2) comparative data would be underproduced because of the inability to charge for it; (3) no firm would have the appropriate incentives to create the least-cost formula for disclosure. We discussed private and state methods by which these may be addressed, but the solutions will be incomplete (at least when compared with a world of no transactions costs). Private organizations cannot compel adherence, so there will be holdout problems. Competition among the states cannot obtain all benefits because of the interstate nature of some of these effects; if being a holdout is in the interest of some firms, it could pay states to be havens to the holdouts.

2. Controlling Interstate Exploitation

This difficulty with coordinating disclosure through competition among the states reflects the fact that such jurisdictional competition is most effective when the consequences of a decision will be experienced in one jurisdiction. Because only one state's law governs the "internal affairs" of a corporation, competition can be effective. Disclosure rules for a firm chartered in State D, in contrast, affect many firms incorporated elsewhere. Indeed, the multistate nature of securities markets creates opportunities for states to attempt to exploit investors who live elsewhere.

Consider the problem of a firm incorporated in State D, which prescribes disclosure of facts X, Y, and Z. Suppose for the moment that this amount of disclosure is optimal; additional disclosures would cost more than the benefits bestowed on investors. The investors reside throughout the nation. A group of investors living in state N might bring litigation there, contending that under the law of N, the firm should have disclosed Q. It may well be in state N's interest to sustain this claim and order the firm to pay damages to

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N's residents, even if N's officials know that the disclosure of Q is counterproductive. This is so because most of the investors live outside state N and will not receive damages. The money to pay to state N's residents will come from residents of other states. State N may seize the occasion to "exploit" the residents of other states, once the firm is underway.[36] State N's residents gain more from the award of damages than they lose from future "inefficiently large" disclosures, since the costs of these disclosures will be borne in the other forty-nine states. State N's residents end up with one hundred percent of the benefits of this transfer payment, while they pay a smaller percentage of the costs of excessive future disclosure.

If state N attempts such exploitation, other actors in the markets will adjust. The firms may sell less stock in state N, but they cannot prevent it from migrating there. Firms may start to disclose fact Q, but by hypothesis this is not optimal, and the disclosure of Q will not prevent state N from insisting on some new disclosure tomorrow. Finally, other states may retaliate: they may penalize firms incorporated in state N if these firms do not disclose fact Q in their dealings with residents of other states. A retaliatory equilibrium could develop in which states systematically called for too much disclosure by firms incorporated in other states.

Everyone is better off if the states desist from such attempts to exploit one another's residents, but it may be costly to control this exploitation. Nations use tariffs to protect their nationals at the expense of others, and it proves very hard to deal with these efforts. The commerce, privileges and immunities, and interstate duty clauses owe their existence, at least in part, to the recognition that similar problems can occur among the states. But the constitutional provisions (and the judicial holdings applying the commerce clause to prevent one state's raw favoritism of its residents) have not prevented all forms of exploitations. One can understand much of modern state tax and products liability law and current doctrines of conflict of laws as efforts to favor residents at the expense of nonresidents. Only federal regulation may be able to prevent states from engaging in exploitation in securities transactions.

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[36] See Levmore, Interstate Exploitation and Judicial Intervention, 69 Va. L. Rev. 563, 619-26 (1983) for an application of this principle to several problems, including the regulation of multi-state tender offers.

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3. Controlling the Costs of the Common Law Process

The state law of fraud that existed in 1933 had the elasticity customarily found in the common law. States prohibited not only outright falsehoods but also statements that misled the reader by selective revelation and omission or by crafty language.[37] The calculated ambiguity of the common law has substantial costs, however.

One is risk. A party cannot know, until long after the fact, whether he will be found in violation of the law. Firms that disclose what they think appropriate for investors may be surprised to learn, a few years later, that they did not disclose enough things or the right things. This is a needless risk, and greater risk increases the firm's cost of capital. Investors would be better off if the risk could be reduced without any corresponding reduction in the prospects of the firm. Investors would pay for certainty, and they could be better off even if part of the price of certainty were disclosure that would be "excessive" if risk were no concern.

Litigation is also costly. Parties will invest in litigation until the last dollar spent affects the recovery by just one dollar. They spend more—because settlements are harder to strike—when there is more risk. Securities issues often are quite large, and the stakes of fraud litigation are correspondingly large. Thus resources invested in litigation could be immense. And these investments often are socially wasteful; when they just serve to divvy up an existing pile of money, rather than to create or maintain the supply of legal precedents, they are wasteful.[38] Everyone might gain if firms and investors could find some way to reduce the amount of litigation. If, for example, it were possible to create an administrative mechanism to determine in advance whether some disclosure is adequate, the total costs of disclosure could fall. Again, investors might be made better off, even if part of the cost of the administrative system were disclosure that would be excessive in a world of no-cost litigation.

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[37] E.g., Restatement of Torts § 529 (1938).

[38] See Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 359-64; Shavell, The Social Versus the Private Incentive to Bring Suit in a Costly Legal System, 11 J. Legal Stud. 333 (1982).

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B. The Contours of Efficient Mandatory Disclosure

So there are, after all, some potential benefits of mandatory disclosure. Whether these are realized in fact is an empirical question. We have no desire to commit the Nirvana Fallacy of asserting that if markets are "imperfect" then regulation must be better. Detecting the "imperfections" of markets may be no more helpful than observing that all good things have irreducible costs, much as paying for steel is a cost of building a car rather than an "imperfection" in the automobile market. Regulation is more failure-prone than markets, because there are few automatic forces that correct regulations gone awry. The regulatory system lacks a competitor, and the very fact of regulation often suppresses the information necessary to detect regulatory failure.

The initial inquiry is whether the federal regulatory system's features track those that we would expect to see if the disclosure rules were reasonably well designed to achieve the objective we have surveyed. The features implied by our discussion are:

1. Standard, routine disclosure.
2. Disclosure by all interstate firms but no intrastate firms.
3. An emphasis on historical facts.
4. A corresponding ban on written disclosures of other facts or of oral "variances" from what is written.
5. Prior review of disclosures and other risk-reduction devices.
6. Sparing use of a "material omissions" test to find fraud in written disclosure documents.

The securities laws embody all of these elements. We now spell out why the elements are appropriate responses to the costs of disclosure and how the securities laws provide them.

C. The Pattern of Mandatory Disclosure Requirements

1. Standard, Routinized Disclosure

Standardization of disclosure goes straight to the heart of the third-party effects discussed in Parts II.B. and III.A. Imposition of a standard format and time of disclosure facilitates comparative use of what is disclosed and helps to create an efficient disclosure language. If every firm must disclose the same things, there will be reciprocal benefits to each firm's investors even though the firm will be compelled to disclose things of advantage to rivals.

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The securities laws standardize disclosure by creating "schedules" to be completed by each firm at designated times and by giving the SEC power to promulgate and define accounting terms. The SEC has used its regulatory power to create many forms of disclosure appropriate to the size of the firms and the industries in which they operate.[39] There is for example, a special form for mineral extraction corporations. Larger firms disclose less than others (Schedule S-3, for the largest firms, is quite streamlined in recognition of the fact that markets generate great quantities of information about such firms). The great specificity of these regulatory schedules both reduces the costs of making the disclosure and increases the comparative value of what is disclosed.

2. *Disclosure by All Interstate Firms but no Intrastate Firms*

The requirement of universal disclosure responds to the third-party problems discussed above by prohibiting "holdouts" of any substantial players. All gain from the disclosures of others; all must pay by making their own disclosures. The distinction between firms with investors in many states, and those with investors in one state, also responds directly to the problem of interstate exploitation discussed in Part III.A.2. Only when holdings are dispersed among many states, so that each state thinks it can "export" damage awards and the costs of excessive disclosure, is there a risk of such exploitation. When the majority of a firm's investors live in one jurisdiction, however, exportation becomes difficult, and competition among jurisdictions is more likely to lead to optimal rules.

The statutes implement this approach by restricting initial disclosure (at the time stock is issued) to securities in interstate commerce. Section 3(a)(11) of the '33 Act exempts intrastate sales, and rules issued by the SEC offer still broader exemptions for transac-

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[39] The Commission has not, however, significantly regulated the accounting profession. Our general argument in favor of a common disclosure language may seem to imply substantial regulation of accounting. The difficulty here is that no one knows the optimal amount of standardization. Attempts by the SEC to prescribe accounting conventions may be premature, blotting out evolutionary development of "better" conventions. It may be that the most effective regulation is to allow the accounting profession to establish the language by common usage and then to prevent significant and misleading deviations from that usage. See Kitch, Book Review, 47 U. Chi. L. Rev. 394, 400-02 (1980).

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tions that are primarily within a state.[40] Subsequent disclosure (annual reports and 10K forms, proxy materials, etc.) is restricted to firms traded on national exchanges or having more than a certain number of investors. This effectively exempts all small or closely-held corporations from the scope of the rules.

Many people find the exemption of these small firms and intrastate deals mysterious, because they believe that such small transactions (with less sophisticated investors) are those in which fraud is most likely and in which stock markets and professional investment analysis offer the least protection. They find the exemptions justified, if at all, only by a need to reduce the costs of making relatively small placements. Our approach, on the other hand, does not need to excuse the statutes' relative inattention to the small offerings. The structure of the Acts follows logically from the ability of state rules to offer optimal structures in single-state but not multi-state transactions.

This leaves open the question why the securities laws reduce interstate exploitation. The statutes do not expressly ban damage judgments by state courts; indeed the statutes have savings clauses. Nonetheless, there are very few awards by state courts that could be characterized as exploitative. Some of this may be attributable to the prior review and safe harbor features of the statutes discussed below; some may be attributable to the threat that the Supreme Court would interpret the federal statutes to ban exploitation, notwithstanding the savings clauses, as a burden on interstate commerce.[41] We needn't offer a complete explanation here; something in the structure of the federal law has in fact stopped securities cases from following the pattern of failure-to-warn products liability cases.

3. *An Emphasis on Historical Facts*

A recitation of specified objective facts is the least-cost method of disclosure. Historical facts also are the easiest to compare across

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[40] Rule 147 creates an exemption from registration when more than 80% of the investments come from one state and more than 80% of the proceeds will be invested there. Regulation A gives a further exemption to certain smaller offerings of a character customarily used in intrastate offerings.

[41] See Edgar v. MITE Corp., 457 U.S. 624 (1982) (preempting state laws regulating tender offers that the Court viewed as exploitative).

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firms. Verification is cheapest, and the fraud rule works best (as part I.B showed) when applied to statements of historical fact. Our approach therefore predicts that the securities rules would emphasize such objective disclosures, leaving to market forces any additional future-oriented disclosures.

The laws and regulations have indeed promoted backward-looking statements, despite much academic criticism pointing out that the market puts more weight on future performance and profits. The SEC's schedules emphasize disclosure of profits, cost of assets, and so on, with little more than a passing nod to "plans" and similar information about prospects. Until the promulgation of Rule 175 in 1979, an issuer acted at great hazard in saying anything about anticipated profits or new products. Today there is a "safe harbor" for projections, sheltering them from being grounds for liability in most cases. This effectively leaves projections to the market: they are neither required nor penalized.

4. A Ban on Written Disclosure of Other Information or Oral Variances

Disclosure rules designed to facilitate the use of a common language and comparisons among firms must root out novel methods of disclosure; the novelty of one firm's disclosures may erode the utility of the disclosures in comparison. A firm could deny to investors in other firms the reciprocal advantages of disclosure by choosing to disclose things that were sufficiently unusual that the ordinary standards of comparison could not be employed.

Any effort to reduce the costs of litigation, moreover, must ensure that the written disclosures on file with the SEC are the operative disclosures. If one set of disclosures applies to all investors, it is possible to litigate securities cases as class actions, with consequent reductions in cost per investor and an increase in the likelihood of recovery in at least some amount. The disclosure will be the nucleus of the claim, and difficulties that often arise in tort or contract cases ("The contract says X, but the salesman said Y") can be avoided.

When all investors have a common claim, moreover, the aggregation of these claims in a single suit will present the class with the right incentives. Solitary investors will disregard the precedential value of the suit for others and thus will tend to underinvest. The lawyers in a class suit, by contrast, will tend to consider the inter-

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ests of all investors in deciding the appropriate sums to spend in investigating claims and pursuing the litigation. Because all of the interested parties are before the court, there are no significant third-party effects.[42]

The securities laws follow a path consistent with this approach. The emphasis is on written disclosure. Section 5 of the '33 Act prohibits oral or written statements that precede or differ from the prescribed disclosures. Although firms with securities trading in the aftermarket may and do make oral disclosures—which are necessary to reveal many firm-specific facts—courts decline to entertain claims that these oral statements differ from the written ones.[43] This ensures that writings control. Except in the case of small deals or individual transactions with brokers, oral statements prove largely irrelevant.

5. *Prior Review and Safe Harbors*

Prior administrative review may be much cheaper than subsequent and risky judicial decisionmaking. Parties would be willing to "overdisclose" to reduce risk.

The securities laws take the prior review/risk reduction path in a variety of ways. For a long time the SEC's staff reviewed every registration statement and prospectus with care before allowing it to become effective. Although the process of review created no formal legal immunity, it did so as a practical matter because the administrative process ensured compliance with all formalities and

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[42] On the economics of investigating and litigating when multiple parties hold property interests in a claim, versus a less diffuse claim, see Landes & Posner, Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws?: An Economic Analysis of the Rule of *Illinois Brick*, 46 U. Chi. L. Rev. 602 (1979). It is true that even if "the class" has the right incentives, the attorneys for the class will not. See Coffee, Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215 (1983); Rosenfield, An Empirical Test of Class Action Settlement, 5 J. Legal Stud. 113 (1976). This is a separate prohlem, however. No matter what the incentives of the attorneys, those who represent a class have hetter incentives than those who represent isolated parties.

[43] See, e.g., Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983) (dismissing a suit because the party relying on the supposed oral statement could not show reliance; in other words, the court declined to allow the oral statements to contradict the written ones). The same result would be achieved by a rigorous application of the parol evidence rule. The considerations advanced in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), which discussed the difficulties that arise when a person can litigate on the basis of personal statements about how disclosures influence inaction, tend to a similar result.

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created precautionary overdisclosure. (This regularity of practice and review also contributed to the routinization of disclosure, and within the last ten years the SEC has been able to rely on the accumulated expertise of the bar to keep up the forms without such detailed review.)[44]

The matters not covered by prior review are covered by statutory or regulatory "safe harbors"—provisions taking advantage of sections 19(a) of the '33 Act and 23(a)(1)of the '34 Act. These statutes say that nothing done in good faith in reliance on rules of the SEC shall be the basis of liability under the Acts. These safe harbor regulations often require a firm to take a complicated series of steps to obtain their shelter; hence the attraction and challenge of securities practice for lawyers. From the investors' point of view, however, the regulations offer them a way to reduce their exposure, often in exchange for very little disclosure

The upshot of the procedures available under the Acts is that while firms face large and unpredictable liabilities concerning the products they make, they face very small expected liabilities concerning the securities they issue—even though the performance of the products is more predictable than the prices of the securities. One must look long and hard to find cases imposing liability on the basis of disclosure documents prepared in the ordinary course and filed with the SEC. There are lots of cases imposing liability, but almost all involve the sales of small businesses or some other unusual, person-specific transactions. The incidence of liability proves our basic point: the broad disclosure rules are very effective in reducing risk in exchange for minor alterations of firms' disclosures.

6. *The Sparing Use of the Material Omission Test*

All of the methods for formulaic disclosure and production of certainty that we have discussed could be undone by a broad definition of fraudulent nondisclosure. The statutes and rules prohibit the omission of material information that is necessary to make that which was disclosed not misleading. Terms such as "material" and "misleading" are vague. The SEC and courts could read them to

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[44] See Pashigian, Regulation, Preventive Law, and the Duties of Attorneys, *in* The Changing Role of the Corporate Attorney (W. Carney ed. 1981) (discusses the economic role of counsel in preventing violations of law).

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require unbounded and uncertain disclosures, which would undermine every other device we have discussed. Again the analogy to torts is instructive. Courts have been imposing stupendous liabilities for "failure to warn" of certain dangers, the tort equivalent of the materially misleading omission.

In securities cases, though, the "material omission" standard has been confined. The Supreme Court has concluded that an omission is material only if "there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote."[45] In the case containing that definition, the Court held not material an omission to state that a package of securities, valued in an initial disclosure at one price, was worth as much as twenty percent less. The Court reasoned that so much other information was disclosed that the change in price could reasonably have been inferred, and that in any event the nondisclosure was so limited in relation to what was disclosed that it need not be the basis of liability.

Under this standard of materiality, the ample disclosures required by the SEC's forms and schedules offer insulation from subsequent efforts to show material omissions. The standardization and risk-reduction functions can be achieved. True, many cases in the lower courts find certain omissions in formal disclosure documents "material"; we cannot deny that some of these holdings involve omissions that were trivial and unimportant from most perspectives. But with only one or two exceptions,[46] these cases do not award damages to the plaintiffs. The process of issuing securities seems almost liability-free. State courts, acting under state law, have used a much broader definition of materiality, giving credence to the interstate exploitation hypothesis.[47] The existence of five or ten "material omission" holdings every year in federal injunction cases, on the other hand, does not undermine the more important observation: damages are rarely if ever available on account of omissions in formal papers filed with the SEC.

The standardization and risk-reduction functions of securities regulation have been achieved much less successfully in the sec-

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[45] TSC Indus. v. Northway Inc., 426 U.S. 438, 449 (1976).

[46] E.g., Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

[47] See, e.g., Lynch v. Vickers Energy Corp., 429 A.2d 497, 501-04 (Del. 1981) (overruled in part by Weinberger v. UOP, Inc. 457 A.2d 701, 703-04 (Del. 1983)).

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ondary trading market. In recent years, it has been increasingly common for a precipitous stock price decline to be followed by a rash of lawsuits challenging the accuracy and completeness of the firm's prior disclosures. Often allegations of material omissions are at the core of such suits. Perhaps the difference from the new issues market is that once stock has been issued, firms are no longer free to give the very cautious statements that accompany new issues. Undue gloom might be portrayed as manipulation. Whatever the explanation, continued receptivity by courts to allegations of material omissions in firms' disclosures will tend to undermine the risk reduction function of securities regulation.

IV. The Evidence on Costs and Benefits

We have suggested so far a welter of arguments pro and con. We have outlined how self-interested disclosure works, why private incentives may leave disclosure at a suboptimal level, how private and state collective action may address or fail to address these problems, and why the usual rationales offered for federal legislation are weak. All of these assertions cry out for testing. After fifty years, what can we say in support of or against these logical arguments? As it turns out, we can say very little. Neither the cost nor the benefit side permits easy measurement.

A. Direct Costs

The direct costs of securities regulation are those of compiling, disseminating, and litigating about information, together with the costs of the SEC (both the costs borne by the government and those of the parties who appear before the agency). These costs include the opportunity costs of the time of all who participate in the disclosure process (corporate executives, lawyers, staff), plus expenses of printing and mailing disclosure documents and rules about disclosure.

Two economists have attempted to measure these costs. They come up with a direct payment figure exceeding one billion dollars for 1980—and this does not include the opportunity cost of the time of the issuers' employees.[48] These economists observe, however, that firms voluntarily incur far larger costs to make disclo-

[48] See S. Phillips & J. Zecher, The SEC and the Public Interest 27-51 (1981).

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sures. Mailing the firms' certified statements and annual reports to investors, which the statutes do not require, costs more than two billion dollars annually.[49] These mailings do not produce new information: everything in an annual report is old hat by the time it is mailed, and the dissemination of the report itself does not assist in making better decisions about investments.

This suggests a substantial problem in all efforts to determine the cost of required disclosure. We do not know what things firms would disclose, and to whom, in the absence of the securities laws. Much of the one billion dollar figure covers costs that would be incurred in the absence of the statutes—recall that voluntary disclosure was extensive in 1933. The marginal direct cost of mandatory disclosure may be small. If the uncertain benefits of mailing the annual statements and reports justify two billion dollars in voluntary expenditures, it would not take much on the benefit side to justify the SEC's incremental requirements.

B. Indirect Costs: Effects on Activity Level

Indirect costs are potentially more substantial and harder to measure. One cost is that disclosure may lead firms to change or abandon profitable projects that they otherwise would have pursued. A new product might be profitable if built in secrecy, stealing a march on rivals; if the rules require advance disclosure, rivals' responses make the project less attractive.

Proponents of disclosure of subjects such as foreign payments and pollution frequently argue that disclosure is beneficial precisely because it leads firms to change what they do.[50] Finding "benefit" here is perverse. The alteration of profitable behavior—whether the profit comes from new products or from not paying the full social costs of emitting pollutants—does not assist investors. They recognize it as a cost.

It may be that few projects are abandoned because of disclosure; the backward-looking, formulaic, and reciprocal nature of required disclosure makes it unlikely that disclosure will give away valuable and uncompensated information. Reciprocal disclosure of pollution

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[49] Id. at 50 (Table 3.3).

[50] Many of these arguments are collected in SEC, Staff Report on Corporate Accountability (1980), reprinted in Staff of the Senate Comm. on Banking, Housing, and Urban Affairs (Comm. Print 1980).

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may even be beneficial to investors as a group, although each firm would profit from being a holdout and staying silent while others disclose. The costs (and potential benefits) of the disclosure-induced changes in firms' behavior are unknown.

Disclosure systems have other potential indirect costs. One is noise. If the law forces firms to disclose more information than they otherwise would, investors then must spend extra time combing through disclosures to find what really matters. Another is substitution. Firms may cease disclosing some category of useful information and switch to some obfuscatory (but complying) information. Firms may become more cautious and leaden on paper, switching the important disclosures to discussions with analysis or other oral exchanges that will be less precise and less widely disseminated. Poorly understood or "coded" disclosures will be decoded imperfectly (and at some cost). In the extreme, a mandatory disclosure system's specification of what to say may stop firms from conveying categories of information altogether. Even if our speculation in Part III that mandatory disclosure may be beneficial is correct, any system of implementing disclosures is bound to have costs like these. If we are wrong in Part III, the costs will be larger. Yet we do not know how large these costs may be or even how to measure them.

C. Benefits: Profits for Investors?

The principal benefit usually asserted for mandatory disclosure is that investors will make more money. They will suffer fewer losses from deceit; even if the level of fraud is unaffected, they will invest more wisely when they know more. The discussion in Part II.C. suggests, on the contrary, that there is little reason to think that the disclosure rules would produce benefits observable in the form of returns to investors.

George Stigler has done the best-known study of the returns to investors before and after the creation of the disclosure requirements.[51] Stigler looked at the market for new issues, computing for

[51] See Stigler, Public Regulation of the Securities Market, 37 J. Bus. 117 (1964), revised and reprinted in Stigler, supra note 3, at 78. See also Jarrell, The Economic Effects of Federal Regulation of the Market for New Security Issues, 24 J.L. & Econ. 613 (1981). Both articles have been criticized. See Friend & Herman, The S.E.C. Through a Glass Darkly, 37 J. Bus. 382 (1964) (finding some errors in Stigler's data as well as criticizing interpretation);

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each stock the percentage difference between the purchase price and its price at some later date. He looked at purchases of new issues in 1923-1927 and asked how these investors fared if they held for one, two, three, four, or five years. They fared well by his test only if they gained relative to investors in existing firms. Then he did the same for purchasers of new issues in 1949-1955. He reached two conclusions. First, although the investors in new issues seemed to lose money relative to the market, and the investors of 1923-1928 lost a little more than the investors of 1949-1955, this difference was not statistically significant. Second, the standard deviation of investors' profits was much lower in the second period than in the first. Stigler concluded that the securities laws had been ineffectual in saving money for new investors, but that they had excluded some small firms from the market, thus reducing the variance of returns.

Gregg Jarrell did essentially the same comparision, but he used methods that had been developed after Stigler's study. He asked not simply whether investors in new firms gained or lost relative to the market, but whether they did so when the volatility (risk) of the investments was taken into account. Because most people are risk averse, they demand higher returns to hold risky startup ventures than to hold established firms such as Exxon. He also used a larger sample, this time comparing the years 1926-1933 with 1934-1939. After holding degree of risk constant, Jarrell concluded that investors in 1926-1933 did not pay "too much" for their stock in light of later returns, and neither did the subsequent investors. Over a five-year period, those who bought new issues in 1926-1933 actually did better relative to the rest of the market than those who bought later. Like Stigler, he found a substantial reduction in volatility after the passage of the '33 Act.

Stigler and Jarrell agree that in the first year after issuance, stocks in new firms decline relative to the market, after making adjustment for risk. Any subsequent gains must be attributable to new information. Irwin Friend has concluded from this and from other work that the '33 Act produces net benefits.[52] Stigler and Jarrell, on the other hand, find Friend's methods flawed (as he

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Smith, supra note 9. See also Stigler, Comment, 37 J. Bus. 414 (1964).

[52] See supra note 51. See also I. Friend, Economic and Equity Aspects of Securities Regulation (1982) (Rodney White Center for Financial Research, University of Pennsylvania,

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finds theirs flawed) and believe that his conclusions are unreliable. No matter which conclusion we credit, none shows substantial effects of the securities laws on investors' returns.

What do we learn from these studies? The finding that investors in new issues do (about) as well as investors in other instruments should not be surprising, no matter what the extent of disclosure. These are, after all, the same investors, and every investor has access to new and old issues as well as to bonds, precious metals, commodities, and other investments. Markets in equilibrium would produce similar risk-adjusted profits in all of these. Even if information is scarce and investors stupid, we would not expect them to be *more* stupid when buying new issues.

There was a good deal of disclosure before 1933, and professional traders acquired by hook or by crook important information that firms declined to reveal. If the '33 Act just codified firms' "good practice," slightly reducing the amount of search by the professionals, it would leave little trace in the data. Suppose, on the other hand, that before 1933 firms did not produce "enough" information, that the '33 Act forced them to produce the "right" information, and that this was beneficial to investors. We probably still would not see profit in studies such as Stigler's and Jarrell's. If the new securities are more attractive with information attached, they will sell for more too; the promoters and underwriters will see to that, and that price adjustment will disguise the gains from the regulation.

Moreover, none of the benefits should show up in comparative returns if the law simultaneously affects new issues ('33 Act) and existing issues trading in the aftermarket ('34 Act). Other changes have proceeded apace: informational intermediaries and money managers have grown in importance over the years. It is almost impossible to compare states of the world against one another when so many things change simultaneously (a point Stigler and Jarrell recognize).

A comparison of unregulated new issues against unregulated old issues in 1923-1933, on the one hand, and regulated new issues against regulated old issues in later years, on the other, will not readily reveal benefits of the statutes as a group. Studies could

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Working Paper No. 7-82) (summarizing his earlier work) (copy on file with the Virginia Law Review Association).

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show relative gains for new investors only if the '33 Act were somehow more efficacious in protecting them than the '34 Act and other changes were in protecting investors in ongoing firms. No one has suggested why it would be. (There is also a problem in interpretation. A study immediately before and after 1933 might show gains, but the presence of gains in a world with fewer informational intermediaries would not support the inference that the '33 Act continues to produce gains today.)

The finding that the '33 Act reduces the variability of returns also is ambiguous on benefits versus losses. One possible interpretation is that the statutes so raised the cost of going public that many firms simply didn't. Only larger firms "seasoned" as closely-held ventures would be available to buy. This would harm investors by depriving them of choice without increasing their returns. A different interpretation is that investors with good information will price the new issues more astutely; the "better" pricing leads to lesser gaps between initial and subsequent price, thus lower variance. At all events, this argument would conclude, investors who can hold diversified portfolios have no interest in buying variance; they can get it by changing the leverage of their portfolios anyway. The '33 Act should not stymie the creation of new firms. So long as the venture capital market is large and reasonably efficient (which it is), private placements will raise all of the necessary funds, at optimal rates, from the pros who deal in new ventures.

The effect of the '33 Act on the riskiness of new issues suggests still another complication. A reduction in risk implies a lower return for the market as a whole, and this factor confounds attempts to deduce investors' welfare from looking at market-wide effects.[53]

D. Benefits: Profits and Losses to Intermediaries and Firms

If the data on comparative returns among types of issue or over time do not enlighten, we may do better with data on instantaneous price changes. It is possible to inquire what happened to the prices of stock when the statutes were enacted. If the new disclosure requirements were beneficial, the argument goes, investors

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[53] See R. Posner & K. Scott, The Economics of Corporation Law and Securities Regulation 378-79 (1980).

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would have valued stock more highly. Prices should have risen smartly to reflect the gains to investors.[54]

George Benston has studied the reaction of the market to the passage of the '34 Act.[55] Because every firm traded on the principal exchanges in 1934 had an annual independent audit and disclosed the results, Benston analyzed the effects of the statute by looking for differences in the stock performance of those that previously had disclosed their sale (sixty-two percent) and those that had not. He found no significant difference in the performance of firms in the different groups between February 1934 (when the first hearings on the Act were held) and June 1935 (by which time every firm had disclosed its sales). Benston inferred from this that the new disclosure rules were of no benefit to investors.

It is hard to know what to make of this. Perhaps "sales" were not the critical bit of information investors desired (although there is evidence that disclosure of this fact often affected the price of stock). Perhaps there were no significant differences in the performance because the market inferred the sales of the non-disclosers from the sales of disclosers in the same industry. Then we would treat the non-disclosers as free riders, under the argument of Part II.B., trying to take advantage of other firms. This interpretation is consistent with Benston's further finding that during the period 1929-1934, the stock price of firms that did not disclose their sales rose slightly compared with firms that did. Benston suggests that this shows that required disclosure of sales damaged investors; we could say as easily that the non-disclosers' extra profits came from their status as free riders, holdouts attempting to get information from disclosures of other firms without tipping their own hands.

We do not want to sound too critical of this work. It is difficult to do, because even relatively inefficient markets will impound a great deal of information. The more information about disclosure and legal rules is reflected in prices in advance, the harder it is to do comparative studies to discern the effects of legal rules. It is fair

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[54] See Schwert, Using Financial Data to Measure Effects of Regulation, 24 J.L. & Econ. 121 (1981), for a discussion of the methodology and a description of some of the more interesting findings.

[55] Benston, supra note 25, at 141-52. But see Friend & Westerfield, Required Disclosure and the Stock Market, 65 Am. Econ. Rev. 467 (1975) (challenging Benston's inferences, though not his basic findings); I. Friend, supra note 52.

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to say, we think, that there is no good evidence that the disclosure rules are beneficial. On the other hand, there is no good evidence that the rules are (a) harmful, or (b) very costly. The insistent equilibrium of the stock market eradicates the information we need to conduct the cost-benefit test. We are left, for the moment at least, with logical argument rather than proof. And the logical arguments are themselves inconclusive.

V. Conclusion

A variety of private and public responses to the problem of asymmetric information establish powerful incentives for firms to disclose what investors want to know. Mandatory national disclosure legislation may well improve the incentives, but if it does this the improvement comes about for reasons other than a need to deal with fraud or any systematic tendency to hide.

Intervention is most likely to be useful when sellers lack incentives to disclose information because of third-party effects, holdouts among other firms, and attempts by states to exploit investors who live elsewhere. Sometimes firms simply will not find it in their interest to disclose adequate industry-wide, comparative, or standarized information. Because securities are not homogeneous products, and direct inspection of business prospects by investors is not cost-effective, there may be gains from collective insistence on certain disclosures.

This is a far cry from saying that our existing securities rules are optimal. No satisfactory data suggest that the SEC's rules are beneficial. Perhaps problems in implementation prevent realization of whatever savings are available in principle. There is less reason to regulate securities than, say, the funeral industry, which also lacks standardized transactions and in which shopping by informed traders may not lead to efficient prices. We have not constructed a compelling case for regulation of any sort, let alone for the particular regulations the SEC uses.

There is nonetheless *a* case for mandatory disclosure, and it is a far different case from that usually advanced by those who endorse the securities laws. Our approach suggests that the telling blows that can be struck against the usual case are not fatal.

What is the appropriate response to this "conclusion," if something so uncertain may be called that? The proponent of change in the legal order bears a substantial hurden. Rules of law may be

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beneficial in ways we do not understand, and if all we can say is that we cannot identify either benefit or detriment from a given set of rules, the injunction to leave well enough alone has great force. At the same time, the study of regulation is sufficiently advanced to support a contrary injunction: Most regulatory regimes reduce aggregate welfare, although they also profit special interest groups. There is no shortage of groups that gain from securities regulation. The impetus that led to the elimination of the CAB and the deregulation of many modes of transportation and communication—and the observable benefits of this deregulation—suggest that the maxim "If it ain't broke, don't fix it" applies only to the outcome of private orderings. Yet the inefficient systems of regulation commonly have entry limits or price controls, which securities laws do not. The final difficulty, as we emphasized at the outset, is that the question for decision is not regulation versus the market but one kind of regulation (disclosure rules enforced by the SEC) versus another (fraud and "material omission" rules, and perhaps disclosure rules, enforced by state courts and agencies). We cannot say that the existing securities laws are beneficial, but we also are not confident that their probable replacements would be better.

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