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Disclosure and Financial Market Regulation

Law Working Paper N° 252/2014
April 2014

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-252-2014

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ECGI Working Paper Series in Law

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Abstract

This is a draft chapter for a forthcoming volume, The Oxford Handbook on Financial Regulation, edited by Eilís Ferran, Niamh Moloney, and Jennifer Payne, (Oxford University Press). It provides an overview of the role of mandatory disclosure in financial markets. Focusing mainly on issuer disclosure, we discuss the various goals that academics and policymakers associate to disclosure-based regulatory techniques and the rationales in support of mandatory, as opposed to voluntary, disclosure. We highlight the limits of disclosure as a regulatory technique and the costs – both direct and indirect – it involves. We conclude by addressing a few selected issues that, in our view, are particularly representative of the challenges that today's policymakers face in the area of mandatory disclosure.

Keywords: Capital markets; mandatory disclosure; selective disclosure; on-going disclosure; securities regulation; therapeutic disclosure; investor protection; price accuracy

JEL Classifications: G28, G38, K22

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Abstract

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I. INTRODUCTION

Disclosure is a technique of central importance in financial market regulation. Anyone offering securities to the public and/or listing them on a stock exchange has to provide a wealth of information before doing so, and remains subject to disclosure obligations so long as the securities are held by the public or listed. Significant long (and, since after the crisis, short) positions in listed shares have to be disclosed to the public. Anyone launching a takeover bid for a listed company's shares has to provide ample information about himself, his intentions, plans, and so forth. Any financial services contract between a consumer and a bank or investment firm is to be preceded by lengthy disclosures and rules are usually in place to ensure that the client is informed about its ongoing relationship with the financial intermediary.

This chapter focuses on mandatory disclosure to the general public (hereinafter also "MD") as opposed to, on the one hand, the regulation of voluntary disclosure (ie the general prohibition on false or misleading statements which applies to it) and, on the other, one-on-one disclosure, which is often mandated in the domain of investment and retail banking services. Our specific focus will be on issuers of securities, but much of our discussion can easily be extended to other forms of MD.

The core function of MD in financial market regulation is to provide economic agents with information to help them make better decisions. Its rationale, in turn, is grounded on the belief that in the absence of MD there would be less information available for such choices than it would be optimal or (which is largely the same) that higher production and dissemination costs would lead to its undersupply.

In the area of financial market regulation, like in others, policymakers tend to make extensive use of disclosure-based techniques. The reasons for this are manifold.[1] First, MD is a cheap regulatory tool, in the sense that extending its scope or content

[1] See Ben-Shahar, O and Schneider, C, 'The Failure of Mandated Disclosure' (2011) 159 University of Pennsylvania Law Review 647, 681-684.

does not usually entail any direct government expenditure.[2] Second, MD is a policy recipe with a high chance of bipartisan support: it offers an answer to the political pressure for "more regulation," which is especially strong in the aftermath of corporate governance scandals or financial crises,[3] but, on the face of it, stops short of positively prescribing a given behavior. Relatedly, MD is often the most viable solution, as it encounters less resistance from affected interest groups: these also tend to prefer enhanced disclosure to more invasive solutions aimed at directly constraining behavior. Finally, MD fits in with two of the most deeply-rooted principles of Western societies: namely, the idea of free markets and the autonomy principle.[4]

Nevertheless, MD comes with costs and, like other regulatory techniques, it has inherent limitations that may impair its effectiveness. Policymakers tend to disregard cost considerations and to overestimate the overall efficacy of disclosure-based recipes. In reconsidering the debate over MD in financial markets, this chapter takes a more balanced view, highlighting why there can be too much of a good thing.

The chapter is structured as follows: Part II outlines the goals that underlie MD and gives an account of the various rationales for mandatory, as opposed to merely voluntary, disclosure. Part III describes MD's limits and costs. Part IV concludes, addressing some of the challenges policymakers face.

[2] ibid 682. Of course, creating a MD system from scratch entails the costs of setting up an enforcement agency.

[3] From the very outset, a large element of the process of regulatory reform in financial markets has occurred in response to scandals or crises, according to what has been called a "boom-bust-regulate" pattern: see eg Bainbridge, S, Dodd-Frank: Quack Federal Corporate Governance Round II (2011), 95 Minnesota Law Review 1779, 1782.

[4] Ben-Shahar and Schneider, n 1 above, 681.

II. GOALS AND RATIONALES OF MANDATORY DISCLOSURE

This section discusses the various goals that academics and policymakers associate to disclosure-based regulatory techniques in financial markets. It then addresses the reasons why firms may not be expected to voluntarily disclose optimal amounts of information, and thus the various rationales in support of MD.

1. The goals

Disclosure in financial markets pursues three objectives of core importance: (*a*) it protects investors and, by thus enhancing their confidence in the market, preserves the well-functioning (if not the very existence) of the (securities) market, thereby supporting its growth; (*b*) it addresses the agency problems affecting large corporations, thus supporting their ability to serve as a means of organizing, financing and operating today's large entrepreneurial ventures; (*c*) it ensures that prices fully reflect all value-relevant information, so as to help financial markets in their fundamental function of efficiently allocating scarce financial resources across the economy.

(a) Investor Protection

MD is said to serve the purpose of protecting unsophisticated investors who trade in the securities market.[5] The need to protect unsophisticated investors may be based on fairness or efficiency considerations.

The fairness rationale has been almost universally discarded. Today, nobody seriously argues that protecting investors via disclosure is a proper policy just because doing so is... just. Many, instead, and especially policymakers, contend that protecting investors is instrumental to the well-functioning – if not to the very existence – of the market and has thus an efficiency justification. Providing investors with adequate

[5] See generally Seligman, J, 'The Historical Need for a Mandatory Corporate Disclosure System' (1983) 9 The Journal of Corporation Law 1. The goal of investor protection dates back to the New Deal and constitutes one of the bedrocks of U.S. securities regulation since its inception: ibid 51.

protection increases their confidence in the market.[6] Absent a strong and widespread belief in market integrity, the investing public would withdraw its savings, with disastrous consequences for the entire economic system.

In the same vein, to the extent that ensuring a minimum degree of *perceived* fairness in the securities markets (eg, by banning insider trading and by guaranteeing a minimum level of "equal access" to information, no matter whether either of these measures per se increases market efficiency) helps retain unsophisticated investors in the market, the fairness rationale converts into an efficiency-grounded justification.[7]

MD protects investors along three main dimensions: first, by providing them with all information reasonably needed to decide on how to invest their savings, ie about a security's risk and expected returns, the issuing entity, the attached rights, and so forth. Thus, MD helps investors find the kind of investment that best matches their preferences and thus minimizes the risk of incurring in "wrong" investment decisions, because of insufficient information regarding the securities purchased or sold.

Recent scholarship has cast serious doubts as to the effectiveness of MD in this regard. Problems of bounded rationality and information overload (the incapacity of the individual investor to "handle" large amounts of information) prevent the unsophisticated investor from really benefiting from MD and may even make matters worse, relative to a situation of less available information (see section III(*b*) below).[8]

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[6] ibid 51-53. The goals of enhanced investor protection and increased public confidence in the financial market underlie all recent EU regulatory efforts in the field of mandatory securities disclosure: see eg European Parliament and Council Directive (EC) 2003/6 on insider dealing and market manipulation (market abuse) [2003] OJ L96/16 (hereinafter, MAD), Preambles (2), (12) and (24); European Parliament and Council Directive (EC) 2003/71, on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64 (hereinafter, Prospectus directive), Preambles (10), (16), (18) and (19); European Parliament and Council Directive (EC) 2004/109, on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38 (hereinafter, Transparency directive), Preamble (1); Proposal for a regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), COM(2011) 651 final, Preambles (2) and (26) and Article 1.

[7] Cf Langevoort, D, 'Taming the Animal Spirits of the Stock Markets: a Behavioral Approach to Securities Regulation' (2002) 97 *Northwestern University Law Review* 135, 165-166 (discussing, and then dismissing, a similar rationale for Regulation FD, an SEC regulation enacted in 2000 and prohibiting selective disclosure).

[8] See eg Paredes, T, 'Blinded by the Light: Information Overload and its Consequences for Securities Regulation' (2003) 81 *Washington University Law Quarterly* 417.

Second, MD may protect investors by enabling them not to be "exploited" by traders having superior information (insiders and professional investors).[9] According to this view, absent MD, unsophisticated investors would systematically lose when trading against such informed counterparties, and would thus soon withdraw their money from the market. MD is said to establish a "level playing field" between unsophisticated and professional investors (or corporate insiders), ie to give the former "equal access" to the same range of information on which the latter base their decisions.[10] This view, usually labeled as "market egalitarianism," has received strong support in the past and has profoundly influenced the evolution of securities regulation on both sides of the Atlantic (for example, it gave rise to the ban on insider trading in the US and has long shaped much of the SEC policy as regards MD).[11]

Nowadays, academic commentators tend to discard this goal. In an efficient stock market, unsophisticated investors are already protected by market prices, which tend to reflect at any time all relevant information (or at least that portion of relevant information which is publicly available),[12] and thus make sure that they will generally receive a fair price in whatever transaction they engage in.[13] In an efficient market unsophisticated investors take a free-ride on the efforts of sophisticated ones and thus do not need, and would not really benefit from,[14] equal access to information.[15]

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[9] See Easterbrook, F and Fischel, D, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 669, 693-695, for a critical view.

[10] See eg Chiu, I, 'Examining the justifications for mandatory ongoing disclosure in securities regulation', 26 *The Company Lawyer* 67, 67.

[11] See eg *SEC v Texas Gulf Sulphur Co.* 401 F.2d 833 (2d Cir. 1968); see also n 15-16 below and accompanying text.

[12] According to Eugene Fama's famous tripartition, securities markets can be said to be efficient in weak-form (when current prices reflect the information contained in past prices), semi-strong form (when prices reflect all the information, both present and past, that is publicly available) or strong-form (when they reflect at any time both publicly available and private information). It is worth noting, however, that this distinction was originally aimed at classifying empirical tests of market efficiency. Only later did it evolve as a classification of the different forms in which market efficiency can be intended, and as a scale of the efficiency level of a given market. See Fama, E, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383; Gilson, R, Kraakman, R, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549, 555-556.

[13] See Easterbrook and Fischel, n 9 above, 694.

[14] ibid.

[15] To be sure, assuming that the market is efficient in semi-strong form does not amount to claiming that unsophisticated investors can never "lose" in whatever transaction they enter into – in fact, they can still be beaten by insiders (a risk they share with the most sophisticated investors) – and, more importantly, does not amount to stating that the market is "fundamentally" efficient, ie that its prices reflect real value.

And even if such "equal access" is provided, it would remain largely unused. Gathering and processing all information affecting the value of securities is a complex task requiring specific skills and entails economies of scale and scope, which are unavailable to the retail investor.[16]

Nevertheless, market egalitarianism is still very popular among regulators and courts: in the EU, for instance, it supports the most recent ECJ case law on insider trading[17] and real-time issuer disclosure duties.[18]

Third, MD protects investors in that it discourages fraud, self-dealing and various other kinds of opportunistic behavior on the part of managers and controllers.[19] From this standpoint, the goal of investor protection tends to identify with that of improved corporate governance, which is addressed in the next section.

(b) Agency cost reduction

Disclosure plays an important role in corporate governance, as a tool to address agency problems:[20] by decreasing both monitoring[21] and bonding costs,[22] it reduces overall agency costs and thus lowers firms' cost of capital.[23] Its main governance function is to permit ex post enforcement of core substantive rules, such as managers'

For these and other important qualifications about the concept of market efficiency, and a reassessment of the Efficient Market Hypothesis in light of the 2007-2009 global financial crisis, see Gilson, R and Kraakman, R, 'Market Efficiency After the Fall: Where Do We Stand After the Financial Crisis?' in Hill, C and McDonnell, B (eds), *Research Handbook on the Economics of Corporate Law* (2012) 456, 457-460; Id, 'Market Efficiency after the Financial Crisis: It's Still a Matter of Information Costs' (2014), available at http://ssrn.com/abstract=2396608.

[16] See eg Moloney, N, *EC Securities Regulation* (2 edn, 2008) 100.

[17] *See* European Court of Justice, Case C-45/08, *Spector Photo Group NV and Chris Van Raemdonck v Commissie voor het Bank-, Financie- en Assurantiewezen (CBFA)*.

[18] *See* European Court of Justice, Case C-19/11, *Marcus Geltl v Daimler AG* (*esp.* section 33).

[19] Seligman, n 5 above, 51.

[20] See generally Mahoney, P, 'Mandatory Disclosure as a Solution to Agency problems' (1995) 62 *University of Chicago Law Review* 1047.

[21] ibid 1051.

[22] See eg Rock, E, 'Securities regulation as a Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure' (2002) 23 *Cardozo Law Review* 675. See also n 63-64 below and accompanying text.

[23] See generally Kraakman, R, 'Disclosure and Corporate Governance: An Overview Essay', in Ferrarini, G, Hopt, K, and Wymeersch, E (eds), *Reforming Company and Takeover Law in Europe* (2004) 95.

fiduciary duties: absent sufficient information, breaches of those duties would remain largely undetected.[24]

But disclosure rules complement substantive rules of corporate law addressing agency problem issues in many other ways. Let us take self-dealing transactions as an example. A rule requiring, say, shareholder approval of conflicted transactions would be less effective in constraining abusive self-dealing, if companies did not have to provide shareholders with complete information about the proposed transaction terms: MD helps achieve this result.[25] MD plays a similar function, in turn, in many other areas of corporate law, such as board elections, shareholders' say on managerial compensation, proxy fights, approval of fundamental transactions, and so on. In all such cases, disclosure is instrumental to shareholder empowerment.[26]

Disclosure rules also increase managerial consciousness: by forcing managers to continuously collect and organize information, disclosure makes them aware of events and circumstances that they would not perhaps have known: increased knowledge may have a positive effect on managerial performance.[27]

MD's beneficial role in curbing managerial opportunism is indisputable and to a large extent obvious: in a context of marked opacity, where little is known about the firm's operations, managers would obviously find it easier to engage in self-dealing, fraud, and other forms of abuse. On the contrary, with a tight and well-designed system of MD in place any would-be wrongdoer must devise a more ingenious, complex and costly plan to conceal his actions and escape punishment.[28] All such elements decrease the expected payoff of engaging in fraud, thus making corporate wrongdoing – all else being equal – a less attractive option.

So far, the chapter has focused on *managerial* opportunism, but disclosure performs the same function with respect to systems where corporate ownership is

[24] See Fox, M, 'Required Disclosure and Corporate Governance' (1999) 62 *Law and Contemporary Problems* 113, 118-120.
[25] ibid 118-119; Kraakman, n 23 above, 97.
[26] See Fox, n 24 above, 116-118, for a discussion of the role of disclosure in empowering shareholders.
[27] ibid 123-125. Of course, this point should not be overstated: most of the time, MD rules do not compel managers to actually create any new information, but force them to disclose data they already possess and routinely process for internal managerial purposes.
[28] ibid 119-120.

concentrated and the bulk of agency problems revolves around the relation between controlling shareholders and outside shareholders. In systems of concentrated corporate ownership, disclosure makes it similarly more difficult for controlling shareholders to engage in self-dealing and thus reduces the amount of pecuniary private benefits of control.[29]

At the same time, however, the effectiveness of disclosure as a technique to prevent fraud and misbehavior may easily be overstated.

First, as many other legal strategies aimed at controlling managerial or dominant shareholder opportunism, disclosure is inherently imperfect. After all, if a manager decides to breach his fiduciary duties and engage in fraudulent behavior, he is equally likely to violate disclosure rules, so as to conceal his actions. The "very bad guys" cannot be expected to be much concerned by MD rules: they would simply violate them, as they violate more substantive rules of conduct, such as the prohibition on unfair self-dealing. The large-scale fraud occurred at Enron – where widespread accounting manipulations and other violations quickly led to the bankruptcy of a seemingly wealthy large company, causing massive losses to both the firm's creditors and shareholders – provides a good illustration of this point: it would be hard to argue that Enron's managers acted within a legal framework in which disclosure duties were scant or unenforced. Enron was required to disclose huge amounts of data, both financial and operational, and its financial statements were audited by (supposed-to-be) independent third parties. Nevertheless, all these barriers proved insufficient to avoid massive fraud.[30]

Second, MD may also have unintended negative consequences. The disclosure of conflicts of interest, for instance, may have perverse effects on the discloser's

[29] See Ferrell, A, 'The case for Mandatory Disclosure in Securities Regulation around the World' (2007) 2 *Brooklyn Journal of Corporate, Financial & Commercial Law* 81, 88-92, for a comprehensive discussion.

[30] For a discussion of the Enron scandal and its implications for US corporate governance see, eg, Gordon, J, 'Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley' (2003) 35 *Connecticut Law Review* 1125; Macey, J, 'Efficient Capital Markets, Corporate Disclosure, and Enron' (2004), 89 *Cornell Law Review* 394, discussing Enron's implications for disclosure major theoretical foundations and for the Efficient Capital Market Hypothesis.

behaviour, who, after having disclosed his conflicting interest, may consider himself free of any further obligation and thus "authorized" to pursue his own interest.[31]

A similar point can be made with respect to executive compensation, where enhanced disclosure could have the unintended consequence of increasing average executive pay (the so-called Lake Wobegon effect of compensation disclosure[32]).

(c) Price accuracy enhancement

MD may also serve the purpose of increasing market prices accuracy in reflecting relevant information.[33] Increased price accuracy, in turn, enhances liquidity,[34] lowers volatility,[35] decreases firms' cost of capital, and promotes market allocative efficiency,[36] at the benefit of the economic system as a whole.

Increased price accuracy plays a beneficial role also in corporate governance. Efficient stock prices improve the effectiveness of the market for corporate control as a disciplining device:[37] they decrease the costs of identifying underperforming firms to target for hostile acquisition, since efficient prices track more closely real value and thus permit more fine-tuned and univocal inferences, thereby reducing the incidence of

[31] Cf Cain D, Loewenstein, G, Moore, D, 'The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest' (2005) 34 *Journal of Legal Studies* 1, esp. 6-8 (with reference to conflicts of interest in the domain of professional advice).

[32] Disclosure makes average compensation available to companies' compensation committees members and CEOs. Even the former will be disinclined to pay the CEO below the industry peers average, because that would signal inferior quality. As an outcome, average executive compensation rises. See eg Davidoff, S, Hill, C, 'Limits of Disclosure' (2013) 36 *Seattle University Law Review* 599, 604, 623-626; Manne, G, 'The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure' (2007) 58 *Alabama Law Review* 473, 476-477. Lake Wobegon is a fictional town where all the children are supposed to be above average. See http://en.wikipedia.org/wiki/Lake_Wobegon.

[33] See eg Gordon, J, Kornhauser, L, 'Efficient Markets, Costly Information, and Securities research' (1985) 60 *New York University Law Review* 761; Goshen, Z, Parchomovsky, G, 'On Insider Trading, Markets, and "Negative" Property Rights in Information' (2001) 87 *Virginia Law Review* 1229, 1244-1246.

[34] See Kahan, M, 'Securities Laws and the Costs of "Inaccurate" Stock Prices' (1992) 41 *Duke Law Journal* 977, 1017-1025; Chiu, n 10 above, 70.

[35] Chiu, n 10 above, 70.

[36] See generally Kahan, n 34 above; Chiu, n 10 above, 70.

[37] See Coffee, J, 'Market failure and the Economic case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717, 742, 747; Fox, n 24 above, 120-121.

"false negatives", ie firms whose negative performance is not reflected in a low market valuation.

Efficient stock prices are also necessary for the proper functioning of incentive compensation. Better functioning incentive compensation, in turn, aligns more closely managers' incentives to those of shareholders and thus reduces agency costs. [38]

The price accuracy enhancement goal of MD is today widely accepted among scholars[39] and represents an increasingly important driver in the evolution of securities regulation.[40] The objective of promoting price accuracy and thereby advancing market efficiency explains many regulatory developments on both sides of the Atlantic: think of the increasing role of "fair value" in accounting and the increasing weight of forward-looking and "soft" information relative to backward-looking and hard data.

In 1979 the EU adopted a rule of real-time disclosure which, in its current formulation, requires issuers to immediately disclose all "price-sensitive" ("material", in US terminology) information.[41] This rule, which represents a bedrock of the current EU MD system and one of its identifying features,[42] can, at least partly, be explained as an attempt to advance price accuracy.[43]

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[38] See ibid 121.

[39] See eg Goshen, Z and Parchomovsky, G, 'The Essential Role of Securities Regulation' (2006) 55 *Duke Law Journal* 711 (who claim that promoting market efficiency – which in turn is determined also by having accurate securities prices – is the goal not only of MD, but of securities regulation as a whole, and that achieving this goal requires protecting and advancing the position of information traders); Kahan, n 34 above, 979 (referring to securities regulation at large). But see Mahoney, n 20 above, 1093-1104, for a critical view.

[40] See ibid 1105-11, where a critical assessment.

[41] See Council Directive (EEC) 79/279 coordinating the conditions for the admission of securities to official stock exchange listing [1979] OJ L066/21, schedule C of the Annex, par. 5 (A) ("The company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares"). In 1989, the scope of the rule has been adjusted so as to cover all securities subject to the insider trading prohibition (Council Directive (EEC) 89/592 coordinating regulations on insider dealing [1989] OJ L334/30, art. 6, para. 2). In 2001 the rule was moved, with no modifications, into Article 68 of the European Parliament and Council Directive (EC) 2001/34 on the admission of securities to official stock exchange listing and on information to be published on those securities [2001] OJ L184/1, and in 2003 was replaced by MAD's Art. 6, according to which "issuers [must] inform the public as soon as possible of inside [price-sensitive] information which directly concerns the said issuers". The Market Abuse Regulation will further reform EU real-time disclosure duties, providing for a slight restriction in the scope of the disclosure duty (see Article 12, para. 3).

[42] U.S. securities regulation, at least as regards the "law on the books", does not have a rule of real-time disclosure. See eg Cox, J, Hillman and R, Langevoort, D, *Securities Regulation, Cases and Materials*,

Although the price accuracy enhancement goal is widely accepted among both academics and policymakers, it raises its own issues. On its face, it justifies the unlimited widening of scope of MD duties: all information that is relevant for assessing firm value becomes a compelling candidate for MD once the goal is price accuracy. No guidance or criterion is available to strike the right balance between the price accuracy goal and countervailing interests such as, most importantly, firms' interest in confidentiality. Rather, the price accuracy goal appears to suggest that the firm's private interest should be unconditionally sacrificed. Because there is something more to confidentiality than individual firms' interests in their own success, this point will be further addressed later.[44]

2. The rationales

Section II.1 gave an account of the various functions that (mandatory) disclosure performs in financial markets and of the many benefits it is thought to bring about. Stating that corporate disclosure is beneficial does not amount, however, to saying that *mandatory* disclosure is necessary or desirable. If information is so valuable for investors, why should not market forces be spontaneously providing it in optimal amounts?[45] This is an issue that has received extensive attention in the literature, ever since the debate on MD has been conducted with an efficiency perspective in mind. The next sections briefly recall the major results of the debate.

(5th ed, 2006), 621 ("...the information's materiality is a necessary but not a sufficient condition to require its disclosure"), 689. However, the joint operation of the duties to avoid half-truths, to update, and to correct information previously disclosed leads the system very close to the positive establishment of an outright duty of ongoing disclosure. See Id, 690-693; Oesterle, D, 'The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet"?' (1998) 20 *Cardozo Law Review* 135.

[43] "Partly" because the rule has a concurrent anti-insider trading function and, to the extent that it aims to put outsiders and insiders on an equal footing, can be concurrently brought back to market egalitarianism goals.

[44] See section III(*f*) below.

[45] See eg Easterbrook and Fischel, n 9 above, 682-685.

(a) Information as a public good

A traditional argument for establishing MD rests upon the public goods-like nature of information. Information is a public good, or at least displays many features of a typical public good: its value is only imperfectly appropriable, given how difficult it is to exclude those who did not pay for it; the use of a given piece of information by someone does not prevent that same piece of information from being used by someone else.

Because of the public goods-like nature of information, private incentives to produce it will be weak and the amount produced less than socially optimal.[46] But, due to collective action problems, investors may also overinvest in information production,[47] leading to: (*a*) redundant production, ie when two or more investors engage in the production of the same piece of information (eg, the firm's earnings for the next reporting quarter)[48] and (*b*) overinvestment, which occurs as a consequence of the distortionary incentives induced by the race to "beat the market" (ie to be first in accessing information that is expected to materially change the price of a security).[49] MD eliminates these inefficiencies by centralizing (some say "collectiviz[ing]"[50]) information production.

The rationale based on the public-good traits of information largely falls short of providing a truly sound justification for MD. Rather, its logic should in itself (ie assuming no other problems exist with the voluntary production of information) lead to an optimal degree of voluntary disclosure. In fact, if issuer disclosure is a superior means of information production and dissemination, why should it not be spontaneously

[46] See generally Coffee, n 37 above, who makes this point with reference to securities research. See also Easterbrook and Fischel, n 9 above, 680-682.
[47] See ibid 681-682.
[48] ibid; Coffee, n 37 above, 733-734, with reference to securities research.
[49] See Easterbrook and Fischel, n 9 above, 682; Franco, J, 'Why Antifraud Prohibitions Are not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure' (2002) 2002 *Columbia Business Law Review* 225, 349-352.
[50] eg, Mahoney, n 20 above, 1095, 1111.

provided? If investors as a class gain from having disclosure, then firms would gain too in organizing themselves as highly-disclosing entities.[51]

(b) Externalities

Imperfect appropriability of the value of information affects not only decentralized dynamics of information production (ie, where the individual investor is the primary information producer), but also individual firms' decisions on disclosure policies. That is because corporate disclosure entails externalities: therein lies what is perhaps the most well-grounded justification for MD.

Information disclosed by an individual firm is also useful for a better assessment of the value of securities issued by other firms,[52] and thus indirectly benefits other issuers' securities.[53] The closer the similarity with the disclosing firm, the higher the spillover effect, and thus the weaker a firm's incentives to disclose.[54] Disclosing Coca-Cola's sales for the second quarter benefits not only Coca Cola investors (both actual and potential ones), who may gauge more precisely the value of Coca Cola shares, but also PepsiCo investors, who, however, do not pay for the benefit they receive. If Coca Cola could obtain a payment from them, it would disclose more.

Further, disclosure may give useful information to a firm's competitors, enhancing their strength and reducing the disclosing firm's competitive advantage.[55] Or it may confer strategic advantages to constituencies, such as suppliers, employees and

[51] See Easterbrook and Fischel, n 9 above, 682-683. See also Bainbridge, S, 'Mandatory Disclosure: A Behavioral Analysis' (2000) 68 *University of Cincinnati Law Review* 1023, 1031.
[52] Easterbrook and Fischel, n 9 above, 685-686.
[53] ibid 686.
[54] ibid.
[55] The threat posed by disclosure to the firm's competitive position is frequently highlighted in the literature: ibid 686 ("information (such as that pertaining to new products) may give a competitive advantage to rivals"); Schön, W, 'Corporate Disclosure in a Competitive Environment – The Quest for a European Framework on Mandatory Disclosure' (2006) 6 *Journal of Corporate Law Studies* 259, 277-279; Guttentag, M, 'An Argument for Imposing Disclosure Requirements on Public Companies' (2004) 32 *Florida State University Law Review* 123, 140; Benston, G, 'The Value of the SEC's Accounting Disclosure Requirements' (1969) 44 *The Accounting Review* 515, 515 (pointing to the costs of revealing information to competitors).

customers, that have contrasting interests with those of the firm.[56] The corresponding harm to the disclosing firm is an "interfirm" cost: the cost borne by the disclosing firm is offset by the benefit that rival firms, customers and suppliers enjoy.[57] It is thus a private cost, but not a cost to society at large. Because the amount of information voluntarily disclosed is governed by a private cost-benefit trade-off (ie the individual firm does not internalize the positive externality), private incentives lead to the disclosure of less information than the social optimum.[58]

(c) Agency problems

The justifications for MD illustrated so far work even assuming that those who actually provide disclosure – corporate managers – act in order to maximize shareholder welfare. What is missing, according to these views, is neither care nor loyalty on the part of corporate agents, but the right incentives for the issuer itself, ie for its shareholders. The agency problem rationale moves from the opposite assumption and justifies mandatory rules on the grounds that managers often do depart from shareholders' interests:[59] they may opportunistically withhold some information valuable to investors.[60]

This justification is most appropriate when related to disclosure of those information items, such as self-dealing transactions and compensation, regarding which managers' self-interest is expected to exert the strongest pressure against disclosure.

But a similar case can be made for "bad news" as well. The disclosure of negative information has many undesired consequences for managers: it decreases their expected compensation, when it is linked, as it is usual today, to stock performance, and

[56] For instance, information about the profitability of a given line of business may help suppliers, customers and the firm's employees discover managers' reservation price thus enhancing their position when negotiating their contracts with the firm. See Fox, M, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment' (1999) 85 *Virginia Law Review* 1335, 1345.
[57] Fox, n 56 above, 1345-1346.
[58] ibid.
[59] Note that the agency cost rationale for MD may justify it irrespective of the goal one attaches to MD regulation, be it investor protection, price accuracy or agency costs reduction.
[60] See Fox, n 56 above, 1355-1356.

exposes them to an increased risk of being ousted.[61] The worse the news, the greater the harm, and thus the higher the temptation not to disclose.[62]

To be sure, as agency theory suggests, managers and promoters likely have strong incentives to commit *ex ante* to full disclosure.[63] However, to credibly commit to full disclosure for an indefinite period of time may not be feasible by contract. MD rules, and more precisely securities regulation more generally, overcome this problem by offering managers and controllers a way to credibly bind themselves to disclosure for an indefinite period of time.[64]

(d) The need for a subsidy to informed traders

Another rationale for the imposition of positive disclosure duties is the need to offer a subsidy to the activity of information gathering and processing by "informed traders" (professional investors and analysts).[65] Because informed traders are the main contributors to market efficiency, strengthening their position may be justified.[66]

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[61] Kraakman, n 23 above, 99-100. See also Kahan, n 34 above, 1028-1029s.

[62] Kraakman, n 23 above, 100. MD skeptics tend to find this argument unconvincing. Investors have rational expectations and know that managers are eager to disclose good news but prefer to conceal bad news: they would thus infer the bad news from a firm's silence or refusal to disclose. Managers, on their part, have equally rational expectations, so they will anticipate investors' inferences and will disclose both good and bad news, unless the bad news are particularly negative. Investors, in turn, anticipate this reaction too, so if a firm fails to disclose, they will always assume the worst. As an outcome, managers will always choose to disclose, since refusing to do so would always lead to worse consequences than disclosing the bad news, no matter how bad they are (see Easterbrook and Fischel, n 9 above, 677, 683 and Schön, n 55 above, 274-275, for a good description of the mechanics of "unraveling"). In real-world scenarios, however, a firm's mere act of nondisclosure is not as univocal as it is in theoretical models. It may indicate absence of news, or existence of good news that the firm cannot disclose for competitive reasons (see Easterbrook and Fischel, n 9 above, 677). When investors are unable to make univocal inferences from non-disclosure, the possibility of opportunistic silence reappears and the whole unraveling mechanics breaks down. See Schön, n 55 above, 275; Franco, n 49 above, 272-276; Easterbrook and Fischel, n 9 above, 687-688 (who also stress that there are ways to overcome the problem); and Langevoort, D, 'Information Technology and the Structure of Securities Regulation' (1985) 98 *Harvard Law Review* 747, 785 (pointing to the inadequacy of managerial incentives to disclose bad news).

[63] See generally Jensen, M and Meckling, W, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

[64] See generally Rock, n 22 above; Kraakman, n 23 above, 100.

[65] See Goshen and Parchomovsky, n 39 above, 755-766.

[66] See generally ibid.

The rationale for subsidizing their activity, in turn, is two-fold: (*a*) information traders can capture only part of the value generated by their activity: in essence, theirs is an information production activity which itself suffers from problems of imperfect appropriability;[67] (*b*) firms cannot be trusted to voluntarily provide information that informed traders need, because of the presence of positive externalities and managerial agency problems.[68] The subsidy rationale, thus, can be largely traced back either to the public good rationale, or to the externality and agency costs ones.

(e) Standardization

MD may be needed to ensure standardization in information provided to investors.[69]

Absent MD, even assuming optimal private incentives toward disclosure, each firm would be free to set the timing and format of its own disclosures. The ensuing lack of uniformity would impair data comparability, something which makes information disclosed by each firm inherently less informative and thus less valuable to investors.[70] To the extent that uniformity in disclosure format and comparability of firm-specific information is valuable to investors, it is equally valuable for each issuer. Nevertheless, no individual firm has sufficiently strong incentives to invest in the creation and promotion of a common format for disclosure, given the positive externalities associated with that. In other words, standardization is a public good, from the standpoint of individual firms.

[67] See Coffee, n 37 above (with reference to the activity of securities research).
[68] See Goshen and Parchomovsky, n 39 above, 758-761.
[69] See Kraakman, n 23 above, 101; Rock, n 22 above, 686; Easterbrook and Fischel, n 9 above, 686-687.
[70] Much of the process of assessing stock value is inherently relational, ie, the value of firm A stock is related to the value of firm B stock, which is related to that of firm C stock, and so on. Homogeneity in the timing, language, and format of information disclosed makes investors' comparisons easier. This, in turn, decreases the costs of information processing and enhances investors' assessments, making prices more informative.

In the absence of MD rules, standardization may thus fail to occur spontaneously and, even if ultimately achieved, the process may nonetheless take a long time. MD can solve this problem and quickly provide a common framework for corporate disclosure.[71]

To be sure, the need for standardization *per se* provides a rationale only for a very narrow regulatory intervention. It justifies disclosure regulation with regard to modes of disclosure (ie the regulation would establish "how" to disclose information to the public). It provides no guidance as to the question of *what* should be disclosed: for this purpose, some other rationale is needed.

3. **Concluding remarks**

A world without MD would not be completely in the dark: corporate agents would still have incentives to disclose and firms, consequently, would display some degree of transparency.[72] However, the amount and contents of information provided would be likely to be less than socially desirable[73] and tend to shy away from agency cost-sensitive items such as tunneling and compensation.

Clearly, this is more a starting point than a conclusion. Except perhaps the agency cost rationale, none of the arguments in favor of positive disclosure duties gives precise guidance as to how to address the ensuing – and more challenging – issue of how to design a MD system, and especially of what its contents should be.

III. SOME LIMITS AND DRAWBACKS OF MD

[71] See Kraakman, n 23 above, 101; Easterbrook and Fischel, n 9 above, 686-687.
[72] This is acknowledged even by the strongest MD supporters: see eg Fox, n 56 above, 1362: "In an issuer choice world where we rely on signaling [which amounts to a world of full voluntary disclosure], issuers will have incentives to choose a regime requiring a level of disclosure greater than zero. But, as we have just seen, these incentives will not be great enough to induce issuers to choose a regime requiring a level as high as is socially optimal [...]"
[73] Franco, n 49 above, 243.

Policymakers tend to be biased in favor of MD, for reasons hinted at in Part I. Their deep-rooted intuition is that more information is better than less, or in other words, that the benefits of MD outweigh its costs almost by hypothesis. Taken at face value, the fallacy of this intuition is clear: no firm could create wealth for long, were it bound to give the public full access to its internally generated information. Highlighting the limits and drawbacks of MD is thus helpful to give a better sense of up to what point more disclosure is better than less, or, conversely, what kind of disclosure obligations are bound to raise more problems than they solve.

The limited effectiveness of MD may flow from flaws affecting the regulatory and enforcement process, which may lead to ill-designed rules, and from users' limited ability to absorb and correctly process information. The costs of MD stem from varying sources and can be classified as direct or indirect:[74] the direct ones are – among others – the costs of drafting, printing, and mailing the documents, the managerial opportunity costs, and the costs of administering and enforcing the rules. Indirect costs have a more multifaceted and elusive nature. While impossible to quantify, they are in principle higher than direct costs.[75]

(a) Policymakers

[74] See Easterbrook and Fischel, n 9 above, 707-709. There may be, of course, different classifications as well: see eg Fox, n 56 above, 1345-1346, who distinguishes between "operational costs" and "interfirm costs".

[75] See Easterbrook and Fischel, n 9 above, 708. As a consequence of the difficulties in identifying and measuring MD costs, assessing the overall desirability of disclosure-enhancing reforms is inherently difficult, if not impossible. Recent empirical research on MD fully acknowledges this problem and cautions against the temptation of inferring such desirability from the beneficial effects that frequently result to be associated with these reforms: see, eg, Christensen, H, Hail and L, Leuz, C, Capital-Market Effects of Securities Regulation: Prior Conditions, Implementation, and Enforcement (2013), ECGI Finance Working Paper No. 407/2014 and Chicago Booth Research Paper No. 12-04, available at http://ssrn.com/abstract=1745105 or http://dx.doi.org/10.2139/ssrn.1745105, 37-8. For surveys of the empirical literature on disclosure see eg Leuz, C and Wysocki, P, Economic consequences of financial reporting and disclosure regulation: A review and suggestions for future research (2008), available at http://ssrn.com/abstract=1105398 or http://dx.doi.org/10.2139/ssrn.1105398; Healy, P and Palepu, K, 'Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature' (2001) 31 *Journal of Accounting and Economics* 405.

Regulation is usually advocated as a corrective response to market failure. The existence of a market failure, however, is a necessary but still not a sufficient condition to call for government intervention. It must still be proven (or at least convincingly argued) that regulators will be capable of "do[ing] it better," which is usually just a matter of presumption.[76]

Policymakers may not necessarily devise good MD systems, on the books and in action. They may deviate from public interest when deciding which rules to set up,[77] whether because they are captured by strong interest groups, or because populism drives their regulatory zeal.

A good example of rules that both cater to issuer insiders' interests and respond to popular hostility against greedy "speculators" are the EU rules requiring disclosure to the public of any short position higher than 0.5% of a company's shares.[78] The low threshold acts as an indirect curb on short-selling, thereby negatively affecting its contribution to market efficiency and its disciplining effect, via share prices, on corporate insiders.[79]

Policymakers may also suffer from cognitive biases, preventing them from making the right choices.[80] The "hot hand" bias, for instance, may induce regulators to see a pattern (e.g., a corporate governance crisis) in a series of facts which are, in fact, casual (a handful of significant reporting irregularities or of unfair self-dealing transactions),[81] leading them to overreaching reactions.

Finally, any MD system's effectiveness crucially depends on the quality of its enforcement institutions: weak, inept, or, even worse, corrupt enforcement agents

[76] See Kraakman, n 23 above, 101.
[77] See Bainbridge, n 51 above, 1058.
[78] See European Parliament and Council Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps [2012] OJ L86/1, Article 6.
[79] Short-selling, by allowing traders to sell shares and other financial instruments even when they do not actually own them, permits new negative information to be rapidly and fully reflected into market prices. Thus, prices are put in the condition to more effectively react to managers' poor performance and, as a consequence, the market disciplining effect over managers is enhanced. See Payne, J, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 *European Business Organization Law Review* 413, 419, 437.
[80] See generally Choi, SJ and Pritchard, AC, 'Behavioral Economics and the SEC' (2003) 56 *Stanford Law Review* 1.
[81] ibid 25.

(including, ultimately, courts) may easily spoil the virtues of any well-designed legislation. In the absence of fair and effective enforcement institutions, MD will hardly matter for investors, who will discount the inability of the disclosure system to ensure compliance. Issuers, however, will incur at least some of the costs of (formally) complying with existing rules, whether because the most blatant violations may still be prosecuted or because selective, bribe-inducing enforcement is possible. Good issuers, in turn, will have to incur the additional costs of credibly signaling, if that is at all possible, their superior quality to the market.

The empirical literature supports the importance of enforcement (and of various other complementary factors) for MD overall effectiveness.[82] For instance, one recent study shows that the beneficial capital market effects following the enactment in the EU of the Market Abuse and the Transparency Directives[83] are more pronounced in countries previously showing high regulatory quality and where stricter implementation and enforcement follows the enactment of the new rules, while they are less pronounced, if not absent at all, in countries with poor regulatory quality and weak enforcement.[84]

Similarly, the adoption of International Financial Reporting Standards (IFRS) is shown to have had beneficial effects only in countries where enforcement is strong and where the institutional environment provides firms with powerful incentives to be transparent.[85]

(b) Users

MD largely relies on the assumption that investors, if provided with all relevant information, will be able to make optimal decisions. Recent scholarship has questioned

[82] See Christensen, Hail and Leuz, n 75 above; Daske, H and Hail, L, Leuz, C, Verdi, R, 'Mandatory IFRS Reporting around the World: Early Evidence on the Economic Consequences' (2008) 46 *Journal of Accounting Research* 1085.
[83] See n. 6 above.
[84] Christensen, Hail and Leuz, n. 75 above, 5-6.
[85] Daske, Hail, Leuz and Verdi, n. 82 above, 1089.

that assumption. Problems of bounded rationality and information overload[86] would impair individual investors' ability to handle and correctly process information and would systematically keep them from making optimal decisions.

The policy implications of investors' alleged inability to deal with information are seemingly sweeping: if investors are to be regarded as truly unable to make any meaningful use of information, the entire system of MD would be useless and, to the extent that more information leads to even worse decisions, harmful. For such reasons, supporters of this view often suggest that the current system be radically reshaped [87] or scaled back,[88] so as to mitigate information overload and the negative consequences of bounded rationality on individual choices.

Retail investors are clearly those who suffer most from such problems. As a consequence, simplification and reduction in the information provided are policy recipes that appear to be mostly suited for the sale of retail products, such as mutual fund shares.[89] The real challenge there is for policymakers to be able to identify those information items that are strictly necessary and sufficient to let individuals select the right products.[90] Success is far from warranted, given (*a*) regulators' incentives (and especially their preference for regulatory strategies that minimize political and liability risk), (*b*) the unavoidability of cognitive biases on the part of regulators themselves, consumers and their financial advisors, and, (*c*) last but not least, financial industry's pressures.

Yet, information overload and bounded rationality do not impair the foundations of the current system of *issuer* MD. Information made available under existing MD rules is still useful for (and used by) professional investors and analysts: the market in

[86] See generally Paredes, n 8 above.
[87] See eg Chen, J and Watson, S, 'Investor Psychology Matters: Is a Prescribed Product Disclosure Statement a Supplement for Healthy Investment Decisions?' (2011) 17 *New Zealand Business Law Quarterly* 412, who give an account of the proposal to substitute prospectuses and other lengthy financial documents with a brief "product disclosure statement". The authors, however, warn against the risk of oversimplification that such reform carries on.
[88] See generally Paredes, n 8 above, where a cautious invitation to scale back the MD system is advanced.
[89] See Moloney, N, *How to Protect Investors* (Cambridge University Press, 2010), Ch. 5.
[90] For a very positive assessment of EU policymakers' attempt to strike the right balance between information and conciseness in shaping mutual fund products disclosure see ibid, 316-22. For a critical view see Burn, L, 'KISS, But Tell All: Short-Form Disclosure for Retail Investors' (2010) 5.2 *Capital Markets Law Journal* 141, 160-65.

the aggregate is itself capable of absorbing and correctly processing disclosed information.[91]

(c) The fixed costs of disclosure and their effect on small issuers

The efficient level of disclosure is likely to vary from firm to firm,[92] according to idiosyncratic patterns that cannot be perfectly mimicked by regulation. Thus, MD systems will inevitably be both over-inclusive and under-inclusive: for some firms mandated disclosure may be lower than optimal (eg some useful pieces of information may stay out of MD's scope), while for some others it may be excessive.

An important dimension along which issuers differ from the point of view of disclosure costs is their size. The direct costs of MD are in large part fixed. Therefore, they tend to be more burdensome for smaller listed firms, putting them at a competitive disadvantage vis-à-vis larger ones.[93] Further, the value of confidentiality for small issuers is in principle higher, making disclosure more costly for them than for well-established, large firms.[94]

Regulators are increasingly aware of the need to increase the system's flexibility, so as to take the larger relative weight of disclosure-related costs for small issuers into account. In the EU, the proposed Market Abuse Regulation moves exactly in this direction: issuers trading on "S[mall and]M[edium-sized]E[nterprise] growth markets" will be subject to a simplified, less burdensome regime as regards ongoing

[91] Consequently, retail investors continue to receive (indirect) protection, despite their inability (and perhaps unwillingness) to handle all disclosed information.

[92] See Bainbridge, n. 51 above, 1057; Fox, n 56 above, 1395 ("Each issuer has a socially efficient level of disclosure...").

[93] See Easterbrook and Fischel, n 9 above, 671; Schön, n 55 above, 288; Leuz and Wysocki, n 75 above, 10; Bushee, B and Leuz, C, 'Economic consequences of SEC disclosure regulation: evidence from the OTC bulletin board' (2005) 39 *Journal of Accounting and Economics* 233 (for indirect empirical evidence); for a comprehensive discussion of disclosure costs for SMEs and of possible solutions to the problem see Ferrarini, G and Ottolia, A, 'Corporate Disclosure as a Transaction Cost: The Case of SMEs' (2013) 9 *European Review of Contract Law* 363.

[94] Small issuers are often non-diversified firms, so their disclosures are in principle more informative (and thus more harmful to their competitive position) than those of large issuers, operating in different business segments and across multiple geographical areas.

disclosure of price-sensitive information and insiders' lists.[95] In the same vein, the JOBS Act reforms in the US are largely aimed at decreasing the regulatory burdens for smaller issuers seeking external finance.[96]

(d) Affecting behavior

MD is said to have a "therapeutic" function,[97] when its ultimate goal is to induce desired corporate behavior. MD may reach this outcome by relying on the negative reputational, or even political, effects of public exposure of a different course of action. In this respect, MD acts as a soft-form substitute of more substantive regulations.

This use of MD as a form of stealth substantive regulation is increasing, especially in the domain of corporate governance, but often has corporate social responsibility purposes, such as the fight against gender or income inequality or the prevention of armed conflicts financing, that have nothing to do with the goals identified in section II.1.[98]

Stealth substantive regulation via MD may be ineffective and lead to unintended adverse consequences. Increased disclosure of performance-based compensation, for instance, instead of constraining its persistent rise, may induce an alteration in the overall structure of managerial compensation, leading to an increase in its fixed,

[95] See Proposal for a Market Abuse Regulation, Explanatory Memorandum, par. 3.4.3.3. See also the European Parliament and Council Directive (EU) 2010/73, on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2010] OJ L327/1, Preambles (2), (18), and Article 1, para. (7)(b)(ii) (introducing the so called "proportionate disclosure regime") and European Parliament and Council Directive (EU) 2013/50, amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC [2013] OJ L294/13, Preambles (2), (3), (4), and Article 1, para. (2)(b).

[96] See Jumpstart Our Business Startups Act 2011. It is an open question whether the increase in information asymmetry that the relaxation of the MD system entails (since firms *may* now disclose less value-relevant information to the marketplace) will have the effect of increasing firms' cost of capital or whether they will be able to avoid that via voluntary (ad hoc or industry-standardized) disclosures.

[97] See Bainbridge, n. 3 above, 1797-1801.

[98] Think of disclosure requirements pertaining to board diversity policies in the EU, the ratio between CEO pay and the average employee's pay in the US, or the rules on conflict minerals on both sides of the Atlantic.

"stealth" or on-the-job components.[99] The decrease of the relative weight of performance-based compensation, in turn, may have adverse effects on managers' incentives and thus increase agency costs.[100]

Another example is that of disclosure on internal codes of ethics. The Sarbanes Oxley Act of 2002 required firms to make extensive disclosure about the adoption of internal codes of ethics and, more importantly, about the waivers that the company may have granted to its top managers.[101] The empirical evidence suggests that the new rules proved ineffective in their purpose of inducing more rigorous adherence to best practices.[102] Indeed, rather than decreasing the number and scope of waivers granted to top managers, MD induced firms to relax their internal codes.[103]

(e) Liability risk

MD increases the risk of litigation, which is not only a source of cost for disclosing firms, but may also negatively interact with firms' voluntary disclosure choices and, ultimately, reduce the overall amount of information disclosed. These negative consequences stem from the risk of liability for affirmative misstatements, which tends to increase as the amount of disclosed information and the frequency of a firm's public announcements increase. Indeed, the larger the amount of information released to the public and the more frequently disclosures have to be made, the higher the probability of issuing an incomplete or misleading statement and the greater the liability risk.

[99] See Bebchuk, L and Fried, J, 'Executive Compensation as an Agency Problem' (2003) 17 *Journal of Economic Perspectives* 71, 79-81 (referring, among other things, to "pension plans, deferred compensation, post-retirement perks, and consulting contracts").
[100] See Manne, n. **Fehler! Textmarke nicht definiert.** above, 493-503, for an extensive discussion.
[101] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §406(a)-(b), 116 Stat. 745, 789 (codified at 15 U.S.C. §7264 (2006)).
[102] See generally Rodrigues, U and Stegemoller, M, 'Placebo Ethics: a Study in Securities Disclosure Arbitrage' (2010) 96 *Virginia Law Review* 1; Manne, n. **Fehler! Textmarke nicht definiert.** above, 487-488.
[103] ibid.

The liability risk associated with MD may reduce the amount of *useful* information provided by firms. For the purpose of minimizing liability risk, issuers may adopt a formalistic approach to MD compliance.[104] They may limit their disclosures to "boilerplate" information of scarce importance for investors, shying away from more informative, but litigation-prone, disclosures. In the same vein, firms may systematically avoid speaking to the market other than when the law so requires. In this respect, MD tends to crowd out more spontaneous forms of communication between issuers and investors.[105]

Provisions ancillary to MD requirements, such as the prohibition on selective disclosure,[106] can amplify this effect. The ban on selective disclosure restricts communication between firms and the marketplace. The former are no longer allowed to select the audience of their disclosures and are forced to choose between full confidentiality and speaking to the public at large, a setting in which the risk of disclosure-driven litigation is the highest and cannot be minimized *ex ante* via contract. For that reason, a firm will often refrain from disclosing information that it would have been willing to give, however indirectly, the market, had it been able to select a smaller audience.[107]

Reliance on general standards, instead of more granular, discrete disclosure mandates, may avoid MD's negative effects on issuers' release of useful information: open-ended disclosure duties, such as those mandating prompt disclosure of a firm's material information, increase the liability risk for "staying silent" in the face of any new significant corporate development, thus offsetting the incentive to forgo disclosure for fears of issuing a statement that may ex post be considered as incomplete or deceiving.[108]

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[104] See Easterbrook and Fischel, n 9 above, 709 (point out to the problem of fully compliant but obfuscatory disclosures induced by mandatory rules).

[105] See Kitch, E, 'The Theory and Practice of Securities Disclosure' (1995) 61 *Brooklyn Law Review* 763, 770-772, 840-846. But see Franco, n 49 above, 243, 271 (antifraud rules chill voluntary disclosure, while MD countervails this problem, by creating an exemption for a firm's affirmative statements issued pursuant to the positive duty).

[106] In the US, see SEC Regulation FD (2000). In the EU, see MAD, Preamble n. 24, and Article 6(3), par. 1, and Market Abuse Regulation, Article 12, par. 6.

[107] See, eg, Langevoort, n. 7 above, 164.

[108] See note 117 below and accompanying text.

However, the use of general standards to counteract MD's chilling effects has a significant drawback: firms become inevitably exposed to a high liability risk irrespective of their disclosure decisions. If, in the face of uncertainty as to the material character of a given piece of information, a firm chooses not to disclose, it exposes itself to the risk of being held liable ex post for having breached its disclosure duties. If, for the purpose of avoiding that risk, the firm chooses to disclose, it nonetheless exposes itself to the risk of being held liable for having issued an incomplete or deceiving statement.

The overall cost of a MD system of this kind crucially depends on the intensity of private and public enforcement. In countries where private enforcement is rare and public enforcement less than aggressive, liability risk will be a lesser concern. This may at least in part explain why the EU and the US have different rules on ongoing disclosure of new material information. In the US, where the enforcement of securities regulation is remarkably strong, the enactment of a far-reaching real-time disclosure obligation would have likely raised issuer liability risk to unbearably high levels. That appears not to be the case in Europe, where private enforcement of securities laws is relatively rare and the intensity of public enforcement lower.[109]

(f) Ex ante effects on value creation

Last, but most importantly, MD may distort firms' investment decisions and induce them to forgo profitable projects.[110] The public release of information about a firm's plans and strategies, when too detailed or premature, enhances competitors' free-

[109] According to varying metrics, private and public enforcement of securities regulation (and corporate law rules aimed at investor protection) is more intense in the US than in major EU jurisdictions: see eg Jackson, H, Roe, M, 'Public and private enforcement of securities laws: Resource-based evidence' (2009), 93 *Journal of Financial Economics* 207, 214-215; La Porta, R, Lopez-De-Silanes, F, Shleifer, A, 'What Works in Securities Laws?' (2006), 61 *Journal of Finance* 1, 15-16.

[110] See, Easterbrook and Fischel, n 9 above, 708; Franco, n. 49 above, 339. This is of course true, *mutatis mutandis*, also of any rule requiring traders or investors who are active in the market for corporate influence or corporate control to reveal their investment strategies by disclosing their long or short positions: see eg Enriques, L, Gargantini, M and Novembre, V, Mandatory and Contract-Based Shareholding Disclosure' (2010) 15 *Uniform Law Review* 713, 729-732.

riding on disclosed information and makes their reaction more effective, thus making the project less profitable in the first place, or no longer profitable at all.[111]

More generally, "excess" disclosure in the financial market may stifle innovation (or at least that portion of innovation brought about by companies subject to MD): it is well known that innovation needs secrecy – at least when patent protection is ineffective or unavailable, whether because it is too early or because the novel product does not meet the relevant requirements. Disclosure, especially when too detailed, forward-looking and targeted at business information (such as the firm's current R&D), may weaken firms' incentives in the creation of new products, and this represents a straightforward drawback from the point of view of societal welfare.[112]

Public disclosure makes a firm's investment decisions (and their outcomes) more observable by rivals. It thus increases the value of passive strategies based on "wait and see."[113] If a free riding strategy becomes dominant, then competition loses much of its Schumpeterian character,[114] at the expense of growth.[115]

IV. CONCLUSION

MD systems have a strong tendency to expand over time.[116] This chapter has provided various reasons why this is the case. One additional reason is MD's reliance

[111] See eg Easterbrook and Fischel, n 9 above, 708.
[112] See Schön, n 55 above, 287, 294-296; Zingales, L, 'The Future of Securities Regulation' (2009) 47 *Journal of Accounting Research* 391, 394; Gilotta, S, 'Disclosure in Securities Markets and the Firm's Need for Confidentiality: Theoretical Framework and Regulatory Analysis' (2012) 13 *European Business Organization Law Review* 45, 66-69.
[113] ibid; Kitch, n 105 above, 856.
[114] Competition is Schumpeterian when it has the traits of "creative destruction" (high degree of innovation and high degree of turnover across competing firms in the product market): Schumpeter, J, *Capitalism, Socialism, and Democracy*, 2013, Chapter VII.
[115] See Fox, n 56 above, 1346.
[116] See Paredes, n 8 above, 424-425; Schön, n 55 above, 286 (with reference to the EU); Gordon, J, 'The Rise of Independent Directors in the United States, 1950-2005: of Shareholder Value and Stock Market Prices' (2007) 59 *Stanford Law Review* 1465, 1548-1553 (documenting the increase in firms' disclosure

on general, open-ended standards, which are expansive by their very nature. Think of the "materiality" requirement, which contributes to defining the content of many MD rules in both the US and the EU: whenever there is uncertainty as to the material character of a given piece of information (and this grey area, given the inherent vagueness of the standard itself, is likely to be wide), firms will be induced to disclose, so as to minimize the risk of being held liable *ex post* by a court which, in hindsight, may easily qualify that piece of information as material.[117]

Yet another explanation for the expansive tendency of MD systems is that much of the implementation and enforcement of firms' disclosure duties is left to regulatory agencies that naturally lean toward more disclosure rather than less. First, a pro-disclosure stance derives from their investor protection mission: ever since Justice Brandeis's sunlight metaphor, transparency is a synonym for prevention of opportunism and fraud. Second, mandating more disclosure is the chief tool whereby agencies' top officers increase their power and advance their political agenda. Third, it is tempting for policymakers and regulators to use MD as a therapeutic tool to mold corporate agents' behavior.[118]

Telling when a MD system becomes excessively burdensome is impossible, but unless policymakers exert some self-restraint, the tipping point will eventually be reached (if it has not been already in some jurisdictions). When that is the case, being a listed company becomes unduly costly, and small issuers in particular may be overly

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over the 1950-2005 period but underlining that it is due only in part to SEC MD); Ben-Shahar and Schneider, n 1 above, 684 ("disclosure's logic is inherently expansive. Only broad disclosure accommodates the variety of disclosees and circumstances. One can always imagine that disclosing one more datum might help. Because it is hard to anticipate what data will help, safety seems to lie in broad mandates").

[117] As pointed out in section III(*e*), general standards act as a countervailing force to the chilling effect that liability risk for affirmative misstatements has on firms' disclosure decisions. In fact, an open-ended disclosure duty (such as that based on the material character of the information) creates an opposite and equally wide liability risk for "staying silent" in the face of any new non-trivial development in the firm's affairs, which offsets the tendency to shy away from disclosure generated by liability for affirmative misstatements. As also pointed out, however, this strategy strongly increases disclosure-related liability risk.

[118] See n 97 above and accompanying text.

discouraged from accessing the public securities markets.[119] This, in turn, may be the source of severe drawbacks. Small, newly-established firms are often those providing for the largest part of technological and business innovation. Too strict disclosure rules may inhibit their access to one of the most important sources of external finance, the securities market, making it ex ante more difficult to finance their start-up phase[120] and leading to reduced dynamic efficiency at the macro level. As pointed out in section III(*c*), regulators seem to have at least partially recognized these risks. Their solution has been to compartmentalize securities markets: disclosure duties for large issuers are untrimmed, while smaller ones are exempted from some of them.

The risk with this polarization is that, as a consequence, policymakers and regulators will hesitate even less before imposing new and broader disclosure duties on large issuers. Further, a polarized system may lead to suboptimal issuers' choices, depending on how the threshold is defined. For instance, if market capitalization is used as a threshold, issuers may switch to the less regulated market segment by carving out a subsidiary and listing it as a controlled or independent entity: at the margin, the reduction in MD costs may offset the forgone benefits of being a single listed entity.

In parallel to the continuous expansion, in scope and reach, of disclosure duties, the channels through which firms and investors communicate are shrinking. Firms are no longer allowed to selectively convey material information: they are only permitted to speak to the public at large. This sclerotization of the way firms and investors communicate may have the effect of reducing the overall amount of corporate information that is conveyed to the marketplace (see section III(*e*) above).

Sensitive business information that issuers would have disclosed to a restricted audience, possibly under a duty of confidentiality (think of firm's plans and strategies,

[119] See Ferrarini and Ottolia, n 93 above, 365 (arguing that recent corporate governance reforms, with their emphasis on enhanced financial disclosure, may have discouraged new SMEs from accessing the public securities markets).

[120] The role of the stock market as a driver for the development of early-stage entrepreneurial finance is highlighted in Black, B and Gilson, R, 'Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets' (1998) 47 *Journal of Financial Economics* 243.

or its advancements in R&D), may not be disclosed to the public at large (or at least not in the same degree of detail), due to increased competitive concerns.[121]

Similarly, liability concerns may overly discourage firms from disclosing "soft" information, which in a modern financial market constitutes the most valuable source of insights on a security's value. Soft information is speculative and conjectural (think of management discussion and analysis) rather than factual, qualitative rather than quantitative, forward-looking rather than backward-looking. All these features make it inherently ambiguous in its meaning and thus more prone to misinterpretation by the public—and the courts.

With selective disclosure no longer available, firms may decide to arrest the flow of that kind of information, or to limit it considerably, for fears of deceiving the investing public.[122] If that happens, market efficiency will suffer.

MD rules may well overall benefit both corporate governance and the functioning of securities markets, by providing investors with information that market forces alone would likely not provide. However, stating that mandatory disclosure is desirable amounts to claiming neither that unconditional firm transparency is beneficial nor that imposing *public* disclosure of information is always the best policy. For this reason, policymakers should exert self-restraint when mandating disclosure and pay careful attention to the design of MD contents and modalities.

[121] See eg Fischel, D, 'Insider Trading and Investment Analysis: An Economic Analysis of Dirks v. Securities and Exchange Commission' (1984)13 *Hofstra Law Review* 127, 142; Langevoort, D, 'Investment Analysts and the Law of Insider Trading' (1990) 76 *Virginia Law Review* 1023, 1029; Choi, S, 'Selective Disclosures in the Public Capital Markets' (2002) 35 *University of California Davis Law Review* 533, 541-542.

[122] See eg Langevoort, n. 121 above, 1029-1030.

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