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The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure

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REGULATION AND OTHER COSTS OF DISCLOSURE**

*GEOFFREY A. MANNE**

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INTRODUCTION

Academics have paid considerable deference to mandatory disclosure as a solution to myriad problems of corporate governance.¹ And “[a]lmost

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¹ The list is long and distinguished. Among the many articles supporting the SEC’s mandatory disclosure regime or else advocating for additional mandatory disclosures are: Joel Seligman, *The Historical Need for a Mandatory Disclosure System*, 9 J. CORP. L. 1 (1983); John C. Coffee, Jr., *Market Failure And The Economic Case For A Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1992); Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996); Dale Arthur Oesterle, *The Inexorable March Toward A Continuous Disclosure Requirement For Publicly Traded Corporations:*

without questioning, many accountants, analysts, comptrollers, the financial press, stockholders and potential investors assume that were it not for government required financial disclosure and the SEC the market for securities would be unregulated and hence unfair and inefficient.”² While mandatory disclosure of certain information may benefit shareholders in the intended fashion, much of this literature pays scant attention to the attendant *costs* of mandatory disclosure regimes. This article argues that, properly understood, mandatory disclosure in certain circumstances will have undesirable consequences—costs born by shareholders—that could outweigh its perceived benefits.³

“*Are We There Yet?*”, 20 CARDOZO L. REV. 135 (1998); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1364 (1999); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future*, 51 DUKE L. J. 1397 (2002); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004).

² George J. Benston, *A Critique of the Rationale for Required Corporate Financial Disclosure*, Saxe Lecture in Accounting, May 6, 1974, available at http://newman.baruch.cuny.edu/digital/saxe/saxe_1973/benston_74.htm, p. 1.

³ The purpose here is not to provide a formal framework for evaluating the net consequences of our securities disclosure regime. Instead the purpose is more limited, but more fundamental: To establish and evaluate the basic intuition underlying the claim that mandatory disclosure has costs.

It is worth pointing out, however, that evidence of the *efficacy* of mandatory disclosure is also ambiguous. Several empirical studies have attempted to evaluate the economic impact of the various reporting requirements of the U.S. and other securities regimes. The results are mixed. *See, e.g.*, George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964) (finding no effect on market-adjusted returns for new issues resulting from the 1933 Securities Act); George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (finding no difference in the post-enactment effect of the 1934 Securities Exchange Act on firms that voluntarily disclosed information prior to enactment and those that did not); Greg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613 (1981) (same as Stigler); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989) (finding no effect on abnormal returns for seasoned or NYSE-traded firms resulting from the 1934 Securities Exchange Act, but finding some effect on unseasoned, non-NYSE-traded firms); Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, Harvard Law and Economics Discussion Paper No. 453, available at <http://ssrn.com/abstract=500123> (2003) (finding a reduction in volatility and abnormal returns resulting from the extension of the Securities Acts’ disclosure requirements to OTC firms); Robert Daines and Charles M. Jones, *Mandatory Disclosure, Asymmetric Information and Liquidity: The Impact of the 1934 Act*, AFA 2006 Boston Meetings Paper, available at <http://ssrn.com/abstract=686888> (2005) (finding no differential effect on bid-ask spreads of the 1934 Securities Exchange Act between firms that voluntarily disclosed information prior to enactment and those that did not); Rafael LaPorta, et al., *What Works in Securities Laws?*, forthcoming, J. FIN., available at <http://www.afajof.org/afa/forthcoming/laporta.pdf> (2006) (collecting data from 49

SEC rules require the collation and wide dissemination of information in registration statements, proxy materials, periodic reports and other public communications. The goal, of course, is to apply the disinfectant of sunlight to the black box of corporate management; the presumption is that issuers exposed to public scrutiny will not be able to exploit investor ignorance to their advantage.⁴ “A critical barrier that stands between issuers of common shares and public investors is asymmetric information.”⁵ Disclosure regulation attempts to overcome this barrier. And ultimately, the success or failure of disclosure regulation turns on the extent to which it leads to the optimal production and dissemination of valuable information; the extent to which forced disclosure contributes to shareholder value; and the extent to which it is less costly than—and at least as effective as—alternative solutions to the information asymmetry problem.⁶

Most critics of the federal mandatory disclosure regime have thus argued that the regime is either *unable* to achieve its intended result (and that at some positive costs to firms) because of the limitations of the information disclosed,⁷ or else it is *inefficient* because it requires the disclosure of too much information.⁸ Proponents counter that the

worldwide securities markets and concluding that mandatory disclosure rules improve stock market performance).

⁴ Leading to the obligatory Brandeis quote: “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (1914).

⁵ Bernie Black, *Legal and Institutional Preconditions for Strong Securities Markets*, 48 *UCLA L. REV.* 781, 786 (2001).

⁶ In this regard it bears noting at the outset that one solution to this problem is no solution at all. The costs of information asymmetry may be less than the costs of even the best available “solution” to the problem. See Ronald H. Coase, *The Problem of Social Cost*, 3 *J. LAW & ECON.* 1, 18 (1960).

⁷ See e.g., Benston, *Required Disclosure and the Stock Market*, 63 *AM. ECON. REV.* at 152-153 (concluding that the assumptions for revealing information to shareholders—namely, timeliness and usefulness—are not born out by empirical research); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure And The Protection Of Investors*, 70 *VA. L. REV.* 669 (1984) (critiquing the public-interest rationale of information in the mandatory disclosure regime).

⁸ See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 306 (1976) (arguing that incentives created by the competition for investors explains “why accounting reports would be provided voluntarily to creditors and stockholders, and why auditors would be engaged by management to testify to the accuracy and correctness of such reports”). See also Stephan A. Ross, *The Economics of Information and the Disclosure Regulation Debate*, in FRANKLIN R. EDWARDS ED., *ISSUES IN FINANCIAL REGULATION* 184-85 (1979) (“[I]n a competitive market (with no mandated disclosure) the managers of firms . . . will have a strong self-interest in disclosing relevant information”); Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for*

information, while imperfect, is in fact valued and valuable,⁹ and that certain market imperfections, in the absence of regulation, stymie the efficient flow of information.¹⁰

But the proponents of disclosure regulation (and even many of its critics) seem to treat regulated behavior as static in fairly important respects; that is, they assume a considerable degree of behavioral constancy, even as some behavior becomes more expensive through regulation. In many cases, the question analyzed by commentators is simply and narrowly one of quantity: Will regulation induce the production and dissemination of more valuable information? In this context “valuable” connotes deterrence: Will the forced disclosure of information deter undesirable forms of behavior about which information must now be disclosed? But while commentators and regulators recognize that behavior made more expensive will become less common, they fail to consider that more nuanced behavioral responses may accompany this reduction.

For example, some defenders of executive compensation information disclosure contend that CEOs would receive less compensation if amounts were more effectively disclosed.¹¹ But many of these same critics do not

Securities Regulation, 81 WASH. U. L. Q. 417, 421 (2003) (“Critics . . . argue that a company will voluntarily disclose information that investors demand in order to reduce its cost of capital and avoid any discount that the market might apply to the company’s stock price if investors think that they have too little information to evaluate the company and its securities properly or, worse yet, if investors think that the company is hiding something.”).

⁹ See, e.g., Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance Of Opportunism, Candor And Signaling In The Economic Case For Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 237 (2002) (arguing that three economic rationales support mandatory disclosure: “informational asymmetry between issuers and investors,” “the positive informational externalities arising from issuer disclosure,” and “the potential of private investors to engage in excessive information gathering”).

¹⁰ See, e.g., Paredes, *Information Overload*, 81 WASH. U. L. Q. at 421-22:

Supporters of mandatory disclosure counter that because information has public good aspects, voluntary disclosure will result in too little disclosure. Further, because investors, securities analysts, brokers, and other securities market professionals do not internalize all the benefits of information they gather and analyze, they will invest too few resources in research and analysis. . . . In addition, companies might have an incentive to withhold competitively sensitive or proprietary information in order to keep it out of their competitors’ hands. Finally, even if companies have an incentive to disclose good news, managers may have an incentive to withhold negative information in the hope that things will turn around for the company or that the market otherwise will not uncover the bad news.

¹¹ See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 254 (1990) (arguing that “[t]he benefits of the public disclosure of top management compensation are obvious since this disclosure can help provide a safeguard against ‘looting’ by management (in collusion with ‘captive’

consider that the *form* of compensation may shift in response to disclosure, rather than the *level*.¹² What is consistently left out of these analyses is a recognition that managerial responses to regulation may be complex and unanticipated. CEOs may simply take less compensation, but they may instead shift the difference into non-pecuniary compensation, for example.¹³ They may work less hard; they may exit the market entirely; they may expend resources to camouflage their compensation. The response to regulation is not simply a matter of the cost of engaging in the behavior subject to disclosure. It is also a matter of what substitutes are available for the regulated behavior and the degree of elasticity between them.¹⁴

Disclosure regulation makes some forms of behavior more expensive relative to others. Rational actors will respond by shifting some conduct into the comparatively cheaper outlets. And these alternative behaviors may actually be less beneficial than the regulated, deterred behavior. In essence, disclosure regulation effectively *proscribes*, it does not *prescribe*. Thus, depending on the availability and viability of other behaviors, forced disclosure may induce unwanted responses.¹⁵

boards of directors”).

¹² An important exception (although flawed for other reasons) is Bebchuk and Fried, whose arguments are, in fact, aimed at changing the *form* and not merely the *level* of executive compensation. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 189 (2004) (“Thus, the problem of executive compensation can be fully addressed only by adopting reforms that would confront boards with a different set of incentives and constraints.”). Bebchuk and Fried go on to describe these reforms throughout the chapter, including: “reducing windfalls in equity-based plans,” “placing a monetary value on all forms of compensation,” increasing disclosure of “the extent to which their top five executives have unloaded any equity instruments received,” and increasing generally the information disclosed to “investors and reformers.” *Id.* at 190, 193, 200. Nevertheless, Bebchuk and Fried do commit an analogous error in failing to consider the possibility that undesirable behavioral shifts may result from their proposals, rather than the advantageous ones they prefer.

¹³ See generally *infra* notes 78-119 and accompanying text .

¹⁴ The first law of demand states that “[w]hatever the quantity of any good consumed at any particular price, a sufficiently higher price will induce any person to consume less.” ARMEN A. ALCHIAN & WILLIAM R. ALLEN, *UNIVERSITY ECONOMICS* 60 (3rd ed. 1972). But the measure of substitution—the degree to which a price increase reduces consumption—is elasticity. “[T]he closer the substitutes available, the greater is the elasticity of demand . . . for a good at any specified price.” *Id.* at 62.

¹⁵ It is probably important to note at the outset that the appropriate response to this problem is not likely more prescriptive, substantive regulation. For while the consequences of proscriptive disclosure regulation may be unanticipated and unintended, the very complexity of corporate organizations and human behavior that causes these consequences makes prescriptive regulation even more problematic. See generally STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 253 (2002) (“Given the significant virtues of discretion, however, one must not lightly interfere with management or the

While we can surely anticipate that corporate agents will expend some resources in order to circumvent information regulation, it is difficult to know in advance what these efforts will look like or how costly they will be.¹⁶ The regulation of complex economic entities frequently results in unintended and costly consequences. Appropriately evaluating the desirability of disclosure rules requires accounting for the cost of efforts to circumvent those rules, however, along with the more attenuated cost of other unintended consequences. It is insufficient either to ignore unanticipated consequences or to presume that the only relevant effects will be the salutary, intended ones.

This article identifies several consequences that can arise from securities disclosure regulation and that are missing from the current discourse on disclosure regulation:

- (a) Behavior made more costly to insiders by disclosure may be deterred by disclosure, but insiders may shift into *less*—not more—desirable alternative activities.
- (b) The pool of entrants into a regime governed by mandatory disclosure may shift in an undesirable direction in response to the regime.
- (c) Regulation by a federal disclosure regime substitutes federal regulator and enforcer biases for the limitations of market enforcement, often to the detriment of investors.
- (d) Disclosure of information may induce too much participation by investors in corporate governance and may imperil corporations' competitive governance schemes.

The article explicates these novel insights and attempts to put them into a useful framework. I identify two broad concepts that encapsulate these dynamics. First, I develop a “hydraulic theory” of securities disclosure regulation. Under this theory, disclosure regulation triggers behavioral hydraulics which may lead to an undesirable shift in underlying behavior as well as an undesirable shift in the pool of candidates for corporate executive positions. Second, I develop an information cost theory of securities disclosure regulation. Under this theory, mandated disclosure is both unnecessary to market efficiency and affirmatively harmful to firms' schemes of corporate governance. Accurate assessment of our securities regulatory regime must evaluate and account for these dynamics.¹⁷

board's decisionmaking authority in the name of accountability.”).

¹⁶ These efforts may be both costly and, ultimately, unavoidable. As Larry Ribstein notes, “fraudsters are highly motivated, they'll find a way around all this.” Larry Ribstein, *Ideoblog*, available at http://busmovie.typepad.com/ideoblog/2006/01/complying_with_.html.

¹⁷ For a brief presentation of many of the ideas contained in this article, along with

THE FUNDAMENTALS OF DISCLOSURE REGULATION

Our securities regulatory regime is a disclosure regime,¹⁸ and large, publicly-traded corporations are under considerable obligation to disclose information from multiple legislative and regulatory sources.¹⁹ This section canvasses the fundamental justifications for, and criticisms of, disclosure regulation.

A. The Value and Limits of Disclosure

A regulatory regime rooted in disclosure of information must have an explicit or implicit theory of the value of disclosure. In the main, disclosure regulation is explained in three interrelated ways.²⁰ First, investors will make better investment decisions (and managers will more likely act in

some related discussion and links, see Geoffrey Manne, *On disclosure: The hydraulic theory*, Truth on the Market Blog (January 28, 2006), available at <http://www.truthonthemarket.com/2006/01/28/on-disclosure-the-hydraulic-theory/>.

¹⁸ See, e.g., 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 29 (3d ed. rev. 1998) (“Then, too, there is the recurrent theme throughout [federal securities law] of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But ‘the truth shall make you free.’”). See also George J. Benston, *The Effectiveness and Effects of the SEC’s Accounting Disclosure Requirements*, in HENRY G. MANNE, ED., *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 23-4 (1969) (“[T]he primary purpose of the Securities Act of 1933 and an important part of the Securities Exchange Act of 1934 is to assure the disclosure of financial accounting information”); Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. at 670 (“The dominating principle of securities regulation is that anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain.”); Henry G. Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws*, in HENRY G. MANNE & EZRA SOLOMON, *WALL STREET IN TRANSITION* 23 (1974) (“For over fifty years now, the American legal and financial communities have experienced the application and elaboration of a concept of securities regulation known as the ‘disclosure philosophy.’”) (citing LOUIS LOSS, 1 *SECURITIES REGULATION* 127 (2d ed. 1961)).

¹⁹ “The federal securities laws require companies to make extensive disclosures in annual reports, quarterly reports, current reports, proxy statements, and other filings with the Securities and Exchange Commission.” Paredes, *Information Overload*, 81 WASH. U. L. Q. at 418. The sources of corporate disclosure regulation have been well-catalogued elsewhere (and far more extensively than is practical here). See, e.g., THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 21-27 (5th ed. 2005). See especially Regulation S-K, 17 C.F.R. 229.10-229.702 (2003).

²⁰ In fact some have provided a fourth, less-charitable, explanation: Early disclosure regulation, far from serving the public interest, was a means employed by established firms to hamstring new rivals. See Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws*, in MANNE & SOLOMON, *WALL STREET IN TRANSITION* at 33-6.

investors' interest) when those decisions are considered in the light of otherwise-undisclosed, relevant information.²¹ Second, required disclosures will cause stock prices better to reflect underlying firm value, thereby enhancing market accuracy.²² And third, fraud will be deterred because "sunlight is the best disinfectant."²³ On this theory, the threat of disclosure of undesirable activity will deter that activity *ex ante*, particularly through the oversight of appointed gatekeepers or experts who closely monitor those subject to disclosure regulation.²⁴ A growing body of literature also avers

²¹ See, e.g., Homer Kripke, *Disclosure Beyond Accounting Disclosure: An Unsatisfied Need*, Saxe Lecture (1979) (available at http://newman.baruch.cuny.edu/digital/saxe/saxe_1979/kripke_80.htm) ("Although the original intention was a little uncertain, unquestionably the SEC's rhetoric has tended more and more toward claiming the value of disclosure for securities decisions."). See also Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004) ("The more information a company discloses, the more effectively investors can evaluate how well the company's management is exploiting opportunities available to the firm."); Fox, *Retaining Mandatory Securities Disclosure*, 85 Va. L. Rev. at 1364 ("Disclosure assists in the effective exercise of the shareholder franchise and in shareholder enforcement of management's fiduciary duties.").

The logic is that by arming investors with information, mandatory disclosure promotes informed investor decision making, capital market integrity, and capital market efficiency. Once they are empowered with information, the argument goes, investors can protect themselves against corporate abuses and mismanagement, and there is no need for the government to engage in more substantive securities regulation—"merit review" in the securities patois. The underlying logic is troubling, however. See *infra* notes 132-44 and accompanying text.

Nevertheless, the SEC appears to hew to this justification, having recently published (in accordance with its Securities Act Rules 421 & 481) a "Plain English" handbook geared toward making SEC-mandated disclosures more readable to the lay investor because, in the words of then-Chairman Arthur Levitt, "[i]nvestors need to read and understand disclosure documents to benefit fully from the protections offered by our federal securities laws." SEC, A PLAIN ENGLISH HANDBOOK 3 (1998) (available at <http://www.sec.gov/pdf/handbook.pdf>).

²² See, e.g., Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 764 (1995) ("The dominant view is that the goal of required securities disclosure is to make prices in securities markets more accurate.").

²³ LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 13 (1913).

²⁴ See, e.g., Seligman, *The Historical Need for a Mandatory Disclosure System*, 9 J. CORP. L. at 9. Seligman actually adduces five justifications for the mandatory disclosure regime. Although all five can be effectively collapsed into the three I have mentioned here, it is worth quoting Seligman in full:

Historically, the proponents of the SEC's mandatory corporate disclosure system have advanced five principal arguments to justify the system. First, in the absence of a compulsory corporate disclosure system some issuers will conceal or misrepresent information material to investment decisions. Second, in the absence of a compulsory corporate disclosure system, underwriting costs and insiders' salaries and perquisites will be excessive. Third, in the absence of a mandatory corporate disclosure system, there will be less 'public confidence' in the markets.

that mandatory disclosure benefits competitors and the market more broadly by disseminating socially-valuable information to competitors which is, for obvious reasons, privately costly to the firms that create it.²⁵

Of course, coupled with available civil and criminal penalties for failure to comply with the disclosure regulations, the regime is not entirely dependent on any of these fundamental justifications; rather, the threat of prosecution for violation of the regulations becomes itself a significant source of potential improvement (or at least alteration) in underlying behavior.²⁶

At the same time, there must be a limit to the extent and scope of required disclosure. From the point of view of information recipients, the additional disclosures provide diminishing returns and increasing costs, some of which may be born directly by the recipient, most notably when the recipient is a stockholder in a company subject to the disclosure

Fourth, in the absence of the laws creating a mandatory corporate disclosure system, neither state laws nor private associations such as the New York Stock Exchange can ensure the optimal level of corporate disclosure. Fifth, in the absence of a mandatory corporate disclosure system, civil or criminal actions will not ensure optimal levels of corporate disclosure.

In particular contrast to this article, Seligman here asserts that executive perquisites will be kept in check by the mandatory disclosure system. In the portion of his article defending this argument, however, he does not maintain the distinction between “salaries” and “perquisites.” *Id.* at 45-51.

²⁵ See, e.g., Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 136 (2004) (“There are several benefits from the disclosure of information that the firm making the disclosure may not be able to fully capture. . . . These externalities can be categorized based on the different third-party beneficiaries identified, including [] a company’s competitors, who may benefit from the disclosure of proprietary information”); Fox, *Retaining Mandatory Securities Disclosure*, 85 VA. L. REV. at 1345 (“For example, if an issuer discloses that a given line of business is particularly profitable, other firms may be attracted to enter the same market, driving prices, and hence the issuer’s profits, down.”).

²⁶ See Franco, *Why Antifraud Prohibitions Are Not Enough*, 2002 COLUM. BUS. L. REV. at 266 (“The possibility of government civil and criminal actions further adds to the deterrence effects of the antifraud provisions. The threat of government actions is effective not only because it increases the penalty imposed on would-be violators, but because government authorities face significantly different litigation incentives than private litigants.”). See also Manne, *Economic Aspects of Required Disclosure*, in MANNE & SOLOMON, *WALL STREET IN TRANSITION* at 38 (noting that although it may not serve its putative purpose, disclosure regulation does provide the SEC “with an enormously powerful ‘enforcement’ device”).

The point is subtle. There are defenses of mandatory disclosure, per se: Information may be used by those to whom it is disclosed; sunlight is a good disinfectant; etc. The threat of prosecution is different, however. Though it, too, *depends* on the extent of compliance with disclosure requirements, it is not actually through the *disclosure* that good behavior results, but through the *threat of punishment* for what, under this reading, is actually an incidental aspect of the real behavior to be deterred.

regulation.²⁷ At the same time, additional disclosure also imposes increasing costs on firms, and even if we accept the argument that firms voluntarily *under-produce* information, an optimal information disclosure regime would surely not require disclosure of *all* private information. Optimal disclosure is not maximal disclosure.²⁸

Many commentators, however, seem to take for granted that increased disclosure is beneficial—and cheap—and therefore recommend disclosure regulation even where they would shun more-intrusive regulation. In a recent review of Lucian Bebchuk and Jesse Fried’s book, *PAY WITHOUT PERFORMANCE*, for example, John Core, Wayne Guay and Randall Thomas impressively critique Bebchuk and Fried’s central claims, effectively hobbling the justifications for Bebchuk and Fried’s policy recommendations.²⁹ Nevertheless, although critical of Bebchuk and Fried’s more intrusive policy proposals,³⁰ the authors “agree that better disclosure on the value of executive pensions and the exercise and sale of options and shares would be beneficial.”³¹ They provide no independent justification for the concession (and the entire article is devoted to criticizing Bebchuk and Fried’s justifications), and note only that “some of [Bebchuk and Fried’s] proposals seem sensible.”³² As this article suggests, however, mandatory disclosure has important and ill-considered consequences; it is not merely regulatory “chicken soup.”³³

B. *The Existing Criticisms*

²⁷ Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. at 696 (“Information is costly, and the costs are borne in large part by investors. Whether investors benefit by more information depends on whether the marginal benefits of increments to knowledge exceed the marginal costs.”). Cf. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 215 (1961) (noting that search for price information yields diminishing returns as a function of minimum price).

²⁸ “Ignorance is like subzero weather: by a sufficient expenditure its effects upon people can be kept within tolerable or even comfortable bounds, but it would be wholly uneconomic entirely to eliminate all its effects.” Stigler, *The Economics of Information*, 69 J. POL. ECON. at 224.

²⁹ John E. Core, et al., *Is U.S. CEO Compensation Inefficient Pay without Performance?*, 103 MICH. L. REV. 1142, 1181 (2005) (“[T]he authors have offered no persuasive evidence that CEO pay contracts are suboptimal.”).

³⁰ See *id.* at 1182-83 (“With regards to their more sweeping proposals, however, Bebchuk & Fried have not provided evidence of why more needs to be done.”).

³¹ *Id.* at 1182.

³² *Id.*

³³ “Look at it [disclosure regulation] as regulatory chicken soup: it won’t do any good, but at least it can’t hurt.” Larry Ribstein, *The SEC and executive compensation: a little regulatory chicken soup*, Ideoblog (January 10, 2006), available at http://busmovie.typepad.com/ideoblog/2006/01/the_sec_and_exe.html.

The securities disclosure regime has been criticized primarily along the following lines:

1. Mandatory disclosure is ineffectual or even counterproductive, because
 - a. the most useful information is already being disclosed;³⁴
 - b. the regime that focuses attention on shareholders' access to *and use of* information suffers from its own success. Shareholders may, in fact, attempt to make use of disclosed information, but it (and the conduct underlying it) may prove too complicated, and they may do so to their own detriment;³⁵ or
 - c. share price accuracy will be impaired, rather than aided, by mandatory disclosure rules.³⁶
2. Mandatory disclosure is inefficient. It makes otherwise efficient behaviors less cost-effective and thus raises the cost of capital to new firms and prices some investors out of the market.³⁷

These criticisms are well-taken, and they are fundamentally rooted in the intractable problem of effectively and efficiently regulating complex corporate entities. Whatever the benefits of forced disclosure, there will always be unintended consequences.

Thus, while the direct cost of the federal securities regulatory apparatus is surely positive,³⁸ the *indirect* costs of regulations may be far more

³⁴ "Investors know something that the SEC still ignores—that macroeconomic conditions can render insignificant the most careful firm-oriented disclosure, especially backward-looking disclosure." HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 29 (1979).

³⁵ See, e.g., Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 5-6:

In Enron, for example, there is no dispute that the existence of the SPE-transactions was generally disclosed to Enron's investors. The disclosure itself, however, was ultimately said to be inadequate. Although this inadequacy might have been intentionally fraudulent, the better explanation is that Enron's structured transactions were so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities.

³⁶ See Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. at 770-2 (noting that disclosure does not necessarily enhance accuracy).

³⁷ See HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 107-39 (1979); Benston, *Required Disclosure and the Stock Market*, 63 AM. ECON. REV. 132. Obviously there is significant overlap between the two criticisms.

³⁸ Although "[t]he marginal direct cost of mandatory disclosure may be small." Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. at 708. As Easterbrook and Fischel note, it is difficult to know what disclosure-related costs would be born *voluntarily* by firms in the absence of mandatory disclosure, an amount that must be subtracted from

substantial. Regulation may induce firms to engage in less-efficient activities if optimal conduct requires impermissible secrecy.³⁹ Moreover, [f]irms may cease disclosing some category of useful information and switch to some obfuscatory (but complying) information. Firms may become more cautious and leaden on paper, switching the important disclosures to discussions with analysis or other oral exchanges that will be less precise and less widely disseminated. Poorly understood or ‘coded’ disclosures will be decoded imperfectly (and at some cost). In the extreme, a mandatory disclosure system’s specification of what to say may stop firms from conveying categories of information altogether.⁴⁰

Meanwhile, outsider opportunists (like plaintiffs’ attorneys and competitors) may use litigation of regulatory compliance to their own advantage, and quite often to the substantial costs of target firms.⁴¹

the nominal cost of regulation in order to identify its real cost. *See also* Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH U. L. Q. 815, 816 (1997) (“[T]he cost of transmitting, storing and manipulating data is a very minor component of the social cost of mandatory corporate disclosure.”).

Moreover, the direct costs may be growing. The SEC’s recently-proposed executive compensation disclosure rule threatens to impose substantial new costs on public companies. “Experts estimate that roughly 25% of the 500 biggest public companies in the U.S. now disclose more about executive pay than current rules require, [but compliance with the new rules] ‘will take real preparation.’” *They Say Jump: The SEC Plans Tougher Pay Rules*, WALL ST. J. (January 11, 2006), available at http://online.wsj.com/article/SB113694940135743465.html?mod=todays_us_money_and_investing.

³⁹ Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. at 708.

⁴⁰ *Id.* at 709. Note that this claim is more complicated post-Regulation FD, but the basic point still holds. Regulation FD, 17 C.F.R. 243.100(a) (2005) *See also*, Joseph Grundfest, *Enron: Can We Craft an Efficient Disclosure-Based Policy Response?* (January 29, 2002), available at <http://www.fed-soc.org/Publications/White%20Papers/enrondraft.htm>:

While it is entirely appropriate to complain about Enron’s alleged failure to comply with GAAP, the far greater problem may be the extent to which Enron could have modified its behavior, ever so slightly, so as to comply with GAAP (or at least with an aggressive interpretation of GAAP), and thereby potentially have continued to conceal its true financial condition from the market for many more months or even years. Enron’s conduct also underscores the extent to which issuers may be willing to engage in financially questionable transactions that comply fully with GAAP only because those transactions generate desirable accounting treatments under GAAP.

⁴¹ The litigation risk is substantial, and, it must be noted, not-necessarily correlated with market optimality. *See, e.g.*, Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH U. L. Q. at 818:

Liability will . . . sometimes attach to statements that were not intentionally or recklessly misleading ex ante, but merely incorrect ex post. Any corporate disclosure—even though made in good faith and after appropriate verification efforts—therefore carries with it a price tag. The price, or expected liability, is a function of the probability that the statement will turn out to be incorrect, the

So imposing restrictions on the manner and content of disclosures may, perversely, have the effect of reducing the overall amount of disclosure, assuming firms would have disclosed voluntarily anyway.⁴² Less dramatically, it may alter the form of material disclosure from broadly-distributed (and regulated) paper disclosures to less-precise (and less controllable) oral disclosures—notably, to the detriment of those further outside a corporation’s inner circle.⁴³ Even more dramatically, however, it may detrimentally alter underlying business decisions.⁴⁴

Of key importance to understanding these consequences is the realization that forced disclosure deters the creation or collection of information which is valuable when kept secret, but which loses its value when disclosed.⁴⁵ As one commentator has noted,

probability that a court will erroneously find that the statement was intentionally or recklessly false given that it is incorrect, and the expected damage award.

See also Larry Ribstein, *The Costs of executive compensation disclosure*, Ideoblog (January 11, 2006), http://busmovie.typepad.com/ideoblog/2006/01/the_costs_of_ex.html (“There will be the lawsuits against the companies that get it wrong. Plaintiffs in these suits must, of course, prove that the misrepresentations and non-disclosures are material. Here we have the makings of a whole new subclass of securities jurisprudence.”).

⁴² A warranted assumption: See, e.g., Benston, *Required Disclosure and the Stock Market*, 63 AM. ECON. REV. at 133 (noting that at the end of 1933—the calendar year before the Securities Exchange Act was passed—all New York Stock Exchange “corporations were audited by CPA firms, all listed current assets and liabilities in their balance sheets, 62 percent gave their sales, 54 percent the cost of goods sold, and 93 percent disclosed the amount of depreciation expense.”). See also generally, Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. 669.

⁴³ As one prominent commentator and critic of the SEC has noted, “securities values are the consensus of unverifiable estimates, and their exclusion [by SEC rules from prospectuses] limited the utility of the SEC’s disclosure process for securities decisions.” HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 17 (1979). Although the SEC has softened its resistance to forward projections and other “unverifiable estimates” since Kripke penned those words, see, for example, *Safe Harbor For Forward-Looking Statements: Concept Release*, Securities Act Release 7101, 1994 WL 562021 (SEC) (Oct. 13, 1994), there remains a disconnect between the official information contained in a corporation’s required disclosures and the less formal information that permeates the market.

⁴⁴ See generally *infra* notes 47-59 and accompanying text. See also Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 424 (1983) (“Requiring firms to disclose [firm information] . . . may affect the willingness of the firm to undertake the conduct at issue. . . . [M]anagers may simply decide that the costs of disclosure may exceed the expected benefits from the activity.”); Manne, *Economic Aspects of Required Disclosure*, in MANNE & SOLOMON, *WALL STREET IN TRANSITION* at 28-9 (“Advocates of disclosure-type securities laws have long claimed that . . . disclosure does not interfere with legitimate business decisions. . . . In fact, however, the argument that required disclosure is generally nonregulatory is . . . mythical . . .”).

⁴⁵ See, e.g., Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH U. L. Q. at 818:

[T]here are two basic reasons why accuracy enhancement cannot be achieved, one internal to the statutes themselves and the other inherent in the world in which issuers do business. The internal reason is that the securities laws themselves reduce the amount of information that is provided by issuers because they impose significant liability for the production of misinformation. . . . The insight, so accepted in the free speech area, that high standards of liability for the production of erroneous information will, as one of its effects, reduce the production of any information, is unacknowledged in the securities area. But unacknowledged or not, the liability structure of the securities laws reduces the production of information.

The second reason why accuracy enhancement cannot be achieved—the reason inherent in the world in which issuers do business—is that information is power, including the power to compete effectively Information is a weapon, and issuers have strong incentives to make disclosures consistent with their success in rivalry with competitors and other adversaries rather than to enhance the accuracy of the prices at which their publicly issued securities are bought and sold. It is no accident that securities documents are opaque.⁴⁶

Information accuracy—the overcoming of information asymmetry—cannot easily be achieved where corporate actors and their investors stand to gain more from *not producing* the information subject to regulation than they do from producing and disclosing.

THE “HYDRAULIC THEORY” OF DISCLOSURE REGULATION

Where information is valuable if secret, mandatory disclosure regulation imposes a cost on creating (or searching for) the information subject to disclosure. Where this information is incidental to a particular behavior, the existence of the rule thus deters the underlying behavior, both because of the direct cost of compliance as well as the costly consequences of widespread dissemination.⁴⁷ A problem arises, however, where unwanted

Opportunity cost is the difference between the value of the information to the company if kept secret and its value to the company if publicly disclosed. Many forms of corporate information are more valuable if they are kept secret. Obvious examples include trade secrets, ideas for new products, plans to enter new markets, and similar information that competitors could use. There are also less obvious examples. A company may have contracts with other firms pursuant to which both parties have made project-specific investments. Those investments give each firm market power vis-à-vis the other. In that situation, information about Party B’s valuation of the contract can enable Party A to gain a greater share of the gains from trade, and vice versa. Thus, any given company at any given time likely has a considerable amount of internal information that would, if made public, result in wealth transfers from the company to its competitors, suppliers or customers.

⁴⁶ Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. at 770-

2.

⁴⁷ If information about a particular behavior is not voluntarily disclosed, it may be because more public acknowledgement (either by shareholders or by various gatekeepers)

conduct is not merely deterred, but also *redirected*.

A. *The Basic Theory*

The hydraulic theory of disclosure rules holds that, as disclosure rules impose costs on behavior subject to disclosure, where behavior can be altered at lower cost than the cost of disclosure, disclosure rules will induce behavioral changes rather than increased information flow.⁴⁸ Where it is more costly to alter behavior—where the full costs of disclosure are either sufficiently low or sufficiently externalized—disclosure rules may be effective in their behavioral aims. But where the costs of disclosure may be avoided at lower cost by substituting other, unintended behavior, the effect is, at best, ambiguous.⁴⁹

would reduce the value of the behavior, or vitiate some important aspect of it. Thus if, as some contend, public outrage would attend clearer disclosure of some executive pay packages, the value to executives of their pay would be reduced by required disclosure. See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE* at 65 (“The more widespread and strong these [public] negative reactions are—that is, the greater the outrage—the larger the costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favor.”); *Id.* at 68 (“There is evidence that directors and executives are indeed influenced—in compensation and other types of decisions—by strong outside criticism and outrage.”). This reduction could occur because the level or type of compensation couldn’t be maintained in the face of public outrage, or because enduring the outrage itself (moral opprobrium or social castigation) extracts a cost from some executives. The outrage argument is, however, contested. See, e.g., Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002) (amassing historical data “starkly at odds” with the outrage theory).

⁴⁸ See *supra* note 44. The name, “hydraulic theory,” as well as the underlying concept is derived from Samuel Issacharoff & Pamela S. Karlan, *The Hydraulics of Campaign Finance Reform*, 77 TEX. L. REV. 1705, 1713 (1999) (noting that regulation of campaign finance does not cause campaign contributions to “shrivel up and disappear,” but instead merely diverts them elsewhere).

⁴⁹ See William J. Stuntz, *Christian Legal Theory*, 116 HARV. L. REV. 1707, 1747 (2003) (“Legal threats produce some compliance . . . but they also produce resistance, as regulated actors invest in finding loopholes and evading detection.”). Cain, Loewenstein and Moore make a conceptually analogous point with regarding the disclosure of conflicts of interest:

[T]here are two ways in which disclosure could potentially worsen the advice that [advisors] provide to estimators. The first involves the advisors’ strategic response to the disclosure of their conflict of interest. . . . On one hand, disclosure might deter advisors from giving biased advice by increasing their concern that estimators (now thought to be alerted by disclosure) will completely discount extreme advice or attribute corrupt motives to advice that seems even remotely questionable. On the other hand, advisors might be tempted to provide even more biased advice, exaggerating their advice in order to counteract the diminished weight that they expect estimators to place on it; this strategic exaggeration is like

The added cost of disclosure may shift behavior in a desirable direction, but it is hard to see why this should necessarily be the case. Actors who benefit from behavior A will expend resources to identify and engage in behavior B from which they also gain advantage before committing to regulated behavior A' from which they do not. The magnitude of the hydraulic effect will turn primarily on the degree of cross-elasticity (substitutability) between the impeded (more costly) and the freer (less costly) sources of behavior.

Proponents of securities disclosure regulations hope that the regulations will make undesirable conduct too expensive relative to desirable, alternative conduct, thus inducing a shift from the former to the latter. And to some extent the proponents are surely correct: All else equal, if individually-remunerative-but-socially-costly conduct is made enough more expensive so that alternative, socially-desirable conduct becomes at least as individually remunerative, the socially-undesirable conduct will be deterred. But it is not always the case that the alternative conduct is, in fact, socially desirable. Frequently unintended consequences mar even the most well-intentioned regulation.⁵⁰ The argument is not (only) that the deterred conduct has unforeseen, socially-desirable functions;⁵¹ rather the argument is that the effort to deter even manifestly *undesirable* behavior may induce a shift to *even less-desirable* conduct.

For example, it is well understood that laws requiring the use of seatbelts in cars are intended by their proponents to reduce the incidence of serious injury and death from automobile accidents.⁵² It is also well

expecting disclosure to cause one's audience to cover its ears and thus compensating for this by yelling even louder.

Daylian M. Cain, et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEG. STUD. 6-7 (2005).

⁵⁰ See Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 421-423 (1990) (demonstrating how well-intentioned laws aimed at redistribution, such as warranties of habitability, minimum wage increases, and labor safety laws, are in effect self-defeating because "the group particularly disadvantaged by the[se] regulation[s] will typically consist of those who are already most disadvantaged"); Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 36 (2002) ("Designing firms' contracts to maximize the net benefits of employing agents obviously is a complex, multi-dimensional task that requires consideration of each firm's characteristics and that regulation can affect in unpredictable ways.").

⁵¹ Although this is a common (and well-taken) criticism of regulation. See Ribstein, *Market vs. Regulatory Responses* 28 J. CORP. L. at 40-1 (noting that deterring certain behavior to combat fraud also has the effect of increasing information costs to the firm).

⁵² See generally Sam Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 667 (1975) (analyzing the unintended consequences flowing from mandatory automobile safety regulation); Alma Cohen & Rajeev Dehejia, *The Effect Of Automobile Insurance And Accident Liability Laws On Traffic Fatalities*, 47 J. LAW & ECON. 357

understood, however, that this result has proved somewhat elusive.⁵³ Drivers seem willing to undertake a certain amount of risk and, if one risky behavior among numerous actions that might contribute to the likelihood of an accident is made more expensive (by threat of a fine, for example), then drivers will simply reduce their self-imposed risk avoidance in other ways—apparently by driving less carefully. To the extent that the laws do not alter drivers’ overall risk preferences they are unlikely significantly to reduce injuries.⁵⁴ And importantly, the shift from one set of behaviors to another, even with the *same* risk profile for drivers, does not impose the same risk on, say, pedestrians, who now suffer the ill effects of more reckless driving, but earn none of the benefit of “safer” accidents.⁵⁵

The regulation of corporate behavior evinces the same dynamic. The SEC has adopted, in compliance with Section 406 of the Sarbanes-Oxley Act,⁵⁶ a rule requiring companies to disclose waivers of their codes of

(2004) (following Peltzman in an analysis of “how economic incentives and liability regulation influence driver behavior and, in turn, traffic fatalities”).

⁵³ *Id.* The argument is not that seatbelt laws do not reduce the cost of motor vehicle accidents; it is that offsetting behaviors could theoretically dissipate all of the gains, and that they have, empirically, dissipated some of the gains. *See, e.g.,* Cohen & Dehejia, *The Effect Of Automobile Insurance And Accident Liability Laws*, 47 J. LAW & ECON. at 388 (“The evidence indicates that compulsory insurance rules do deliver their intended effect, which is a significant reduction in the incidence of uninsured motorists. The evidence also indicates that increasing the incidence of insurance produces an increase in the number of fatalities. . . . While the switch by some motorists to become insured increases fatalities, this is at least partly offset by the effect of compulsory insurance on those drivers who chose to remain uninsured.”).

⁵⁴ That is, mandatory seat belt laws force drivers to consume more safety, thereby lowering the price of risky driving. Unless, I suppose, the cost of seat belt use were so large that it induced drivers to stop driving, the fundamental law of demand holds that drivers will “consume” more risky driving as the price decreases. *See generally* ALCHIAN & ALLEN, *UNIVERSITY ECONOMICS* at 60 (“Any person’s consumption rate for any good will be increased . . . if the price is lowered . . . sufficiently.”).

It is worth noting, however, that a growing body of literature does suggest that laws can alter preferences—even risk preferences—in such a way that this effect may be mitigated. *See, e.g.,* Cass R. Sunstein, *Social Roles, Social Norms*, 96 COLUM. L. REV. 904, 958-959 (1996):

Much legal regulation . . . consist[s] of direct coercion, designed to generate good norms or to pick up the slack in their absence. . . . The[se] [laws] do this in large part because there is a general norm in favor of obeying the law. The relevant laws help to inculcate both shame and pride; they help define the appropriate sources of these things. . . . They readjust the personal calculation, making what is rational, and what is in one’s self-interest, different from what they were before.

⁵⁵ STEVEN E. LANDSBURG, *THE ARMCHAIR ECONOMIST* 4 (1993) (“An interesting side effect [of mandatory seat belt laws] appears to have been an increase in the number of pedestrian deaths; pedestrians, after all, gain no benefit from padded dashboards.”).

⁵⁶ Sarbanes-Oxley § 406(b), *codified at* 15 U.S.C.A. § 7264(b):

CHANGES IN CODES OF ETHICS. The Commission shall revise its regulations

ethics.⁵⁷ The implicit assumption is that disclosure to shareholders will deter inappropriate waivers, inducing better compliance with the underlying code of ethics.⁵⁸ But that assumption must be animated by a further assumption that some conduct will be relatively static—that codes of ethics will not themselves be re-written and relaxed in response to the rule. In fact, however, the more likely outcome is that codes of ethics will be (and have been) re-written in order to minimize the need for waivers, in the event actually stemming rather than improving the flow of information. “The disclosure rules will lead companies to make different decisions . . . [a]nd perversely, those decisions may directly undermine the goals of section 406 and of Sarbanes-Oxley more generally.”⁵⁹ In other words, disclosed waivers are (privately) costly, and it may be less (privately) costly to amend codes of ethics than to seek and publicize waivers. Underlying behavior of the sort requiring waivers may not change, or it may even deteriorate. And either way *less* of it will be disclosed.

B. *The Role of Institutional (In)Competence*

Some commentators argue that the benefit of a mandatory disclosure

concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

⁵⁷ SEC Final Rule Rel. No. 33-8177, amending 17 CFR 249.308 (68 Fed. Reg. 5117-18). The rule adds Item 5.05 to Form 8-K, requiring disclosure (within five days) of a description of the nature of any waiver for a firm’s senior officers from the corporate code of ethics.

⁵⁸ The adoption (or non-adoption) of which must also be disclosed (and explained, if a code of ethics is not adopted). Sarbanes-Oxley § 406(a), 15 U.S.C.A. § 7264(a), requires this disclosure, and it is implemented via Items 406(a) of Regulation S-K and Item 16B(a) of Form 20-F. As one commentator puts it, “[t]he theory here is that if Enron had been forced to notify the market that it had waived its code of ethics, the market might have investigated the [suspicious] transactions more closely.” John R. Kroger, *Enron, Fraud and Securities Reform: An Enron Prosecutor’s Perspective*, 76 U. COLO. L. REV 57 (2005).

⁵⁹ Note, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2135 (2003). The author continues:

In light of the new disclosure requirements, general counsel may advise the boards of public companies to draft very narrow codes to avoid ever having any waivers to disclose. The aversion to public disclosure stems from the concern that shareholders and regulators will not give due consideration to the beneficial aspects of otherwise prohibited activities that receive waivers, and consequently, that well-informed decisions to grant waivers will be perceived negatively in the market and, even worse, second-guessed in litigation when hindsight proves those business decisions to be poor ones.

Id. at 2137-38.

regime policed by the SEC is that it permits corporations to make credible commitments, otherwise difficult to come by, with respect to conduct that is difficult to monitor.⁶⁰ But as long as there exist alternative behaviors to those subject to mandatory disclosure, and the value of the new behavior without disclosure outweighs the value of the old with disclosure, no mandatory disclosure regime can deliver *either* full disclosure *or* completely credible commitment. Both high-value and low-value securities issuers may thrive in the regulated environment: The former by disclosing and the latter by evading disclosure. In other words, even a mandatory regime may not impose costs sufficient to enable sorting between types.⁶¹ And in such a case the imposition of costs may be particularly inefficient. The costs of compliance are themselves wasteful, but, in addition, the mandatory regime may garner undeserved credibility, conferring a false imprimatur on malfeasant corporate actors.⁶²

⁶⁰ See Edward Rock, *Securities Regulation As Lobster Trap: A Credible Commitment Theory Of Mandatory Disclosure*, 23 CARDOZO L. REV. 675 (2002); Franco, *Why Antifraud Prohibitions Are Not Enough*, 2002 COLUM. BUS. L. REV. at 277-304 (arguing that “mandatory disclosure performs an important function by enabling candid issuers to provide more credible firm-specific disclosure”). *But see* Easterbrook & Fischel, *Mandatory Disclosure*, 70 VA. L. REV. at 674:

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

The problem of credible commitment is real, but perhaps mitigated fairly well by market mechanisms. Easterbrook and Fischel here mention one. Another is independent organizations with their own reputational capital at stake; another still is advertising or other bonding mechanisms. On the former, see generally Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WISC. L. REV. 227. On the latter see generally, Pauline M. Ippolito, *Bonding and Nonbonding Signals of Product Quality*, 63 J. BUS. 41 (1990).

⁶¹ The underlying argument implies that only truly valuable securities issuers would opt into a costly mandatory disclosure regime, while fraudsters and other low-value issuers would find the regime unattractive. But this logic falls apart if the consequences of the regime can be avoided at relatively low cost through behavioral modification; if, that is, undesirable behavior need not be disclosed even in a purported mandatory regime. *See generally* JAMES D. MORROW, *GAME THEORY FOR POLITICAL SCIENTISTS* 225 (1994) (explaining the mechanics and implications of a separating equilibrium).

⁶² And perceived-effective government protection may crowd out private protections, to the detriment of all. *See, e.g.*, James Andreoni & A. Abigail Payne, *Do Government*

To be sure, in part this hydraulic effect is caused by the SEC's institutional incompetence. Mandatory disclosure of "legitimate" compensation does not necessarily induce disclosure of "illegitimate" compensation, which is the sort about which we worry.⁶³ And, as I have argued, even in the face of market or regulatory punishment, illegitimate compensation will be comparatively more attractive where legitimate compensation is made comparatively more costly. But this does turn in part on the SEC's limited ability to police fraud (to catch and prosecute "illegitimate" compensation via theft or perk-taking)—an ability which could, presumably, be bolstered in the future.

But the institutional problems run deeper. Because the SEC's and investors' interests are not perfectly aligned,⁶⁴ more effective SEC enforcement may be harmful to investors' interests (and, correspondingly, the SEC's failures may in fact inure to the benefit of investors). It is undoubtedly the case that some measure of "illegitimate" compensation is

Grants to Private Charities Crowd Out Giving or Fund-Raising?, 93 AM. ECON. REV. 792 (2003) (finding government grants to private charities reduce fund-raising by such groups).

⁶³ Jeff Gordon has recently proposed strengthening the compensation disclosure regime (which is already fairly robust: *See* Regulation S-K, 17 CFR 229.1 *et seq.*):

Disclosure should be buttressed by amendment to current SEC rules to better report the "bottom line" amounts of various sources of compensation, particularly retirement benefits and deferred compensation, and to update disclosure in light of the anticipated effects of the expensing of options. In particular the SEC should require inclusion in the proxy materials of a "Compensation Disclosure and Analysis" ("CD&A"), signed by members of the compensation committee, that presents bottom line compensation summaries for the senior managers and that provides explanation and justification.

Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'*, J. CORP. L. (forthcoming 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=686464. See also Charles M. Yablon, *Bonus Questions: Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271 (1999). The SEC seemingly agrees with these claims and has proposed more rigorous disclosure rules for executive compensation. *See* SEC Proposed Rule 33-8655 on Executive Compensation and Related Party Disclosure, available at <http://www.sec.gov/rules/proposed/33-8655.pdf>.

⁶⁴ *See, e.g.*, Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 33 (2003):

[T]he SEC may engage in self-serving inferences, choosing to view investors in the light most supportive of the need and importance of the SEC. The SEC's insistence that investor attitudes mirror views among SEC commissioners and staff may lead the agency toward ill-advised regulations. The SEC often uncritically states that it seeks to protect investors—and in particular, that absent the SEC's efforts investor confidence in the market will deteriorate. Rarely, however, does the SEC verify if its assumptions are correct.

See also Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1058 (2000).

desired by investors, either because it is not worth the cost of policing or because, in some instances, it is the most efficient form of compensation.⁶⁵ Any SEC effort to restrict this compensation might, therefore, harm investors. And mandatory disclosure of all compensation elements coupled with more effective SEC enforcement may doubly harm investors: First by imposing reporting costs and by shifting compensation too far toward inefficient sources (which the SEC is unable effectively to police), but also by indiscriminately imposing costs on those (difficult to identify) alternative compensation regimes that are in fact desirable to investors.

So if, on the one hand, SEC enforcement garners more reliable compliance with valuable commitments (and thus more commitments) than we could otherwise expect (because government enforcement is costly and unavoidable⁶⁶), it might improve the market's efficiency. But if compliance with government-required and enforced disclosure exceeds market requirements, or if SEC enforcement deviates significantly from shareholders' enforcement preferences, compliance may be merely costly.

Of course this highlights the hydraulic nature of SEC regulation itself: regulatory efforts will be directed not, necessarily, where most desired by investors, but primarily where the SEC can exercise its comparative competence. Thus some have argued that a mandatory disclosure regime is by its very nature a second-best regulatory regime, perhaps worse even than a purely market-based governance system. Both markets and governments are imperfect, and it is not a foregone conclusion that the particular incompetence of one is better than the other.⁶⁷

⁶⁵ Jensen & Meckling, *The Theory of the Firm*, 3 J. FIN. ECON. at 339:

However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal as a result of this divergence is also a cost of the agency relationship, and we refer to this latter cost as the 'residual loss.'

As I have noted, for the rational shareholder, *optimal* enforcement is not *maximal* enforcement.

⁶⁶ See Rock, *Securities Regulation As Lobster Trap*, 23 CARDOZO L. REV. at 686-691 (explaining how SEC regulation of disclosure is mandatory in two senses and thus "unavoidable").

⁶⁷ See Harold Demsetz, *Information and Efficiency: Another Viewpoint*, in MARKET FAILURE OR SUCCESS: THE NEW DEBATE 107 (Tyler Cowen & Eric Crampton eds., 2002):

The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from the *comparative institution* approach in which the relevant choice is between alternative real

This story does not turn on—but is potentially bolstered by—the informational limitations of both regulators and regulated (and investors).⁶⁸ Regulators are limited in their ability to predict the effects of their regulations, and they are subject to forces that may induce them to turn intentionally from socially-desirable regulation in the first place.⁶⁹ Even well-intentioned regulation is bound to have unintended consequences, some of which may be less-desirable corporate behavior. At the same time corporate actors are also constrained, and even targeted efforts to direct their behavioral responses in the “right” direction may fail.⁷⁰

At the same time, to the extent that market success is a product of systemic forces rather than individual intention, the relatively inefficient firm (which is to say, the relatively less-profitable firm), will tend to fail.⁷¹ If managerial conduct renders a firm less profitable than its peers, it will be punished in the market whether the conduct is clearly detrimental or not.

institutional arrangements.

See also Coase, *The Problem of Social Cost*, 3 J. L. & ECON. at 18. Coase concludes that [t]here is, of course, a further alternative, which is to do nothing about the problem at all [because] the costs involved in solving the problem by regulations . . . will often be heavy [and] it will no doubt be commonly the case that the gain which would come from regulating the actions which give rise to the harmful effects will be less than the costs involved in government regulation.

⁶⁸ See Choi & Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. at 2-6 (describing the various informational shortcomings that both investors and regulators evince). There remains considerable disagreement over the validity and the reach of the behavioral critique, however. For a comprehensive critique of behavioral economic analysis of corporate law, see the articles from the 11th Annual Fall Business Law Forum: Behavioral Analysis of Corporate Law: Instruction or Distraction?, forthcoming in 10 LEWIS & CLARK L. REV. (2006).

⁶⁹ See Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. at 1058:

A welfare economics model that posits legal intervention as a solution to market failure ignores the fact that regulators are themselves actors with their own self-interested motivations. The capital, product, and labor markets give corporate directors incentives to attract capital at the lowest possible cost. Voluntary disclosure thus should be designed to meet specific firm needs relating to monitoring and information transmission. In contrast, the incentives of legislators and regulators are driven by rent-seeking and interest group politics, which have no necessary correlation to corporate profit-maximization. Accordingly, mandatory disclosure is likely to be driven by the political concerns of the governmental actors drafting the mandates.

⁷⁰ See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 30-32 (1985) (explaining that principals and agents are “subject to bounded rationality, whence behavior is ‘intendedly rational, but only limitedly so.’”), Thus a regulatory effort to “correct” these actors’ behaviors may fail by bumping up against those limitations.

⁷¹ For an application of this point to antitrust law, see Geoffrey A. Manne & E. Marcellus Williamson, *Hot Docs vs. Cold Economics*, 47 ARIZ. L. REV. 609, 619-26 (2005).

Because corporate managers are subject to powerful market constraints on their behavior, seriously deleterious activity is unlikely to occur, and those who engage in it are likely to be punished in the market.⁷² Each manager orders his behavior according to his own preferences and motivations, and the “impersonal market system . . . selects survivors: those who realize *positive profits* are the survivors; those who suffer losses disappear.”⁷³

The limitation here, of course, is the case where managerial conduct inures sufficiently to the benefit of the managers that even the expectation of eventual failure in the market is insufficient to outweigh the manager’s gains.⁷⁴ In other words, within the range where managerial behavior is sufficiently insulated from market forces (or effective regulation), even managers responding to market incentives can be expected to engage in some undesirable conduct. At the same time, managers may succeed in hiding their excesses from boards of directors and auditors,⁷⁵ preventing intermediate corrective measures (most notably employment termination).⁷⁶

Adequate regulation may bridge this gap. To the extent that disclosure regulations do make existing forms of malfeasance more expensive, they must tend at the margin to make malfeasance generally more expensive. To

⁷² See, e.g., FRANK H. EASTERBROOK AND DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 6 (1991) (“[S]elf-interested entrepreneurs and managers, just like other investors, are driven to find the devices most likely to maximize net profits. If they do not, they pay for their mistakes because they receive lower prices for corporate paper. . . . The firms and managers that make the choices investors prefer will prosper relative to others.”).

⁷³ Armen Alchian, *Uncertainty, Evolution and Economic Theory*, 58 J. POL. ECON. 211, 213 (1950), *reprinted in* ARMEN A. ALCHIAN, *ECONOMIC FORCES AT WORK* 15, 19-20 (1977).

⁷⁴ See, e.g., Larry E. Ribstein, *Market vs. Regulatory Responses To Corporate Fraud: A Critique Of The Sarbanes-Oxley Act Of 2002*, 28 J. CORP. L. 1, 36 (2003):

On the one hand, agency costs can be associated with agent behavior that is too cautious, as well as with behavior that is too risky from the principal’s perspective. On the other hand, nonowner agents who do not bear even the small burden of failure that is borne by diversified owners might have an incentive to invest the firm’s assets in projects with poor expected returns. Optimal agency contract design involves encouraging the agent to take the owners’ interests into account, but not forcing the agent to bear so much of the firm’s risks that she is more cautious than the owners would want her to be.

But note, also, that to the extent that managers have significant firm-specific investment, they may be overly concerned about the firm’s solvency.

⁷⁵ This is not an argument for more disclosure of the sort the SEC deals in; it is only a recognition that boards are imperfect monitors of managerial behavior. It is clear that shareholders are not in a position to do a better job, even if they did have access to more information. See *infra* notes 132-44 and accompanying text.

⁷⁶ See generally Roman Inderst & Holger M. Mueller, *Keeping the Boards in the Dark: CEO Compensation and Entrenchment*, September 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=811744.

the extent that actors must find “second-best” vehicles for illegitimate compensation or fraud in the wake of regulation, we must suppose that the return on the new vehicle is lower than the return on the old vehicle absent regulation, or else the actor would already have been employing the new mechanism.⁷⁷

C. The Hydraulic Theory of Executive Compensation Disclosure Regulation

Recent attention focused on the size of some corporate managers’ compensation packages threatens to yield regulation aimed, ultimately, at curbing the level of executive compensation by requiring more consistent accounting and expanded disclosure.⁷⁸ Both performance-based (options, bonuses) and non-performance-based (salary and other benefits) compensation are suffering increased scrutiny, but particular attention has been paid to bonuses and other forms of compensation tied to accounting-based performance targets.⁷⁹ If incentive-based compensation comes under increased investor and regulator scrutiny, more managerial compensation may shift into non-incentive-based forms. Many of the proponents of

⁷⁷ There are potential limitations to this story. One important caveat is that if cognitive or other impediments function to artificially restrict the actor’s original choice, the effect of regulation may be to bring to light an otherwise-overlooked, but superior alternative.

⁷⁸ See SEC Proposed Rule 33-8655 on Executive Compensation and Related Party Disclosure, available at <http://www.sec.gov/rules/proposed/33-8655.pdf>. See also Roberta S. Karmel, *Realizing The Dream Of William O. Douglas: The Securities And Exchange Commission Takes Charge Of Corporate Governance*, 30 DEL. J. CORP. L. 79, 100 (2005) (“Perhaps making high-ranking corporate officers individually responsible for a corporation’s financial statements will lead to more accurate and more meaningful financial disclosure. Probably executive greed has become so completely out of control that substantive regulation of executive compensation is the only way to curb management remuneration.”).

⁷⁹ See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE* at 95 (“As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to postretirement payments and benefits as ways to compensate managers.”); *id.* at 102 (“Deferred compensation is a second technique used to transfer large amounts of mostly performance-insensitive value to executives without attracting much shareholder attention.”); *id.* at 109 (“[C]onsulting contracts provide substantial value to retired executives. They usually offer the retiring CEO an annual fee for ‘being available’ to advise the new CEO for a specified amount of time per year. . . . These consulting arrangements provide flat, guaranteed fees . . . rather than payment for work actually done.”). See also Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005).

It must also be noted that even across-the-board scrutiny would seem to “favor” more esoteric forms of compensation. It is difficult to disguise the bottom line of an annual salary whose value must be disclosed; it is far easier to disguise the value of in-kind compensation or complex bonus schemes.

regulation seem to hope and expect, however, that the size of compensation will simply decrease—not that it will be shifted into another form.⁸⁰ And in large part proponents base their expectation on the presumed decoupling of performance and pay, and the assumption that scrutiny will rein in managers' ability to maintain this disconnect.⁸¹ But the evidence supporting these expectations is weaker than its proponents suggest.⁸²

1. Behavioral Hydraulics: Substitution among Types of Compensation

In the abstract, each of the various forms of compensation has independent justification along with related problems. Fixed (i.e., non-performance-based) compensation may drive a wedge between managerial and investor preferences,⁸³ but some measure of fixed compensation clearly induces risk averse, would-be managers to enter the race in the first place by offering a minimum level of secure compensation.⁸⁴ Incentive-based

⁸⁰ See, e.g., GEORGE BENSTON, ET AL., FOLLOWING THE MONEY: THE ENRON FAILURE AND THE STATE OF CORPORATE DISCLOSURE 70 (2003) (“[T]here is at least some prospect that the new NYSE and NASDAQ listing rules, which require shareholders to approve executive compensation packages, will reduce the size of those packages . . .”). See also Public Comments on SEC Proposed Rule 33-8655 on Executive Compensation and Related Party Disclosure, available at <http://www.sec.gov/rules/proposed/s70306.shtml>.

⁸¹ See, e.g., BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE at 65-66 (citing the example of how Jack Welch responded to scrutiny by trying “to protect the approval and esteem he had earlier enjoyed at the expense of his narrow economic interests,” the authors suggest that scrutiny, especially in the form of “outrage,” may constrain executives’ compensation).

⁸² See generally, e.g., Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002); Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615; Tyler Cowen, *Nice Work if You Can Get It*, WALL ST. J., Dec. 23, 2004, at D8; Jeffrey N. Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for ‘Compensation Disclosure and Analysis’*, J. CORP. L. (forthcoming 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=686464; Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990). See also Daniel Akst, “Why Rules Can’t Stop Executive Greed,” NYT (March 5, 2006), available at <http://www.nytimes.com/2006/03/05/business/yourmoney/05cont.html> (“Although more disclosure and pay-for-performance requirements won’t dampen runaway C.E.O. compensation, both are useful for illustrating a larger lesson: that it’s naïve to place too much faith in the power of rules to limit human behavior.”).

⁸³ See Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. at 1634, n. 110.

⁸⁴ See BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE at 19 (“Because the company’s performance will depend on some future factors beyond the executive’s control, tying a manager’s compensation to performance makes the level of compensation uncertain. Managers are generally risk averse—they value a dollar paid with certainty more than they value variable pay with an expected value of a dollar.”)

compensation may induce better performance,⁸⁵ but it also may not.⁸⁶ Perks and other non-pecuniary compensation, finally, may serve to solve the difficult last-stage problem,⁸⁷ but they also facilitate camouflaged extraction of rents by managers.⁸⁸

The problems become more acute if one considers marginal shifts among the types of compensation. Despite justification, moving from performance-based compensation to fixed compensation exacerbates the problem of relatively risk-averse managers. Moving from fixed to performance-based compensation raises the specter of more complex and therefore more easily abused compensation schemes. Inducing a shift from either to perks increases the likelihood of hidden and therefore abused compensation and increases the variance in compensation levels (because amounts are harder to pin down). At the same time, shifting compensation away from perks increases the likelihood of turnover among executives and reduces executives' dependence on continued employment as an agency-cost reduction device.⁸⁹

For simplicity, we may reduce the forms of compensation available to corporate managers into two broad categories: pecuniary compensation (income, stock, stock options, bonuses, etc.) and non-pecuniary or in-kind compensation (prestige, fancy jets, expensive dinners, idiosyncratic work environments, light workloads, etc.). As Armen Alchian has noted, the important distinction between the two types of compensation is that the former may be consumed at home and the latter largely only at work.⁹⁰ As a consequence, in-kind compensation is more restrictive than its pecuniary counterpart,⁹¹ but nevertheless valuable.⁹²

⁸⁵ See, e.g., Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. at 1632 (“It seems unlikely that performance-based compensation schemes deter an executive bent on self-dealing . . . [nor] do much to affect the degree of managerial slack.”); Tyler Cowen, *Nice Work if You Can Get It*, WALL ST. J., Dec. 23, 2004, at D8 (“In any case there is little evidence, as the economist Kevin Murphy has noted, that CEOs perform better even when their pay is closely tied to earnings or other corporate-performance measures.”).

⁸⁶ See BENSTON, ET AL., FOLLOWING THE MONEY at 34-35 (arguing that compensation through stock-price-based incentives can lead to costly accounting manipulations); Lucian Arye Bebchuk, et al., *Managerial Power And Rent Extraction In The Design Of Executive Compensation* 69 U. CHI. L. REV. 751, 824-28 (2002) (“[f]irms take surprisingly few steps to prevent or regulate the unwinding of the incentives provided by the grant of options and restricted stock.”).

⁸⁷ See M. Todd Henderson & James C. Spindler, *Corporate Heroin: A Defense of Perks, Executive Loans, and Conspicuous Consumption*, 93 GEO. L. J. 1835 (2005).

⁸⁸ See, e.g., BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE at 102-109 (describing the ways in which retirement benefits are easily camouflaged).

⁸⁹ See generally Henderson & Spindler, *Corporate Heroin*, 93 GEO. L. J. 1835.

⁹⁰ See generally Armen A. Alchian & Reuben A. Kessel, *Competition, Monopoly and the Pursuit of Money*, in ALCHIAN, ECONOMIC FORCES AT WORK at 151.

⁹¹ *Id.* at 161 (“For the total amount of resources used, these constrained expenditure

Corporate managers (and firms), in determining appropriate pay, choose combinations of compensation that maximize their utility rather than “profits” narrowly defined—meaning at-work compensation will at times and along some margins be more valuable to the manager than pecuniary compensation.⁹³ If the cost to the firm of providing the manager with non-pecuniary pay (say, plush surroundings) is less than the cost of providing the cash compensation he would require in its stead, the profit-maximizing firm will provide the non-cash compensation.

Because the []manager pays for his amenities by accepting a reduction in his implicit managerial compensation he will not consume while on the job unless the cost of doing so, per unit of utility received, is *less* than if he consumed at home. . . . On-the-job consumption, when known, occurs only if there is a utility advantage to consuming at the firm, because the equivalent value in larger take-home pay is more fungible than is on-the-job consumption. If consumption at home is more efficient, then it will not take place on the job . . .

⁹⁴

Thus a shift in the price of non-pecuniary compensation relative to pecuniary compensation should occasion a corresponding shift in the use of each form of compensation. As Armen Alchian and Reuben Kessel note, “whatever [a manager’s] preference patterns may be, the less he must pay for an increase in one [type of compensation], the more it will be utilized. This principle, of course, is merely the fundamental demand theorem in economics”⁹⁵

The relevant question is not whether each form of compensation can be independently justified, but whether the marginal increase in one form of compensation and corresponding decrease in another occasioned by a shift in regulation provides a net gain to shareholders. Unfortunately, the SEC

patterns necessarily yield less utility than the unconstrained.”) There is some spillover here, of course. Some in-kind compensation substitutes perfectly for goods the recipient would have chosen to purchase with the cash compensation, and some perks may, in fact, be consumed outside the workplace. Nevertheless, in-kind compensation is obviously more restrictive than cash compensation.

⁹² *Id.* at 154-56 (citing GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION* (1957)):

[A] person . . . will choose to accept a lower salary or smaller rate of return on invested capital in exchange for non-pecuniary income in the form of, say, working with pretty secretaries, nonforeigners, or whites. . . . Presumably, the known sacrifice of pecuniary income is more than compensated for by the gain in nonpecuniary income.

⁹³ See generally *id.* (urging substitution of a “utility maximization postulate” for the narrower “pecuniary wealth maximization postulate” in assessing institutional behavior).

⁹⁴ Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375, 379 (1983).

⁹⁵ Alchian & Kessel, *Competition, Monopoly and the Pursuit of Money*, in ALCHIAN, *ECONOMIC FORCES AT WORK* at 153.

does not appear to consider the relevant, marginal question. For example, although it is possible to identify abstract justifications for the expanded use of restricted stock grants in executive compensation,⁹⁶ it is not clear that, for any particular company, a regulatory policy that induced such an expansion would be desirable. The broad-brushed nature of federal regulation effectively precludes a firm-by-firm marginal analysis.

2. Pool Hydraulics: Substitution among Types of Managers

By increasing the cost of one form of compensation relative to another, compensation disclosure regulation will have one of two overall effects: A firm may lower total (known) compensation to its managers but maintain the pre-regulatory distribution (among forms of compensation), or a firm may maintain total compensation at about the same level, but alter the *form* of compensation.⁹⁷ The consequences depend ultimately on the utilities of the managers. By assumption, compensation prior to regulation was constructed to maximize manager utility within market limits.⁹⁸ A change (a reduction) in either level or form would price some of these managers out of the market. Assuming a rational and efficient market, the total level will not drop much, but the form may shift. For the firm, although a higher proportion of compensation was paid in pecuniary form pre-regulatory shift, it may be more cost-effective post-regulation to shift more compensation into non-pecuniary forms because they remain more camouflaged even with more disclosure. Some firms and some managers will be better positioned than others to make this shift.⁹⁹

It is of course the case that managers may be consuming more compensation of both or either type than the firm would prefer, but that

⁹⁶ As many have recommended. See, e.g., TIAA-CREF Policy Statement on Corporate Governance: Executive Compensation, available at http://www.tiaa-cref.org/pubs/html/governance_policy/exec_compensation.html (“Equity-based plans should emphasize restricted stock awards. Restricted stock more closely aligns the interests of executives with shareholders . . .”).

⁹⁷ A third possibility—a likelihood, in fact—is that compensation falls *and* the form shifts. Either way, it will be more expensive to maintain utility-maximizing compensation under an alternative regime.

⁹⁸ But, of course, this may not be the case. Bebchuk and Fried have put forth a “managerial power” hypothesis which claims that, for various institutional reasons, managers often capture their compensating boards, and receive compensation well in excess of any market limits. The hypothesis is superficially plausible, but it proves defective under close empirical and theoretical scrutiny. For criticisms, see the articles cited *supra* at note 98.

⁹⁹ Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. at 382 (discussing the difference between types of managers, their comparative working condition preferences, and maximization of firm value by owners).

managerial control prevents the firm from adopting the appropriate remedy (whether through disclosure or direct governance). But then the question is whether mandatory disclosure will help, or only alter the form of compensation further away from public scrutiny, at greater cost.

As the contours of the managerial playing field shift in response to regulation, the pool of potential participants will shift, as well. As disclosure regulation marginally reduces the value to existing executives of their amended pay packages, some of them will exit the workforce and the market for managers. At the same time, as disclosure regulation makes non-pecuniary compensation and at-work consumption more valuable relative to cash or stock-based compensation, it attracts into the managerial ranks those who have a comparative advantage in maximizing the value of non-pecuniary compensation.

I hypothesize that there are, broadly speaking, two classes of prospective corporate managers: “peculiarists” and “non-peculiarists.” Some people have a comparative advantage in taking compensation in pecuniary form; but there must also be people who are comparatively better than others at deriving utility from non-pecuniary sources.¹⁰⁰

The existence of alternative business organizations (meaning different capabilities for monitoring employee behavior) implies a predictable self-selection process, in which managerial talent (of a given quality) with a taste for on-the-job consumption will tend to manage firms that have chosen a high-monitoring-cost organization.¹⁰¹

This may be because they are better at convincing boards of the “necessity” of non-pecuniary compensation, because they enjoy more than average the sorts of perks obtained through non-pecuniary compensation, or because they are more successful in camouflaging illicit compensation. Regardless of the reason, however, the effect on the pool is the same: Those potential managers who perceive that they have a comparative advantage in receiving utility from non-pecuniary compensation will be more likely to enter the managerial market and, at the same time, potential managers with a comparative disadvantage in receiving utility from non-pecuniary compensation will be induced to exit.

The net result is not, in the first instance, a shift in the *efficiency* of firms except perhaps insofar as the shift increases the likelihood of

¹⁰⁰ “[P]articular employees may have a comparative advantage in the ‘art’ of shirking.” Harold Demsetz, *Agency and Nonagency Explanations of the Firm’s Organization* in HAROLD DEMSETZ, *THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES* 26 n. 13 (1997). The point is not that anyone prefers *all* non-pecuniary compensation. Rather, the point is that, at the margin, some people are better than others at deriving utility from non-pecuniary sources.

¹⁰¹ Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. at 384.

turnover.¹⁰² But there should be some shift in the characteristics of corporate managers. With what consequences?

This effect may or may not be socially harmful. It is impossible to infer from the mere existence of at-work compensation or any other form of compensation that a firm is not profit maximizing, and it is perhaps the case that firms systematically underestimate the retention benefits of payment in-kind and immediately-consumed compensation.¹⁰³ Perhaps the employment histories, management styles, education and other characteristics of those executives who excel at at-work consumption correlate—unbeknownst to firms—with more effective management and higher returns. It may be the case that, *ex post*, continuity is improved and agency costs decreased along with more in-kind compensation. Alternatively and more likely, however, the effects may be costly.

In the first place, the characteristics of the non-pecuniarist might be expected to translate, on average, to the detriment of the corporation. Non-pecuniarists are likely to be relatively interested in shirking and, in general, distracted at work.¹⁰⁴ This should inure to the detriment of the corporation.

Moreover, by making pecuniary compensation less desirable, it is surely the case that pecuniary compensation would be reduced. And presumably this is the desired result of those arguing for more intrusive regulation of executive compensation. But this does not, in and of itself, mean that total compensation will be reduced. Rather it means that some compensation will migrate from pecuniary to non-pecuniary forms:

If wealth cannot be taken out of an organization in salaries or other forms of personal pecuniary property, the terms of trade between pecuniary wealth and nonpecuniary business-associated forms of satisfaction turn against the former. More of the organization's funds will now be reinvested . . . in ways that enhance the manager's prestige or status in the community. Or more money can be spent for goods and services that enhance the manager's . . . utility.¹⁰⁵

¹⁰² Turnover can be costly, as continuity can be beneficial, although entrenchment might impose costs at the other end of the spectrum. *See infra* notes 117-19 and accompanying text.

¹⁰³ *See* Henderson & Spindler, *Corporate Heroin*, 93 GEO. L. J. 1835 at 31-33 (describing how perks serve to keep employers in the firm because in-kind payment “is a little bit like paying them in heroin: it delivers a tremendous amount of utility in the short term, none of which can be saved until later periods,” hindering managers from retiring sooner than optimal from the firm's perspective).

¹⁰⁴ Because in-kind compensation is less flexible than cash compensation, it is often consumed “at-work.” In the classic conception, such in-kind, at-work consumption might take the form of expensive buildings and furniture, excessive “corporate” philanthropy, reduced work load, intentionally-attenuated oversight, etc. To the extent, then that in-kind compensation is consumed at work, its consumption may come at the expense of a manager's attention to his work.

¹⁰⁵ Alchian & Kessel, *Competition, Monopoly and the Pursuit of Money*, in ALCHIAN,

This is premised on the assumption that the market for corporate managers is a relatively rational one—that managers are rewarded in a competitive market largely in accordance with their perceived productivity.¹⁰⁶ But this assumption may not be warranted. And if it does not hold, it is possible that a restriction on pecuniary pay will not result in an increase in non-pecuniary pay. That is, if compensation is proved by disclosure to be excessive, and managers have been successful at commanding above-market returns on their human capital, it is not necessarily the case that they will be as successful in rent seeking through non-pecuniary means. Rather, the heightened scrutiny, the inertia-overcoming regulatory shock and the relative complexity of non-pecuniary compensation could result in a net reduction in management compensation without, even, a corresponding efficiency loss (in other words, the effect might be merely a redistribution from managers to owners).

Regardless, however, the existence of a mandatory disclosure regime means that, on the margin, only those potential managers who place a relatively high value on non-pecuniary compensation will compete effectively for management positions. Potential managers who place a relatively high value on pecuniary (now lowered) compensation are priced out of the market because the explicit salaries they require are too difficult to maintain in the face of their disclosure.¹⁰⁷

A further complication here is the likely shift from more-legitimate to less-legitimate compensation. As sufficiently-large legitimate (and largely pecuniary) compensation becomes harder to maintain in the face of regulatory and public scrutiny, it is more likely not only that less transparent forms of legitimate compensation will arise, but also that more compensation will take illegitimate forms (with, presumably, a heavy emphasis on the non-pecuniary). To the extent that it is more expensive for both managers and directors to set compensation legitimately, directors may choose, instead, to permit more unauthorized compensation by policing it

ECONOMIC FORCES AT WORK at 161.

¹⁰⁶ See, e.g., Charles P. Himmelberg and R. Glenn Hubbard, *Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity* at 3-4, working paper (2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236089 (claiming that higher CEO compensation is related to perceived productivity and the relative supply inelasticity of talented CEOs, and is not necessarily a market failing).

¹⁰⁷ Remember, we assume that non-pecuniary compensation is easier to hide (in part because it may appear as a firm-wide benefit (say, a new building)) and that forces of outrage or the like will, as proponents contend, reduce disclosed pecuniary compensation. This latter point is, however, somewhat contentious. See *infra* notes 47 and 81 and accompanying text.

less.¹⁰⁸

It is worth pointing out that in-kind, at-work consumption may not impose direct costs on the firm. To some degree, at-work consumption is incidental to employment and other compensation, and neither significantly monitored, accounted for, nor paid by firms themselves. For example, the prestige associated with highly-remunerative executive employment is a form of compensation which is neither paid by nor (likely) monitored by firms. In fact, the desire by managers to receive these psychic benefits will inure to the *benefit* of the firm, at least to the extent that they are correlated with the firm's success.¹⁰⁹ And we should expect similar benefits accruing to the firm from an executive's social connections, increased self-confidence and other forms of so-called "psychic income."¹¹⁰

But there may be a deleterious side to these forms of compensation, however. Unauthorized consumption in the form of shirking and perk-taking impose well-known costs on the firm.¹¹¹ But likewise psychic, at-work consumption may impose costs. There may be a conflict between the behavior conducive to the firm's interest and that necessary to capitalize on psychic income. For example, social distance among colleagues may to

¹⁰⁸ It is not clear, however, whether abstaining from monitoring is a winning proposition for boards, especially given post-Sarbanes-Oxley attention to internal controls and the ambiguities of the Disney litigation. See Sarbanes-Oxley Act of 2002 §404 (2002); *In re The Walt Disney Co. Derivative Litigation*, No. Civ. A. 15452, 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).

¹⁰⁹ See, e.g., Bainbridge, *Executive Compensation: Who Decides?*, 83 Tex. L. Rev. at 1632 (suggesting that executives are "motivated principally by other concerns such as ego, reputation, and social-effort norms"). See also James A. McConvill, *Executive Compensation in Contemporary Corporate Governance: Why Pay for Performance is a Flawed Methodology*, working paper (May 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723521.

¹¹⁰ See Lester C. Thurow, *Psychic Income: Useful or Useless?*, 68 AM. ECON. REV. 142 (1978).

¹¹¹ Although it is important to note that the costs of shirking born by the firm may be a cheaper form of compensation than the alternatives, and doubtless some shirking is an implicit (if not explicit) part of considered executive compensation. See Jensen & Meckling, *The Theory of the Firm*, 3 J. FIN. ECON. at 339:

The reduced value of the firm caused by the manager's consumption of perquisites . . . is 'non-optimal' or inefficient only in comparison to a world in which we could obtain compliance of the agent to the principal's wishes at zero cost or in comparison to a hypothetical world in which the agency costs were lower. But these costs (monitoring and bonding costs and 'residual loss') are an unavoidable result of the agency relationship. Furthermore, since they are borne entirely by the decision maker (in this case the original owner) responsible for creating the relationship he has the incentives to see that they are minimized (because he captures the benefits from their reduction). Furthermore, these agency costs will be incurred only if the benefits to the owner-manager from their creation are great enough to outweigh them.

some extent impair the effectiveness of hierarchical management. But distance (superiority) is a source of psychic consumption for many, and one surely actively cultivated by some.¹¹² Likewise managers who consume “dominance” over their subordinates surely often do so at the company’s expense.¹¹³

But the larger problem is also the more subtle one. For it is not the case that the value to the executive of psychic income is independent of his own actions. Quite the contrary; the recipient may actively cultivate the conditions that enable the maximization of psychic income *at the expense of the firm* (a form of rent seeking). In the first and most obvious instance this effort entails shirking: Time spent cultivating social capital may not provide returns for the firm and is thus time not spent working for the firm’s benefit. At the same time, the return on this effort makes the *value* of shirking to the shirker correspondingly greater, thus encouraging more shirking, reducing the returns to bonding and inducing more expenditure by the firm to prevent it. Firms are not without the ability to encourage the beneficial aspects of psychic consumption and to deter the deleterious, but it is costly to do so.

And managers’ efforts to maximize psychic income may also tax the firm in still more subtle ways. The executive who effectively bolsters his reputation may become more attractive in the market for managers, leading to a decreased probability of retention, the threat of discontinuity¹¹⁴ and higher real compensation. Hubris derived from self importance may lead to increased fiduciary litigation (and/or increased D & O insurance premiums) both because the manager is in fact more likely to breach duties and because he may be a more attractive or identifiable litigation target.¹¹⁵ Similarly problematic is the phenomenon of “benchmarking,” through operation of which executives’ efforts to position themselves ahead of their peers leads

¹¹² See, e.g., *Inconspicuous Consumption*, THE ECONOMIST, Dec 24, 2005, p. 66 (discussing how in an attempt to maintain their class status as the super-rich, some high-earners are buying private jets not for their conspicuousness but for their distancing effect from the “masses . . . stuck . . . in a[n] [airport] security line.”).

¹¹³ Demsetz, *The Structure of Ownership*, 26 J. L. & ECON. at 383 (describing Henry Ford).

¹¹⁴ See *infra* notes 117-19 and accompanying text. Continuity in management may be inherently valuable to the firm and thus a manager’s attractiveness in the market may command additional compensation above and beyond the manager’s perceived value to the firm *qua* manager.

¹¹⁵ See Troy A. Paredes, *Corporate Decisionmaking: Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, And Corporate Governance*, 32 FLA. ST. U.L. REV. 673, 674 (2005) (explaining that CEO hubris (“overconfidence”) exists because “people in powerful and influential positions with track records of success—qualities that typify CEOs—might particularly be overconfident and prone to believe that they are in control”).

to compensation creep,¹¹⁶ thus providing ever-increasing return on efforts to jockey for position.

And finally, to the extent that disclosure regulation does lead to turnover (substitution from pecuniarist to non-pecuniarist managers) it may be inherently costly. There is a value in continuity, and “[i]t is efficient in many instances of teamwork to avoid switching personnel, not (only) because of transaction cost or opportunistic behavior but because task performance would be compromised.”¹¹⁷ In fact, this can go some way toward explaining seemingly-extravagant executive compensation. Part of compensation may be a pecuniary transfer from shareholders to executives equal to (or less than) the cost of discontinuity. Similar reasoning might explain some portion of takeover premiums, as well.

And in this context it also helps to explain the perceived one-way ratchet of executive pay.¹¹⁸ The value of continuity increases with longevity. Whether or not executive pay is tied to some observable performance measure, it should increase over time to reflect the increasing value of continuity. But because the value of continuity is in large measure a function of the length of tenure rather than the expenditure of effort, it is

¹¹⁶ See, e.g., D. Gordon Smith, *Yipee! More Executive Compensation Disclosure is on the Way!*, Conglomerate Blog (January 10, 2006), available at http://www.theconglomerate.org/2006/01/_yipee_more_exe.html:

If you don't remember the last time the SEC attacked executive compensation, it happened in 1992. The SEC mandated more transparent disclosure of executive compensation, which caused an immediate outbreak of *compensation envy* among America's business elite. The remedy for compensation envy—prescribed, strangely enough, by those most afflicted—was additional compensation, which had the perverse effect of transferring the malady to other executives. The result has been an upward spiral of executive compensation in the United States. (The process of comparing CEO pay is called “benchmarking.”)

See also Daniel Akst, “Why Rules Can't Stop Executive Greed,” NYT (March 5, 2006), available at <http://www.nytimes.com/2006/03/05/business/yourmoney/05cont.html> (“Any benefit from shining the cleansing light of day on executive greed will probably be outweighed by the inflationary effect of additional disclosure, which will provide more ammunition for executives and consultants seeking to justify additional increases.”)

¹¹⁷ Harold Demsetz, *Agency and Nonagency Explanations of the Firm's Organization* in DEMSETZ, *THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES* at 21.

¹¹⁸ See BEBCHUK & FRIED, *PAY WITHOUT PERFORMANCE* at 71-72. Bebchuk and Fried explain the phenomenon of “ratcheting” in executive compensation as one where “CEOs who were initially paid below the median amount received larger than average pay increases, in both percentage and absolute terms, even when their firms had worse accounting and stock price performance.” The authors refer to a study by Kim Clark, Dean of Harvard Business School, who calls ratcheting the “Lake Wobegon effect” because “in Lake Wobegon everybody is above average[,] [a]nd in a lot of companies the way the system works is most CEOs want to be at the 75th percentile ... of compensation.”

fairly sticky. A decrease in stock price which might reflect poor performance over time should not directly decrease executive pay because some pay is compensation for tenure rather than performance. Of course the executive's ability to capture this surplus must be dependent in part on his performance, and it is not at all surprising that there is *some* correlation between poor performance and decreasing compensation.¹¹⁹

TOO MUCH DISCLOSURE: THE COSTS OF INFORMATION

A. The Limited Benefits of Information Disclosure

Despite regulatory claims to the contrary, most of the information contained in mandated disclosures is of limited benefit to its intended recipients.¹²⁰ Although the SEC focuses on the importance of information for ordinary investment decisions, ordinary investors are rationally uninterested in such information.¹²¹ It is well-known that stockholders are relatively uninformed and apathetic in their roles as "owners" of public companies: Small stakes, diversification and attenuated influence render the acquisition and use of most firm-specific information far more costly

¹¹⁹ See John E. Core, et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. at 1174:

Table Two illustrates the magnitude of equity incentives held by U.S. CEOs relative to their pay. The Table shows data on annual compensation and beginning-of-year portfolio value and incentive data for S&P 500 CEOs from 1993-2003 [W]e measure incentives as the increase (decrease) in the value of the CEO's stock and option portfolio that occurs when the stock price increases (decreases) by 1%. . . . Thus, . . . these CEOs can lose large amounts of their wealth when prices fall. Note that this \$8.6 million decrease is larger than the median CEO's pay for 2003 of \$6.6 million

¹²⁰ See, e.g., HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* at 86-7 ("If a market layman or an unsophisticated market professional determined from [disclosed] documents that a security were under-valued, he might or might not be wrong on the facts, but in any event he would be wrong on the timing.").

¹²¹ Rational voters are apathetic and ill-informed both for purposes of voting and for investing. On voting, see, for example, Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. at 402 ("When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1439-44 (1964). On investing, see, for example, Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J. L. & PUB. POL'Y 671, 696 (1995) ("Efficient capital markets theory and portfolio theory, which have become reasonably well-accepted in the investment community, argue strongly for a highly passive approach to investing. Indeed, their logical implication is that the best investment approach is passive indexing, a strategy now widely followed by individual and institutional investors.").

than they would be worth.¹²²

Moreover, the pragmatic value of the information disclosed subject to securities regulation may be quite low.¹²³ First, adherence to the standards of accounting can restrict an auditor's ability accurately to describe financial conditions for the sake of the standard's uniformity.¹²⁴

Second, accounting information employed ex post for the benefit of the investing public may have been created in the first place using a different metric and for a very different purpose. Managers and executives use rough-hewn accounting data to facilitate internal cost allocations, for example. This information is included in its required disclosures, ostensibly for the benefit of well-informed investment decisions.¹²⁵ But the divergence between the accounting assumptions inherent in each intended purpose may make the information of limited use to investors. In other words, the information need not be wrong for it to be misleading. "In particular, the assumptions made by an accountant in amassing, assessing and presenting [] data for investors . . . yield results different than those that they would obtain with different assumptions."¹²⁶

¹²² As one commentator notes, commenting on the SEC's executive compensation proposal, "[w]hat the proposals assume is irrational non-apathy." Larry Ribstein, "The SEC's Compensation Proposal," Ideoblog (January 18, 2006), available at http://busmovie.typepad.com/ideoblog/2006/01/the_costs_of_ex.html

¹²³ See generally, Manne & Williamson, *Hot Docs vs. Cold Economics*, 47 ARIZ. L. REV. 609 (2005).

¹²⁴ "[C]ompulsory uniformity of standards or detailed rules constrains managers' ability to 'best' convey their superior knowledge about the past, present, and future. Restricting [the manager's] choice to a single method or even to a specific menu of such methods limits his ability to convey truthful information if he has incentives to do so." Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J. L. BUS. & FIN. 39, 62 (2002). See also William T. Baxter, *Accounting Standards: Boon or Curse?*, Saxe Lecture (1979) (available at http://newman.baruch.cuny.edu/digital/saxe/saxe_1978/baxter_79.htm. ("Accounting figures are not docile, and do not lend themselves to standardization. Industries differ from one another. So do firms within an industry (or, very likely, straddling several industries). The same firm may change from year to year. And the needs of users vary.")).

¹²⁵ Regulation S-K, 17 C.F.R. 229.10(e)(1)(i)(A)-(B); See also David S. Ruder et al., *The Sec At 70: The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1135-36 (2005) (explaining the requirements of Regulation S-K); George J. Benston, *The Regulation Of Accountants And Public Accounting Before And After Enron*, 52 EMORY L.J. 1325, 1336 (2003).

¹²⁶ Manne & Williamson, *Hot Docs vs. Cold Economics*, 47 ARIZ. L. REV. at 628. The divergence may be not only a function of legitimate, divergent assumptions and accounting methods, but may also arise from manipulation. See, e.g., George J. Benston, *The Validity of Profits-Structure Studies with Particular Reference to the FTC's Line of Business Data*, 75 AM. ECON. REV. 37, 40 (1985) ("[I]t may be that executives who manage lines of business with large market shares are compensated, in part, with a share of accounting

Furthermore, because accounting data bears a tenuous relationship to economic reality,¹²⁷ interpreting the economic significance of even correctly-focused accounting numbers can be tricky, even for experts.¹²⁸ As one prominent critic of the securities disclosure regime has noted, “differences between accounting measures and economic market values are likely to be significant and very difficult (in many important instances, impossible) to determine.”¹²⁹

B. The Affirmative Costs of Information Disclosure

Mandating disclosure, at least if penalties for non-disclosure are effectively administered, has the effect of removing an important signal from the market.¹³⁰ Although such signals are difficult to interpret, in an environment where the *fact* of disclosure can reveal information (about, for example, the firm’s own assessment of the likelihood that its practices would be absorbed without incident by its shareholders or the investing public), removal of the choice to disclose or not also removes the signal. As with other potential costs outlined in this article, it is surely the case that the value of information forcibly disclosed may outweigh the lost value of the informational signal.¹³¹ But mandatory disclosure carries with it less ambiguous information costs, as well.

profits. In a particular year, they (and their bosses) may find it desirable to show larger profits.”).

¹²⁷ See generally, Franklin M. Fisher & John J. McGowan, *On the Misuse of Accounting Rates of Return to Infer Monopoly Profits*, 73 AM. ECON. REV. 82 (1983); George J. Benston, *Accounting Numbers and Economic Values*, 27 ANTITRUST BULL. 161 (1982).

¹²⁸ But this does not mean the data are useless, of course, and experts do attempt the mental calculations necessary for interpretation, and firms do use accounting data for internal purposes. See, e.g., Benston, *Accounting Numbers and Economic Values*, 27 ANTITRUST BULL. at 211-15.

¹²⁹ Benston, *Validity of Profits-Structure Studies*, 75 AM. ECON. REV. at 39. See also ALCHIAN & ALLEN, UNIVERSITY ECONOMICS at 291 (“Regardless of what the accountant does, we must not take his final figure for ‘profits or net earnings’ to be a measure of the actual change in value of wealth.”) (emphasis in original).

¹³⁰ George J. Benston, *Regulation of Stock Trading: Private Exchanges vs. Government Agencies*, 83 VA. L. REV. 1501 (“[T]he incentive for companies is to publish financial data to reduce their current and potential investors’ costs or the ‘signaling’ incentive, whereby a company that does not disclose might be seen as hiding negative information compared to companies that do.”).

¹³¹ And of course each is affected by the applicability of mechanisms to ensure accuracy in disclosures. Thus to the extent the information disclosed may be harmful, mandatory disclosure carries with it a greater likelihood of (i.e., greater payoff to) false or misleading disclosures, but the signal inherent in a voluntary disclosure can also be clouded by the possibility that even information voluntarily disclosed is false.

1. Corporate Governance and the Cost of Information

An important point, often overlooked in the disclosure debates, regards the role of disclosure in internal corporate management and accountability, and the problem for governance of “information overload.”¹³² The problem is the traditional lemons problem.¹³³ Managers determine the extent, form and contours of accountability information taking account of the cost of production, the value of the data and, importantly, the quality of the information. Requiring the disclosure of substantial quantities of additional information corrodes the decisionmaking value of information as managers find it more difficult to distinguish between useful and useless information.

Investors, too, of course, would prefer optimal rather than maximal production of accountability information. In the first place, they bear the increased direct costs of the production of a greater volume of material. At the same time, they bear the consequences of relatively inefficient management resulting from managers’ costly efforts to attempt to separate useful from useless information, along with the residual cost of managers’ failure successfully to do so.

Troy Paredes explores the problem of cognitive limitations from the point of view of *investor* decisions.¹³⁴ But the problem is both more acute and more subtle from the point of view of internal accountability. It is more acute because the consequences of overload are not mitigated by a market (where more choice is better than less, not because each individual needs more information than less, but because each individual needs different information). It is more subtle because the overload problem stems not only

¹³² See Paredes, *Blinded by the Light*, 81 WASH. U. L. Q. 417.

¹³³ Essentially, the problem is one of asymmetry of information. George Akerlof famously explained this phenomenon using the example of the used car market, which he dubbed the “lemons problem”:

After owning a specific car, however, for a length of time, the car owner can form a good idea of the quality of this machine; i.e., the owner assigns a new probability to the event that his car is a lemon. This estimate is more accurate than the original estimate. An asymmetry in available information has developed: for the sellers now have more knowledge about the quality of a car than the buyers.

George Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

¹³⁴ Paredes, *Blinded by the Light*, 81 WASH. U. L. Q. at 419:

The net result of having access to more information, combined with using a less accurate decision strategy as the information load increases, is often an inferior decision. In other words, people might make better decisions by bringing a more complex decision strategy to bear on less information than by bringing a simpler decision strategy to bear on more information. Borrowing Brandeis’ terminology, in addition to being a disinfectant, sunlight can also be blinding.

from increased volume but also from the complication that information produced for one purpose (SEC-required mandatory disclosure for investors) is difficult for others (managers) to separate and to ignore.

At the same time that disclosure of “too much” information can impose decision-making costs on appropriate decision-makers, it can also impose costs on *inappropriate* decision-makers. This criticism fundamentally challenges the stated goals of the SEC’s disclosure regime, the provision of information for well-informed investing by individual shareholders. It is precisely individual shareholders who are *not* in a position to evaluate complex information regarding, for example, executive pay packages. But it is also precisely these individuals at whom mandatory disclosures are directed.¹³⁵ As a result of such disclosures, shareholders will surely waste resources digesting unhelpful information.

But even more problematically, they may use resources in an effort to influence corporate decision-making if they perceive that the disclosed information merits a response.¹³⁶ The limits on shareholder action and influence in large, publicly-held corporations remain, of course.¹³⁷ But the rise of institutional investors (and, more recently, hedge funds), along with increasing efforts to provide shareholder access to corporate proxies,¹³⁸ combine with cheap information to increase the influence of shareholders on corporate decisions. The danger is that the lower cost of access will induce increased expenditure, even though the *benefits* of influence do not increase correspondingly.¹³⁹

¹³⁵ See *supra* note 21 and accompanying text.

¹³⁶ As noted, however, investor perception that disclosed information merits response is likely ill-informed.

¹³⁷ “In general, shareholders of public corporation[s] have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation’s agents.” BAINBRIDGE, CORPORATION LAW AND ECONOMICS at 37.

¹³⁸ See Securities and Exchange Commission, Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Release No. 34-48301 (Aug. 8, 2003) available at <http://www.sec.gov/rules/proposed/34-48301.htm> (“Under the proposals, we would expand the disclosure that is currently required in company proxy or information statements regarding the functions of a company’s nominating committee.”). See also Securities and Exchange Commission, SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors (Dec. 2004), available at <http://www.sec.gov/news/press/2004-176.htm>. But see Brett McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=659322 (forthcoming Berkeley Business Law Journal).

¹³⁹ See, e.g., Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. at 419-21 (criticizing the inference that “if some voting is good, more disclosure and more voting must be better still”).

Firms competing for investment dollars make intentional and competitive governance choices. And just as firms choose the extent to which corporate directors and managers will monitor agents or subordinates, firms also choose a suitable level of available monitoring by shareholders.¹⁴⁰ The dynamic is slightly different; firms cannot generally control what shareholders will do if granted access to firm information, so rather than controlling the *level* of shareholder monitoring, firms must control the *level of access* in order to ensure that the appropriate level of monitoring is not exceeded.¹⁴¹ Firms in different situations will find different degrees of shareholder involvement to be competitively advantageous, and they may rationally choose levels of disclosure partly calculated to deter shareholder participation. Removing that deterrence makes monitoring more likely—to the detriment of some firms.

Disclosure regulation is premised on the notion that more monitoring—or at least the availability of more monitoring—by shareholders and gatekeepers is preferable for all firms. This is demonstrably false, and disclosure-induced expenditure of resources on shareholder monitoring may be bad for some firms.¹⁴² At the same time, without limitations imposed by corporations or by law, the classic collective action dynamic nevertheless

¹⁴⁰ See Easterbrook and Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. at 402 (1983) (“Because voting is expensive, the participants in the venture will arrange to conserve on its use.”).

¹⁴¹ In other words, firms (and their shareholders) engage in “hands-tying,” an effort to remove from shareholders ex ante the temptation and the ability to intervene when they might exercise it ex post. The concept of hands-tying as a commitment strategy originates in THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* (1960). It is well-developed in Schelling’s essay, “Strategies of Commitment,” in THOMAS C. SCHELLING, *STRATEGIES OF COMMITMENT AND OTHER ESSAYS* (2006):

I use “commitment” to mean becoming committed, bound, or obligated to some course of action or inaction or to some constraint on future action. It is relinquishing some options, eliminating some choices, surrendering some control over one’s future behavior. And it is doing so deliberately, with a purpose. The purpose is to influence someone else’s choices. Commitment does so by affecting that other’s expectations of the committed one’s behavior.

See also Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PENN. L. REV. 667 (2003).

¹⁴² See Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. at 419-21 (arguing that the “behavioral assumptions underlying [disclosure] rules are . . . not supported by any evidence”). While *some* level of disclosure and monitoring may be necessary for all firms, they surely exhibit diminishing marginal returns, just like everything else. See generally ALCHIAN & ALLEN, *UNIVERSITY ECONOMICS* at 391-93. Finally, corporations exhibit and profit from specialized, centralized decisionmaking. “[G]reater accountability necessarily makes the decisionmaking process less efficient, while highly efficient decisionmaking structures necessarily entail nonreviewable discretion.” BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* at 199.

suggests that too much monitoring might occur anyway.¹⁴³ And although corporations have substantial leeway in foreclosing direct avenues of governance to their shareholders,¹⁴⁴ restricting or controlling information may be the most effective way to direct shareholder participation.

2. Market Costs: Efficient Markets and Information

A related criticism of expansive disclosure regulations is that users of information (including regulators as well as investors) are constrained—boundedly rational—in their ability to know what information is useful to them and how to use the information they receive to make optimal decisions.¹⁴⁵ These criticisms undoubtedly have some truth to them, and it is particularly important to bear in mind the regulators’ limitations when assessing the desirability of regulations. But at the same time, behavioral economics does not yet yield sufficiently-robust predictions to rely on it in policymaking.¹⁴⁶

But it is not clear that, even if accurate, such theories would have much bearing on the question of optimal disclosure regulation. The standard line has it that securities markets are efficient—if they are—because a multitude of investors, each making her investment decisions on the basis of her informed assessment of the relevant information and her knowledge of background economic conditions, bring diverse bits of information to bear

¹⁴³ This may seem paradoxical, for usually collective actions problems are held to suggest that shareholders rationally *under*-invest in information gathering and monitoring. But here the problem is the familiar coordination problem. As long as shareholders have an incentive to invest *something* in these activities—particularly in the world of securities class actions—where their actions cannot be coordinated, there is the risk of over-investment. Moreover, the problem (if coupled with a lawsuit) can arise from even a single enthusiastic investor. So although shareholders may each under-invest on average, even a few forays by a few investors may be quite costly. The point is not that shareholders engage in lots of monitoring; it is, rather, that they engage in more than the optimal level (likely around zero), given specialization, bounded rationality and other market constraints.

¹⁴⁴ For example, corporations typically restrict (as much as the law allows) shareholder access to proxies and shareholder voting. Mere monitoring without these avenues of input may be relatively fruitless.

¹⁴⁵ See Bainbridge, *Behavioral Economics*, 68 U. CIN. L. REV. at 1056 (“[R]egulators must be treated as actors with their own systematic decision-making biases.”); Choi & Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. at 24 (“The SEC’s inability to assess all market risks and prioritize among them (due to the bounded capabilities of the agency staff and commissioners) may help explain the SEC’s difficulties in grappling with problems in the financial markets.”).

¹⁴⁶ See, e.g., Papers from Lewis & Clark Symposium, 10 LEWIS & CLARK L. REV. (forthcoming, 2006); Bainbridge, *Behavioral Economics*, 68 U. CIN. L. REV. at 1059 (counseling caution and noting that “[a]s applied to U.S. capital markets, behavioral economics appears to offer little or no support for the mandatory regime”).

on securities prices until the price reflects all or most available information.¹⁴⁷ On this theory, “[c]areful accumulation and skilled interpretation of . . . information is said to be the *sine qua non* of accurate evaluation of securities.”¹⁴⁸ But, in fact, it may be that traders need very little in the way of “accurate” information or unbiased decisionmaking in order to produce an informationally-efficient market. Rather, accurate stock prices may be obtained with a large enough number of traders, self-interest and well-distributed, even if inaccurate, information.¹⁴⁹ If this is so, putative cognitive problems might have little effect on the ultimate accuracy of share prices.¹⁵⁰

And at the same time, for most investors, the relevant trading information is contained in the stock price, along with some background macroeconomic assumptions.¹⁵¹ So while it is true that share price information is “based, in part, on the information provided in financial

¹⁴⁷ See generally BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 190-95 (7th ed. 1999).

¹⁴⁸ Paul Slovic, *Psychological Study of Human Judgment: Implications for Investment Decision Making*, 27 J. FIN. 779, 779 (1972).

¹⁴⁹ See Robin Hanson, *Combinatorial Information Market Design*, 5 INFO. SYSTEMS FRONTIERS 107 (2003) (explaining how financial markets are aggregates of information that create accurate price estimates, even though the participants operate under uncertainty and speculation). For example, if a price is an average of all active traders’ estimations of a security’s value, even if not a *single* trader has accurate information, a security’s price might be quite accurate. See JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES AND NATIONS* (2004). As Henry Manne has it,

[t]he [price formation] mechanism might also include the pure gamblers and technicians who previously were thought to add nothing to the efficiency of the market other than a ‘way in or out’ (liquidity) for their betters (‘fundamentalists’) who had ‘real’ information. Oddly under this approach the least useful traders in making a market efficient will be the pure investors, since they presumably only trade in order to balance or adjust portfolios, and they do not even purport to have any new market information.. They are true ‘price takers.’”

Ideoblog, December 20, 2005, available at http://busmovie.typepad.com/ideoblog/2005/12/toward_a_theory.html.

One recent article presents a model of price formation in binary-contract information futures markets and finds that “while prediction market prices and mean beliefs may diverge, they are typically very close.” Justin Wolfers & Eric Zitzewitz, *Interpreting Prediction Market Prices as Probabilities*, NBER Working Paper No. 10359, available at <http://bpp.wharton.upenn.edu/jwolfers/Papers/InterpretingPredictionMarketPrices.pdf>.

¹⁵⁰ See Robin Hanson, *Decision Markets*, 14 IEEE INTELLIGENT SYS. 16, 18 (1999), reprinted in ALEXANDER TABARROK, *ENTREPRENEURIAL ECONOMICS* 79 (2002). Other implications would follow, as well. The fundamental justification for the entire range of disclosure-related regulations would come into question, for example.

¹⁵¹ See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

reports,¹⁵² inaccuracy in this information may be less harmful than some contend; it is enough that some traders have accurate information (insiders, for example) or an estimate of *how much* mis-reporting is in financial reports so that these error estimates are incorporated into the stock price.¹⁵³

Regardless of the mechanism by which information is incorporated into price, there is an argument that some disclosure regulations, in a misguided effort to broaden the scope of disclosure, actually impair the overall quality of public information. In particular, the SEC's Regulation FD requires that "[w]henever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any [relevant] person . . . the issuer shall make [simultaneous or prompt] public disclosure of that information."¹⁵⁴ Of course, "companies are more likely to give candid reports if they can talk privately to selected analysts, and analysts will invest more in these conferences if they get some exclusivity."¹⁵⁵ The quality of information—and perhaps as importantly, the investment in the interpretation of that information—suffers, even while the nominal scope of dissemination may increase.¹⁵⁶

A related and final problem with mandatory public disclosure of firm information is that there is no easy way to limit the recipients of publicly-disclosed information. Thus a blunt *ex ante* standard of disclosure is

¹⁵² BENSTON, ET AL., *FOLLOWING THE MONEY* at 20 (2003).

¹⁵³ Lynn A. Stout, *The Mechanisms Of Market Inefficiency: An Introduction To The New Finance* 28 IOWA J. CORP. L. 635 (2003):

In *The Mechanisms of Market Efficiency*, Gilson and Kraakman suggest an answer in their discussion of what they call 'uninformed' trading. They begin by recognizing that even if all investors had equal access and ability to use to all available information about securities' expected risks and returns, one important category of information remains fundamentally 'unavailable'—knowledge of what is going to happen in the future. As a result, investors can and do disagree in their forecasts. It is worth emphasizing that disagreement over the future is not a minor matter in a securities market. Securities are nothing more than claims to a stream of future income, so minor disagreements in predictions can lead to major disagreements about valuations. Nevertheless, Gilson and Kraakman suggest investors' divergent forecasts may not lead to inaccurate securities prices, so long as mistakes in forecasting are random. As they put it, 'the random biases of individual forecasts will cancel one another out, leaving price to reflect a single, best-informed aggregate forecast.'

¹⁵⁴ Regulation FD, 17 CFR 243.100(a) (2003).

¹⁵⁵ Larry Ribstein, "IBM, Reg FD and Options Expensing," Ideoblog, April 18, 2005 available at http://busmovie.typepad.com/ideoblog/2005/04/ibm_reg_fd_and_.html.

¹⁵⁶ "Imposing a duty to disclose . . . 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." *Dirks v. SEC*, 463 U.S. 646, 658 (1983). See also Patrick T. Morgan, *Regulation FD: Leveling the Playing Field for Some but not for Others*, 66 MO. L. REV. 959 (2001).

substituted for a firm's (perhaps self-interested and wrong) ad hoc determinations of the relative costs and benefits of disclosure. While the latter may, as suggested, be flawed (judged from the standpoint of social welfare), so may the former. There is no reason to believe that the costs imposed by the blanket standard, although different in nature, are any smaller in magnitude than the ones imposed by the firm's ad hoc decisions. This is particularly true when one considers not only the cost of inadvertent (or even required though unfortunate) release of proprietary, competitive information,¹⁵⁷ but also when one considers the "benchmarking" phenomenon in executive pay.¹⁵⁸

CONCLUSION

This article demonstrates that mandatory disclosure regulation may impose subtle and unintended costs on its targets and on markets generally. Proponents of expanded federal disclosure regulation must contend with these effects. In particular, unintended behavioral responses may whittle away the value of increased disclosure. Managers may opt into less-desirable behaviors and directors may focus oversight in undesirable ways. Moreover, the consequences of disclosure regulation on the characteristics of those competing for executive positions may be unintentionally costly. And the unintended consequences of "information overload" and other problems of information processing may also be substantial.

In the end, none of this means a mandatory disclosure regime is not the best form of securities regulation from among the set of imperfect alternatives.¹⁵⁹ But weighing the relative benefits of the alternatives requires a more systematic and thoughtful consideration of the costs.¹⁶⁰

¹⁵⁷ A problem ameliorated (although at a cost) by Rule 406 of the Securities Act and Rule 24b-d2 of the Securities Exchange Act (permitting a company to file a Confidential Treatment Request with the SEC that an otherwise-required disclosure be kept confidential). 17 C.F.R. § 230.406 (2005).

¹⁵⁸ See *supra* note 116 and accompanying text.

¹⁵⁹ In particular, it is worth noting that although substantive corporate governance regulation is traditionally outside the scope of federal regulation, the Sarbanes-Oxley Act of 2002 did include a number of substantive provisions. Several commentators roundly condemn these substantive incursions into the traditional state realm of corporate governance regulation, and advocate for, at most, disclosure regulation instead. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005); Larry Ribstein, *Sarbanes-Oxley After Three Years*, (June 20, 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=746884.

¹⁶⁰ For a similar conclusion, see BENSTON, ET AL., FOLLOWING THE MONEY at 92 ("[R]easonable people can differ on whether . . . the net social benefits from mandating disclosure exceed the cost thereof. More research into the cost issue will be required

Behavioral responses to regulation, even via mere disclosure, can be costly. Firms and managers will endeavor to circumvent costly regulations; regulations will have unintended consequences; and dynamic market shifts may undermine much of the regulations' force. That these effects eradicate the benefits of mandatory disclosure is not itself inevitable; that they exist, however, is.

* * *

before policymakers can be confident about getting too heavily involved in mandating [changes to the disclosure regime].”)