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## Market Failure and the Economic Case for a Mandatory Disclosure System

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## MARKET FAILURE AND THE ECONOMIC CASE FOR A MANDATORY DISCLOSURE SYSTEM

*John C. Coffee, Jr.\**

RECENT academic commentary on the securities laws has much in common with the battles fought in historiography over the origins of the First World War. The same progression of phases is evident. First, there is an orthodox school, which tends to see historical events largely as a moral drama of good against evil. Next come the revisionists, debunking all and explaining that the good guys were actually the bad. Eventually, a new wave of more professional, craftsmanlike scholars arrives on the scene to correct the gross overstatements of the revisionists and produce a more balanced, if problematic, assessment.

This same cycle is evident in the recent securities law literature. Not so long ago, academic treatment of the securities laws was clearly at the first or “motherhood” stage: to criticize the SEC was tantamount to favoring fraud. Then came the revisionists—most notably Professors Stigler,<sup>1</sup> Benston,<sup>2</sup> and Manne<sup>3</sup>—who argued that the securities laws produced few benefits and considerable costs. According to Professor Benston, the passage of these statutes did not even significantly improve the quality of information

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\* Professor of Law, Columbia University Law School. The author wishes to acknowledge the advice and comments of Bruce Ackerman, Susan Rose-Ackerman, Ronald Gilson, and Joel Seigman. None of them bear responsibility for the views expressed herein.

<sup>1</sup> See Stigler, *Public Regulation of the Securities Markets*, 37 *J. Bus.* 117 (1964).

<sup>2</sup> Professor Benston's prolific writings on this topic include the following: G. Benston, *Corporate Financial Disclosure in the UK and the USA* (1976); Benston, *The Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements*, in *Corporations at the Crossroads: Governance and Reform* 37-69 (D. DeMott ed. 1980); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 *Am. Econ. Rev.* 132 (1973) [hereinafter cited as Benston, *An Evaluation of the Securities Exchange Act of 1934*]; Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 *Acct. Rev.* 515 (1969) [hereinafter cited as Benston, *The Value of the SEC's Accounting Disclosure Requirements*].

<sup>3</sup> See H. Manne, *Insider Trading and the Stock Market* (1966); H. Manne & E. Solomon, *Wall Street in Transition: The Emerging System and its Impact on the Economy* (1974). For a critique of Manne, see Schotland, *Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 *Va. L. Rev.* 1425 (1967).

provided to investors.<sup>4</sup> These claims provoked a flurry of critical responses, both from academic critics<sup>5</sup> and the SEC.<sup>6</sup> Commentators have charged Professor Stigler with methodological laxness;<sup>7</sup> a new literature on insider trading has suggested that such trading may create perverse incentives;<sup>8</sup> and the leading historian on the SEC has effectively rebutted Professor Benston's account of market conditions prior to the passage of the Securities Exchange Act of 1934 (the '34 Act).<sup>9</sup>

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<sup>4</sup> Benston, *An Evaluation of the Securities Exchange Act of 1934*, supra note 2; Benston, *The Value of the SEC's Accounting Disclosure Requirements*, supra note 2.

<sup>5</sup> See, e.g., Friend & Herman, *Professor Stigler on Securities Regulation: A Further Comment*, 38 J. Bus. 106 (1965) [hereinafter cited as Benston, *Professor Stigler on Securities Regulation*]; Friend & Herman, *The SEC Through a Glass Darkly*, 37 J. Bus. 382 (1964) [hereinafter cited as Friend & Herman, *The SEC Through a Glass Darkly*]; Friend & West-erfield, *Required Disclosure and the Stock Market*, 65 Am. Econ. Rev. 467 (1975); Mendel-son, *Economics and the Assessment of Disclosure Requirements*, 1 J. Comp. Corp. L. & Sec. Reg. 49 (1978). See also Friend, *Economic and Equity Aspects of Securities Regulation* (1982) (Working Paper No. 7-82, Rodney L. White Center for Financial Research, Univer-sity of Pennsylvania) (copy on file with the Virginia Law Review Association). Probably the most comprehensive recent survey of these critiques is contained in Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. Corp. L. 1 (1983).

<sup>6</sup> The SEC responded in 1977 with a report prepared by a distinguished Advisory Com-mittee. See House Comm. on Interstate and Foreign Commerce, *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, 95th Cong., 1st Sess. (Comm. Print 1977) (hereinafter cited as *Advisory Committee Report*). For a critique of this report, see H. Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* (1979).

<sup>7</sup> See Friend & Herman, *Professor Stigler on Securities Regulation*, supra note 5, at 107-09; Mendelson, supra note 5. A more recent empirical study by Professor Jarrell, while also discounting the impact of the federal securities laws, produced results in some respects strikingly at odds with Professor Stigler's findings. See Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & Econ. 613 (1981). For a review of the inconsistencies in results, see Friend, supra note 5.

<sup>8</sup> See Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Pro-duction of Information*, 1981 Sup. Ct. Rev. 309; Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 Va. L. Rev. 117 (1982); Schotland, supra note 3; Scott, *Insider Trading: Rule 10(b)-5 Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801 (1980). For a critique from a managerial perspective, see Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich. L. Rev. 1051 (1982).

<sup>9</sup> See Seligman, supra note 5, at 12-18. Professor Seligman is the author of a compre-hensive work regarding the history of the SEC. See J. Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Fi-nance* (1982). Briefly, Professor Benston studied the financial information disclosed in Moody's Manuals by 508 corporations that were traded on the New York Stock Exchange on June 1935, just before the Securities and Exchange Act took effect. Sixty-two percent of these corporations disclosed sales figures, as opposed to only 55% in 1926. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, supra note 2, at 519. This increase, which to Professor Benston demonstrated that regulation was unnecessary, is susceptible to

We therefore may be approaching a new stage, which can be called "post-revisionism." Among post-revisionism's defining characteristics are (1) a recognition of the Efficient Capital Market Hypothesis as, at the least, the best generalization by which to summarize the available empirical evidence;<sup>10</sup> (2) a clearer sense of the

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different interpretations. Corporations may have begun to bow before the Act's requirements as the inevitable effective date approached, or as Professor Seligman suggests, this increase may have been largely a statistical artifact caused by non-complying firms leaving the Exchange to avoid the '34 Act's coverage (as some did). Seligman, *supra* note 5, at 14-15. The more significant fact actually appears to be that even on the eve of the '34 Act's effectiveness, 38% of New York Stock Exchange corporations were still not publishing sales figures. In any event, because Professor Seligman's critique of Benston's data is detailed and lengthy, it will not be summarized further here.

<sup>10</sup> Conventionally, the Efficient Capital Market Hypothesis (ECMH) is subdivided into three distinct versions: the "weak" form, the "semi-strong," and the "strong." See Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. Fin.* 383 (1970). As so often happens in the relationship between the law and social sciences, at the very moment that judicial and administrative decisions have begun to accept the ECMH, anomalies have begun to appear in the research data. These anomalies call into question either the extent of the ECMH's applicability or suggest the need for technical reformation. Research in three areas has identified fissures in the foundation of the ECMH. First, studies of the volatility of securities prices suggest that the response of securities prices may be excessive in relation to the significance of the underlying events. See, e.g., Shiller, *Do Stock Prices Move Too Much to Be Justified By Subsequent Changes in Dividends?*, 71 *Am. Econ. Rev.* 421 (1981). Second, studies demonstrate a "small firm" effect under which small firms (typically, the bottom 20% of publicly traded companies) earn abnormally high returns, even after risk adjustment. Other anomalies involving seasonal and weekly variations in stock returns and similar cyclical regularities are also recurrently documented. For an easily accessible summary of these findings, see Seligman, *Can You Beat the Stock Market?*, *Fortune*, Dec. 26, 1983, at 82, 94. For the latest data on the small firm effect, see *Symposium on Size and Stock Returns, and Other Empirical Regularities*, 12 *J. Fin. Econ.* 3 (1983). For the response of the Chicago School, see Rosett, *Chicago School Bets on Inefficiency*, *N.Y. Times*, Dec. 11, 1983, at F10, col. 3 (group of Chicago graduate students and professors formed investment company that invests solely in small firm stocks). Third, the conceptual and practical utility of beta—the measure of stock market volatility—remains in serious doubt and some theorists are trying to replace it with a reformulated definition of non-diversifiable risk. See B. Malkiel, *A Random Walk Down Wall Street* 213-26 (2d ed. 1981); Black, *Yes, Virginia There Is Hope: Tests of the Value Line Ranking System*, *Fin. Anal. J.*, Sept.-Oct. 1973, at 10-14; Downes & Dyckman, *A Critical Look at the Efficient Market Empirical Research Literature as it Relates to Accounting Information*, 48 *Acct. Rev.* 300 (1973); Downes & Dyckman, *The Efficient Market Reconsidered* 4 *J. Portfolio Mgmt.* 4, 4-74 (Fall 1977); Seligman, *supra* note 5.

Although none of these anomalies seem likely to weaken the basic point that investors cannot "beat" the market based on diligent search efforts, they do suggest that distinctions should be drawn in terms of the degree to which the ECMH is used as a justification for deregulation—particularly since very little evidence exists with respect to any market other than the New York Stock Exchange. This article will suggest that a mandatory disclosure system should focus on disclosures that assist the investor in assessing beta and better en-

difficulties inherent in relying on aggregate statistical evidence either to prove or rebut any broad thesis about the impact and effects of disclosure;<sup>11</sup> and (3) a shift in focus from continued debate over the impact the federal securities laws had fifty years ago to an examination of contemporary market structure and the needs of investors under existing conditions.<sup>12</sup>

In this typology of phases, the article by Professors Easterbrook and Fischel<sup>13</sup> seems at the threshold of "post-revisionism." This categorization may overstate the degree to which they have moved beyond the simple catechism of Professors Stigler and Benston, but at least their article recognizes that the statistical studies are not clearly dispositive<sup>14</sup> and that a faint possibility remains open that benefits might accrue to investors from a mandatory disclosure system.<sup>15</sup> On the other hand, of the possible reasons they offer

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able him to reduce diversifiable risk; greater disclosure seems also justified in the case of small firms given their apparent immunity to the predictions of the ECMH.

<sup>11</sup> Recent studies have agreed that the variance in debt securities returns declined after the '34 Act. This decline, however, can be interpreted in various ways. Professor Friend concludes that it resulted from the prevention of fraudulent issues, which were recurrent before 1934. See Friend, *supra* note 5. Professor Jarrell posits that this change was the consequence of a paternalistic SEC policy that denied investors the opportunity to invest in higher risk securities having a higher return. See Jarrell, *supra* note 7, at 648-49. Although statistical data can often be interpreted in various ways, the usual approach of social scientists in such instances is to utilize direct observation and interview data. Here, the historical evidence compiled by Professor Seligman seems compelling in its thesis that fraud was prevalent prior to 1934. See Seligman, *supra* note 5, at 18-33.

<sup>12</sup> Much has changed since the 1920's. Among the most obvious differences are the following: (1) the appearance in the stock market of small investors, who were a rarity before 1934, (2) the increasing domination of trading by institutional investors, and (3) the maturation of the securities analyst into a true professional. Each of these trends really dates from after World War II (at the earliest).

These trends, however, do not necessarily point in the same direction. Institutional investors, who began to dominate trading in the 1960's, see *infra* note 43 and accompanying text, clearly are better able to fend for themselves than are individuals whose small holdings make investment in securities research infeasible. Conversely, the abolition of fixed rate brokerage commissions in 1975 probably has lessened the desire and ability of competing firms to provide securities advice and research to customers as a form of non-price competition. No attempt is made here to assess the net balance of these changes; rather, the point is that a series of economists, in comparing pre-1933 and post-1933 returns on securities, and even in comparing pre-1933 and 1950-era returns, have overlooked the probability that the securities markets have changed dramatically since the 1950's so as to call into question the relevance of any prior conclusions about the impact of the '34 Act.

<sup>13</sup> Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

<sup>14</sup> *Id.* at 709-13.

<sup>15</sup> *Id.* at 696-707.

for believing that issuers might underprovide information, only one—the third party effects hypothesis<sup>16</sup>—seems plausible.<sup>17</sup>

In contrast, a simpler theory can justify a mandatory disclosure system. Such a theory can also explain where a disclosure system should focus. Essentially, this response will make four claims.

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<sup>16</sup> *Id.* at 685-87, 697.

<sup>17</sup> Others have also suggested that issuers might resist disclosures, particularly involving line-of-business data, for fear of informing business rivals. See Foster, *Externalities and Financial Reporting*, 35 *J. Fin.* 521, 523-25 (1980) (discussing externalities of “competitive sensitive” content to the reporting firm); Advisory Committee Report, *supra* note 6, at xxi (noting analysts’ complaints about their difficulties in obtaining information not required for disclosure but important for investment decisions). This point has then been made before, but Professors Easterbrook and Fischel correctly elaborate on it. See Easterbrook & Fischel, *supra* note 13, at 685-87.

As to their interstate exploitation argument, see *id.* at 697-98, their discussion seems to extrapolate the problem of state anti-takeover statutes, which admittedly is a serious problem, beyond its realistic limits. No evidence is cited to support the proposition that before 1933 states placed excessive demands on corporate issuers to favor local investors. Nor did the ‘34 Act change anything in this regard. States continued to legislate disclosure requirements under their “Blue Sky” statutes, which were expressly not preempted by either the Securities Act of 1933 or the ‘34 Act. See Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (codified as amended at 15 U.S.C. § 77zzz (1982)); Securities Exchange Act of 1934, ch. 404, § 28(a), 48 Stat. 881, 903 (codified as amended at 15 U.S.C. § 78bb(a) (1982)).

As all securities lawyers know, the individual states have differed markedly in the nature of their “Blue Sky” disclosure requirements. Some have sought to regulate the “fairness” of the issuance by imposing substantial requirements in addition to those mandated by federal law, whereas others have been satisfied with compliance with the federal statute. See L. Loss & E. Cowett, *Blue Sky Law* 17-42 (1958). Yet to this author’s knowledge, no state has ever sought to apply its statute extraterritorially or to compel issuers to disclose information if the issuer decided not to offer its securities for sale in that jurisdiction. Because each state knows that the consequence of restrictive Blue Sky provisions is to cause issuers to decline to offer in their jurisdiction, the result is not favoritism toward intrastate investors, but rather a dubious paternalism that excludes intrastate investors from the opportunity of investing in securities fully registered with the SEC. Moreover, in upholding Blue Sky laws against a commerce clause challenge, the Supreme Court emphasized that such statutes applied only to intrastate sales of securities. See *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557-58 (1917). Only in one strange California case has the problem of “interstate exploitation” raised by Professors Easterbrook and Fischel, see Easterbrook & Fischel, *supra* note 13, at 697-98, ever surfaced. See *Western Air Lines v. Sobieski*, 258 Cal. App. 2d 213, 218, 66 Cal. Rptr. 293, 316 (1968); *Western Air Lines v. Sobieski*, 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961) (holding that California had the power to forbid a Delaware corporation with substantial California contacts from eliminating cumulative voting, which was mandatory in California and optional in Delaware). Consequently, their discussion of the “interstate exploitation” problem seems both ahistorical and inattentive to the constitutional barriers to any such attempt. Although state courts may on occasion favor the local plaintiff, this problem was long ago addressed by giving federal courts diversity jurisdiction. Moreover, it seems unlikely that the federal securities laws have reduced undesirable litigation. Certainly, the history of Rule 10b-5 prior to the mid-1970’s does not support their claim.

First, because information has many characteristics of a public good, securities research tends to be underprovided. This underprovision means both that information provided by corporate issuers will not be optimally verified and that insufficient efforts will be made to search for material information from non-issuer sources. A mandatory disclosure system can thus be seen as a desirable cost reduction strategy through which society, in effect, subsidizes search costs to secure both a greater quantity of information and a better testing of its accuracy. Although the end result of such increased efforts may not significantly affect the balance of advantage between buyers and sellers, or even the more general goal of distributive fairness, it does improve the allocative efficiency of the capital market—and this improvement in turn implies a more productive economy.

Second, a substantial basis exists for believing that greater inefficiency would exist without a mandatory disclosure system because excess social costs would be incurred by investors pursuing trading gains. Collectivization minimizes the social waste that would otherwise result from the misallocation of economic resources to this pursuit.

Third, the theory of self-induced disclosure, now popular among theorists of the firm and relied upon by Professors Easterbrook and Fischel,<sup>18</sup> has only a limited validity. A particular flaw in this theory is that it overlooks the significance of corporate control transactions and assumes much too facetly that manager and shareholder interests can be perfectly aligned. In fact, the very preconditions specified by these theorists as being necessary for an effective voluntary disclosure system do not seem to be satisfied. Although management can be induced through incentive contracting devices to identify its self-interest with the maximization of share value, it will still have an interest in acquiring the shareholders' ownership at a discounted price, at least so long as it can engage in insider trading or leveraged buyouts. Because the incentives for both seem likely to remain strong, instances will arise in which management can profit by giving a false signal to the market.

Fourth, even in an efficient capital market, there remains information that the rational investor needs to optimize his securities

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<sup>18</sup> See Easterbrook & Fischel, *supra* note 13, at 684-85.

portfolio. Such information seems best provided through a mandatory disclosure system.

None of these claims is intended, however, as a complete defense of the status quo, nor will this response address the important, but distinct, question of the utility of disclosure as a form of substantive regulation of corporate behavior through the sanction of stigmatization.

### I. A PUBLIC GOODS PERSPECTIVE

Easy as it is today to criticize the original premise of the federal securities laws—i.e., that mandatory disclosure would enable the small investor to identify and invest in higher quality and lower risk securities—such criticism does not take us very far because its target has shifted. The securities markets have evolved significantly since the 1930's, and one of the most important developments is the appearance of the professional securities analyst.<sup>19</sup> Little known in 1934 and common today, the analyst seems likely to become the critical mechanism of market efficiency because on-line computerization of SEC-filed data makes access to such information both immediate and relatively costless to the analyst.<sup>20</sup>

The work of the securities analyst can be subdivided into two basic functions. First, the analyst searches for information obtainable from non-issuer sources bearing on the value of a corporate security. Often, this information is critical because the issuer's performance may be substantially dependent on exogenous factors—e.g., interest rates, the behavior of competitors, governmental actions, consumer attitudes, and demographic

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<sup>19</sup> The SEC's Advisory Committee on Corporate Disclosure found that there were some 14,646 professional securities analysts employed by financial institutions, brokerage firms, and consulting services as of 1977. See Advisory Committee Report, *supra* note 6, at 36. Presumably, this profession has survived because it performs a useful service. Typically, the chief source of firm-specific data used by the analyst appears to come from personal conversations with managers. *Id.* at 66-68. That managers do divulge information in this fashion to analysts provides some support for the theory of voluntary disclosure discussed below. See *infra* section II. For a refreshingly skeptical treatment of the analyst, however, see B. Malkiel, *supra* note 10, at 157-61.

<sup>20</sup> For this view of the future, see Sanger, S.E.C.'s Computer Revolution: Benefits Seen for Investors, *N.Y. Times*, Apr. 3, 1984, at D1, col 3. As contemplated, issuers would both file and update their reports electronically. Although the individual investor could also obtain access, the analyst and the broker would have significant economies of scale, operating in their favor.



trends—about which the issuer has no special knowledge or the analyst has superior access. Second, the analyst verifies, tests, and compares the issuer's disclosures, both to prevent deliberate fraud and to remove the unconscious bias that usually affects all forms of information transfer.<sup>21</sup>

Although individual investors could also perform these search and verification functions, the professional securities analyst typically can do so at a lower cost because there appear to be significant economies of scale and specialization associated with these tasks. As a result, most accounts explaining the stock market's efficiency assign a substantial responsibility to the competition among analysts for securities information.<sup>22</sup>

In principle, the information volume developed by securities analysts is determined by the usual market forces and should result in the usual equilibrium: analysts should invest in verifying and obtaining material information about corporate securities until the marginal cost of this information to them equals their marginal return. Ordinarily, this private equilibrium should also result in allocative efficiency: social resources would be devoted to information verification until the social costs rose to meet the social benefits. There is a basic flaw, however, in this simple neoclassical analysis, and it involves a recurring problem that arises whenever a public good is produced.

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<sup>21</sup> Too much emphasis tends to be placed on fraud as opposed to other forms of information distortion. Selective filtering of information through multiple layers of transmission is a fact of life within complex social institutions, and tends to be more aggravated within hierarchical institutions such as the corporation. For a discussion of these problems, see L. Festinger, *A Theory of Cognitive Dissonance* (1957); Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 *Va. L. Rev.* 1099, 1137-1139 (1976) (discussing "authority linkage" and the loss of information through social relays within a hierarchy).

<sup>22</sup> The view that the competition among analysts to "ferret out and analyze information" maintains market efficiency has now received the imprimatur of the Supreme Court in *Dirks v. SEC*, 103 S. Ct. 3255 (1983): "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, *which the SEC itself recognizes is necessary to the preservation of a healthy market.*" *Id.* at 3263 (emphasis added). It needs to be emphasized that the ECMH does not imply that securities research is without value, although it does call into question the price that is often paid. See Fama, *Random Walks in Stock Market Prices*, *Fin. Anal. J.*, Sept.-Oct. 1965, at 55-59; Pozen, *Money Managers and Securities Research*, 51 *N.Y.U. L. Rev.* 923, 950-53 (1976).

A. *Market Failure as a Cause of Insufficient Securities Research*

Public goods are a well-known economic concept.<sup>23</sup> What has not been adequately recognized, however, is the degree to which information about corporate securities from non-issuer sources resembles (albeit imperfectly) a public good. The key characteristic of a public good is the non-excludability of users who have not paid for it; people benefit whether or not they contribute to the costs of acquiring the good, in part because consumption of the good by one user does not diminish its availability to others. Public parks, public television, and the national defense establishment are all examples of public goods. Because people can "free ride" on others' payments, they have an incentive to underpay, even though they may consider these goods vitally important and would be willing to purchase them in the open market if they were unable to free ride. The net result is that public goods tend to be underprovided.<sup>24</sup>

Securities information displays this key characteristic of non-excludability. It seldom can be confined to a single user because many people have a motive to leak it. When the corporate insider tips a friend of a material impending development, the information does not stop with the tippee, but tends to be passed on. In fact, it is generally in the tippee's interest, once he has traded, to inform others to create excitement and induce a market upswing. Otherwise, the tippee achieves only the dubious victory of owning an un-

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<sup>23</sup> For important treatments of this concept, see R. Musgrave, *The Theory of Public Finance* 61-89, 116-35 (1959); M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965); Head, *Public Goods and Public Policy*, 17 *Pub. Fin.* 197 (1962). Technically, a public good is characterized by both nonexcludability and indivisibility—the latter term meaning that use or consumption of the good by one user does not diminish it for others. Thus, once a public park is built, it is infeasible to exclude citizens who did not contribute taxes or contributions toward its construction. Moreover, such citizens' use of the park does not diminish its availability to others. For our purposes, non-excludability is the critical concept because it gives rise to the "free rider" problem that one can benefit without having to pay for a public good.

<sup>24</sup> Professors Easterbrook and Fischel have elsewhere utilized this analysis to explain why shareholders will not resist management. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161, 1171 (1981). Because the benefit of any resistance undertaken by a single shareholder or a group of shareholders must be shared with all shareholders, "each shareholder finds it in his self-interest to be passive." *Id.* This free-riding problem also applies to the analyst as well as to the shareholder, because the securities analyst cannot obtain the full economic value that this efforts created. See *infra* text accompanying notes 26-28.

dervalued security, and as the Wall Street Traders' credo says: "A bargain that remains a bargain is no bargain." Subsequent users thus gain a largely gratuitous benefit from material information leaked to them, although the value of the benefit quickly diminishes because of the market's rapid adjustment.<sup>25</sup>

As applied to the securities analyst, the public goods-like character of securities research implies that the analyst cannot obtain the full economic value of his discovery, and this in turn means that he will engage in less search or verification behavior than investors collectively desire. The public goods character of securities research is illustrated by the well-known commercial: "When E.F. Hutton talks, people listen." Indeed, people do listen, but the eavesdroppers do not pay for what they receive; they are, in the parlance, "free riders." Typically, securities research is reduced to an analyst's report that is circulated among prominent institutional investors in return for expected future commissions or other investment banking business.<sup>26</sup> Contracting for research in this fashion is presumably more efficient than each institutional investor employing its own analysts (which also happens) because of the economies of scale and specialization.<sup>27</sup> Once securities research is initially disseminated in this fashion (or any similar fashion), however, free riding is predictable: news leaks out almost immediately because the confidentiality of a circulated report cannot be protected for long and because institutional investors have an incentive (after they trade) to make the analyst's report a self-fulfilling prophecy by encouraging others to trade.<sup>28</sup> Either way, those in the tippee chain do not compensate the analyst. As a result, securities

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<sup>25</sup> The rapidity of the market's response depends, however, on whether the information is truly publicly available information (e.g., earnings reports or projections or dividend announcements) or semi-public data that is slowly being leaked from an inside source. The facts of *Dirks v. SEC*, 103 S. Ct. 3255 (1983), illustrate this. In *Dirks*, Ronald Secrist, a former officer of Equity Funding, sought without success to alert regulatory authorities and others to the existence of a classic fraud. Between March 7, 1973, when Secrist alerted both Dirks and insurance authorities and March 28th, when the SEC suspended trading, the critical information was in the hands of numerous individuals. Their reaction time was relatively slow (for a number of understandable reasons). Dirks' clients were thus able to liquidate their positions in the stock and avoid serious loss, even though the details of the fraud had been described to public authorities two weeks earlier. See also *infra* note 43.

<sup>26</sup> See *infra* text accompanying note 30.

<sup>27</sup> See *supra* text accompanying note 22. If it were not more efficient, such an institutional structure would presumably not have survived.

<sup>28</sup> See *supra* note 25 and accompanying text.

research is likely to be undercompensated. This undercompensation implies that there is underinvestment in securities research in terms of the aggregate wealth it creates or preserves. Thus, we are back to the classic public goods problem: so long as the free riders do not have to pay, the commodity will be underprovided.

A related problem with securities research involves the difficulties inherent in contracting for it. Normally, compensation for such research is on an *ex post* basis because the investor cannot know its value in advance. This problem is not unique to securities research; it also complicates bargaining over trade secrets, patents, and other forms of valuable information.<sup>29</sup> The only objective test of the advice's value is the ultimate occurrence of the predicted market reaction. Although the buyer of valuable information should be willing to compensate the provider (at least to the extent that the buyer wishes to obtain such information from him in the future), the *ex post* and unilateral character of the payment results in less compensation being paid than if the negotiation were on a bilateral basis.

This problem is further complicated because payment typically is not made in cash. Rather, the user directs some of its brokerage business to the firm whose analyst supplied the information. In effect, the institutional investor pays above market price for brokerage services to obtain valuable research; the investor purchases advice with nothing more than the promise of future brokerage commissions at a premium rate. This premium is evidenced by the recent appearance of discount brokers, who offer only clearing services and provide no investment advice. The cost of such brokerage is estimated to be fifty percent below that of full service brokerage firms.<sup>30</sup> Thus, the customer has his choice of financial services—a simple clearing service or a clearing service plus advice.

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<sup>29</sup> Put simply, if the inventor or discoverer discloses his secret in advance, the recipient need not compensate him unless some form of property right is conferred by the law on the inventor or discoverer. See generally, Kitch, *The Law and Economics of Rights in Valuable Information*, 9 *J. Legal Stud.* 683 (1980).

<sup>30</sup> See Vartan, *Those Discount Stockbrokers*, *N.Y. Times*, Jan. 19, 1984, at D10, col. 3. Discount brokerage now accounts for between 15% and 16% of retail trading, up from 1% in 1975, and appears to be increasing its market share still further. *Id.* This transition correlates with the abolition of fixed rate brokerage commissions in 1975. Price competition has, in effect, begun to replace service competition, in part because the brokerage community cannot prevent clients from having it both ways: listening to the advice of the full service broker and using the cheaper brokerage services of the discount broker.

This curious institutional structure has two important implications, which the neoclassical critics of mandatory disclosure have simply ignored. First, there is clearly an incentive for the buyer to cheat on the implicit deal; he can use the investment advice provided by the full service firm and then steer the majority of his brokerage business to the discount firm. Second, the persistence of full service firms and the very survival of the securities analyst as a profession in the face of this price competition suggest that consumers do want securities advice and research, both on the individual client and institutional investor levels. Otherwise, brokerage firms would fire their analysts to cut costs. Moreover, one cannot dismiss this evident demand for securities research as an irrational preference because the consumers include the most sophisticated of institutional investors.

These contractual problems, in combination with the public goods nature of securities research, help explain how a mandatory disclosure system benefits investors. Put simply, if market forces are inadequate to produce the socially optimal supply of research, then a regulatory response may be justified. Although securities advisers are regulated only in the most minimal way by the federal securities laws,<sup>31</sup> they are in effect heavily subsidized by these statutes. Thus, the contemporary impact of the '34 Act may lie less in providing usable information to the ultimate investor than it does in reducing costs for the securities analyst.<sup>32</sup> Indeed, the detailed periodic reports that "reporting" companies file under the '34 Act

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<sup>31</sup> Securities analysts may be required to register as investment advisers under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (1982), which contains reporting and anti-fraud provisions. No educational or other qualifications, however, are required to be an investment adviser, and the regulatory strictures appear to be relatively looser than those that apply to broker dealers. For an overview, see L. Loss, *Fundamentals of Securities Regulation* 733-48 (1983).

<sup>32</sup> For a similar analysis of the impact of the '34 Act, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 559, 637-42 (1983). Although they see the '34 Act as "a form of special-interest relief legislation" to aid the securities industries, *id.*, this evaluation appears to give too little attention to the benefits that flow to ordinary investors in the form of more publicly available research and a greater number of companies being closely followed by securities analysts. See *infra* notes 38-43 and accompanying text. Although this data will not enable them to "beat the market," it should benefit investors in at least two distinct ways: (1) it better enables the investor to assess the risk level of individual securities, to avoid investing in securities whose risk level exceeds his personal level of risk aversion, and (2) it should reduce the variance in returns applicable to those securities not traded on major exchanges, which otherwise analysts would not closely watch.

are chiefly useful only to the professional analyst and not the individual trader.<sup>33</sup> It is therefore no surprise that the professional investment community has long supported the continuous disclosure system of the '34 Act: to them the system implies cost savings.<sup>34</sup>

What do these cost savings imply for the structure and efficiency of the securities market? To the extent that mandated disclosure reduces the market professional's marginal cost of acquiring and verifying information, it increases the aggregate amount of securities research and verification provided. That is, because the analyst as a rational entrepreneur will increase his output until his marginal cost equals his marginal return, it follows axiomatically that the collectivization of securities information will produce more information. Over time, excess returns to securities analysts will induce new competitors to enter the market, which will increase the competitiveness of the industry. Casual empiricism suggests that both these predictions can be observed in the post-1934 experience of the securities industry. Certainly, the volume of securities research is much higher today than in 1934, and the very title "securities analyst" would not have been understood back then.<sup>35</sup>

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<sup>33</sup> This point has been persuasively argued by Professor Kripke. See Kripke, *The Myth of the Informed Layman*, 28 *Bus. Law.* 631, 632-38 (1973). The SEC Advisory Committee fully recognized that a material disclosure typically reached the market and was impacted in price well before it was set forth in a '34 Act filing. It responded, however, that this did not make such filings irrelevant because federal fraud liability attached to '34 Act filings and because such filings could then be verified by analysts: "the information contained in the filings is usually much more extensive than that released earlier. Thus, it provides to analysts and others a means the more abbreviated information released may be qualitatively reviewed, parsed and assessed." Advisory Committee Report, *supra* note 6, at xlvi. See also *id.* at 289-98. To be sure, this justification of disclosure as a cost economizing technique to aid market professionals was not the intent of Congress in 1933, but this seems to be irrelevant.

<sup>34</sup> See J. Seligman, *supra* note 9, at 311-12, 630 n.50 (1982) (industry welcomed 1964 amendments expanding scope of '34 Act to corporations having over 500 shareholders and defined level of assets). The industry did, however, oppose the Securities Act of 1933 bitterly and conducted what Professor Seligman has termed a "capital strike." *Id.* at 71-115.

<sup>35</sup> The term "security analysis" was popularized by Benjamin Graham and David Dodd, whose immensely influential statement of the fundamental principles of financial analysis was published, interestingly enough, in 1934. See B. Graham & D. Dodd, *Security Analysis: Principles and Techniques* (1st ed. 1934). Although this book had its precursors, it is as difficult to conceive of the securities analyst developing in recognizable form before its publication as it is to imagine the job description of psychoanalyst arising before Freud. For example, the New York Society of Security Analysts, the largest professional organization in this field, was not founded until the late 1930's. Telephone interview with staff official, New York Society of Security Analysts (Apr. 1984). Admittedly, publications such as Moody's

The unresolved question is why these cost savings were not clearly reflected in stock price increases or any other observable impact immediately following the '34 Act's passage?<sup>36</sup> Although the one existing study of the market's reaction to the '34 Act's adoption may have been too methodologically flawed to capture any changes that occurred, another possible answer is that all the gains were captured by informed traders and other market professionals in the form of cost reductions. Arguably, these traders received the same approximate volume of information both before and after 1934, but simply obtained this data at a lower price after the '34 Act.<sup>37</sup> Yet this answer seems incomplete; it ignores that the securities analyst—or his predecessor in that era—should produce more information if he has a lower marginal cost.

This argument that lower costs for the securities analyst should result in more information production takes us only so far. As Professors Easterbrook and Fischel correctly observe, it is theoretically possible that too much information is already produced, particularly because not all, or even most, investors need to be well

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were published in the 19th century, and a prototype of the securities analyst can be traced back well before 1934, but the real development of the modern securities analyst had to await both the development of the theory that Graham and Dodd codified and the rise of the institutional investor, which essentially occurred in the 1960's. See *infra* note 43 and accompanying text.

<sup>36</sup> Only one study has been conducted on the effect of the '34 Act on stock prices. See Benston, *An Evaluation of the Securities Exchange Act of 1934*, *supra* note 2. Professor Benston isolated two groups of companies for comparison: one that disclosed their sales figures prior to the '34 Act and the other that did not. Neither group showed significant changes in its aggregate rate of return after the Act's passage. In theory, one might expect the non-disclosing companies to experience abnormal negative returns as investors learned of adverse information that had previously been withheld by management. Nevertheless, Professor Benston concluded that the Act had no effect. Professor Benston's methodology, however, has been recurrently challenged, in part because his "non-disclosure" group appears to have consisted of companies that did in fact disclose net income, the most important variable for investors. See Friend & Westerfield, *supra* note 5, at 468-70; Seligman, *supra* note 5, at 17. Professors Friend and Westerfield also found that both the disclosing and non-disclosing firms performed better in the post-1934 period. See Friend & Westerfield, *supra* note 5, at 468-70. But see Benston, *Required Disclosure and the Stock Market: Rejoinder*, 65 *Am. Econ. Rev.* 473 (1975). Although it is commonplace for scholars to rely on Benston's findings without pointing out the serious methodological flaws in his approach (or the variable interpretations that can be placed on his data), the issue still seems to be unresolved as to whether the '34 Act had an immediate impact on stock prices or investors.

<sup>37</sup> This is the thesis that Professors Gilson and Kraakman advance. See Gilson & Kraakman, *supra* note 32, at 636-38.

informed for the market to be efficient.<sup>38</sup> Yet they stop at this point, which seems to be the threshold where close analysis should begin.

According to the SEC Advisory Committee on disclosure, only about 1,000 of the 10,000 odd "reporting" companies registered under the '34 Act are regularly followed by securities analysts.<sup>39</sup> In the absence of analyst monitoring and in the presence of erratic trading, there is considerable reason to doubt that the market for the other 9,000 firms is "efficient," even in some cases in the "weak" sense of that term. Although other mechanisms exist by which to achieve efficiency, their efficacy is unproven and highly debatable.<sup>40</sup> The desirability of expending social resources to improve the efficiency of the trading in these smaller issues can also be reasonably disputed. What seems to be beyond argument, however, is the consequence of increasing the securities analysts' marginal costs for obtaining or verifying information. If we repealed the '34 Act, and thereby increased analysts' marginal costs, the number of companies regularly followed by analysts would likely decline below this 1,000 figure.<sup>41</sup> In short, cost reductions for ana-

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<sup>38</sup> "The more sophisticated version of the public goods explanation is that although investors produce information, they produce both too much and too little." Easterbrook & Fischel, *supra* note 13, at 681. Although their statement appears to be correct, it only frames the problem, and does not assess the impact of the '34 Act, which encourages the analyst to produce more information, while also eliminating the need for wasteful duplication of efforts by rival analysts or rival investors. Professors Easterbrook and Fischel instead rely on the Coase Theorem, which by its own terms is inapplicable when transaction costs are high, as is likely the case for widely dispersed small shareholders.

<sup>39</sup> Advisory Committee Report, *supra* note 6, at xviii-xix. Professor Kripke has challenged this number as too low. H. Kripke, *supra* note 6, at 126-28. This challenge appears to be correct, but only in terms of degree. Even if the number of closely watched companies were twice as high, this figure would leave 8,000 corporations with over 500 shareholders and no following within the professional financial analyst community.

<sup>40</sup> Of course, some will argue that market forces are adequate to induce disclosure even if monitoring by analysts is not occurring. This theory of self-induced disclosure is examined in section II of this article, which finds it a partial truth.

<sup>41</sup> At the margin, the securities analyst can be expected as his marginal cost increases to reduce his operations (and either follow fewer companies or investigate the same number less thoroughly). One test of this thesis might be to compare the number of companies that were closely followed prior to 1934. There is, however, no simple measure of this variable, partly because there were fewer securities analysts in this era and their techniques were more rudimentary. A cursory survey reveals that as of 1941, there were 1,210 issuers listed on the New York Stock Exchange. See 7 SEC Ann. Rep. 305 (1941). Assuming that this number constitutes the upper boundary of closely followed stocks, it still does not contrast sharply with the estimated number of closely followed stocks today. See text accompanying



lysts imply broader coverage of firms, and cost increases imply the converse. This conclusion, in turn, leads to the bottom line: the more firms that are closely followed by analysts, the greater assurance both that capital markets will be allocatively efficient and that the game will be fair with respect to such companies.

No immutable principle says that 1,000 (or whatever the current level) is the correct breakpoint, but the policy question must be framed in these terms. From this perspective, the securities analyst is the child of the '34 Act. To be sure, the '34 Act is only one parent: the birth of the modern analyst also had to await the development of an institutional structure that could support and sustain securities research as a specialized profession. Because of the earlier noted difficulties in contracting for securities research,<sup>42</sup> the development of the securities analyst required the prior emergence of a class of investors—i.e., the modern institutional investor—who traded in transactions repetitive enough and in a large enough volume to be able to compensate the analyst by the unique system of exchanging advice for future brokerage commissions.

In 1934, institutional investors represented only a small fraction of equity securities trading; the dominant figure was still the professional trader, who relied more on rumors, tips, and personal contacts than on hard data. Only with the later appearance (probably in the 1960's) of the institutional investor—and in particular, a nationwide population of institutional investors—did the institutional structure arise that could support the modern securities analyst.<sup>43</sup> In this light, the '34 Act becomes the logical, if premature, answer to a problem that had yet to emerge: how to increase the volume of securities research, which then was not even in demand. In 1934, any gains that the Act created may well have been fully captured by a small coterie of professional traders, but with the

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note 39. This figure of 1,210, however, probably overstates the number of firms that were closely monitored; Professor Seligman has informed this author that in his view few firms prior to 1934 released enough data to be closely watched to the degree presumed by the SEC Advisory Committee in its estimate that currently analysts closely follow 1,000 firms. Another test of this thesis would be to contrast the number of full time securities analysts before and after 1934. Although the 14,646 figure given by the SEC Advisory Committee in 1977, see *supra* note 19, probably is greatly in excess of the pre-1934 figure, this is an illegitimate comparison because the securities analysis profession was then only in its infancy.

<sup>42</sup> See *supra* text accompanying notes 29-31.

<sup>43</sup> The volume of institutional trading on the New York Stock Exchange rose during the 1960's from a low of 17% to a high of 52% in 1969. See J. Seligman, *supra* note 9, at 351-52.

subsequent expansion of the industry, the cost savings that the '34 Act engendered helped to create the securities analyst as a distinct profession. That this result was serendipitous does not make it any less desirable.

### *B. Social Waste and the Problem of Excess Research*

This hypothesis that a mandatory disclosure system reduces the costs incurred by market professionals has another important corollary: aggregate social wealth is arguably increased because the partial collectivization of securities information that the '34 Act mandates in effect economizes on the total amounts expended in pursuing trading gains. From a social welfare perspective, trading gains do not create additional wealth; one party's gain comes at the other party's loss, whereas the process of researching and verifying securities information consumes real resources.<sup>44</sup> Although securities research sometimes creates social wealth (both by perfecting the allocative efficiency of the capital markets and by facilitating the entrepreneur's ability to raise capital for wealth-creating projects), the '34 Act chiefly addresses the secondary trading market. Here, one can view the participants as engaged in pursuing trading gains that do not affect aggregate shareholder wealth. Their expenditures in pursuit of such gains therefore represent social waste, as Professor Hirschleifer long ago pointed out in a classic article.<sup>45</sup> In this light, a major significance of a mandatory disclosure system is that it can reduce these costs. Rival firms do not need to incur expenses to produce essentially duplicative data banks when a central securities data bank is in effect created at the SEC. Thus, rather than the '34 Act producing too much information (as Professors Easterbrook and Fischel suggest),<sup>46</sup> it probably reduces wasteful duplication by establishing a central information repository.

This claim that wasteful duplication is eliminated by a mandatory disclosure system may sound inconsistent with the ear-

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<sup>44</sup> See Fama & Laffer, *Information and Capital Markets*, 44 *J. Bus.* 289 (1971); Hirschleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 *Am. Econ. Rev.* 561 (1971).

<sup>45</sup> See Hirschleifer, *supra* note 44. Indeed, society might rationally decide to pay analysts not to engage in rival research efforts where the resources so utilized would only affect the distribution of trading gains and not increase market efficiency.

<sup>46</sup> See Easterbrook & Fischel, *supra* note 13, at 693-95.

lier assertion that inadequate securities research occurs because of the public goods-like character of securities information. Yet there is no contradiction. Financial professionals may simultaneously expend both too little and too much resources on verifying and obtaining information. The first problem arises because too few companies are followed or are researched inadequately; the second, because investigations by one analyst are duplicated by another. Still, the existence of a central information repository in the form of the SEC is at least a partial answer to both problems.

*C. Allocative Efficiency: The Public Interest in Adequate Securities Research*

Which of the last two problems discussed—too much research or too little—is more serious? This question is important because the design of an optimal disclosure system depends in large part on how one answers it. Two very different perspectives are possible on the securities market. If we see it as simply a “fair game” in which securities prices are “unbiased” (that is, prices are as likely to move in the buyer’s favor as the seller’s), there is little cause for regulatory intervention (except possibly to prevent insider trading). Moreover, because in this light the securities market is essentially a “zero-sum game”—that is, one side’s gain in every transaction is the other side’s loss—society has no reason to encourage the parties to invest their resources in this nonproductive attempt to obtain wealth at the other’s expense. So viewed, a mandatory disclosure system would be justifiable principally as a means of minimizing the wasted resources devoted to the pursuit of trading gains.

Conversely, if we view the securities market as the principal allocative mechanism for investment capital, the behavior of securities prices is important not so much because of their distributive consequences on investors but more because of their effect on allocative efficiency. In this light, it is important not only that the game be fair, but that it be accurate—that is, that capital be correctly priced. Depending on a firm’s share price, its cost for obtaining capital will be either too high or low as compared to the cost that would prevail in a perfectly efficient market. In either case, society’s mechanism for allocating scarce investment capital among competing users becomes distorted, even though the game remains equally fair to buyers and sellers. From this perspective, the criti-

cal empirical question shifts from whether the federal securities laws improved the mean return to investors to whether they reduced the variance associated with these returns. That is, if the federal securities laws reduced the dispersion associated with the returns on new issues, it can reasonably be inferred that they made the market for new issues more allocatively efficient. Professor Stigler appears to acknowledge this point: "Price dispersion," he writes, "is a manifestation—and, indeed, it is a measure—of ignorance in the market."<sup>47</sup> The greater this variance associated with securities returns, the greater the uncertainty and heterogeneity of investor expectations, and the less the likelihood that our capital allocation mechanism is working efficiently. Yet the stock market may still appear efficient to the extent that prices move randomly and mandatory public disclosures appear not to cause price adjustments.

Once the focus is shifted to the degree of dispersion associated with securities prices in the presence or absence of a mandatory disclosure system, the empirical issue is narrowed. Every scholar who has investigated the impact of the federal securities laws—including Stigler, Bentson, Jarrell, and Friend—appears to agree that price dispersion declined after the passage of the Securities Act of 1933.<sup>48</sup> The most logical conclusion to draw from this

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<sup>47</sup> See Stigler, *The Economics of Information*, 69 *J. Pol. Econ.* 213, 214 (1961).

<sup>48</sup> Professor Stigler's initial study found that the variance associated with the returns on new securities issues declined after the passage of the '33 Act. See Stigler, *Comment*, 37 *J. Bus.* 414, 418-19 (1964); Stigler, *supra* note 1, at 122. Cf. Seligman, *supra* note 5, at 10-11 (criticizing Stigler's conclusion that a decline in the variance of new securities' prices was not meaningful). Similar findings were reported by Friend and Herman. See Friend & Herman, *The SEC Through a Glass Darkly*, *supra* note 5. In response, Professor Benston has not contested that there was a reduction in the standard deviations associated with security issues after 1933, but has disputed this reduction's relevance. See Benston, *Required Disclosure and the Stock Market: Rejoinder*, 65 *Am. Econ. Rev.* 473 (1974). For the latest round in this debate, see Friend, *supra* note 5, at 8-12. Finally, in a recent study Professor Jarrell has also found a decline in the variance in returns associated with new stock issues after 1933. See Jarrell, *supra* note 7. Like Benston, he also doubts that this reduction in variance is a meaningful achievement and suggests that it instead signifies excessive paternalism on the SEC's part. Their position is that because this variance reduction was not associated with an increase in the mean returns, it did not benefit investors; rather, it implies to them that the SEC discouraged attractive high risk offerings at the same rate that it discouraged fraudulent ones. Even if this were true, it is curious to interpret it as a dubious achievement. If we assume that investors are risk averse, any reduction in the variance (or risk associated with a return) that does not reduce the mean return is desirable. This point has been well made by Friend. See Friend, *supra* note 5, at 15-16.

evidence is that allocative efficiency was enhanced and that investors thereby benefited.<sup>49</sup> The key point then is that the social benefit of the federal securities laws may exceed their benefit to investors. The beneficiaries of increased allocative efficiency include virtually all members of society, not just investors. In this light, it is myopic to view the '34 Act as simply a subsidy for investors or to denigrate its benefits as merely trading gains.

This focus on allocative efficiency should also frame future research efforts. Rather than debate endlessly the effect that the federal securities laws had a half century ago, it is time to turn to issues of greater contemporary significance. For example, has the recent trend toward deregulation in connection with the administration of the '34 Act been associated with any increase in price dispersions or market volatility? To ask this question is not to answer it. Testable hypotheses, however, can be framed: for example, one could inquire whether price dispersion has increased following the adoption of the integrated disclosure system in 1982<sup>50</sup> and the expanded use of shelf registration statements.<sup>51</sup> If not, the cost reductions to corporate issuers associated with these regulatory reforms would seem justified.<sup>52</sup> Clearly, however, this question can-

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<sup>49</sup> As noted in the preceding footnote, investors benefit from any variance reduction that does not reduce the mean return. For example, if a bond issued by Chrysler bearing interest at 13% were suddenly made risk free (that is, the possible variance in returns were eliminated), it would appreciate in value significantly.

<sup>50</sup> For an overview, see SEC Securities Act Release No. 6383, 47 Fed. Reg. 11,380 (1982), reprinted in [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982). Under integrated disclosure, some issuers may use a prospectus consisting almost exclusively of references to previously filed '34 Act reports. Compare Banoff, *Regulatory Subsidies, Efficient Market, and Shelf Registration: An Analysis of Rule 415*, 70 Va. L. Rev. 135 (1984), with Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis* 70 Va. L. Rev. — (June 1984) (forthcoming).

<sup>51</sup> See SEC Rule 415, SEC Securities Act Release No. 6499, 48 Fed. Reg. 52,889 (1983), reprinted in 1 Fed. Sec. L. Rep. (CCH) ¶ 3383 (Nov. 17, 1983). For an overview, see Ferrara & Sweeney, *Shelf Registration Under SEC Temporary Rule 415*, 5 Corp. L. Rev. 308 (1982). Rule 415 was adopted on a temporary basis in Securities Act Release 6383, but has now been made permanent. For an analysis of Rule 415, see Banoff, *supra* note 50.

<sup>52</sup> A substantial debate is continuing as to whether integrated disclosure and shelf registration statements will erode the due diligence efforts of underwriters and their counsel. Because Rule 176, 17 C.F.R. § 230.176 (1983), reprinted in 1 Fed. Sec. L. Rep. ¶ 4600 (Mar. 31, 1982), reduces the potential liability of underwriters for data that is incorporated by reference into a prospectus, it is arguable that underwriters and their counsel have less incentive today to verify the accuracy of information under an integrated disclosure system. Former Commissioner Barbara Thomas dissented from the adoption of Rule 415 on these

not be safely answered by looking only at the market's immediate reaction to these developments or only at the change, if any, in mean returns to investors. Once we recognize that there is a social interest associated with an allocatively efficient capital market, then it is an overly narrow form of social cost accounting to calculate only the costs to issuers and benefits to investors.

## II. THE THEORY OF VOLUNTARY DISCLOSURE

Underlying much of the thesis advanced by Professors Easterbrook and Fischel is the view that corporate managers have strong incentives to disclose voluntarily all material information to investors; thus, a mandated system is largely superfluous.<sup>53</sup> This thesis derives from the work of the economic theorists of the firm—most notably the work of Jensen and Meckling on agency costs<sup>54</sup> and Stephen Ross on signaling theory.<sup>55</sup>

These theorists do not deny that the separation of ownership and control in the modern public corporation implies a conflict between the interests of management and shareholders. They argue, however, that the burden of this conflict falls on the manager. To sell the firm's securities initially or to maintain the price of the firm's stock thereafter, the manager must convince the market that all relevant disclosures are being (and will continue to be) made; otherwise, he is the primary loser. As a result, according to these theorists, managers and shareholders have mutual incentives to structure the firm so that the market will be confident that all material information is being disclosed.

The typical techniques to this end are summarized in the Eas-

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grounds. See SEC Securities Act Release No. 6423, 47 Fed. Reg. 39,799, 39,803 (1982), reprinted in [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,250, 85,279 (Sept. 2, 1982) (Thomas, Comm'r, dissenting). On the positive side of the ledger, it is clear that Rule 415 has reduced underwriters' commissions by encouraging greater competition among underwriters. See Ehrbar, *Upheaval in Investment Banking*, *Fortune*, Aug. 23, 1982, at 90. The suggestion made here is that any significant decline in socially desirable "due diligence" efforts would be observable in highest stock volatility (net of overall market movement) and increased price dispersion. Until efforts are made to test this thesis, the debate is indeterminate.

<sup>53</sup> See Easterbrook & Fischel, *supra* note 13, at 683-85.

<sup>54</sup> See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976).

<sup>55</sup> See Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in *Issues in Financial Regulation* 177 (F. Edwards ed. 1979).

terbrook and Fischel article: firms will use auditors to give their statements credibility;<sup>56</sup> firms will encourage managers, through stock options, to hold a substantial portion of their portfolio in the firm's stock;<sup>57</sup> and the underwriters who sell the firm's stock will also retain a substantial block of stock in their own account.<sup>58</sup> The reputational interests of managers also prevent behavior that would be injurious to shareholders.<sup>59</sup> Clearly, to some extent these forces should inhibit opportunistic behavior by management, constrain their consumption of perquisites, and reduce any managerial tendency to shirk. The claim that they are sufficient, however, to render irrelevant the need for a mandatory disclosure system is a far stronger assertion, for which the evidence is much weaker. Agency costs should still persist,<sup>60</sup> and a basic conflict of interests still remain to the extent that managers can acquire the firm from its shareholders.

#### A. *A Critique of the Theory*

The fallacy in concluding that a mandatory disclosure system is irrelevant lies not in the premise that if a manager's compensation is made a function of the firm's performance, the manager is encouraged to act only to benefit the firm, but rather with the difficulties of systematically implementing such a compensation system so as to eliminate all occasions for opportunistic behavior. Typically, some economists simply assume these problems away.

For example Stephen Ross, whose incentive signaling theory contains the fullest statement of the preconditions to a wholly voluntary disclosure systems, states that managers' compensation will be limited "by the wage level they could receive in competitive jobs."<sup>61</sup> In other words, "no firm will hire a manager for \$1 million a year when the going wage is \$100,000."<sup>62</sup> As he recognizes, however, any program of restricting managerial compensation to mar-

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<sup>56</sup> See Easterbrook & Fischel, *supra* note 13, at 675.

<sup>57</sup> See *id.* at 676.

<sup>58</sup> See *id.* at 675.

<sup>59</sup> See *id.*

<sup>60</sup> See Williamson, *Organizational Form, Residual Claimants and Corporate Control*, 26 *J.L. & Econ.* 351, 363 (1983) (arguing that changes in organizational form and prevalence of takeovers have mitigated but not eliminated managerial opportunism and agency costs).

<sup>61</sup> Ross, *supra* note 55, at 184.

<sup>62</sup> *Id.*

ket levels must address the problem of insider trading. Such trading offers the manager an inviting means of profiting, whether or not his firm does. Ross's argument at this critical juncture is symptomatic of the economist's disregard for the problems of implementation. He writes:

Stockholders will not permit a \$100,000-a-year manager to have the freedom to trade in the firm for his own account and make million-dollar gains. . . . This is not to say that managers will not have an incentive to use inside information for their own gain, but rather that stockholders are aware of such incentives and will enter into contracts that penalize such activities.<sup>63</sup>

Correct as it may be that shareholders would like to prevent insider trading by their management, it does not follow that they can do so as a practical matter. Professor Ross has, in effect, "assumed the can opener,"<sup>64</sup> rather than tackled the problems that flow from a recognition that insider trading is virtually undetectable.<sup>65</sup> Moreover, to the extent that insider trading can be detected, public enforcement is a far more feasible technique than any system of contractual restraints.<sup>66</sup> Indeed, no such contractual system has been attempted.<sup>67</sup> As a result, the bottom line is that insider trading will persist and the prerequisites to Professor Ross's theory of voluntary disclosure are therefore not satisfied.

Although this lack of congruence between the interests of managers and shareholders may show the need for a fraud rule, it is

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<sup>63</sup> *Id.*

<sup>64</sup> This refers to the standard joke about the two scientists and an economist stranded on a deserted island with only a can of beans for food, which they cannot open. The physicist develops a theory for breaking open the can, and the chemist similarly devises a plan for boiling it open, but the economist suggests the simplest plan: "Assume a can opener."

<sup>65</sup> With respect to the difficulty of detecting insider trading, see Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1 (1980).

<sup>66</sup> Economies of scale probably favor public enforcement because the New York Stock Exchange and the SEC can learn quickly of unusual trading activity and indeed already have a fixed investment in market surveillance. Moreover, that classic engine of discovery—the grand jury—can (and is) used by federal prosecutors to trace leads and develop information, which a private plaintiff cannot do as easily. There are also other problems with private enforcement. 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).

<sup>67</sup> This point has been made by Professors Carlton and Fischel, who argue that insider trading should be legalized. See Carlton & Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 (1983). This response's point is simply that the feasibility of contractual restrictions, such as those envisioned by Professor Ross, has never been demonstrated.



debatable whether it demonstrates the need for a mandatory disclosure system. Because managers can trade almost instantaneously once they recognize the significance of undisclosed material information, a system of periodic quarterly filings—such as the '34 Act essentially imposes<sup>68</sup>—does little to inhibit such trading. Once management has traded, it has in fact a particularly strong incentive to release the positive or adverse information to hasten the desired market response.<sup>69</sup> Any delay in the information's release may thus be trivial.<sup>70</sup>

Even if the traditional form of insider trading supplies little justification for a mandatory disclosure system, a new phenomenon, which essentially poses the same dilemma, does suggest the utility of mandated disclosure. Within the last few years, there has been an extraordinary increase in the frequency of "leveraged buyouts." The leveraged buyout (LBO) is a technique for the purchase of the firm by its management (with possibly a few equity investors) by mortgaging the firm's assets to secure financing for the purchase price. By some accounts, LBO's rose from twenty percent of all acquisitions in 1982 to fifty percent in 1983.<sup>71</sup> Although there are economic justifications for such transactions,<sup>72</sup> the recent popularity of LBO's seems best explained as a defensive response to the

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<sup>68</sup> Section 13(a) of the '34 Act requires a reporting company to file such annual and quarterly reports as the SEC by rule may prescribe. SEC rules require that a quarterly report on Form 10-Q must be filed within forty-five days after the end of such an issuer's first three fiscal quarters. See 17 C.F.R. § 240.13a-13 (1983), reprinted in 2 Fed. Sec. L. Rep. (CCH) ¶ 23,608 (May 4, 1983); Form 10-Q, 17 C.F.R. § 240.308a (1983). In addition, under 17 C.F.R. § 240.13a-11 (1983), reprinted in 2 Fed. Sec. L. Rep. (CCH) ¶ 23,512 (May 4, 1983), a "current report" on Form 8-K must be filed within fifteen days after the occurrence of specified extraordinary events that were not previously reported. See Form 8-K, Gen. Instr. B.

<sup>69</sup> See *supra* notes 25, 28 and accompanying text.

<sup>70</sup> But consider the facts in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) & cert. denied, 404 U.S. 1004 (1971). There, officers of the issuer learned of extraordinarily valuable ore deposits in November of 1963 and began to trade in large quantities. The corporation, however, did not accurately disclose its discovery until April of 1964. See also *supra* note 25.

<sup>71</sup> See Hill, *Buyout Boom: Leveraged Purchases of Firms Keep Gaining Despite Risks*, Wall St. J., Dec. 29, 1983, at 1, col. 6 (quoting Robert Mancuso, Managing Director of Merrill Lynch Capital Markets). See also, Meyer & McGough, *Where the Smart Money Wants to Go*, Forbes, Dec. 19, 1983, at 38.

<sup>72</sup> Above all, LBO's reduce agency costs, which may increase the value of the firm in the hands of its shareholders. Also, more flexible compensation arrangements for managers may be possible, and certain economically desirable self-dealing transactions can be approved more quickly.

increased threat of hostile takeovers. As a result, however, the availability of the managerial buyout option greatly intensifies the conflict of interests that already exists between management and shareholders. In effect, it enables management to engage in insider trading not on a piecemeal scale in the stock market, but on the much larger scale of corporate control transactions. At present, LBO's tend to occur at high premiums, and thus some will see them as a benign and desirable phenomenon. This tendency for the buyout to be effected at a high premium, however, may be more the consequence of our existing mandatory disclosure system than proof of its irrelevance.

In the absence of a mandatory disclosure system, the popularity of the LBO would likely increase. This increase should exacerbate two distinct perverse incentives. First, the possibility of a low premium takeover might lead a management to withhold or underplay positive information to preempt the appreciation by buying the firm in an LBO. Second, this possibility might induce management to release false information of adverse developments. This second point has special relevance because the theory of voluntary disclosure as expounded by both Ross and Jensen and by Meckling posits that management must report all adverse information accurately because any suspension in the corporation's stream of disclosures released will lead the market to assume that a financial disaster had occurred. In effect, these theorists conclude that the market will overrespond unless the bad news is disclosed with full candor. Professors Easterbrook and Fischel accurately summarize this argument when they state:

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 will assume that the bad is even worse than it is.<sup>73</sup>

Although this iron law will come as news to the investors in Penn Central or Equity Funding, the more basic point is that any such market response is subject to obvious manipulation. Put simply, if non-disclosure did mean disaster, management could manipulate this pattern to its own self-interested ends. It could deliber-

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<sup>73</sup> Easterbrook & Fischel, *supra* note 13, at 683.

ately suspend disclosure to cause an economically unjustified decline in the stock price and then buy the stock at an artificially depressed price (or even sell short prior to the suspension of disclosure). Even better, it could use silence to scare the market and then offer an LBO.

In time, investors would learn to anticipate these tactics, and they would no longer equate non-disclosure with disaster. As a result, however, there would be great uncertainty as to the meaning of a halt in the flow of disclosure, and the original premise that non-disclosure would lead the market to overcorrect would no longer be true. Hence, an incentive would again arise for management to withhold disclosure of adverse information.

In short, one cannot have it both ways: if non-disclosure implies disaster, this equation can be exploited by management to facilitate its acquisition of either the firm's stock or assets; if non-disclosure does not imply disaster, then management need not ordinarily disclose adverse information. How does this inconsistency in the theory of voluntary disclosure relate to the need for a mandatory disclosure system (as opposed to simply supplying a justification for an anti-fraud rule)? The answer is two-fold.

First, under a mandatory disclosure system, an LBO at an inadequate price is likely to elicit a higher counter-bid from a third party. Such a counter-bid is the ideal remedy: it is self-enforcing and costless to the investor. An anti-fraud rule alone, however, cannot achieve this result. Although a fraud rule may give the investor a cause of action, it does not ensure sufficient dissemination of information to activate the market for corporate control. Bidders need information before they will invest millions (or billions) in an acquisition. A mandatory disclosure system responds to this need and so facilitates control contests. More generally, although an anti-fraud rule compensates victims, it does not sufficiently deter the underlying misbehavior because the wrongdoer does not suffer a significant loss. Instead, the wrongdoer only has to restore the gain he converted. Yet the possibility of a higher counter-bid is likely to deter because in the aftermath of a takeover, incumbent management is likely to be removed.

Second, given the incentives for nondisclosure of adverse information (either to induce a market decline and thereby to facilitate a buyout or to postpone the timing of the market response in management's self-interest), a mandatory disclosure system is a desira-

ble supplement to an anti-fraud rule. The law of fraud has great conceptual difficulties with non-disclosures. Nor can it easily impose the costs of the wrongdoing on the responsible management. Rather, if management does not trade but simply withholds adverse information to protect its own position, it has little litigation exposure as a practical matter. The corporate issuer may be held liable (although even this is far from certain), but corporate liability in this context may mean only that a transfer payment is made from one class of stockholders to another.

In the last analysis, the assertion that market forces will alone induce adequate disclosure rests upon the flawed premise that management should see itself as a "repeat player" that can maximize its own interests over the long run only by maintaining the market's confidence. Often, this premise is accurate. In an environment increasingly characterized both by hostile takeovers and LBO's, however, it is no longer safe to assume that management expects or intends to remain a "repeat player." If management believes a stock decline will trigger a hostile takeover that will remove it from office, it does not have the luxury of taking a long-run view and may therefore seek to delay adverse news from reaching the market. Fearing a takeover, it may also decide to undertake an LBO (even though such a transaction forces it to hold an undiversified portfolio), and thus it will suppress or downplay positive information. Only in a static (and today nonexistent) world, where management is confident that it can remain in control of its firm, should we expect it to adopt the long-run perspective of the "repeat player."

### *B. The Comparative Evidence*

Plausibility is not the ultimate test of a theory. As a result, the seeming flaws in the theory of market induced disclosure still do not eliminate the more difficult question of whether any empirical evidence is available by which to gauge the comparative efficacy of voluntary and mandatory disclosure. The one study, by Benston, comparing pre-'34 Act and post-'34 Act stock prices has generated substantial criticism.<sup>74</sup> Even if this study were redone, however, other problems would still confound any attempt to evaluate the

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<sup>74</sup> See *supra* note 36.

current impact of the '34 Act based primarily on a comparison of stock returns before and after its passage.<sup>75</sup> Institutional investors, securities analysis, and the modern law of securities fraud did not emerge until decades after 1934. Substantial reason exists to believe, as outlined above,<sup>76</sup> that the '34 Act had its principal significance only in combination with these other developments. Thus, no simple comparison of the marketplace before and after 1934 can suffice to measure the Act's impact. The large scale appearance of individual investors in the equity securities markets after World War II complicates the picture even further. Their appearance may have increased "agency costs" and thereby reduced the returns on securities.<sup>77</sup> Consequently, there are offsetting impacts that compromise temporal studies.

Other social science techniques exist, however, for obtaining at least an inferential understanding of the impact of mandatory disclosure. When social scientists cannot do controlled experiments, they frequently look for "natural experiments" that can be interpreted.<sup>78</sup> An example is Thorsten Sellin's classic study capital punishment's impact, in which he compares crime rates in contiguous states that either did or did not have the death penalty.<sup>79</sup> Correspondingly, we can look today at the differences between the disclosure level within the public securities market subject to SEC

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<sup>75</sup> All statistical studies must confront the problem of multicollinearity. Whenever we attempt to measure the relationship between two variables, there is always the possibility that the seeming relationship between the independent and the dependent variable is actually the result of a different and unexamined variable. Among the other variables that may confound any before and after comparison of stock returns preceding and following the '34 Act are the following: (1) the possibility of changed investor attitudes, (2) different enforcement policies at the state level, (3) the greater reluctance of issuers to offer securities in the face of new federal anti-fraud rules, (4) the gradual trend among institutional investors to invest in equity securities, and (5) an increased willingness of individual investors to buy securities in reliance on federal protections.

<sup>76</sup> See *supra* at 723-33.

<sup>77</sup> If stock ownership became more dispersed after 1934, this would increase the possibility of managerial opportunism and so reduce stock prices. This conclusion follows directly from the Jensen and Meckling thesis if one assumes that some exogenous change (such as the '34 Act's passage) resulted in more dispersed stockholders with smaller holdings, because such shareholders could incur smaller monitoring expenses. See Jensen & Meckling, *supra* note 54.

<sup>78</sup> For a discussion of natural experiments, see F. Zimring & G. Hawkins, *Deterrence: The Legal Threat in Crime Control* 263-70 (1973).

<sup>79</sup> T. Sellin, *The Death Penalty* (1959) (quoted in F. Zimring & G. Hawkins, *supra* note 78, at 254, 263).

regulation and the level that prevails within the one major securities market that is exempt from registration—the municipal bond market.

A full assessment of the practices and level of disclosure within the municipal bond market is beyond this article's scope. Still, if the recent experiences with the New York City bond offerings in the 1970's<sup>80</sup> and the Washington Public Power System's failure in the 1980's are indicative, critical information is not being disclosed to investors. Most observers would agree with this statement,<sup>81</sup> but the neoclassical theorist will respond that little information need reach investors because they are protected instead by the bond rating agencies—Moody's or Standard and Poor's; these agencies digest the relevant information, which in the case of a debt security consists only of its risk level, and assign a rating to each security.

If one examines the securities markets only at a distance and through the telescope of neoclassical economic theory, this rebuttal may sound persuasive. If one examines the institutional structure more closely, however, disturbing problems begin to appear. First, in the New York City fiscal crisis, Moody's did not reduce New York's rating until the crisis was universally acknowledged.<sup>82</sup> Second, because the issuer pays the bond rating agency to be rated, there is a conflict of interest problem.<sup>83</sup> Third, the bond rating

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<sup>80</sup> For a detailed exposition of the inadequacies in the municipal bond market as revealed by the New York City fiscal crisis, see SEC, Final Report in the Matter of Transactions in the Securities of the City of New York (1979).

<sup>81</sup> Some will disagree. Professor Kripke has argued that the low rate of municipal bond defaults lulled investors into a false sense of security. See H. Kripke, *supra* note 6, at 129. This seems to be, however, an economically untenable position. The default rate on the bonds of major industrial corporations was also low, but investors still presumably focused on the relative risk and demanded a higher return from higher risk securities. A lower bond rating would have meant a lower trading value for outstanding bonds. Properly informed, the investors in New York City bonds would have required a higher interest yield. They were denied the chance, however, by inadequate disclosure under an essentially voluntary system (even though an anti-fraud rule—Rule 10b(5)—did apply in principle).

<sup>82</sup> Moody's Investors Services did not lower its A-rating of New York City bonds until October 1975. See Peacock, *A Review of Municipal Securities and their Status Under the Federal Securities Laws as Amended by the Securities Acts Amendments of 1975*, 31 Bus. Law. 2037, 2040 n.22 (1976). This author concludes: "Owing to the notable lack of information available to investors concerning issuers of municipal securities, ratings have doubtless played too important a role in investors' decision making process." *Id.*

<sup>83</sup> Fees are today charged by all bond rating services, although this was not the historical practice. Moody's Investors Services, Inc. charges \$600 to \$4,000 for each issue, depending on the amount offered and the processing work involved. *Id.* See also J. Petersen, *The Rat-*

agencies are not themselves investigating agencies. Instead, they depend on the data that the issuer gives them.<sup>84</sup> Yet a recent survey by Arthur Young & Co., the auditing firm, suggests that this data's accuracy is in serious doubt.<sup>85</sup> In a 1983 survey of 557 municipalities, it found that fifty-four percent of the municipalities issued financial reports that were so incomplete or flawed that their independent accountants could give only qualified opinions.<sup>86</sup> In part, these problems may stem from the still rudimentary state of the accounting principles applicable to governmental and non-profit bodies.<sup>87</sup> The bottom line, however, is that if ratings are based on poor data, they will not protect investors who desire to avoid high risk: garbage in, garbage out. This conclusion leads to a broader criticism not only of the article by Professors Easterbrook and Fischel but also of other articles in this volume: too little attention has been paid to the institutional context or to observational data not reduced to hard statistics.

Where then are we left? Notwithstanding these criticisms, the theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions. This theory has far less persuasive force, however, when applied to secondary market trading, which the '34 Act chiefly governs. Here, high agency costs currently exist (as the persistence of high takeover premiums averaging between fifty percent and seventy percent in recent years arguably seems to show),

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ing Game: Report of Twentieth Century Fund Task Force on Municipal Bond Ratings (1974). Although the fact that a fee is charged does not imply that the bond rating agencies are biased (such a presumption would also disqualify underwriters and attorneys, who are similarly paid by their clients), their position is different from that of the securities analyst who looks primarily to the investor for his compensation. Thus, there is a relative difference in the degree of disinterestedness.

<sup>84</sup> The bond rating agencies may demand supplemental information and may refuse to rate an issue unless this information is supplied, but they do not approach the investigatory role of the underwriter in a public offering. Also, they neither face statutory (or common law) liability, nor are they typically assisted by their own counsel or other experts.

<sup>85</sup> See Survey Finds Flaws in Financial Data of Cities, Counties, *Wall St. J.*, Oct. 6, 1983, at 38, col. 3.

<sup>86</sup> *Id.* Typically, the financial statement defects were due to incomplete records. Other common flaws included failure to conform to generally accepted accounting principles or to report other items such as a pending lawsuit or larger pension liabilities.

<sup>87</sup> This difference can also be ascribed to the '34 Act, which authorized the SEC to standardize accounting principles for financial statements filed with it.

thus sheltering opportunistic managerial behavior.<sup>88</sup> A management that will oppose a lucrative takeover offer to its shareholders is also capable of biasing its disclosures to suppress adverse information; indeed, suppressing adverse information may be the most effective defense technique available to management because by delaying the inevitable downward adjustment in stock price, it delays the moment when the corporation becomes vulnerable to a hostile takeover. A mandatory disclosure system is a partial response to these problems because it both subsidizes the search costs of bidders (thereby reinforcing the disciplinary capacity of the market for corporate control) and also activates some degree of shareholder opposition through proxy fights and other means.<sup>89</sup>

### III. DISCLOSURE TO INVESTORS: THE CASE FOR AN INVESTOR ORIENTED DISCLOSURE SYSTEM IN AN EFFICIENT MARKET

An efficient market is often defined as one in which securities prices impact all publicly available information instantaneously.<sup>90</sup> Even in such a market, a case can still be made for a mandatory disclosure system that primarily seeks to provide technical information to securities analysts and market professionals on the reasonable premise that they are the motor force that principally keeps the market efficient. But what case can be made for a disclosure system oriented toward the individual investor when the market has already adjusted securities prices to reflect all available information? If it is impossible to identify undervalued securities,

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<sup>88</sup> A 1980 study found the average premium in successful tender offers to be 49%. See Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 *J. Bus.* 345 (1980). Other studies have placed the average premium even higher. See Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 *J.L. & Econ.* 371, 373 (1980) (average takeover premium rose to over 70% in wake of state anti-takeover statutes). In effect, these studies measure the agency cost level at which an external monitor—the hostile bidder—will intervene, and they suggest that this level is quite high.

<sup>89</sup> Although the conventional wisdom is that proxy contests are seldom successful, a recent empirical study has found this conclusion overbroad. See Dodd & Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 *J. Fin. Econ.* 401 (1983). In 58% of the contests studied, the dissidents won at least one seat on the board, and typically the value of the corporation's shares rose in response to the control contest. *Id.* at 409. To the extent that more complete disclosure enables an insurgent to decide whether it is cost justified to undertake such a contest, economic efficiency is enhanced.

<sup>90</sup> See Fama, *Efficient Capital Markets*, 25 *J. Fin.* 383 (1970).



why should investors be given disclosure documents that seemingly have this aim?

Two sensible responses exist to these questions. Although each involves a modest claim that does not assert that investors can outperform the market, together they suggest that much information remains relevant to the securities decisions of individual investors.

#### A. *Disclosure as a Means to Efficient Diversification*

Modern financial theory divides the risk associated with securities into two components: "alpha" and "beta."<sup>91</sup> "Beta" is the measure of stock volatility with respect to general market movements, and "alpha" is the measure of non-market or residual factors unique to the individual stock. In a fully diversified portfolio, the alphas by definition cancel out; thus, the only inquiry for the investor who holds a diversified portfolio is to ascertain his portfolio's beta value and adjust it according to his risk preferences. Because a portfolio's beta value is the product of multiple securities, the disclosures that any one issuer can make have only a marginal relevance to this inquiry. Furthermore, according to the traditional theory, historical price movements rather than basic investment data best show the beta value. As a result, the theory implies that the individual investor has little need for the basic financial disclosures required by the federal securities laws.

An initial response to this conclusion is that many, and probably most, investors do not hold fully diversified portfolios. Thus, they are interested in the beta values of individual securities. This argument, however, faces a potential counterargument: why should society or the corporate issuer subsidize the folly of investors who fail to diversify their portfolios? Indeed, it is not difficult to acquire a fully diversified portfolio because investors can purchase "index funds" from any securities dealer. Professors Easterbrook and Fischel have made essentially this argument in other contexts.<sup>92</sup> Yet there is a simple answer to it: for most investors, it may well be rational to fail to diversify fully their *securities* portfolio because their real goal is to hold a reasonably diversified *investment* portfolio.

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<sup>91</sup> For an accessible overview of the lore and learning about beta values, see B. Malkiel, *supra* note 10, at 208-32.

<sup>92</sup> See Easterbrook & Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698, 713 (1982).

Most individual investors either hold or have an expectancy in a variety of investments other than public securities: e.g., real estate, insurance, stock options, deferred compensation, or a private business. Their real need is to wrap their securities portfolio around these other investments to produce a reasonably diversified overall investment portfolio. For example, the middle or senior level manager is likely to have, or to anticipate acquiring, a substantial investment in his business. Adding a purely diversified securities portfolio to his undiversified investments would not diversify away the risk he incurs by having a significant investment in his own firm. To achieve optimal diversification, this manager must counterbalance his securities investments against his other investments. Such counterbalancing requires identifying securities that in conjunction with his locked-in investment in his own firm produce relative diversification. Modern portfolio theory holds that such an investor should seek to identify securities that are negative covariants in terms of their cyclical performance. By balancing counter-cyclical investments, the investor reduces the overall variance (or risk) in his portfolio.<sup>93</sup>

This goal justifies disclosing line-of-business data to individual investors because in this era of conglomerate structure, it is not evident which lines of business a corporation is engaged (or to what extent). Thus, even though the search for high alpha stocks is theoretically impossible in an efficient market, much of the same data remains relevant to rational investors seeking to minimize the variance in their overall investment portfolio by acquiring negatively covariant securities.

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<sup>93</sup> For a brief explanation of covariance as it applies to modern portfolio theory, see B. Malkiel, *supra* note 10, at 193-94. See also V. Brudney & M. Chirelstein, *Corporate Finance: Cases and Materials* 1151-54 (2d ed. 1979). The classic example given by Malkiel is of an umbrella company and a resort. These two firms, which have the same dispersion of expected returns, but are counter-cyclical, can combine and thereby reduce the variance in their expected returns without changing the mean expected return. B. Malkiel, *supra* note 10, at 193-94. A theoretical reply is that the individual investor may do this on his own by buying shares in both companies and so corporate combinations should not create value if their only virtue is the reduction of variance. The standard counter-rebuttal, however, is that because bankruptcy would imply a loss of value for all concerned, it is desirable that the individual firm seek to reduce the variance of its own expected returns in order to minimize bankruptcy costs.

*B. Risk Assessment and Portfolio Revision*

A second justification for requiring detailed disclosure to the individual investor concerns the relevance of fundamental analysis to the assessment of a portfolio's risk level. To begin with, knowing that a security is efficiently priced does not tell the investor whether the security carries a risk level that is incompatible with his individual preferences. Although this in itself would require some form of an individualized system of disclosure, financial theorists have responded that diversification should protect the investor from all risks, except the systematic or "market" risk that affects all securities. Although this assertion is at the heart of the Capital Asset Pricing Model, it is becoming clear today that the financial theorists are not in agreement about how to measure or even how to define systematic risk.<sup>94</sup> Few accept the accuracy of individual beta predictions.<sup>95</sup> Moreover, even if we could reliably measure beta at the portfolio level, investors are constantly confronted with the need to revise their portfolios. Here they must estimate the impact of a new individual security upon the overall beta level of their portfolio. It is in this portfolio revision context that disclosure of basic financial data and prior stock price levels may be of particular significance to the individual investor. Although financial theorists have argued that beta is best measured by historical stock prices, the contrary view is that a portfolio's overall beta level can be best estimated by a review of "investment fundamentals"—meaning in essence the basic balance sheet and income data that traditional securities analysis has long been pred-

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<sup>94</sup> The recurrent finding that small firms earn abnormally high returns even after adjustment for risk has led a number of financial theorists to conclude that existing models misspecify the systematic risk component. See Seligman, *supra* note 10; Symposium on Size and Stock Returns, and other Empirical Regularities, *supra* note 10. Consequently, alternative models—most notably, Professor Ross's Arbitrage Pricing Theory—have been proposed that do not rely on the standard mean and variance analysis of the Capital Asset Pricing Model. In short, the topic of beta (or systematic risk) is currently causing considerable intellectual embarrassment to the field of financial theory.

<sup>95</sup> See B. Malkiel, *supra* note 10, at 218-26, for a brief overview. It is generally agreed that the beta value for an individual security is unstable. There have also been recent periods when, paradoxically, prior beta values correlated negatively with stock market performance. *Id.* For the conclusion that the current state of the theoretical research into the definition and reliability of risk measurement variables does not justify precluding money managers from purchasing research in this area, see Pozen, *supra* note 22, at 950-53. If this is so, mandatory disclosure of information relevant to this inquiry is important if we wish securities professionals to calculate it for smaller firms.

icated upon.<sup>96</sup> Although this point can be debated at some length, a demand for data about "fundamental beta" now exists among institutional investors. Financial theorists should be cautious before they reject as irrational the market's demand for such data. In any event, this response's purpose is not to claim that this issue is resolved, but rather to suggest that this is precisely the sort of narrower issue that needs to be re-assessed in the "post-revisionist" era.

In summary, at least two justifications can be asserted for the disclosure of basic financial and line-of-business data to ordinary investors: (1) the need to diversify around existing investment assets makes it important for the individual investor to seek negative covariant securities to achieve optimal diversification, and (2) even in the case of a diversified portfolio, it may be important to assess the beta values of individual securities in the portfolio revision process.

#### IV. CONCLUSION

In their critical review of the arguments for a mandatory disclosure system, Professors Easterbrook and Fischel consider and reject a number of fairness-based justifications; e.g., investor confidence, the protection of investors, and the deterrence of fraud. Only tangentially do they consider the issue of efficiency-based justifications, and here they limit their attention largely to the problems associated with mandated disclosure of proprietary information. This focus on fairness, rather than efficiency, is not surprising because proponents of a mandatory disclosure system have historically stressed the former over the latter.

Nonetheless, the strongest arguments for a mandatory disclosure system may be efficiency-based. Empirical data strongly suggests that the adoption of a mandatory disclosure system reduced price dispersion and thereby enhanced the allocative efficiency of our

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<sup>96</sup> The originator of this theory of "fundamental betas" is Barr Rosenberg, a professor at Berkeley. See B. Malkiel, *supra* note 10, at 223-24. To estimate "Barr's bionic beta," one must assess the basic earnings of the company relative to its size and industry position and its financial structure. See Rosenberg & Guy, *Prediction of Beta from Investment Fundamentals*, *Fin. Analysts J.*, May-June 1976, at 60; Rosenberg & Guy, *Prediction of Beta from Investment Fundamentals*, *Fin. Analysts J.*, July-Aug. 1976, at 62 (concluding that fundamental variables "were substantially better predictors than the historical beta in the sense that they achieved a smaller measurement error").

capital markets. Nor need we rely only on historical evidence. Economic logic also points to the conclusion that there will be inadequate securities research and verification in the absence of a mandatory disclosure system. In the computerized securities marketplace of the future, individual investor review of corporate disclosures will be the exception, rather than the rule,<sup>97</sup> and clients will increasingly rely on professional advice, both to select individual securities and to diversify their portfolios efficiently. In this world, collectivization of financial data within the SEC is best justified as a strategy for making more efficient use of securities analysts and other market professionals, both by eliminating duplication and by making it feasible for them, at the margin, to cover smaller firms.

Although substantial disclosure might be made in the absence of a mandatory disclosure system, the theories offered by Jensen and Meckling or Ross are best understood as only generalized tendencies, to which there are significant exceptions. Essentially, they ignore that managers in a corporate environment increasingly characterized by rapid control changes that they cannot effectively block have strong incentives to withhold adverse information and to undertake preemptive buyouts of their own firm, which are facilitated by withholding positive information. In short, a mandatory disclosure system should reduce the average agency costs of corporate governance. To the extent that this reduction occurs, even fully diversified investors benefit because, in effect, we are reducing an element of the systematic risk that portfolio diversification cannot itself eliminate. Thus, properly applied, neither agency theory nor portfolio theory leads to conclusions inconsistent with the probable desirability of a mandatory disclosure system. Rather, they point to the need to refocus disclosure on precisely those areas that agency theory identifies as sensitive (basi-

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<sup>97</sup> Although the popularity of personal computers will enable each investor to obtain access to '34 Act data that is effectively unavailable to him today, this data has never been oriented toward the individual investor. More sophisticated computer software may enable the investor to obtain current beta values (however computed) for individual securities and even to estimate the impact of an individual security upon the beta level of his portfolio. Still, the more likely scenario is that this technological revolution will enable the broker or other adviser to compute these values for the client. Hence, the impact of this new technology may require us to reconsider and redefine the nature of the broker's fiduciary duty to his client.

cally, LBO's and takeover defenses) and those decisions that portfolio diversification cannot eliminate (i.e., the choice of risk level and the need to diversify around an existing portfolio of nonsecurities investments).

Finally, although the public goods-like character of securities research cannot justify an unlimited subsidy for securities research, no careful cost-benefit analysis has yet been conducted that recognizes the likelihood of market failure due to the special character of securities research. Other alternatives may exist by which this problem could be addressed,<sup>98</sup> but the known evil is often preferable to the unknown one. Before the current trend toward deregulation continues much further, closer attention should be given to the impact of deregulation on the market's allocative efficiency; in particular, such measures as price dispersion and volatility need to be more carefully monitored. Here, the interests of the public at large may transcend those of investors.

In summary, the federal securities laws ain't necessarily broke, so let's be careful about fixing them.

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<sup>98</sup> One can imagine other ways of subsidizing market professionals to monitor firms that otherwise would not be followed. Yet in contrast to a direct public subsidy, a mandatory disclosure system taxes corporations and shareholders and thus has marginally less of an impact on noninvestor classes. In addition, a mandatory disclosure system has the by-product of establishing a mechanism through which the individual investor can acquire information on the risk level of individual securities, whereas a system solely focused on the market professional would tend not to provide information to such an investor. In the last analysis, the long-term and most fundamental issue that securities regulation must confront is whether the law should seek to induce diversification by discouraging individual investors from holding undiversified portfolios. In all likelihood, this would be the principal consequence of abolishing the '34 Act's mandatory disclosure system. Arguments about whether public policy should seek to induce investor diversification can be made on both sides, but our experience with mutual funds suggests that it would add a second level of agency cost problems to those that already exist between shareholders and management.