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The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation

Susanna K. Ripken

THE DANGERS AND DRAWBACKS OF THE DISCLOSURE ANTIDOTE: TOWARD A MORE SUBSTANTIVE APPROACH TO SECURITIES REGULATION

Susanna Kim Ripken*

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I. INTRODUCTION

In recent years, American investors have suffered large damages from an unprecedented number of corporate frauds, scandals, and bankruptcies. The accounting irregularities and financial turmoil that engulfed companies like Enron, WorldCom, Global Crossing, and Qwest caused the broad markets to lose trillions of dollars in value and wiped out thousands of jobs

* Professor of Law, Chapman University School of Law. B.A., Stanford University; J.D., UCLA School of Law. The author would like to thank Timothy Canova and Scott Howe for helpful comments. Special thanks to Oriana Kim-Rajab for instrumental research assistance and to Randy Ripken for support throughout all stages of this Article.

and employee pensions.[1] Executives of several public corporations have been found civilly and criminally liable for their part in these corporate collapses.[2] Investigations and prosecutions remain ongoing, and the securities markets continue to feel the effects of the deep abuses committed by large numbers of public corporations and their accountants.

In the aftermath of these corporate scandals and market crashes, confidence in the securities markets plummeted. Investors felt betrayed by the fraudulent conduct and were reluctant to continue investing in a system that seemed rigged.[3] Legislators and regulators felt compelled to do

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[1] *See* 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, 98 (2005) (noting that the recent demise of several large public corporations resulted in the enormous loss of jobs and pensions for shareholders and employees); Seth W. Feaster, *The Incredible Shrinking Stock Market*, N.Y. TIMES, July 21, 2002, at § 4, 14 (showing the decline in the Wilshire Total Market Index from $17.25 trillion in 2000 to $10.03 trillion in 2002); David E. Rovella, *Charges Unlikely for Top Execs at Enron, WorldCom*, L.A. BUS. J., Aug. 25, 2003, at 18 (noting that corporate collapses destroyed 35,000 jobs and $1 billion in employee pensions). For a good description of the corporate and accounting scandals in companies such as Enron, WorldCom, Global Crossing, and Qwest, see Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915, 928–36 (2003). The dimensions of Enron's failure alone were enormous. *See* 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, 225 n.2 (2002). By the time Enron declared bankruptcy, it had lost over 99% of its market capitalization from just the previous year. *Id.* For additional discussions of the Enron fiasco, see generally ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B. Rapoport & Bala G. Dharan eds., 2004); Symposium, *Enron: What Went Wrong?*, 8 FORDHAM J. CORP. & FIN. L. 1 (2002); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002); Anthony H. Catanach, Jr. & Shelley Rhoades-Catanach, *Enron: A Financial Reporting Failure?*, 48 VILL. L. REV. 1057 (2003); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233 (2002).

[2] *See, e.g.*, Ken Belson, *WorldCom Head Is Given 25 Years for Huge Fraud*, N.Y. TIMES, July 14, 2005, at A1 (noting that Bernard Ebbers, former chairman of WorldCom, was sentenced to "25 years in prison for orchestrating a record $11 billion fraud that toppled the telecommunications company"); Thomas S. Mulligan & Walter Hamilton, *John Rigas Is Sentenced to 15 Years*, L.A. TIMES, June 21, 2005, at C1 (describing conviction and sentence of founder and former head of Adelphia Communications Corp., John Rigas, for stealing $100 million from the company); Andrew Ross Sorkin, *Ex-Chief and Aide Guilty of Looting Millions at Tyco*, N.Y. TIMES, June 18, 2005, at A1 (discussing conviction of Dennis Kozlowki, former chief executive of Tyco International, for fraud, conspiracy and grand larceny).

[3] Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,731 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, 249) ("[I]nvestors will lose confidence in a market that they

something immediately to restore investor confidence and to ensure that the financial abuses would not be repeated.[4] The result was the passage of the Sarbanes-Oxley Act of 2002 (the Act),[5] a substantial body of federal legislation that was described as the "most far-reaching reform of American business practices since the time of Franklin Delano Roosevelt."[6] The purpose of the Act was to protect investors and revive public confidence in the integrity and transparency of the securities markets after the financial and emotional devastation caused by Enron and related corporate scandals.[7]

The Act was thus a direct and immediate response to the public outcry over the widespread corporate frauds that gripped the nation. Some commentators have been critical of the Act, arguing that the emotionally-charged political climate at the time of Enron prompted Congress to satisfy angry constituents by adopting the Act with little time for comprehensive

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believe is unfairly rigged against them."); Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 414–15 (2002) (noting the American investor "did not expect her corporate managers to lie, cheat or steal. Now that she suspects many of them have, she feels anxious. She feels distrustful. She feels—as the cover of Business Week magazine recently trumpeted—betrayed."); *see also* Tamar Frankel, *Regulation and Investors' Trust in the Securities Markets*, 68 BROOK. L. REV. 439, 443–44 (2002) ("[W]hen the market crashes and investors lose significant amounts of money, they . . . cannot avoid a suspicion that something wrong in the system caused the crash. Losing investors suspect that the system allowed someone to gain at their expense. They begin to question the integrity of the system, and their trust falters.").

[4] *See* Frankel, *supra* note 3, at 442 (noting that market crashes draw national attention, and that regulators consequently feel compelled to show their voters and investors that they are committed to doing something about investors' losses); *see also* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 27 n.129 (2003) (noting that "the urge to 'do something' is highest immediately following a drop in the financial markets") (citing Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997)).

[5] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in various sections of 15 U.S.C.).

[6] Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1 (quoting President George W. Bush); *see also* Shanon D. Murray, *Is SEC Ready for Its Own Sweeping Changes?*, N.Y. L.J., Aug. 29, 2002, at 5 (quoting Harvey J. Goldschmid, former Commissioner of the Securities and Exchange Commission, who described the Sarbanes-Oxley Act as the "most sweeping legislation since the New Deal").

[7] Marc Morgenstern & Peter Nealis, *The Impact of Sarbanes-Oxley on Mid-Cap Issuers*, 37 REVIEW OF SECURITIES & COMMODITIES REGULATION 245, 245 (Dec. 8, 2004). At the very least, the Sarbanes-Oxley Act expressed to investors that Congress intended to address the abuses and corporate misconduct that enabled the large-scale financial frauds to occur.

deliberation and debate.[8] The Act appeared to be nothing more than a hasty response by Congress and the Securities and Exchange Commission (SEC) triggered by the immediacy of politics and the panic of American investors.[9] The legislation "emerged under circumstances that virtually ensure[d] against the sensitive cost-benefit tradeoff that . . . is necessary" to combat corporate and accounting misconduct.[10] Therefore, despite the rhetoric of sweeping reform, many believe that the Act constitutes only fairly moderate legislation, accomplishing less than it initially appears and fooling investors into a false sense of confidence.[11]

In fairness, the Act does make significant substantive changes in certain areas of corporate governance. For example, the Act flatly prohibits

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[8] *Id*. at 247 (arguing that an "emotionally-charged cauldron of political hysteria" created the Act); *see also* Karmel, *supra* note 1, at 100 (noting that the consequences of enacting vast amounts of federal regulation were not considered or debated in Congress before the Sarbanes-Oxley Act was passed because "newspapers were full of corporate scandals and the SEC, Congress, and the White House felt they had to act to satisfy angry constituents").

[9] *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 52 (2002) (describing the apparent panic that existed at the time of the passage of the Sarbanes-Oxley Act and the possible political origins of the panic); Jonathan H. Gabriel, Note, *Misdirected? Potential Issues with Reliance on Independent Directors for Prevention of Corporate Fraud*, 38 SUFFOLK U. L. REV. 641, 641 (2005) (arguing that the public outcry stemming from the corporate scandals "triggered a response by Congress that in some ways favored the immediacy of politics over long-standing policy").

[10] Ribstein, *supra* note 9, at 45–46. Several commentators have argued that the Sarbanes-Oxley Act, much like securities legislation in general, arose in response to certain perceived crises. *See* Choi & Pritchard, *supra* note 4, at 24 (asserting that certain aspects of the Sarbanes-Oxley Act "would not have been adopted without the external pressure to react to a supposed crisis"); John C. Coates IV, *Private v. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 568–70 (2001) (explaining how recessions, crashes, and scandals place pressure on politicians to act, thereby making new regulation politically irresistible); David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441, 448 (2004) ("Securities law arises in response to crises '—manias, panics, and crashes' . . . .").

[11] *See* Cunningham, *supra* note 1, at 918 (arguing that the Sarbanes-Oxley Act does "little more than shine a spotlight on some best practices, an important function but hardly reform of any sort, sweeping or otherwise"); *id*. at 942 (suggesting that, from a cynical standpoint, the new law simply fools investors); Karmel, *supra* note 1, at 143 (stating that critics characterize the Sarbanes-Oxley Act as a superficial ploy to bolster the status quo); Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1143 (2003) [hereinafter Langevoort, *Expectations Gap*] (acknowledging that the Sarbanes-Oxley Act does "some very good things," but, "it is still fairly moderate legislation"); Westbrook, *supra* note 10, at 461 (observing that the Sarbanes-Oxley Act has a redundant quality, making things illegal that already were outlawed).

corporations from extending personal loans to corporate directors and officers.[12] This ban on insider loans was intended to end the conflicts of interest that were present in the sweetheart loans many corporate executives received from corporations at shareholder expense.[13] The Act also directly prohibits auditors from performing other non-audit services for their corporate clients, including bookkeeping, appraisal or valuation services, investment banking services, or legal and expert services unrelated to the audit.[14] This rule of auditor independence was adopted to prevent the conflicts of interest that arose as auditors conducted their audits to please the corporate managers who hired the auditors simultaneously for non-audit services.[15] These rules are examples of substantive prohibitions the Act adopted to deal with conduct that Congress perceived as being sufficiently serious to merit direct regulation.

However, the explicitly stated goal of the Act was not to substantively regulate corporate behavior, but "to protect investors by improving the accuracy and reliability of corporate *disclosures* made pursuant to the securities laws . . . ."[16] The thrust of the Act is to improve the *disclosure of*

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[12] Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C. § 78m(k)(l) (Supp. II 2002) ("It shall be unlawful for any issuer . . . to extend or maintain credit . . . in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.").

[13] John Rigas, and his son Timothy Rigas, executives at Adelphia Communications Corp., reportedly received a corporate loan for $13 million to build a private golf course and used $26 million of the company's money to purchase forest land adjacent to their estate. *See* Christopher Stern, *Director Describes Rigas Loans; Adelphia Board Didn't Approve Some, He Testifies*, WASHINGTON POST, March 5, 2004, at E2. Adelphia collapsed in 2002 after it revealed that the Rigas family owed more than $2 billion in loans to the company. *Id*. Former Tyco chief executive Dennis Kozlowski was convicted of stealing $156 million from Tyco through unauthorized bonuses and by abusing company loan programs. *See* Karen Freifeld, *Ex-Tyco Duo Guilty; After Deliberating 11 Days, Jury Convicts Ex-CEO, Finance Chief on Charges They Stole $600 Million from Company*, NEWSDAY (N.Y.), June 18, 2005, at A5.

[14] Sarbanes-Oxley § 201(a), 15 U.S.C. § 78j-1(g) (Supp. II 2002).

[15] *See* Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 485–86 (2001) [hereinafter Langevoort, *Seeking Sunlight*] (discussing the biases that auditors have in favor of the corporate managers who hire them and interact closely with them). "Nonaudit sources of income from the firm being audited can surely alter the mix of financial incentives that accountants face." *Id*. at 485; *see also* Ribstein, *supra* note 9, at 13 ("Even the largest accounting firm may have an incentive to overlook misconduct from a client from which it makes significant fees for consulting and other nonaudit work.").

[16] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in various sections of 15 U.S.C.) (preamble) (emphasis added).

information about corporate activities to investors so that they can make informed investment decisions.[17] Thus, several portions of the Act stop short of directly prohibiting or mandating certain corporate or auditor behavior, but rather use disclosure of information as the solution instead.

For instance, the Act requires corporations to disclose whether they have at least one "financial expert" (as described by the statute) on the audit committee of the board of directors, and if the corporation does not have such an expert, the corporation must disclose why not.[18] This is a curious method of regulation. The rule does not require anything substantive. It simply tells companies to adopt a practice of including a financial expert on the audit committee, or explain to investors why the company has not done so. This "adopt-or-disclose" approach is a weak and timid way of promoting competence on audit committees. If it is important to dictate the composition of the audit committee or mandate a certain level of expertise, the Act could simply say and do so, rather than use this back-handed method of compliance-or-disclosure.[19]

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[17] Indeed, the regulation of stock market transactions in general assumes that by disclosing all material information to investors, they can make informed and intelligent investment decisions. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 22 (5th ed. 2005) (noting that federal securities regulation assumes that the full and fair disclosure of all relevant aspects of securities allows investors to evaluate the merits of investments and to fend for themselves); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (describing the purpose of the securities laws as "substitut[ing] a philosophy of full disclosure for the philosophy of caveat emptor . . . ."). The House Report on the Securities Exchange Act of 1934 explained the importance of providing investors with sufficient information to make intelligent investment decisions: "No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. REP. NO. 73-1383, at 11 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

[18] Sarbanes-Oxley Act, § 407(a), 15 U.S.C. § 7265(a) (Supp. II 2002). The statute directs the SEC to define the term "financial expert" by considering a person's education and experience as a public accountant or auditor, along with his knowledge of generally accepted accounting principles, financial statements, audit committee functions, and internal accounting controls. *Id*. § 7265(b).

[19] *See* Cunningham, *supra* note 1, at 948–49 (noting that the "financial expert" rule contains little substance and resembles the European "have-or-disclose" model of best practices which calls for companies to comply with suggestions voluntarily, or explain deviations from best practices). The European Union provides public companies with codes of ethics that companies must either comply with or, alternatively, disclose the reasons why compliance has not been effected. *See* Miguel Lamo de Espinosa Abarca, *The Need for Substantive Regulation on Investor Protection*

This is not the only place where the Act follows an adopt-or-disclose format. Another example can be found in the Act's ethics rules. The Act instructs the SEC to issue rules requiring corporations to adopt a code of ethics for senior financial officers, or if no such ethics code is adopted, corporations must disclose why not.[20] No code of ethics is actually required, but its absence must be disclosed and explained by the company if it chooses to forego one. Again, it is difficult to see the substantive purpose of formulating a rule in this fashion. If codes of ethics are thought to be essential to the proper functioning of senior financial officers, then why not require the outright adoption of ethics codes? Alternatively, if codes of ethics are not critical, what business does Congress have forcing corporations to discuss why they have not adopted something that is nonessential? It is as if Congress and the SEC are afraid to face the merits of the issue head-on. They would rather choose a rule of disclosure than choose a substantive rule that directly mandates certain behavior.

This approach to regulation reflects the long held belief in and preference for disclosure, rather than substantive regulation, as the antidote for most of the securities markets' ills. "[T]here is the recurrent theme throughout [the federal securities laws] of disclosure, again disclosure, and still more disclosure."[21] The disclosure of material information is said to do everything from producing more transparent and efficient markets, to making corporate executives behave more honestly and diligently, to decreasing investor risks and protecting the public interest.[22] The main goal of the securities laws is to provide sufficient disclosure to enable investors to make informed decisions about the securities they buy and sell.[23] For the last seventy years, federal securities legislation in general has consistently relied on the philosophy of disclosure as the primary tool for protecting investors and regulating the securities market.[24]

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and Corporate Governance in Europe: Does Europe Need a Sarbanes-Oxley?, 19 J. INT'L BANKING L. REG. 419, 422 (2004).

[20] Sarbanes-Oxley Act, § 406(a), 15 U.S.C. § 7264(a) (Supp. II 2002). The term "code of ethics" is defined as standards that promote "honest and ethical conduct . . . full, fair, accurate, timely, and understandable disclosure in the periodic reports . . . [and] compliance with applicable governmental rules and regulations." *Id*. § 7264(a).

[21] 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29 (3d ed. rev. 1998).

[22] *See* discussion of disclosure rationales *infra* Part II.A.

[23] *See* discussion *supra* note 17 and accompanying text.

[24] *See* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 83 (1992) (noting that "disclosure-enforcement" was the foundation of early securities regulation and remains the premise of the SEC's regulatory activities today); Elaine A.

In light of the recent corporate scandals and the enactment of the Sarbanes-Oxley Act, it is important to ask whether our time-honored belief in the power of disclosure is really merited. Our system of disclosure has serious weaknesses that cannot be ignored. In order for a disclosure system to be effective, not only must the information that is supplied be disclosed completely, clearly, and accurately, but it must also be read and comprehended by the consumer.[25] Here is where disclosure today fails in its purpose. The emphasis in securities law on providing information to the public is premised on the belief that individuals are rational, self-governing actors who are willing and able to process the information wisely.[26] If we assume that investors are rational risk calculators who are consistently capable of weighing the costs and benefits of risky alternatives and selecting the best option, then a system of disclosure makes good sense. However, substantial evidence indicates that such assumptions of rationality and efficiency in information processing are faulty. Cognitive biases and decision-making constraints cause individuals to depart systematically from rational choice models of decision-making.[27] Moreover, disclosure that is

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Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 534 (1999) (describing the start of federal involvement in securities regulation in the 1930s and noting that "[f]rom the beginning, the central focus of the federal regulatory structure has been disclosure").

[25] Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 692 (1985); *see also* Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 830 (1986) (noting the insufficiency of a disclosure system when disclosure documents either are not read by the investor or, if read, are incomprehensible).

[26] *See* Anne C. Dailey, *Striving for Rationality*, 86 VA. L. REV. 349, 351 (2000) ("The law as we know it operates on the premise that individuals are autonomous, rational, self-governing beings."); Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 699 (1996) [hereinafter Langevoort, *Selling Hope*] (observing that "most doctrinal structures invoke the assumption of dominating rationality" and that "[t]he emphasis in securities law is on making accurate information available").

[27] *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998) ("[H]uman behavior differs in systematic ways from that predicted by the standard economic model of unbounded rationality. . . . Actual judgments show systematic departures from models of unbiased forecasts, and actual decisions often violate the axioms of expected utility theory."); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1503–06 (1998) [hereinafter Langevoort, *Behavioral Theories*] (discussing cognitive psychology research revealing mental biases in making decisions); *see also infra* Part III (examining research on cognitive constraints and biases).

too long or complex to be comprehensible to the average person floods the individual with too much nonessential data and overloads the person with information that inhibits optimal decision-making.[28] Securities regulation is motivated by the assumption that more information is better than less, but evidence shows that too much disclosure can ultimately be counterproductive to the decision-making processes of the individual investor.[29]

If this is true, then perhaps we should rethink the prudence of placing so much confidence in disclosure as the primary means of regulating securities. This Article analyzes and critiques the philosophy of disclosure and questions the legitimacy of always turning to disclosure as the regulatory solution to all of our securities market problems. Today, public companies are required to disclose more information than ever, and in the aftermath of the recent corporate scandals, Congress and the SEC continue to add new disclosure requirements to the mix. However, this obsession with disclosure rules, and especially the type of adopt-or-disclose approach contained in statutes like the Sarbanes-Oxley Act, tends to skirt around the more important issue of whether to mandate or prohibit certain corporate behaviors in the first place. Rather than avoiding the merits of difficult questions, it may be time for regulators to lay aside the gospel of disclosure in favor of more substantive laws that regulate conduct directly.

Part II of this Article traces the evolution of federal policy regarding disclosure and describes the goals and rationales of disclosure regimes. Disclosure-based strategies of regulation have the advantage of constituting a minimalist form of government intervention and preserving investors' freedom to make their own personal assessment of the benefits and risks of potential investments. However, market systems that are based on disclosure also have serious weaknesses. One of the most significant problems with relying on a disclosure-based system to protect securities markets and investors is the flawed assumption that investors are purely rational actors who can utilize the disclosure effectively to make optimal

[28] Courts have recognized this problem with information overload and devised materiality standards that reflect the cognitive limitations that investors face. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) (warning against the tendency "to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking"); *see also* Kohn v. Am. Metal Climax, Inc., 322 F. Supp. 1331, 1362–65 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir. 1972) (leading case on the buried facts doctrine of materiality).

[29] *See* discussion on information overload *infra* Part III.A.

investment decisions. Part II criticizes the assumptions of investor rationality that underlie the philosophy of disclosure.

Psychological data reveal that cognitive and behavioral constraints, biases, and heuristics can impair investors' ability to read, process, and factor disclosure into their decisions to buy and sell securities. The focus of Part III is to determine what the social and psychological research has to say about the costs and benefits of rules that emphasize disclosure versus rules that directly regulate conduct. Investor psychology should play a more significant role in fashioning regulation that does the best job of protecting investors and promoting confidence in the securities markets.

These issues implicate deeper concerns about the efficiency of modern financial markets to incorporate all relevant information in the pricing of securities. Adherence to efficient capital market theory would suggest that even if unsophisticated investors suffer from cognitive errors in decision-making, the presence of sophisticated investors and market intermediaries will move the market price of securities to their fair, intrinsic value. Thus, a disclosure-based regime is the most efficient and effective method of protecting all investors. Part III criticizes this theory and analyzes the presumed efficiency of the securities markets to process disclosure effectively. What often makes investors vulnerable is not their lack of information, but cognitive limits on their decision-making processes. Sophisticated investors are not immune from this vulnerability. These concerns pose broader policy questions about whether securities regulation should be designed to help the average, unsophisticated investor, or the sophisticated market professional.

Part IV highlights the costs and fundamental weaknesses associated with the disclosure system of regulation. One of the limitations of disclosure is the difficulty of drafting simplistic, understandable descriptions of the structure and operations of business organizations that are today more complex than at any other time in history. The sheer magnitude, reach, technology, and complexity of large multi-national corporations defy simple and uncomplicated description in disclosure documents. Moreover, in practical terms, corporate disclosure documents today are riddled with formalized language written by corporate attorneys to protect companies from liability, rather than to provide investors with meaningful information.

In light of the problems associated with disclosure, Part V proposes an alternative approach to securities regulation that utilizes more substantive mandates and prohibitions to shape corporate conduct. Regulating conduct directly, rather than taking the easy approach of demanding more and more disclosure, requires far more thought and analysis of difficult questions on their merits. For example, should we ask that directors who have conflicts of interest merely disclose them in annual reports, or should we instead demand that certain conflict transactions and relationships be prohibited outright? Opting for disclosure may seem less controversial because it allows investors to decide whether the conflict is sufficiently important to affect their investment decisions. However, the disclosure solution constantly tends to avoid the harder question of whether we want to allow certain conflict activity to exist at all. Part V argues that the Sarbanes-Oxley Act in many respects falls short of addressing these deeper issues in a meaningful way.

Proponents of disclosure may argue that more substantive forms of regulation constitute merit regulation which is paternalistic. Substantive regulation violates our concept of investor autonomy and is antithetical to our philosophy of freedom of contract, private ordering, and free market economics. Part V addresses these and other counterarguments. Closer analysis reveals that markets are legally constructed instruments that require substantive regulation to operate effectively. Securities laws, by their very nature, have social as well as economic consequences, and securities regulation carries certain obligations to protect the public interest. "[T]he issue is not regulation versus free market. The issue is what type of regulatory structure should be imposed."[30]

The purpose of this Article is not to argue that disclosure is an improper means of regulating securities, but instead, to try to introduce a note of caution. Reliance on disclosure as the safety net for securities markets may be overdone, and we should be careful about placing too much confidence in the disclosure solution.

II. DISCLOSURE PHILOSOPHY

A. Goals of the Disclosure System

When the stock market crashed in 1929, countless investors lost their life savings and learned that the securities they had purchased for years were worthless. These investors, who had been given little information about the securities they had invested in, were allured by promises of easy

[30] Welle, *supra* note 24, at 551.

wealth and became victims of widespread fraud and manipulation.[31] Of the approximately $50 billion of securities that were sold in the decade following World War I, approximately $25 billion worth proved to be totally valueless.[32] Because the entire country was affected by the economic collapse of the market and the desperation of the Depression, Congress held hearings to study the problem and devise a strategy for restoring public confidence in the securities market.[33] The result was the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934.[34] The goal was to eliminate abuses, restore investor confidence, and maintain the integrity of the capital markets.[35] The method by which the

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[31] *See* Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 BUS. LAW. 61, 61 (1971) (citing H.R. REP. NO. 73-85, at 2 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973)); Welle, *supra* note 24, at 534 (describing the rampant "fraud, manipulation, and victimization of investors" that occurred during the time of the stock market crash of 1929).

[32] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 1–2 (3d ed. 2003); Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 496 n.9 (1984).

[33] *See* STOCK EXCHANGE PRACTICES: REPORT OF THE COMMITTEE ON BANKING AND SECURITY, S. REP. NO. 73-1455, at 1–4, *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973); *see also* Levenson, *supra* note 31, at 61 (noting that the federal securities laws were enacted "at a time when the stock market was at its lowest ebb as was our general economy"); Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1339 (1996) (observing that the securities laws were "adopted by a Congress fearful of a loss of confidence in U.S. financial markets brought on by the Great Depression"); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 24–30 (1983) (describing the Congressional hearings that preceded enactment of the 1933 and 1934 securities laws); Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 757 (1984) (asserting that "the federal securities laws were Congress's response to a national catastrophe").

[34] Securities Act of 1933, 15 U.S.C. § 77a–77aa (2000 & Supp. II 2002); Securities Exchange Act of 1934, 15 U.S.C. § 78a–78nn (2000 & Supp. II 2002).

[35] *See* Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 545 (2003) ("The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s. There was also a need to assure against systemic collapses caused by excessive stock market speculation . . . ."); Seligman, *supra* note 33, at 51 (describing Roosevelt's arguments in favor of the 1933 Act emphasizing the goal of bringing back public confidence); Welle, *supra* note 24, at 575 ("The securities laws were enacted to restore order, to foster fair play, and to insure the integrity of the financial markets.");

1933 and 1934 Acts were to accomplish this goal was through a system of comprehensive disclosure.[36] So long as corporations disclosed all material information about their operations and their securities, investors could make their own investment decisions. To this day, disclosure remains the primary tool for regulating our securities markets.[37]

Using a disclosure-based system of regulation has several rationales. First, disclosure rules can induce corporate managers to behave more diligently and honestly because they know their actions will be regularly exposed to the light of day.[38] As Louis Brandeis famously stated, "Sunlight

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see also Marine Bank v. Weaver, 455 U.S. 551, 555 (1982) ("The Act was adopted to restore investors' confidence in the financial markets . . . .").

[36] The legislative history of the federal securities laws makes clear that investor protection through disclosure is the key aim of the laws: "The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; . . . to restore the confidence of the prospective investor in his ability to select sound securities . . . ." REGULATION OF SECURITIES, S. REP. NO. 73-47, at 1 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

Prior to the passage of the 1933 and 1934 Acts, securities regulation consisted of state merit laws that were considered paternalistic because they gave state administrators the power to bar the sale of securities that, in the administrator's mind, lacked merit or posed an unreasonable risk of unfairness or fraud. *See* Warren, *supra* note 32, at 529 (noting critics' complaint that the fairness standards in merit regulation are unduly paternalistic); *see also* Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79, 87, 106 (1976) (discussing state merit regulation). As it turned out, state laws could do little to prevent or punish the securities fraud that led to the market crash because they were limited in their jurisdictional reach. *See* Seligman, *supra* note 33, at 18, 21; Warren, *supra* note 32, at 501 ("In passing federal securities legislation, Congress acted primarily to fill regulatory gaps which the states could not fill because of jurisdictional limits on their authority.").

[37] Choi & Pritchard, *supra* note 4, at 71 ("Disclosure is the primary tool of the present U.S. securities regulatory regime."); *see also* James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 156 (1998) (describing the SEC's traditional mission as disclosure related to securities transactions).

[38] Lowenstein, *supra* note 33, at 1339 ("[C]orporate executives, like the rest of us, behave more honestly, diligently and competently when they know that their stewardship of other people's money is open to scrutiny."). Because corporate executives "manage today what they know we will measure tomorrow," advocates of disclosure argue that disclosure is an "effective mechanism for inducing managers to manage better." *Id*. at 1336; *see also* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1205, 1227 (1999) (describing the historical view of disclosure as the regulatory means to ensure greater public accountability and ethical behavior in corporate management). Disclosure of corporate executives' misconduct is a form of shaming and can actively be used to

is said to be the best of disinfectants; electric light the most efficient policeman."[39] The threat of public exposure can deter corporate misconduct and prevent fraudulent behavior from occurring in the first place.[40] Another way of expressing this rationale is to say that disclosure serves to reduce agency costs, the costs that shareholders would otherwise incur to monitor their agent directors and officers to ensure that they are performing their duties properly.[41] It is argued that disclosure rules can thus be used to indirectly influence corporate decision-making without having to adopt substantive rules of conduct.[42]

Second, the disclosure of information allows investors to make fully informed investment decisions whether to buy securities.[43] By reducing the

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influence corporate conduct. David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001) (noting that shaming sanctions are a potentially effective penalty for corporations and their directors).

[39] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914). Another oft-quoted phrase that expresses the sunlight principle is, "people who are forced to undress in public will presumably pay some attention to their figures." LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 36 (1983). In the language of norm creation and enforcement, disclosure of corporate activity "can provide the necessary publicity to help create and enforce business norms" and notify the public "about 'rogue' corporations and/or corporate actors." James A. Fanto, *Investor Education, Securities Disclosure, and the Creation and Enforcement of Corporate Governance and Firm Norms*, 48 CATH. U. L. REV. 15, 24 (1998).

[40] *See* Choi & Pritchard, *supra* note 4, at 22 (describing the philosophy of disclosure and noting that "[o]nce investors (and others) can see [problematic] activities clearly, then market participants are less likely to engage in opportunistic behavior in the first place"); Skeel, *supra* note 38, at 1857 ("In short, a firm that is required to disclose misbehavior may not engage in it in the first instance."); A.A. Sommer, Jr., *Random Thoughts on Disclosure as "Consumer" Protection*, 27 BUS. LAW. 85, 87 (1971) (noting that one of the stated purposes of disclosure is to "prevent some fraudulent transactions which could not stand the scrutiny of publicity . . . .").

[41] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048–1051 (1995) (describing the agency cost model and contending that the purpose of the disclosure regime when it was adopted was to help shareholders monitor managers' self-interested behavior, thereby reducing monitoring costs and agency costs).

[42] *See* RUSSELL B. STEVENSON, JR., CORPORATIONS AND INFORMATION: SECRECY, ACCESS AND DISCLOSURE 81–82 (1980) ("Today the disclosure requirements of the securities laws are used, in a variety of ways, for the explicit purpose of influencing a wide range of corporate primary behavior . . . ."); Elliott J. Weiss, *Disclosure and Corporate Accountability*, 34 BUS. LAW. 575, 575 (1979) (noting that "corporate decision-making [can] be regulated through mandatory disclosure requirements rather than direct government intervention").

[43] Congress relied on this rationale in adopting the federal securities laws. *See* H.R. REP. NO. 73-1383, at 11 (1934) *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) ("No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of

informational asymmetry that exists between corporations and investors, disclosure levels the playing field so that all market participants have equal access to information about corporations and their securities.[44] Investors can then make informed valuation judgments about the price of securities and determine for themselves whether a certain piece of stock is worthless.[45] The premise is that, without disclosure, investors would have inadequate information regarding the risks associated with any particular

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the securities he buys or sells."). The SEC has also explained this disclosure rationale: "[I]f the investor had available to him all the material facts concerning a security, he would then be in a position to make an informed judgment whether or not to buy." Securities Act Release No. 33-5223, 37 Fed. Reg. 591, 592 (Jan. 14, 1972).

[44] *See* Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1044 (1987) ("By mandating such disclosure, the law attempts to redress the informational imbalance between promoters and investors."); *see also* Aleta G. Estreicher, *Securities Regulation and the First Amendment*, 24 GA. L. REV. 223, 291 n.283 (1990) ("The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller."). Disclosure is a remedy for informational asymmetries in markets other than securities as well. For example, information disclosure can be beneficial in the context of healthcare. *See, e.g.*, William M. Sage, *Regulating Through Information: Disclosure Laws and American Health Care*, 99 COLUM. L. REV. 1701, 1716 (1999) ("If information is asymmetric, with the asymmetry favoring sellers over buyers, disclosure laws can restore the balance of knowledge and allow consumers to make efficient choices among market offerings. Indeed, imbalances of information . . . have long been identified as the principal reason health care markets might fail.").

[45] *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 985 (1992) (discussing how securities laws "make stock prices more accurate"); Langevoort, *Expectations Gap, supra* note 11, at 1152 (noting that one of the purposes of disclosure is "to allow investors to make informed valuation decisions—in other words, what are the securities worth compared to their current price?"); Sage, *supra* note 44, at 1716 ("A prerequisite to accurate pricing is that consumers understand exactly what they are buying."); *see also Federal Securities Act: Hearings on H.R. 4314 Before the H. Comm. on Interstate and Foreign Commerce*, 73d Cong. 53 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) (stating that the theory for the 1933 Act was "not to prevent the issuance of worthless stock, but merely to give such facts as will enable a purchaser to recognize it as worthless stock"). *But see* Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 17 (1999) (questioning the premise that disclosure "enables investors to more accurately price expected returns and risks, and thus distinguish between good and bad investments").

investment.[46] Disclosure promotes fairness and empowers the investor with information to make smart investment choices.

All of this results in increasing the transparency and efficiency of the securities markets.[47] Greater transparency produces increased price stability and diminished market volatility. With full disclosure, the price of a given security can be expected to shift less drastically because there is more accurate public information about the security floating in the market and therefore less of a need to rely on rumor and speculation.[48]

Another goal of disclosure regulation is to boost investor confidence in the securities market. Disclosure rules that deter fraudulent corporate conduct and equalize access to information promote investor trust and confidence.[49] When investors believe that the market will treat them fairly and that they will not be defrauded if they invest in securities, investors are more likely to participate in the market rather than invest their funds elsewhere.[50] In turn, the increased capital that investors bring to the market benefits corporations by making more capital available to them at lower

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[46] *See* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 345 (1999) ("The premise of all these mandatory disclosure rules is that in the absence of these rules investors would have inadequate information about the risks associated with particular securities.").

[47] *See* Westbrook, *supra* note 10, at 453 (noting that disclosure regimes "increase transparency and thereby increase informational efficiency of markets" by reducing excessive trading volume and volatility). Transparency is an important ideal in American life generally, not just in the securities markets. *See* Lowenstein, *supra* note 33, at 1342 (observing that the public's "right to know" and our insistence on openness and candor are ubiquitous features of our society that affect government operations, public officers, and major businesses).

[48] *See* Levenson, *supra* note 31, at 62 (postulating that disclosure results in less dramatic shifts in estimates of expected profitability of a given stock due to the greater level of economic information available and the diminished reliance on rumors).

[49] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 692 (1984) (explaining argument that "[d]isclosure rules both deter fraud and equalize 'access' to information, restoring the necessary confidence" in the capital markets); Seligman, *supra* note 33, at 51 (noting the expectation that full disclosure of material information can reduce investors' concerns that they can be defrauded or treated unfairly and help facilitate an increased level of corporate securities sales).

[50] *See* Marc I. Steinberg, *Curtailing Investor Protection Under the Securities Laws: Good for the Economy?*, 55 SMU L. REV. 347, 354 (2002) (arguing that without investor confidence, the markets would experience reduced liquidity and investor funds would flow to other types of investments); Stout, *supra* note 3, at 408 (contending that absent investor trust, investors would refuse to purchase corporate securities and instead "would put their savings into tangible assets like gold or real estate, or under their mattresses").

prices.[51] Investor trust is therefore critical for the securities markets to work, and disclosure helps to facilitate that trust.

Ultimately, disclosure decreases investor risks and protects the public interest.[52] It can be seen as a way of remedying the social and economic wrongs that occur when those with greater information exploit those with less information.[53] Disclosure regulation performs this task in a manner that constitutes a minimalist form of government intervention.[54] Rather than flatly prohibiting certain forms of conduct, disclosure rules require only the dissemination of information about that conduct, preserving the autonomy of investors to decide for themselves whether the conduct is sufficiently significant to deter their purchase of a given security. Thus, the advantage of disclosure regulation is that it promotes the protection of investors and the public interest without interfering too greatly in the operation of the free market.

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[51] *See* Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 668 (1988) ("According to the 'investor-confidence' theory, inefficient pricing erodes investor trust in the market's 'integrity,' discouraging investor participation in the stock market and reducing capital formation."); *see also* Lamo de Espinosa, *supra* note 19, at 426–27 (describing cases that prove investor confidence results in lower capital costs for companies because investors do not demand a higher price for their investment). In order to attract capital, companies may voluntarily subject themselves to the rigors of the mandatory disclosure regime, thereby signaling to the market that they are companies of quality that will credibly commit to comprehensive, truthful disclosures. *See* Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 684–91 (2002) (describing disclosure system as a credible commitment device).

[52] *See* Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 313–14 (1974) (discussing the use of disclosure to protect investors from unfair treatment, fraud, and exploitation); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1247 (1977) (describing SEC's position that "disclosure can be used as a tool to realize social goals and to protect the public interest"); Troy L. Harder, Comment, *Searching for a Level Playing Field: The Internationalization of U.S. Securities Disclosure Rules*, 24 HOUS. J. INT'L L. 345, 348 (2002) (citing three main benefits to disclosure: "making markets more fair for investors, decreasing risk to investors, and allocating capital resources more efficiently").

[53] *See* Sargent, *supra* note 44, at 1037 (describing disclosure regulation as "an inheritance of the Progressive faith in the value of disclosure as a remedy to social and economic wrongs").

[54] Jackson, *supra* note 46, at 344 (noting that the "great advantage of disclosure-based strategies is that they constitute a minimalist form of government intervention" because "[c]onsumer knowledge is enhanced, while consumer preferences are left largely undisturbed").

While the philosophy of disclosure may offer certain advantages for regulating the securities market, reliance on disclosure regulation alone raises broader questions about the law's dependence on rational choice models of decision-making. The belief that disclosure is beneficial, and the emphasis on ensuring that accurate information is available to the public, rests on the assumption that investors are rational, competent actors who are capable of circumspectly processing the information. It would make no sense to insist that risks be disclosed if we did not assume that people could rationally weigh the costs and benefits of risky alternatives and select the optimal choice. However, as the following discussion indicates, evidence suggests that this assumption may be somewhat misguided.

B. Flawed Assumptions of the Rational Choice Model

Disclosure-based strategies of regulation begin with the assumption that people are rational and that material information given to investors provides a rational basis to evaluate securities.[55] The rational choice model of human behavior postulates that individuals "can perfectly process available information about alternative courses of action, . . . can rank possible outcomes in order of expected utility . . . [and can] choose the course of action that will maximize [their] personal expected utility . . . ."[56] In other

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[55] *See* Levenson, *supra* note 31, at 62 ("The economic justification for disclosure as the keystone of investor protection lies in the belief that material corporate and financial information disseminated to prospective investors provides a rational basis to evaluate securities and this is a necessary precondition to efficient markets.").

[56] Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 23 (1989); *see also* GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOR 14 (1976) ("[A]ll human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets."); Chris Guthrie, *Prospect Theory, Risk Preference, and the Law*, 97 NW. U. L. REV. 1115, 1115–16 (2003) ("Rational choice theory, which describes how people would behave if they followed the dictates of a series of logical axioms, posits that people make outcome-maximizing decisions."); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 642 (1999) ("Rational behavior came to be synonymous with expected-utility-maximizing behavior."). Rational choice theory has influenced a wide range of disciplines for many years. *See* Dailey, *supra* note 26, at 381–83 (noting that the rational actor model is a "simple and elegant paradigm for human behavior" that has prevailed in the law and economics field for over thirty years); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1060 (2000) (observing that scholars in "political science, history, international relations, sociology, finance and accountancy, and, of course, law, have adopted rational choice

words, people should be viewed as rational actors who will seek out information regarding alternatives, skillfully calculate utilities for each option, and select the course of action that will maximize their wealth and preferences.[57] In the securities context, the model suggests that autonomous investors are cool, calculating, self-interested actors who can evaluate the pros and cons of risky investments in light of the information they are given, and then make rational choices for their benefit.[58]

If we accept the premise that individuals are competent, rational information processors who can derive helpful insight from disclosure, then disclosure-based regulation seems sensible. Rules that emphasize the disclosure of information, rather than the outright elimination of risky activities or misconduct, are consistent with assumptions of rational decision-making.[59]

There are good reasons to believe, however, that reliance on such assumptions of rationality and efficiency in information processing is misplaced. Human decision-making processes are not always governed by reason.[60] A substantial amount of behavioral evidence reveals that people

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theory as their central account of human decision making"). *See generally* RATIONAL CHOICE: THE CONTRAST BETWEEN ECONOMICS AND PSYCHOLOGY (Robin M. Hogarth & Melvin W. Reder eds., 1987) [hereinafter RATIONAL CHOICE] (discussing rational choice theory from the perspectives of multiple economists and psychologists).

[57] *See* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q. J. ECON. 99, 99 (1955); *see also* Clifford Rechtschaffen, *The Warning Game: Evaluating Warnings Under California's Proposition 65*, 23 ECOLOGY L.Q. 303, 315–16 (1996). The model assumes that individuals have a stable set of preferences against which they can evaluate alternatives when making decisions. Simon, *supra*, at 99.

[58] *See* Stout, *supra* note 3, at 410–15 (describing the rational expectations model of investor behavior); *see also* Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. ASS'N 1, 2 (1978) ("As is well known, the rational man of economics is a maximizer, who will settle for nothing less than the best."). On a more global level, markets are assumed to incorporate actions taken by rational decision-makers who act to maximize their own gains, thereby keeping the market efficient. *See* Robin M. Hogarth & Melvin W. Reder, *Introduction: Perspective from Economics and Psychology*, *in* RATIONAL CHOICE, *supra* note 56, at 1, 6; *see also infra* Part III.E (discussing the efficient capital market hypothesis).

[59] *See* WESLEY A. MAGAT & W. KIP VISCUSI, INFORMATION APPROACHES TO REGULATION xiii (1992) (describing economists' argument that, assuming consumers are rational, the government should choose information provision over regulation of risky activities).

[60] Critics of rational choice theory argue that it "is a simplistic theory having little correspondence with the real world of (individual) consumer behavior." Jacob Jacoby, *Is It Rational to Assume Consumer Rationality? Some Consumer Psychological Perspectives on Rational Choice Theory*, 6 ROGER WILLIAMS U. L. REV. 81, 84 (2000). Several of the key

do not consistently act in accordance with rational choice theory.[61] Instead, the rationality of individuals' decisions and actions is bounded because of inevitable limits on time, attention, skill, and information.[62] The constraints of human reasoning cause people to make choices that often may not maximize their utilities. People have a tendency to use heuristics, i.e., mental shortcuts or rules of thumb, when making decisions about risks.[63] Cognitive constraints, heuristics, and decision-making biases cause

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assumptions underlying rational choice theory have been subject to criticism. *See id.* at 100–22 (attacking nine assumptions of the theory).

[61] *See* Werner F.M. De Bondt, *A Portrait of the Individual Investor*, 42 EUR. ECON. REV. 831, 831 (1998) (noting that psychologists for the last forty years have amassed evidence that reason is not an adequate basis for a descriptive theory of decision-making); Korobkin & Ulen, *supra* note 56, at 1055 ("There is simply too much credible experimental evidence that individuals frequently act in ways that are incompatible with the assumptions of rational choice theory."); Robert A. Prentice & Jonathan J. Koehler, *A Normality Bias in Legal Decision Making*, 88 CORNELL L. REV. 583, 584–85 (2003) (observing that "a veritable mountain of scientific evidence now exists showing that decision makers" do not always act in "rational pursuit of self-interest"). Critics of the rational actor model argue that it is incompatible with effective legal analysis. *See, e.g.*, Howard Latin, *Activity Levels, Due Care, and Selective Realism in Economic Analysis of Tort Law*, 39 RUTGERS L. REV. 487, 487 (1987).

[62] *See* Jolls et al., *supra* note 27, at 1477; Howard A. Latin, *Problem-Solving Behavior and Theories of Tort Liability*, 73 CAL. L. REV. 677, 684 (1985). Herbert Simon introduced and discussed the bounded nature of rationality in several of his articles. Bounded rationality refers to the intrinsic limitations people have in processing information and making decisions that reflect optimal choices. *See* HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1961) (explaining that people are "*intendedly* rational, but only *limitedly* so"). *See generally* HERBERT A. SIMON, MODELS OF BOUNDED RATIONALITY (1982). Other bounds on human behavior include "bounded willpower" and "bounded self-interest." *See* Jolls et al., *supra* note 27, at 1479.

[63] *See* James R. Bettman et al., *Cognitive Considerations in Designing Effective Labels for Presenting Risk Information*, 5 J. PUB. POL'Y & MARKETING 1, 6 (1987); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 906 (2002); *see also* Matthew L. Spitzer, *Book Review*, 9 HOFSTRA L. REV. 1621, 1622 (1981) (reviewing RICHARD NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT (1980)) (explaining that "[j]udgmental heuristics are rules of thumb and short cuts which help to create, maintain, alter or summon particular knowledge structures"); Kenneth Ian Weissman, *A "Comment J" Parry to Howard Latin's "Good" Warnings, Bad Products, and Cognitive Limitations*, 70 ST. JOHN'S L. REV. 629, 668 (1996) (noting that cognitive heuristics are mental strategies that people adopt to simplify the processing of complex information). Although reliance on heuristics can be useful, it can also cause severe and systematic errors in judgment. Chris Guthrie et al., *Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 780 (2001).

systematic departures in behavior from outcomes predicted by rational actor models of behavior.[64]

These cognitive limitations come into play whenever a person must assess the probability of an uncertain event—a circumstance that characterizes the very nature of investing in securities markets.[65] People do not always approach money rationally. In fact, the psychological data show that people do not make rational choices when it comes to their saving and investing activities.[66] Many investors' decisions are influenced by systematic biases that impair their abilities to maximize their investment returns.[67] The following section discusses several of these cognitive and behavioral constraints with reference to their specific effects on corporate executives and individual investors. In the context of individual behavior within markets, evidence of heuristics, biases, and shortcomings in decision-making processes suggests that it may be wise to rethink certain assumptions of rationality. The insights gained from the psychological research may be helpful in evaluating the wisdom of relying so heavily on disclosure alone to regulate the securities markets.

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[64] Classic resources describe these systematic judgment and decision-making constraints. ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD (1988); DECISION MAKING: DESCRIPTIVE, NORMATIVE, AND PRESCRIPTIVE INTERACTIONS (David E. Bell et al. eds., 1988) [hereinafter DECISION MAKING]; JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982) [hereinafter JUDGMENT UNDER UNCERTAINTY]; RICHARD NISBETT & LEE ROSS, HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT (1980). *But see* Jennifer Arlen, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1768 (1998) (arguing that rational choice theory remains viable because many cognitive biases can be remedied by experience, work within organizations, or expert advice). Deviations from the value-maximizing behavior predicted by rational choice models occur both at the individual and organizational levels. *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1413–14 (2002).

[65] *See* Hanson & Kysar, *supra* note 56, at 662–72 (discussing several cognitive anomalies exhibited when people attempt to assess probabilistic judgments).

[66] *See* Fanto, *supra* note 37, at 118 (noting that people's inability to act rationally with respect to their saving and investing activities is a strong basis for paternalistic pension policies).

[67] Choi & Pritchard, *supra* note 4, at 2.

III. BEHAVIORAL AND COGNITIVE BIASES, HEURISTICS, AND CONSTRAINTS

A. *Information Overload*

Information is empowering; it enables people to make informed decisions and thereby protect their own interests. But, information is beneficial only to the extent that it can be understood and utilized effectively by the individual to whom it is directed. In some contexts, too much information can be worse than too little because people are boundedly rational and have only limited cognitive abilities to process vast amounts of complex information at once.[68] Evidence suggests that when people are given too much information in a limited time, the information overload can result in confusion, cognitive strain, and poorer decision-making.[69]

When faced with too much data, people have a tendency to become distracted by less relevant information and to ignore information that may turn out to be highly relevant.[70] They can handle moderate amounts of data

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[68] *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418–19 (2003) (describing effects of information overload); *see also* JAMES R. BETTMAN, AN INFORMATION PROCESSING THEORY OF CONSUMER CHOICE 174 (1979) ("[C]onsumers do not have the resources or the abilities necessary to process the total amount of information which might potentially be available for making any particular choice. . . . [C]onsumers have limited processing capacity.").

[69] Naresh K. Malhotra, *Reflections on the Information Overload Paradigm in Consumer Decision Making*, 10 J. CONSUMER RES. 436, 437–38 (1984); Paredes, *supra* note 68, at 440–41; *see also* MAGAT & VISCUSI, *supra* note 59, at 90–92 (1992) (discussing information overload). Information overload has been applied to the consumer context of product warnings where detailed hazard warnings can prove to be counterproductive in conveying risks to consumers. *See* Howard Latin, *"Good" Warnings, Bad Products, and Cognitive Limitations*, 41 UCLA L. REV. 1193, 1212 (1994) (noting that too much information can be as much of an impediment to effective user comprehension of product hazards as too little information because consumers choose to read only part of the information and find it hard to select the most important parts to read). *But see* David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 294, 301 (1986) (questioning the concept of information overload and arguing that consumers "satisfice" rather than overload when information sets become large); Roberta Romano, *A Comment on Information Overload, Cognitive Illusions, and Their Implications for Public Policy*, 59 S. CAL. L. REV. 313, 313 (1986) (agreeing with David Grether et al. that information overload is not a serious issue for consumer law).

[70] *See* Jacob Jacoby, *Perspectives on Information Overload*, 10 J. CONSUMER RES. 432, 433 (1984) (finding that information overload "can make processing more time-consuming and can also cause consumers to pay less attention to relevant information"). To the extent that the

well, but tend to make inferior decisions when required to process increasingly more information.[71] Therefore, the assumption that more information is always better may not hold true in certain contexts that involve complex decision-making.

In the securities markets, investors can be overloaded with overly dense, lengthy disclosure documents, such as prospectuses and annual reports, that are filled with an abundance of information presented in "mind-numbing detail."[72] Corporations have become accustomed to disclosing more and more information to investors without accounting for the drawbacks of information overload. As one large public corporation put it: "If [our] annual report or quarterly report has to be the size of the New York City phone book, that's life."[73] A document of that size hardly seems conducive to effective decision-making for the average investor. In fact, evidence shows that when people know that they probably will be unable to understand and process dense text, they simply will not read it at all.[74]

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amount of information makes consumers less likely to pay attention to critical information, such amounts of information can actually be dysfunctional. *Id.* at 435. "[T]he more information there is, the more each bit of it is diluted. The immediate and salient crowds out the less attention-grabbing." Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 759 (1997).

[71] *See* Jacoby, *supra* note 60, at 133 (stating that the acquisition of information is helpful up to a point, but thereafter "acquiring more information leads consumers to make poorer decisions"); Robert A. Robertson, *In Search of the Perfect Mutual Fund Prospectus*, 54 BUS. LAW. 461, 486 n.114 (1999) ("Consumers may make incorrect decisions when they are required to process too much information; they do well with moderate amounts of data but poorly when data sets become too large."); *see also* Jason Ross Penzer, Note, *Grading the Report Card: Lessons from Cognitive Psychology, Marketing, and the Law of Information Disclosure for Quality Assessment in Health Care Reform*, 12 YALE J. ON REG. 207, 238–39 (1995) ("Consumers provided with too much information disregard most of it and therefore make objectively poorer decisions. . . . As a result, choices are based on a fraction of the significant data.").

[72] *See* Aetna Cas. & Sur. Co. v. Ralph Wilson Plastics Co., 509 N.W.2d 520, 523 (Mich. Ct. App. 1993) (finding in products liability cases that "excessive warnings on product labels may be counterproductive, causing 'sensory overload' that literally drowns crucial information in a sea of mind-numbing detail"). Overloading the consumer with too much detail is of particular concern in the product warning setting. *See* W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 RUTGERS L. REV. 625, 633 (1996) (speculating that consumers are inhibited from effectively processing warnings when they are "inundated with so many pieces of information that they cannot process all the warning messages they receive").

[73] Rachel Emma Silverman, *GE to Change Its Practices of Disclosure*, WALL ST. J., Feb. 20, 2002, at A3 (quoting Jeffrey Immelt, GE's chairman and chief executive).

[74] Melvin Aron Eisenberg, *Text Anxiety*, 59 S. CAL. L. REV. 305, 309 (1986) (noting that consumers who are faced with dense text that they know they probably will not be able to

Even former SEC Chairman Arthur Levitt noted that "[t]oo much information can be as much a problem as too little," and "[m]ore disclosure does not always mean better disclosure."[75]

When the average investor is presented with disclosure that is too long and complex to be processed efficiently, the overload can hinder informed decision-making and thereby defeat the very purpose of disclosure requirements.[76] Investors who attempt to process all the available financial disclosure in the securities markets can actually perform worse than those who disregard the disclosure.[77] Some have speculated that the volatility of the stock market may stem in part from information overload of investors in efficient markets.[78] What this means for securities regulation is that a preference for disclosure-based rules may not always be the best approach.

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understand simply do not load any information at all and thereby avoid anxiety and emotional frustration); s*ee also* Norman I. Silber, *Observing Reasonable Consumers: Cognitive Psychology, Consumer Behavior and Consumer Law*, 2 LOY. CONSUMER L. REP. 69, 72 (1990) (contending that consumers may be entirely reasonable in ignoring information when overloaded with dense text).

[75] Arthur Levitt, *Corporate Finance in the Information Age*, 11 INSIGHTS, Mar. 1997, at 19; *see also* Paredes, *supra* note 68, at 451–52 (noting that in the securities context, "[m]ore information is not per se better than less"). In fact, the "more is better approach [to disclosure laws assumes] incorrectly that all information is useful . . . ." *See* Sage, *supra* note 44, at 1724.

[76] The Supreme Court has recognized that "bury[ing] the shareholders in an avalanche of trivial information [is] a result that is hardly conducive to informed decisionmaking." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976). Some commentators have suggested that less information may in fact promote more informed investor decision-making. *See* Paredes, *supra* note 68, at 452.

[77] *See* GARY BELSKY & THOMAS GILOVICH, WHY SMART PEOPLE MAKE BIG MONEY MISTAKES—AND HOW TO CORRECT THEM: LESSONS FROM THE NEW SCIENCE OF BEHAVIORAL ECONOMICS 188 (1999) ("Investors who tune in too closely to financial reports probably fare worse than those who tune the news out."). In one study, one group of investors was given constant news reports about a company, while another group received none. *Id.* "Investors who received no news performed better than those who received a constant stream of information, good and bad." *Id.* Investors who traded more volatile stock and received no news earned twice as much money as those whose trades were influenced by media reports. *Id.*; *see also* Sarah Hewitt et al., *SEC Internet Report*, NAT'L L.J., Jan. 24, 2000, at B5 (noting that the Internet has "resulted in many over-informed investors who are unsure of how to digest the information made available to them"); Charles Zehren, *Online Investing: Here's a Winnow of Opportunity*, NEWSDAY (N.Y.), May 24, 2000, at A50 (noting that information overload is "among online investors' greatest enemies").

[78] *See* Alex Berenson, *Of Information Overload and the 'Efficient' Market*, N.Y. TIMES, May 21, 2000, at C1 (discussing work of Professor Greg Duffee, former researcher for the Federal Reserve, who attributes increased stock market volatility to the effect of the availability of information on efficient markets).

Requiring the disclosure of more and more information can perhaps be counterproductive for the average investor who is unsuccessful in effectively processing the available information. Regulation that emphasizes disclosure, rather than the merits of particular corporate conduct, may not be as beneficial or empowering for investors as it might seem.

B. Overconfidence Bias

Another bias that is evident from the psychological literature is that people exhibit a startling degree of overconfidence.[79] As a general rule, most people think that they are better than average at many tasks. For example, studies have shown that the vast majority of people are confident that their driving abilities are better than average.[80] They have a tendency to think they are more intelligent and more ethical than average,[81] and are more likely to have gifted children, a higher than average salary, and greater than average satisfaction in their jobs.[82]

For corporate executives, this overconfidence bias can lead not only to self-serving beliefs about their managerial skills, but also to an overestimation of their knowledge and of the validity of their judgments.[83]

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[79] *See* Werner F.M. De Bondt & Richard H. Thaler, *Financial Decision-Making in Markets and Firms: A Behavioral Perspective*, *in* 9 HANDBOOKS IN OPERATIONS RESEARCH AND MANAGEMENT SCIENCE 389 (R. Jarrow et al. eds. 1995) (noting that one of the most widespread and "robust finding[s] in the psychology of judgment is that people are overconfident").

[80] *See* Paul Slovic et al., *Facts Versus Fears: Understanding Perceived Risk*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 64, at 463, 468, 470; Ola Svensen, *Are We All Less Risky and More Skillful than Our Fellow Drivers?*, 47 ACTA PSYCHOLOGICA 143, 146–47 (1981). This overconfidence may stem from a person's belief that "I am different" or "I am more careful." Baruch Fischhoff, *Cognitive Liabilities and Product Liability*, 1 J. PROD. LIAB. 207, 212 (1977).

[81] Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1613 (2000); *see also* Marsha T. Gabriel et al., *Narcissistic Illusions in Self-Evaluations of Intelligence and Attractiveness*, 62 J. PERSONALITY 143, 146–51 (1994).

[82] Shelley E. Taylor & Jonathan D. Brown, *Illusion and Well-Being: A Social Psychological Perspective on Mental Health*, 103 PSYCHOL. BULL. 193, 196–97 (1988). Recently married couples almost unanimously expect that they will not get divorced, despite knowing the average divorce rate. *See* Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 LAW & HUM. BEHAV. 439, 442–43 (1993).

[83] *See generally* Baruch Fischhoff et al., *Knowing with Certainty: The Appropriateness of Extreme Confidence*, 3 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 552 (1977) (summarizing experiment showing people tend to be overconfident in their beliefs and the

The bias drives a systematic and persistent view that one's own company is superior to its competitors and will perform better than average in the competitive market.[84] Executives can develop an inflated sense of the value of what they do and the quality of the products or services their company sells.

Overconfidence facilitates an enhanced sense of ability to control events and risks. This illusion of control can induce corporate executives to believe that their own actions and skill can cause positive outcomes to occur, even when events are uncontrollable.[85] This motivational bias leads people generally to view positive results and good fortune as the product of their own talents and decision-making abilities, while attributing negative outcomes to external circumstances over which they had no control.[86] Evidence suggests that the bias appears regularly in the annual reports that corporations send to their shareholders. Studies of annual reports indicate that favorable corporate outcomes are more likely to be attributed to company strategy and managerial effort, while negative results are more

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degree of certainty in their judgments); Dale W. Griffin & Carol A. Varey, *Towards a Consensus on Overconfidence*, 65 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 227, 228 (1996) (describing the overestimation of one's knowledge and judgment as a form of overconfidence).

[84] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause other Social Harms)*, 146 U. PA. L. REV. 101, 140 (1997) [hereinafter Langevoort, *Organized Illusions*] (discussing overconfidence in business organizations).

[85] *See* Paul M. Biner et al., *Need State and the Illusion of Control*, 21 PERSONALITY & SOC. PSYCHOL. BULL. 899, 899 (1995) (describing the "illusion of control" as the "tendency to be overconfident in one's ability to attain outcomes that are chance determined"); *see also* DAWES, *supra* note 64, at 256 (citing studies that show "we treat chance events as if they involve skill and are hence controllable"). An example of this tendency is found when gamblers throw the dice with greater force when they want high numbers than when they are trying to roll low numbers. *See id*. at 257. *See generally* Ellen J. Langer, *The Illusion of Control*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 64, at 231 (discussing the illusion of control and possible causes for its persistence).

[86] *See* DAWES, *supra* note 64, at 263 (citing evidence that most people tend to ascribe their successes to their own abilities and their failures to factors beyond their control, such as bad luck); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 147 (2002) [hereinafter Langevoort, *Taming*] (noting that overconfidence leads to the tendency to take credit for good results, but to externalize blame for bad ones). "[P]eople are not willing to recognize that their failures stem from a lack of competence or skill." *Id*.

often attributed to external constraints such as inflation, poor weather, or governmental policy.[87]

These tendencies can cause executives to place unwarranted confidence in their predictions about future events. People tend to overestimate their ability to predict outcomes accurately.[88] In making predictive judgments under uncertainty, people are prone to exhibit far too much confidence in highly fallible choices.[89] Corporate executives may take on too many risks with the belief that adverse outcomes are unlikely to occur, or that they can be prevented from occurring by executives' own skill and expertise.[90] Overconfidence in their abilities may motivate them to trivialize potential risks or not to see them as risks at all.[91]

All of these tendencies can have important effects on the manner in which corporate executives disclose information to the public. If the overconfidence bias leads executives to have an exaggerated belief in the superiority of their company, in the strength of their own management skills, and in the probability that adverse risks will never materialize, then executives' disclosure statements about the company and its performance may end up being rather distorted. Moreover, if executives have a tendency to underestimate or rationalize potential risks, then disclosure about the

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[87] *See* Gary Johns, *A Multi-Level Theory of Self-Serving Behavior in and by Organizations*, *in* 21 RESEARCH IN ORGANIZATIONAL BEHAVIOR 1, 8 (Robert I. Sutton & Barry M. Staw eds., 1999) (summarizing studies of causal attribution statements in corporate annual reports).

[88] HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 51 (2000) (noting people's tendency to be overconfident in their ability to predict what will happen in the stock market); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1172 (2003) (describing overconfidence as "overestimating one's ability to predict outcomes").

[89] *See* Daniel Kahneman & Amos Tversky, *On the Psychology of Prediction*, 80 PSYCHOL. REV. 237, 249 (1973). This phenomenon is termed the "illusion of validity," and it "often persists even when its illusory character is recognized." *Id*. One ironic aspect of the phenomenon is that "people are much less likely to be overconfident about easy probability judgments . . . [it is the] difficult judgments [that] produce the most overconfidence." Ward Edwards & Detlof von Winterfeldt, *Cognitive Illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 239 (1986).

[90] *See* A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 5 (2003).

[91] *See* Langevoort, *Selling Hope*, *supra* note 26, at 695 (suggesting that because motivational biases may lead stock brokers to ignore or trivialize risks, brokers may push securities on investors without adequately disclosing the investment risks).

risks associated with investing in the company may not be as substantive as would otherwise be the case, leading to boilerplate risk disclosures.[92]

Corporate executives are not the only ones whose decisions and actions may be influenced by the overconfidence bias. Investors also can be overconfident in their abilities to assess risks and to make wise investment decisions. Most investors overrate their stock-picking abilities and believe that their investment skills are above average.[93] Studies have shown that investors consistently overestimate both the future performance and the past performance of their investments.[94] The illusion of control causes investors to believe that positive investment outcomes are due to investors' own skills and superior strategy, rather than good luck.[95] Success itself can lead traders to become even more overconfident.[96]

Overconfidence also leads people to believe they have better-than-average abilities to judge people and identify cheaters or liars. The psychological research shows that people substantially overrate their own

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[92] *See* Langevoort, *Organized Illusions*, *supra* note 84, at 161 n.212 (sensing that biases in organizations may result in boilerplate risk disclosure due to a resistance to meaningful public acknowledgement of the seriousness of risks).

[93] *See* SHEFRIN, *supra* note 88, at 132–33 (discussing overconfidence of investors); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 142–46 (2000) (discussing investors' overconfidence and intuitive judgments). Overconfidence can lead to increased market trading volume and volatility. Terrance Odean, *Volume, Volatility, Price, and Profit When All Traders Are Above Average*, 53 J. FIN. 1887, 1888–89 (1998); *see also* Brad M. Barber & Terrance Odean, *Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773, 800 (2000) (finding that overconfidence sparks excessively high trading levels which, in turn, result in poor investment performance for individual traders).

[94] Don A. Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORGANIZATIONAL BEHAV. & HUMAN DECISION PROCESSES 95, 95 (1999).

[95] Jonathan Clements, *The Stock Market Isn't as Bad as You Think: The Right Moves for Tough Times*, WALL ST. J., Sept. 11, 2002, at D1 (noting that "[o]verconfident investors also attributed those gains to their own investment savvy, leading them to become even bolder in their investment bets"); *see also* SHILLER, *supra* note 93, at 59 (noting investors' tendency to interpret their investing success as confirmation of their own abilities); Langevoort, *Taming*, *supra* note 86, at 147 (commenting that due to overconfidence, investors "will attribute a streak of good luck as skill and will attribute a run of losses to bad luck or someone else's fault"); Moore et al., *supra* note 94, at 97 (noting illusion of control may cause investors to overestimate their investment performance); Meir Statman, *Lottery Players/Stock Traders*, 58 FIN. ANALYSTS J., Jan.–Feb. 2002, at 14, 18 (observing that the illusion of control "leads stock traders to believe that their chosen stocks have better odds than stocks chosen by darts thrown at stock tables").

[96] Simon Gervais & Terrance Odean, *Learning to Be Overconfident*, 14 REV. FIN. STUD. 1, 2 (2001) ("Overconfidence does not make traders wealthy, but the process of becoming wealthy *can* make traders overconfident.").

capacity to evaluate the trustworthiness of others.[97] In the context of the securities market, investors' overconfidence may cause them to feel they can comb through corporate disclosures and know which companies' disclosures are truthful and which sets of corporate executives can be trusted.

Such overconfidence and overly broad sense of control is especially acute for online traders and day traders.[98] Placing trades directly online, rather than having to use a broker as an intermediary, can make investors feel even more empowered and in control of their investments.[99] The abundance of online investment information now available to individual investors can bolster the illusion of knowledge and control.[100]

Just like corporate executives, overconfident investors can systematically underestimate the levels of risk they assume.[101] Investors may feel certain that they have better-than-average abilities to avoid adverse risks and to invest only in those companies that will produce positive outcomes. This overconfidence may make it difficult for investors to process disclosure statements effectively, especially when the disclosure is intended to convey the risks of investing in a particular company. Investors may ignore such information because they feel confident that their superior investment strategies will produce successful outcomes, regardless of the disclosed risks.

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[97] *See* Peter J. DePaulo et al., *Lying and Detecting Lies in Organizations*, *in* IMPRESSION MANAGEMENT IN THE ORGANIZATION 377, 386 (Robert A. Giacalone & Paul Rosenfeld eds., 1989) (discussing factors that make it especially difficult to detect lies in organizational settings); Paul Eckman & Maureen O'Sullivan, *Who Can Catch a Liar?*, 46 AM. PSYCH. 913 (1991).

[98] *See* SHEFRIN, *supra* note 88, at 133–34 (discussing overconfidence of online investors). For a description of day traders and the regulation of day trading, see Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets"*, 26 J. CORP. L. 63, 88–95 (2000). The number of day traders peaked during the bull market of the late 1990s. *See* Aaron Elstein, *Yes, Day Traders Still Exist, They Just Keep a Lower Profile*, WALL ST. J., Oct. 17, 2002, at D4 (estimating that 400,000 people were involved in day trading at the bull market's peak).

[99] Brad M. Barber & Terrance Odean, *The Internet and the Investor*, 15 J. ECON. PERSP. 41, 42 (2001).

[100] *Id*. at 42, 47. An illusion of knowledge can stem from a greater volume and variety of information made available to online investors. *Id*. at 46.

[101] Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 859 (1992) [hereinafter Langevoort, *Theories*].

C. Optimism

People have a tendency to be unrealistically optimistic about their lives and the future. Studies show that people consistently believe that they are far more likely than others to experience positive life outcomes.[102] In the corporate context in particular, optimism is critical. Corporations must set forth the most positive image possible in their efforts to sell their products, services, or securities to the public. Indeed, it has been observed that information contained in the "Management Discussion & Analysis" section of required corporate SEC filings tends to reflect the optimism bias.[103]

The tendency toward optimism in corporate disclosures may be due to structural factors within organizations themselves. The reasons why companies systematically present unduly optimistic information to the public could stem from the hierarchical nature of communication and decision-making structures inside the organization. As information flows upward and is filtered through multiple layers within the managerial hierarchy, positive information tends to move more quickly to the top while negative information travels more slowly and is skewed to minimize blame at each level.[104] The upward transmission of adverse information within the corporate hierarchy can be unconsciously hindered at every level, as each person in the chain is reluctant to pass along negative news to immediate supervisors lest it reflect badly on his performance.[105] The "tendency to

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[102] *See* Hanson & Kysar, *supra* note 56, at 654–57 (discussing studies that exhibit individuals' bias for optimism); Taylor & Brown, *supra* note 82, at 196–97 (discussing unrealistic optimism).

[103] *See* Langevoort, *Organized Illusions*, *supra* note 84, at 157–58 n.197 (citing Moses L. Pava & Marc J. Epstein, *How Good Is MD&A as an Investment Tool?*, 175 J. ACCT., Mar. 1993, at 51, 52–53).

[104] *Id.* at 125. Professor Langevoort insightfully explains how the nature of upward information flow within organizations poses a challenge for corporate decision-making because of pressures at each level in the hierarchy to place a positive spin on the information being relayed. *Id*. at 119–26. In some corporations, a dozen or more hierarchical levels separate the first-line supervisor and the company president, making it likely that only a very diluted and positive message will reach the top. Coffee, *supra* note 52, at 1138. Moreover, the bias toward optimism is even more pronounced in groups than in individuals. *See, e.g.*, Chip Heath & Forest J. Jourden, *Illusion, Disillusion and the Buffering Effect of Groups*, 69 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 103, 104–13 (1997) (finding that group activities tend to foster more positive illusions than individual efforts, and groups produce higher levels of positive affect by buffering people from negative feelings they typically harbor after completing a task individually).

[105] *See* Coffee, *supra* note 52, at 1137–38 (discussing psychological effects of cognitive dissonance on the transmission of adverse or conflicting information in the corporate hierarchy). This systematic censorship of negative information may be why studies of corporate collapses

report information selectively, emphasizing the positive while filtering out the negative, is characteristic of all bureaucratic organizations."[106] The larger and more authoritarian the organization, the more likely it is that its top executives, who make important decisions and are responsible for the way corporate disclosures are phrased, "will be operating in purely imaginary worlds."[107] A natural optimistic bias results and is reflected in the ultimate corporate disclosure statements that are disseminated to the public. Thus, organizational communication systems, in conjunction with individual cognitive biases, can exacerbate the tendencies to put an overly optimistic spin on disclosed information.

Moreover, people who are optimistic are prized in the hiring and promotion process. They make better leaders who have the ability to motivate others and spread their "can do" attitude throughout the organization.[108] In the business setting, the most successful people tend not to be the realists, but the optimists, whose high levels of self-esteem, decisiveness, and assertiveness make them more influential and persuasive.[109] Corporate executives who are optimistic are more willing to take risks and to minimize the likelihood that adverse results will occur. Overoptimism and self-confidence are traits that are disproportionately represented in corporate executives, especially CEOs.[110] The culture of the corporation can exacerbate optimistic biases as companies tend to reward

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have often found that the boards of directors knew very little information to warn them of the impending disasters. *Id*. at 1134.

[106] *Id*. at 1131.

[107] *Id*. at 1138 (quoting Kenneth E. Boulding, *The Economics of Knowledge and the Knowledge of Economics*, 56 AM. ECON. REV., May 1966, at 1, 8).

[108] *See* Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 645 (1997) [hereinafter Langevoort, *Epistemology*] (describing overoptimism in younger firms that prize energetic and enthusiastic managers). Optimistic corporate managers "will place great weight on hiring new managers with similar traits . . . resisting the enthusiasm-draining acknowledgment of uncontrollable risk." *Id*. Overoptimism may constitute the greatest threat to accurate disclosure of risks and negative information. *Id*.

[109] Langevoort, *Organized Illusions*, *supra* note 84, at 153–54 (discussing the adaptive nature of optimism for success in business and citing supporting social science data).

[110] Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 288–300 (2004) [hereinafter Langevoort, *Resetting*]. In fact, some commentators note that high corporate offices can often be filled by certain personality types, like narcissists. *See* Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, the Inevitable Cons*, HARV. BUS. REV., Jan. 2004, at 92, 92–96.

executives who are positive and self-confident. To the extent that the optimism leads executives to work harder, be more persistent, and more willing to take risks, it benefits the firm.[111]

Such attitudes have direct effects on the types of disclosures that corporate executives make about the company. Executives are likely to provide disclosure that is habitually overoptimistic and self-serving, which can be misleading to the public.[112] Faced with the prospect that a product under development is failing or that earnings are faltering, optimistic corporate executives may honestly believe that these are minor obstacles that can be overcome; hence, they will be disinclined to publicly acknowledge the seriousness of these potential problems.[113] Executives' overoptimism can lead them to mislead investors about the true state of affairs in the company and its future profitability. Indeed, the optimistic view that the business eventually will turn around and prosper can cause executives to cut corners and rationalize short-term falsifications.[114] Disclosures that tend to reduce the significance of risk factors can have misleading effects because the market is not adequately warned of the negative outcomes that have some probability of occurring.

Corporate executives are not alone in their tendency toward optimism. Investors can also be exceedingly optimistic about the future of the market and about their own investment performance.[115] They tend to harbor irrational beliefs that their investment decisions will consistently produce

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[111] Langevoort, *Resetting*, *supra* note 110, at 300–01.

[112] Langevoort, *Organized Illusions*, *supra* note 84, at 157; *see also* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 110–11 (2002) [hereinafter Langevoort, *Monitoring*] (explaining "why senior managers work so hard to be optimistic in their utterances (and why charismatic leaders almost always exude optimism), although there is no reason to suspect that cheerleading alone produces the desired result").

[113] Langevoort, *Organized Illusions*, *supra* note 84, at 141. Indeed, persistent overconfidence and optimism can lead directors of a company on the verge of bankruptcy, with full knowledge of the dire state of the firm's finances, to believe nonetheless that the firm can fully recover. *See* Dickerson, *supra* note 90, at 6–7.

[114] Langevoort, *Seeking Sunlight*, *supra* note 15, at 482; *see also* Ribstein, *supra* note 9, at 21 ("Hypermotivated and superoptimistic insiders might be able to persuade themselves that any setbacks were temporary, so that cover-ups need only work for a little while to be successful.").

[115] *See* SHEFRIN, *supra* note 88, at 131–32 (discussing excessive optimism of investors); De Bondt, *supra* note 61, at 839 (finding that investors are overoptimistic about the likely performance of their shares).

good results and that they can beat the market.[116] The optimism about the future can make them more confident in their judgment and their ability to control future events. They underestimate the risks associated with buying securities and resist the possibility that catastrophic risks may materialize. Evidence shows that people fail to estimate the likelihood of low probability, high loss events, such as securities fraud.[117] The reason is because the optimism bias, in general, causes people systematically to discount or underrate risks in their lives.[118] Although they recognize that risks of bad outcomes exist, they are reluctant to believe these risks apply to them personally.[119] People think they are less likely to experience negative events and less vulnerable to risks than others.[120]

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[116] *See* Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 861 (2000) ("Investors have a patently unrealistic view of the true downside [of investing in the stock market]."). Many studies have shown that individual investors tend to be poor traders, "buying stocks for the wrong reasons, holding losers for too long, and acting on whims and emotions." Marcia Vickers & Gary Weiss, *Wall Street's Hype Machine: It Could Spell Trouble for Investors*, BUS. WK., Apr. 3, 2000, at 112, 115. Excess optimism may lead investors to believe that they can become millionaires overnight by investing in the market. *See* Rachlinski, *supra* note 88, at 1187 (noting that media stories about investors who become instant millionaires spur exuberance in trading).

[117] *See* Prentice, *supra* note 64, at 1482; Ribstein, *supra* note 9, at 22; Welle, *supra* note 24, at 580–81; *see also* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1676 (1989) (stating that "individuals systematically underestimate future risk" and "tend to discount excessively the risk of future exploitation").

[118] *See* Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997); *see also* Arlen, *supra* note 64, at 1773–74.

[119] *See* David M. DeJoy, *Attitudes and Beliefs*, *in* WARNINGS AND RISK COMMUNICATION 189, 198 (Michael S. Wogalter et al. eds., 1999) (finding that people have great difficulty in personalizing risk). This behavior might be characterized as the "'it can't happen to me' syndrome or, more properly, the 'it's less likely to happen to me than the average person' syndrome." Hanson & Kysar, *supra* note 56, at 656. For example, studies suggest that smokers perceive smoking to be significantly less risky for themselves than for other smokers. *See* Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1512–14 (1999) (summarizing studies). In *Contreras v. St. Luke's Hosp.*, 144 Cal. Rptr. 647, 650 (Cal. Ct. App. 1978), the defendant told the plaintiff, "In one out of a hundred operations, infection was one of the complications," to which the plaintiff replied, "Doctor, you say it's one out of a hundred. Then I'm not going to be the one."

[120] *See* Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659–61 (1998); Jolls et al., *supra* note 27, at 1524; *see also* DeJoy, *supra* note 119, at 198 (noting that people consistently underestimate the likelihood of experiencing negative events in their lives); Prentice, *supra* note 81, at 1614 (citing studies indicating that people underestimate their risk of lung cancer, infection from AIDS, and drug addiction);

These optimistic tendencies may affect the way investors respond to corporate disclosure. Disclosure statements that are positive or project favorable outcomes reinforce investors' own optimism about the future and exacerbate optimism biases. Disclosure that is more negative or that contains cautionary statements about risk factors may not be particularly effective because optimistic investors "want to think the warnings are meant for someone else, not them."[121] Thus, overoptimism can lead investors to neglect disclosure provisions that are intended to protect them from poor investments.[122] Because corporate executives' own optimism can lead them cognitively to minimize certain risks, investors may not have a clear picture of how damaging the risks can be. Overly optimistic executives may be motivated to say what they think the market wants to hear, and in turn, the market may focus too readily on only those aspects of the message that it likes. In light of these cognitive biases, the law's emphasis on disclosure itself appears overly optimistic about the ability of information alone to enable investors to protect their own interests.[123]

D. Confirmation Bias and Anchoring Heuristic

In order to avoid cognitive dissonance, people have a tendency to seek out confirming evidence of their beliefs and to discount information that contradicts their views.[124] The confirmation bias involves a tendency to

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Sunstein, *supra* note 118, at 1183–84 (citing studies finding that the vast majority of people believe they are less likely than others to have car accidents, heart attacks, asthma, and other health problems). Unrealistic optimism may even induce people to believe they are less likely than their peers to be a victim of crime. *See* Moore et al., *supra* note 94, at 97 (citing Linda S. Perloff & Barbara K. Fetzer, *Self-Other Judgments and Perceived Vulnerability to Victimization*, 50 J. PERSONALITY & SOC. PSYCHOL. 502 (1986)).

[121] Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 880 (1995) [hereinafter Langevoort, *Ego*].

[122] Choi & Pritchard, *supra* note 4, at 12.

[123] An analogous argument has been made about the doctrine of informed consent in the context of medical treatments. *See* Jon F. Merz & Baruch Fischhoff, *Informed Consent Does Not Mean Rational Consent: Cognitive Limitations on Decision-Making*, 11 J. LEGAL MED. 321, 345 (1990) ("In light of these cognitive limitations, the legal rhetoric of informed consent appears unreasonably optimistic about the ability of information alone to ensure that patients will make decisions in their own best interests.").

[124] *See* Barber & Odean, *supra* note 99, at 46–47; Dickerson, *supra* note 90, at 5–6; *see also* Langevoort, *Monitoring*, *supra* note 112, at 87 (discussing people's tendency to construe information in ways that bolster their prior decisions); Prentice, *supra* note 81, at 1617 n.98 (citing studies discussing the confirmation bias).

"search for, treat kindly, and be overly impressed by information that confirms [one's] initial impressions or preferences."[125] Individuals can become polarized in their perspectives as they filter information for evidence that supports their decisions or actions. Once they make up their mind about something, they tend to avoid, minimize, or reject new information that contradicts their previously established beliefs.[126] This reaction may stem from a desire to continue believing what they want or expect to believe.[127]

The anchoring heuristic can also come into play when people are confronted with new information. Anchoring refers to the tendency of individuals to "latch on to an idea or fact and [use] it as a reference point for future decisions."[128] Once a person begins with an initial value or probability estimate, subsequent decisions are biased toward that initial reference point,[129] and people tend to resist altering the original assessment

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[125] BELSKY & GILOVICH, *supra* note 77, at 130. By the same token, people will avoid asking questions or gathering data challenging their previously held ideas, the bias could therefore be termed "disconfirmation disinclination." *Id.*; *see also* SHEFRIN, *supra* note 88, at 64 (noting the psychological finding that people "are prone to search for confirming evidence, not disconfirming evidence"). Research in the area of belief perseverance is also relevant. *See* NISBETT & ROSS, *supra* note 64, at 179–92 (discussing the belief perseverance phenomenon). The confirmation bias causes even "trained scientists [to] judge research reports that agree with their views to be of higher quality than those that disagree." Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 146 (2000) (citing Jonathan J. Koehler, *The Influence of Prior Beliefs on Scientific Judgments of Evidence Quality*, 56 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 28, 47 (1993)).

[126] *See* DeJoy, *supra* note 119, at 199 (discussing the suppression of conflicting information); Latin, *supra* note 69, at 1227–28 (noting that people tend to avoid new information that conflicts with established beliefs); Prentice, *supra* note 81, at 1618 n.102 (citing studies showing that people persevere in beliefs even after the evidence upon which their beliefs were formed has been completely discredited). A possible motivation for this reaction is that the suggestion that a person made a mistake in judgment is ego-threatening and stressful. Filtering out or ignoring such threatening information resolves the person's cognitive dissonance. Langevoort, *Ego*, *supra* note 121, at 857.

[127] This tendency may arise out of self-serving beliefs to "see what we expect to see" and to "see what we want to see." THOMAS GILOVICH, HOW WE KNOW WHAT ISN'T SO: THE FALLIBILITY OF HUMAN REASON IN EVERYDAY LIFE 49–87 (discussing the motivational determinants of belief and the evaluation of ambiguous data).

[128] BELSKY & GILOVICH, *supra* note 77, at 136; *see also* DAWES, *supra* note 64, at 121–25 (discussing anchoring and adjustment); Guthrie et al., *supra* note 63, at 787–90 (discussing anchoring).

[129] *See* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, *in* JUDGMENT UNDER UNCERTAINTY, *supra* note 64, at 3, 14; *see also* Stephen M.

when presented with pertinent new information.[130] If the initial probability judgment is incorrect or irrational, then all future assessments based on the original anchor will likely be in error as well.[131] Much like the confirmation bias, the anchoring heuristic can lead people to make initial judgments that "prove remarkably resistant to further information, alternative modes of reasoning, and even logical or evidential challenges."[132] Thus, after people make initial probability estimates of risk, they may not modify their risk assessments as much as is warranted by new information regarding the risk.[133]

In the corporate setting, once executives have committed to a course of action or particular business strategy, the confirmation bias provides strong motivation to resist evidence that their decisions were wrong.[134] In fact, when faced with contradictory information, they may become even more entrenched in their viewpoints and persevere to an unwarranted degree with their previously planned objectives. This can lead to what is termed an escalation of commitment in which the executives direct even more resources and efforts toward achieving the originally conceived goals.[135] If

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Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1046 (2000) (describing the anchoring phenomenon); Rachlinski, *supra* note 88, at 1171 (noting that people rely heavily on reference points when making numeric estimates).

[130] *See* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 754–55 (1990) (describing anchoring as a source of error in making probability estimates).

[131] *See* Sunstein, *supra* note 118, at 1188.

[132] NISBETT & ROSS, *supra* note 64, at 41; *see also* Rechtschaffen, *supra* note 57, at 330 (identifying the anchoring heuristic as a tendency people have "to maintain their prior beliefs despite later evidence to the contrary"). The extent to which individuals may be unwilling to integrate new information can be unwarranted if they "yield ground only grudgingly and [are] primed to challenge the relevance, reliability, or authority of subsequent information." NISBETT & ROSS, *supra* note 64, at 41.

[133] *See* Latin, *supra* note 69, at 1237–38 (discussing the implications of the anchoring heuristic on warnings).

[134] *See* MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 39–41, 85–88 (3d ed. 1994); *see also* Langevoort, *Organized Illusions*, *supra* note 84, at 142–43 (discussing managerial reluctance to reverse course once a commitment has been made).

[135] *See* Johns, *supra* note 87, at 22–25 (discussing the escalation of commitment as a self-serving search for identity and resources); Barry M. Staw, *The Escalation of Commitment to a Course of Action,* 6 ACAD. MGMT. REV. 577, 584 (1981) (finding that people have a tendency to escalate commitment to an extent unwarranted by "objective" facts). Corporate executives may have difficulty terminating losing projects due to loss aversion. *See* SHEFRIN, *supra* note 88, at 24; *see also* Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, *in* DECISION MAKING, *supra* note 64, at 167, 173 (explaining that loss aversion causes people's

it turns out the executives' decisions were wrong, the usual response is "not recognition of the mistake followed by regret, but rather an increasingly unrealistic revisionism to justify those choices as ones a reasonable person would make."[136]

In the context of disclosing information about the company, executives describing particular corporate projects or strategies may be motivated to focus on the projects' favorable potential, rather than on their risks of failure, in order to bolster the wisdom of their decision. They may seek out information that confirms the positive nature of their descriptions and discount evidence that contradicts their views. Anchoring can cause executives to underestimate the probability of failure.[137] Because the tendency will be to ignore danger signals and to de-emphasize information that conflicts with executives' favorable impressions, executives may end up unwittingly withholding important information from the public in their disclosure statements.[138]

The behavior of investors can also be influenced by the confirmation bias and the anchoring heuristic. Investors may look for information that affirms, rather than undermines, their beliefs, and they may be slow to change their beliefs in the face of new evidence.[139] Once investors have decided to select a particular investment, changing course would imply that they made a mistake in judgment. Via an escalation of commitment, investors may "throw good money after bad" to losing investments in order

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response to losses to be far more extreme than their responses to gains). People have a strong aversion to losses and often feel the need to continue with the committed activity in order to recoup their losses or break even. This tendency has been referred to as the get-evenitis disease. *See* SHEFRIN, *supra* note 88, at 24, 107–17.

[136] Langevoort, *Seeking Sunlight*, *supra* note 15, at 482; *see also* Ribstein, *supra* note 9, at 21 (noting that "once having begun their conduct, insiders managed to deceive themselves that their actions were right").

[137] *See* Tversky & Kahneman, *supra* note 129, at 15–16 (explaining anchoring biases in the evaluation of conjunctive and disjunctive events, and concluding that anchoring can result in the overestimation of the probability that a plan will succeed and the underestimation of the likelihood that it will fail).

[138] Choi & Pritchard, *supra* note 4, at 19–20 (discussing managers' susceptibility to the confirmation bias and its effects on disclosure).

[139] *See* SHEFRIN, *supra* note 88, at 62 ("Investors search only for confirming evidence, and they ignore disconfirming evidence."); Nicholas Barberis et al., *A Model of Investor Sentiment*, 49 J. FIN. ECON. 307, 315 (1998) (discussing the related phenomenon of conservatism that causes investors to disregard new information and cling to their prior estimates of earnings performance).

to try to break even.[140] Investors have a systematic tendency to hold onto bad investments longer than they should, perhaps with the optimistic belief that the investment is bound to pay off.[141] People "rationaliz[e] their prior investment decision no matter how poor the returns" in order to avoid cognitive dissonance.[142] With the same motivation that executives have "to see what they want to see," investors who read positive corporate disclosures may be persuaded that favorable results are likely to occur and that the risks are minimal.[143] Thus, the confirmation bias and the anchoring heuristic may lead investors who have already formed a favorable impression of a company to interpret corporate disclosure in a manner that conforms to investors' own previously held optimistic views.

E. Weaknesses in the Efficient Capital Market Solution

As the foregoing discussion suggests, the effects of behavioral and cognitive biases on human decision-making processes indicate that people do not always think and behave in a manner consistent with rational choice theory. An individual's ability to process information and make sound judgments under conditions of uncertainty is inevitably bound by limits on time, attention, and information. Information overload, overconfidence, optimism, confirmation and anchoring biases may inhibit investors from effectively comprehending and using disclosure to protect their interests.

Efficient capital market theorists may be unfazed by the evidence of cognitive biases because they believe that the efficiency of modern financial markets as a whole can take care of the problems associated with the information processing difficulties that afflict individuals. The Efficient

[140] Langevoort, *Ego*, *supra* note 121, at 857–58. Studies have shown that investors "seem more willing to invest in a faltering venture when they have previously committed funds to it." *See* Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice*, 36 MGMT. SCI. 643, 659 (1990) (citing Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Alternative*, 16 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 27, 28–29 (1976)).

[141] *See* Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. FIN. 1775, 1797 (1998) (finding that individual investors tend to sell winning stock and hold losing stock, leading to lower returns); Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, 40 J. FIN. 777, 778 (1985) (discussing seemingly irrational reluctance of investors to hold winning stocks and sell losing stocks).

[142] Choi & Pritchard, *supra* note 4, at 13.

[143] *See* GILOVICH, *supra* note 127, at 75–87 (discussing motivational determinants of belief as "seeing what we want to see").

Capital Market Hypothesis (the ECMH) posits that efficient securities markets rapidly and accurately incorporate all relevant available information into the market price of any given security.[144] The theory assumes that market prices react immediately to each new bit of public information that becomes available, and therefore, the price of securities is always a reflection of their fair, intrinsic value.[145] According to the ECMH, the pricing of stocks is accurate because the presence of sophisticated, institutional investors, analysts, and professional market intermediaries, who can process information accurately, moves stocks to their true value in accordance with the best estimates of the risks and returns.[146]

The ECMH is unaffected by evidence of investors' cognitive constraints because it assumes that the biases, errors in judgments, and decision-making shortcomings of uninformed investors are random and will cancel each other out in the market.[147] Even if people are subject to errors and

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[144] *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 84 (1979) (describing the semi-strong version of the theory which asserts that "the current price reflects everything that is publicly known about the stocks being traded"); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–65 (1984) (defining market efficiency); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 770–72 (1985) (explaining the efficient market hypothesis); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 646–48 (1995) (describing concept of the ECMH in modern financial theory). Different forms of the ECMH range from the weak, to the semi-strong, to the strong versions, depending on how much past and present information is believed to be reflected in prices. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 28–31 (3d ed. 2001) (discussing different types of efficiency); Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N.C. L. REV. 137, 154–55 (1991) (describing three different forms of efficient market theory).

[145] *See* Stout, *supra* note 144, at 647 (noting that the ECMH assumes that efficient prices are accurate prices because the stock market's quick and accurate response to new information causes market prices to correctly reflect best estimates of expected risks and returns); Christopher Paul Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1037–39, 1069 (1977) (noting that in efficient markets, the market price of a security will always reflect its true worth and the price will always be fair).

[146] *See* Louis Lowenstein, *Efficient Market Theory: Let the Punishment Fit the Crime*, 51 WASH. & LEE L. REV. 925, 926 (1994) (describing the ECMH's explanation for pricing securities).

[147] *See* Arlen, *supra* note 64, at 1766 (noting that law and economics scholars believe "deviations from rational choice generally are not systematic, and thus generally will cancel each other out"); Langevoort, *Theories*, *supra* note 101, at 862 (questioning the ECMH's assumption

inconsistencies in decision-making, these fallibilities will be exploited and weeded out of the market by more sophisticated, rational agents.[148]

The ECMH sparks questions about the need to protect unsophisticated investors through information disclosure rules in the first place. The ECMH may acknowledge that unsophisticated investors as a group are saddled with cognitive biases that cause them to make irrational, non-utility maximizing choices, and that these investors will not benefit from, nor understand or perhaps even read, corporate disclosure documents. However, the trading activity of these nonprofessionals is thought to have little net effect on the market prices of securities anyway.[149] The ECMH assumes that sophisticated investors and professionals in the market will read, understand, analyze, and scrutinize corporate disclosures, and the rational judgments and trading activity of these sophisticated traders ultimately will set the market price of securities for the rest of the market. Sophisticated market intermediaries filter the information that investors receive from corporations. Unsophisticated investors are thereby protected because the prices of the securities they buy and sell are fair and reflect their fundamental value.[150]

The problem with this argument and with many of the arguments stemming from the ECMH is that the market is hardly as efficient as the theory presumes.[151] Critics argue that markets are volatile, and the bounded

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that "[m]istakes, biases, and excessive optimism or pessimism are removed from the price-setting process because the random, uninformed biases of individuals in the market will cancel each other out").

[148] *See* RATIONAL CHOICE, *supra* note 56, at 6 (noting the importance of market discipline through competition and stating the assumption that markets "reflect actions taken by experienced decision makers seeking to maximize their own gains"); Howard Kunreuther & Paul Slovic, *Economics, Psychology, and Protective Behavior*, 68 AM. ECON. REV. 64, 64 (1978) (noting that economists tend to dismiss arguments against the rationality of individual behavior on the grounds that "in the competitive world outside the laboratory, rational agents will survive at the expense of others").

[149] *See* Langevoort, *Epistemology*, *supra* note 108, at 658 n.78 (noting that the efficient market hypothesis holds that "[u]ninformed traders have no significant price impact"); *see also* Lowenstein, *supra* note 146, at 926 (noting that the efficient market theory posits that sophisticated investors are the ones who accurately price stocks and that the trading by nonprofessionals is random and of no effect).

[150] *See* Edmund W. Kitch, *Proposals for Reform of Securities Regulation: An Overview*, 41 VA. J. INT'L L. 629, 649 (2001) (discussing debate in connection with the view that investors are helpless, but nonetheless protected by the actions of sophisticated investors in pricing securities).

[151] *See, e.g.*, Lawrence A. Cunningham, *Capital Market Theory, Mandatory Disclosure, and Price Discovery*, 51 WASH. & LEE L. REV. 843, 843 (1994) (arguing that the ECMH is flawed);

rationality of investors bounds the efficiency of the securities market.[152] Cognitive and behavioral constraints can, and do, affect markets. Heuristic-driven biases cause prices to stray from fundamental values as psychological factors and emotions play a role in market movement.[153] Market watchers have cataloged seemingly irrational correlations between stock prices and various calendar patterns, weekend effects, and weather changes.[154] Investing is susceptible to fads and fashions, like any other

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Gordon & Kornhauser, *supra* note 144, at 841–46 (describing empirical work questioning whether even the most well-developed capital markets are efficient); Lowenstein, *supra* note 146, at 927–28 (indicting the efficient market theory for increasingly desocializing the financial markets); William K.S. Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 349–94 (1986) (describing theoretical and empirical problems with the efficient market hypothesis).

[152] *See generally* ADVANCES IN BEHAVIORAL FINANCE (Richard H. Thaler ed., 1993) [hereinafter BEHAVIORAL FINANCE] (collecting several articles that indicate behavioral research undermines the efficient market hypothesis); ROBERT J. SHILLER, MARKET VOLATILITY (1991) (collecting earlier works critiquing the efficient market hypothesis); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 10–23 (2000) (discussing theoretical and empirical challenges to the efficient market hypothesis); Langevoort, *Taming*, *supra* note 86, at 140–43 (discussing some evidence against market efficiency); Prentice, *supra* note 64, at 1409 (noting that there is overwhelming evidence that the efficiency of the stock market is substantially bounded). Even supporters of the rational choice theory acknowledge that not all markets act rationally. *See* Charles R. Plott, *Rational Choice in Experimental Markets*, *in* RATIONAL CHOICE, *supra* note 56, at 117, 139–41. There is the possibility that markets are not efficient because noise traders create inefficiencies by trading in an uninformed fashion. *See, e.g.*, J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 705–06 (1990); *see also* Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?*, 81 VA. L. REV. 713, 718–21 (1995) (discussing the noise trading theory).

[153] *See* Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591, 592, 600 (1986) (arguing that "existing evidence does not establish that financial markets are efficient in the sense of rationally reflecting fundamentals" and that "valuation errors are being made continuously" in the financial markets); *see also* SHILLER, *supra* note 93, at 203 (asserting that the market is set by millions of investors "who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom"); LARS TVEDE, THE PSYCHOLOGY OF FINANCE 15 (1999) (observing that the market can be "subjective, emotional and ruled by the whim of changing trends").

[154] *See* RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 140–47 (1992) (discussing abnormal market activity and price returns in the month of January, before and after weekends, before holidays, and at the turn of the month); Hazen, *supra* note 144, at 156–57 (describing the apparent irrationality of the "October syndrome" in which many of the stock market's worst and volatile performances have occurred in the month of October); Prentice, *supra* note 64, at 1410 (citing empirical studies showing that good weather tends to put investors in an upbeat mood and translates into higher daily stock returns). All of these patterns are inconsistent with the ECMH because it assumes that prices will follow an

social activity.[155] During the Internet craze a few years ago, corporations that announced that they were changing their names to include the term "dot.com" enjoyed abnormal returns, even if the change was not due to any difference in business plan.[156] Observations of herding behavior indicate that investors often overreact emotionally to what they perceive others are doing and simply follow the crowd blindly.[157] Because individual investors share common cognitive biases and information processing problems, investors in the aggregate may err in the same direction.[158] As a result, investor irrationality has contributed to speculative bubbles and market crashes in a manner that the ECMH cannot comprehensively explain.[159]

The ECMH assumes that the presence of sophisticated investors in the long run corrects for all of these market anomalies, and that corporate

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unpredictable random walk as information is instantly incorporated into market prices. *See* Homer Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 311 (1975).

[155] BRUCE I. JACOBS, CAPITAL IDEAS AND MARKET REALITIES: OPTION REPLICATION, INVESTOR BEHAVIOR, AND STOCK MARKET CRASHES 87 (1999); *see also* Langevoort, *Theories*, *supra* note 101, at 863 (noting that one problem with the efficient market hypothesis is that there is anecdotal evidence of apparent market fads and fashions). Another way to characterize such investing may be to say that investors who buy securities because of a perception of public enthusiasm are "buying the public fancy." *See* Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. L. 225, 237 (2001).

[156] *See* Michael J. Cooper et al., *A Rose.com by Any Other Name*, 56 J. FIN. 2371, 2386–87 (2001) (finding a significantly positive, abnormal return for companies that added "dot.com" to their name).

[157] *See* BELSKY & GILOVICH, *supra* note 77, at 175–92 (discussing herd behavior in the stock market); Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 997–99 (1992) (discussing the phenomenon of herd behavior). Herd behavior occurs when decision-makers imitate what other people are doing rather than choose a course of action based on information and judgment with regard to the merits. *See* Bainbridge, *supra* note 129, at 1038. Herding can amplify price swings that are attributable to irrelevant external factors rather than to relevant information concerning economic performance. Hazen, *supra*, at 998. "By mimicking or anticipating the behavior of other investors," the herd instinct can be a substantial cause of irrational market volatility. *Id.*

[158] JACOBS, *supra* note 155, at 87.

[159] *See* Cunningham, *supra* note 151, at 847–48 (arguing that catastrophic market crashes reveal infirmities in the ECMH); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741, 755–57 (2000) (discussing cognitive errors as causes of market crashes); Prentice, *supra* note 64, at 1411 (citing ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 203 (2000)).

disclosures should be directed only toward knowledgeable, sophisticated investors and market professionals who will then "filter information to the masses and thereby cause the market price to adjust efficiently."[160] The reality, however, is that the professional investment community, with all of its sophistication, does not always behave with the rationality and efficiency that the ECMH expects. Counting on sophisticated investors and market professionals to analyze and filter corporate disclosures, to incorporate such information accurately in the pricing of securities, and thereby to protect the entire market, may be asking for too much.

Sophisticated investors and professionals can suffer from the same cognitive and behavioral biases that constrain individual, unsophisticated investors.[161] Experts can become information overloaded in ways that affect their decision-making processes.[162] In fact, under certain circumstances, experts can actually perform worse than non-experts.[163] Overconfidence and optimism biases can be even more pronounced in

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[160] Ted J. Fiflis, *Soft Information: The SEC's Former Exogenous Zone*, 26 UCLA L. REV. 95, 106 (1978). Homer Kripke argued that the average layperson does not read or comprehend corporate disclosure documents. *See* Homer Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 633, 638 (1973) (arguing that corporate disclosure should be oriented toward the sophisticated investors and professionals through whom information and suggestions for action filter down to the layperson); Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1165 (1970) ("The heart of my position is that the intelligent investor . . . who tries to act in any informed way does so by getting at least part of his information second hand, filtered through professionals.").

[161] *See* Daniel Kahneman & Mark W. Riepe, *Aspects of Investor Psychology: Beliefs, Preferences, and Biases Investment Advisors Should Know About*, J. PORTFOLIO MGMT., Summer 1998, at 52, 53–54 (describing several cognitive illusions, including overconfidence and overoptimism, that affect the decision-making of professional brokers and investors); Langevoort, *Selling Hope*, *supra* note 26, at 634–69 (drawing on behavioral research to explain why professional brokers and sophisticated investors may engage in excessively risky investment choices); Prentice, *supra* note 64, at 1489 ("Even the most intelligent, expert investors are subject to the vast majority of the cognitive limitations" that apply to individual investors.). Analogously, in the informed consent context, physicians can suffer from the same cognitive errors as their patients in making risk comparisons for medical treatment. *See* Peter H. Schuck, *Rethinking Informed Consent*, 103 YALE L.J. 899, 950 (1994) (noting that even expert physicians "are subject to many of the cognitive errors concerning risk that laypeople, including patients, are likely to commit").

[162] *See* Paredes, *supra* note 68, at 453–55 (stating that "the assumption that the experts are not overloaded . . . is too simplistic" and citing studies showing that experts can become overloaded).

[163] *See id*. at 456–58 (discussing experts' heightened susceptibility to cognitive biases such as information overload and overconfidence).

professional investors than lay investors.[164] Sophisticated investors' past investment experience may lead them to take greater risks in the belief that they are much better stock-pickers than they really are. They may also be overconfident in their ability to assess corporate executives' credibility and performance, and reluctant to admit their own shortcomings in decision-making.[165] Some evidence shows that even professional security analysts and economic forecasters overreact to information in the market.[166]

Because professional institutional investors are managed by human beings who have cognitive biases, institutional investors are just as susceptible to the effects of the popular investing culture as individual investors.[167] Evidence indicates that even large institutional investors engage in speculative investment activity,[168] and they may be just as likely

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[164] *See* Hanson & Kysar, *supra* note 56, at 661 (explaining that "when the pertinent events are not easily predictable and the feedback is not unambiguous, experts tend to be even more overconfident than laypersons"); *see also* BELSKY & GILOVICH, *supra* note 77, at 152 (stating that numerous studies have demonstrated that several professional groups, including securities analysts, are capable of displaying significant overconfidence); JACOBS, *supra* note 155, at 88–89 (discussing evidence of significant overoptimism in stock analysts' earnings estimates); Rachlinski, *supra* note 88, at 1172–73 (summarizing research indicating that overoptimism, overconfidence, and egocentricism can be "particularly potent when individuals possess some expertise"); Slovic et al., *supra* note 80, at 475–78 (noting that experts also display overconfidence bias).

[165] *See* Langevoort, *Epistemology*, *supra* note 108, at 659 n.84. It is interesting to note that in many securities fraud class actions, the primary claimants are typically institutional investors who have a great deal of investment sophistication. *Id.* at 658–59 n.83. Their expertise does not immunize them from being deceived by misleading corporate disclosure. *Id*.

[166] *See* Werner F. M. De Bondt & Richard H. Thaler, *Does the Stock Market Overreact?*, *in* BEHAVIORAL FINANCE, *supra* note 152, at 249, 250; Werner F. M. De Bondt & Richard H. Thaler, *Do Security Analysts Overreact?*, 80 AM. ECON. REV. 52, 56–57 (1990).

[167] *See* SHILLER, *supra* note 93, at 18 (arguing that it is inappropriate to draw sharp distinctions between professional investors and individual investors and to assume that professional investors offset the irrational exuberance of the nonprofessional investing public).

[168] *See* Hazen, *supra* note 157, at 997 (noting that irrational speculative behavior is not limited to individuals, but has also been a characteristic of institutional investors in recent years); Felix G. Rohatyn, *Institutional 'Investor' or 'Speculator'?*, WALL ST. J., June 24, 1988, at A18 (stating that speculative behavior today is no longer driven by individual investors, but by pension funds, banks, savings and loans, and insurance companies). Sophisticated investors have shown the same tendency as gamblers, corporate executives, and individual investors to engage in more risky behavior when they are trying to recoup losses or break even. *See* Prentice, *supra* note 64, at 1487–88, 1487–88 nn.439–42 (discussing escalation of commitment, loss aversion, and get-evenitis tendencies). Case studies indicate that get-evenitis afflicts both sophisticated and unsophisticated investors. SHEFRIN, *supra* note 88, at 107. The belief that sophisticated investors are smarter and therefore less likely to make irrational speculative judgments is not necessarily

to exhibit and contribute to herding behavior in the market.[169] Sophisticated investors are not immune from tendencies to make risky decisions based on fads, emotions, and intuitions.[170] Just like every other participant in the securities market, sophisticated investors and professionals are trying to make investment decisions under conditions of uncertainty and subject to information processing and decision-making biases. Thus, sophisticated investors and professionals may not scrutinize corporate disclosures and publicity with the level of care and skepticism that efficient market proponents believe.

To assume that the only listener of corporate publicity and disclosure is the informed, sophisticated investor, and that the unsophisticated trader can be ignored because sophisticated traders act as a protective buffer, misses the point to some degree. The bounded rationality and bounded efficiency of the market and its participants suggest that individual, unsophisticated investors deserve the attention of securities regulation protections, and that reliance solely on the efforts of sophisticated investors to protect the integrity of the market is foolish.

The stock market today is very different from times past when only a small segment of the public invested in publicly traded securities; today, a huge portion of the U.S. population owns publicly traded stocks either directly or indirectly.[171] A large number of individual investors now trade

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accurate. "[I]t makes little more sense to talk about smart money in terms of predicting future earnings than it does to talk about smart money in the Illinois lottery. They are guesses, and often not very good ones." Langevoort, *Theories*, *supra* note 101, at 867 n.50.

[169] *See* Bainbridge, *supra* note 129, at 1039 (describing herding behavior by institutional investors and market professionals); Hazen, *supra* note 157, at 998 ("Herd behavior is not limited to individual investors, institutional investors through their professional money managers similarly have shown a tendency to run with the herd."); David Hirshleifer et al., *Security Analysis and Trading Patterns When Some Investors Receive Information Before Others*, 49 J. FIN. 1665, 1667 n.2 (1994) (citing empirical and theoretical work discussing herding behavior of institutional investors and security analysts); Langevoort, *Selling Hope*, *supra* note 26, at 644 (noting that financial economists have found a remarkable amount of herding behavior among professional investors.)

[170] *See* Langevoort, *Theories*, *supra* note 101, at 863 (discussing anecdotal evidence of apparent market fads and fashions).

[171] CHARLES P. JONES, INVESTMENTS: ANALYSIS AND MANAGEMENT 51 (8th ed. 2002). Nearly half of all U.S. households own equities. *See* EQUITY OWNERSHIP IN AMERICA 15 (Investment Company Institute & Securities Industry Association 2002) [hereinafter EQUITY OWNERSHIP]. There are approximately 84.3 million individual equity investors in the U.S. *Id.* The proportion of families with stock holdings continues to rise as even investors of modest means can take advantage of low-cost, no-load mutual funds that offer a diversified portfolio of

online directly through online brokerage accounts.[172] The current generation of individual investors trades very actively by historical standards.[173] The trading activity of day traders, for example, can have significant effects on the market.[174] Individual investors can trade stocks quickly and cheaply without the help, advice, or filtering efforts of professional market intermediaries. It is unwise to ignore the trading behavior of individual investors under the mistaken belief that only sophisticated investors and market professionals influence the market price of securities.

In light of the cognitive and behavioral limitations that individuals face, along with the inefficiency of the market to incorporate disclosure accurately in the price of securities, the utopian vision of a perfectly efficient market composed of fully-informed, rational actors who make utility-maximizing investment choices is merely a myth and false imagery.[175] Evidence of bounded rationality in individuals and in the securities market has important implications for the disclosure system of regulation on which we so heavily rely. We are left with the realization that our dependence on disclosure as the solution for regulating financial markets may be ill-advised. As the following section indicates, we must be wary of placing too much confidence in the disclosure antidote because it has its weaknesses as a form of regulation.

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stocks. *See* Hu, *supra* note 116, at 805–06 (citing evidence showing that increasing percentages of families and individual investors are entering the stock market).

[172] Nearly forty percent of investors who bought or sold individual stock in 2001 used the Internet to conduct some or all of those transactions. EQUITY OWNERSHIP, *supra* note 171, at 54; *see also* Barber & Odean, *supra* note 99, at 41 (citing evidence of tremendous growth in online trading accounts).

[173] Barber & Odean, *supra* note 99, at 49.

[174] *See* Gabaldon, *supra* note 155, at 239 (discussing day traders' ability to affect the securities markets). It has been asserted that day traders can account for up to fifteen percent of the volume on the Nasdaq stock exchange. *Id.* Day traders are not market professionals, but they arguably are not quite like typical ordinary investors either. *See* Bradley, *supra* note 98, at 90 ("The day trader seems to live in the space between the categories of professional and nonprofessional market participants.").

[175] *Cf.* Welle, *supra* note 24, at 574–75 (criticizing the economic and contractual freedom arguments for contractual waiver of securities law protections).

IV. FUNDAMENTAL WEAKNESSES IN THE DISCLOSURE SYSTEM OF REGULATION

In practical terms, the disclosure that we see today in documents such as registration statements, proxy statements, annual reports, and financial documents is often too long and complex to be of much use to the ordinary investor. Prospectuses have become "so elaborate that many investors [are] unable to detect even blatant fraud solely by reading [them]."[176] Many argue that our current financial disclosure rules require far too much nonessential data.[177] Investors faced with this flood of information often lack the skills to identify what the information means or how to use it effectively. The complexity and detail in disclosure documents can make them almost incomprehensible at times, and the disconcerting truth is that investors will typically choose not to read documents that they know they will not understand.[178] Disclosure cannot fulfill its communicative purpose if investors find it impenetrable and therefore ignore it.

Part of the problem is that the structure and operations of business organizations today are more complex than ever, and the task of describing them in simplistic terms is almost impossible. Former SEC Chairman William Douglas was critical of the securities laws because they seemed to assume that corporations were still the basic "Main Street" businesses of yesteryear that were simple to understand and simple to describe in disclosure documents.[179] Modern business organizations in our current

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[176] Anderson, *supra* note 52, at 325. Proponents of merit regulation argue that even sophisticated analysts can have difficulty with the complexity and confusing nature of disclosure documents and that merit regulation is one method of solving this problem. *See* Brandi, *supra* note 25, at 693.

[177] Ray J. Groves, *Here's the Annual Report. Got a Few Hours?*, WALL ST. J., Aug. 4, 1994, at A12.

[178] Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 19 (1994) ("[M]ost investors do not read, let alone thoroughly analyze, financial statements, prospectuses, or other corporate disclosures . . . ."); Prentice, *supra* note 64, at 1456 ("It is well known that investors typically do not read disclosure documents when investing in securities . . . ."); *see* Sargent, *supra* note 25, at 830 (noting that disclosure documents are often not read by investors, and even if investors do read them, they are "either incomprehensible or ha[ve] little effect on the investment decision").

[179] *See* William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 529 (1934). Douglas described the Securities Act as a "nineteenth-century piece of legislation. To understand it we must 'turn back the clock' to simpler days. We must unscramble our large forms of organization." *Id*. The disclosure problem can be even more pronounced in corporations whose operations involve advanced technology, medicine, or science. *See* Jackson, *supra* note 46, at 344 ("The

economy cannot be so easily understood and described. The sheer magnitude, reach, technology, and complexity of large multi-national corporations defy simple and uncomplicated description in disclosure documents:

> [F]rom time immemorial, persons with funds to invest were considered capable of determining the soundness of business ventures but recent developments in the field of business have been so rapid and so gigantic that even persons trained in one field are incapable of determining values in a related business. Even trained accountants are unable to determine, without detailed investigation, the intrinsic value of securities of corporations whose property and activities extend into many States and foreign countries.[180]

Disclosure cannot always give investors all the information needed to accurately value the securities of such complex organizations.

Another problem with the disclosure regime is that disclosure documents today are written by corporate lawyers in formalized language to protect the corporation from liability rather than to provide the investor with meaningful information. "[T]he document is, consequently, often presented in technical language and unreadable 'legaleze.'"[181] This type of disclosure is not helpful to investors because it loads them down in legal jargon that they cannot understand. This is especially true in the context of risk factors and cautionary warnings because corporations can escape liability if they couch their optimistic forward-looking statements in sufficiently descriptive

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drawback of disclosure strategies is that they are inappropriate or ineffective in a variety of contexts. For example, where the disclosure involves information of a highly technical or scientific nature, many consumers will find it difficult to assess the disclosure efficiently and accurately.").

[180] *Federal Securities Act: Hearing on H.R. 4314 Before the House Committee on Interstate and Foreign Commerce*, 73rd Cong., 1st Sess. 92 (1933), *reprinted in* 2 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) (Dept. of Commerce Study of the Economic and Legal Aspects of the Proposed Federal Securities Act).

[181] Levenson, *supra* note 31, at 68; *see also* Paredes, *supra* note 68, at 429 n.58 (describing lawyers' remarks that suggest "companies often disclose information not to better inform investors, but to reduce the risk of liability for omitting a material fact or disclosing a 'half truth'").

cautionary language.[182] In order to avoid this problem, there has been a movement in securities regulation toward requiring more "plain English" in disclosure documents.[183]

However, even if we could purge disclosure documents of legaleze and make them easier to read, we are still faced with the problem of cognitive and behavioral biases and constraints that prevent the accurate processing of information and risk.[184] As discussed previously, information overload, excessive confidence in one's own judgment, overoptimism, and confirmation biases can undermine the effectiveness of disclosure in communicating relevant information to investors.[185] Disclosure may not protect investors if these cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions.[186] No matter how much we do to make disclosure more meaningful and accessible to investors, it will still be difficult for people to overcome their bounded rationality. The disclosure of more information alone cannot cure investors of the psychological constraints that may lead them to ignore or misuse the information. If investors are overloaded, more information may simply make matters worse by causing investors to be distracted and miss the most important aspects of the disclosure. We know that corporations are likely to produce disclosure that is habitually overoptimistic and self-serving.[187] Any warning signs that do appear in disclosure documents may

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[182] *See generally* Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929 (describing the judicial bespeaks caution doctrine).

[183] *See* Securities Act of 1933, 17 C.F.R. § 230.421 (2005) (requiring issuers to use plain English principles in drafting prospectuses in order to provide more clear, concise and understandable disclosures); Isaac C. Hunt, Jr., *Plain English—Changing the Corporate Culture*, 51 U. MIAMI L. REV. 713, 714 (1997) (discussing reasons for the plain English rule); *see also* Fanto, *supra* note 37, at 164–71 (describing the plain English movement); Westbrook, *supra* note 10, at 458 (noting that "regulators have come to focus on making disclosures understandable ('plain English'), realizing that too much information, or information delivered in impenetrable terms, is not useful to the investor").

[184] *See* Welle, *supra* note 24, at 583 (noting that the problem is not just one of insufficient or incomprehensible information, but of "people's inability to process such information and to assess one's own risk" because of "strong and pervasive cognitive and motivational distortions").

[185] *See supra* Part III (discussing behavioral and cognitive biases, heuristics, and constraints).

[186] In fact, if such biases "are simply hardwired into our brains, then no amount of effort may be able to change them." Choi & Pritchard, *supra* note 4, at 42. Certainly, disclosure alone would not cure investors "operating under a dense cloud of behavioral illusions." *Id*.

[187] *See supra* notes 112–114 and accompanying text (discussing overoptimism in corporate disclosures).

simply be disregarded by overconfident investors who like to believe that warnings are always meant for someone else.[188] In the case of information overload, warnings may end up being lost in the clutter. The bottom line is that there is "doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases."[189]

The disclosure system itself is not cost-free. The direct and indirect costs of complying with a disclosure-based regulatory system are enormous.[190] Creating, gathering, analyzing, summarizing, and drafting all the information necessary to generate the required disclosure involves extensive time and effort from corporate executives, lawyers, accountants, and staff.[191] The costs of compiling and disseminating the information, including the expense of printing and mailing disclosure documents, can be quite high.[192] Corporations must disclose more information now than ever before, and their compliance costs continue to rise with the addition of more regulation, like the Sarbanes-Oxley Act, demanding even greater disclosure.[193]

In light of the problems and costs associated with disclosure strategies of regulation, our heavy reliance on disclosure as the primary philosophy of

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[188] *See supra* notes 118–120 and accompanying text (discussing people's tendency to believe bad things will not happen to them).

[189] Choi & Pritchard, *supra* note 4, at 22.

[190] *See* Easterbrook & Fischel, *supra* note 49, at 707–09 (discussing the direct and indirect costs of disclosure regulation); Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2550–52 (1997) (examining the costs of disclosure to individual issuers, issuers as a class, and the economy as a whole); Palmiter, *supra* note 45, at 12 (describing the various costs of disclosure rules in securities offerings including direct costs, indirect opportunity costs, competitive costs, and liability costs).

[191] *See* Fox, *supra* note 190, at 2550 (discussing the operational costs of disclosure); Palmiter, *supra* note 45, at 12 (noting that "[t]he issuer pays for assembling mandatory information, retaining accountants to certify financial information, and hiring inside and outside lawyers to format and present it"); Stout, *supra* note 51, at 701 (noting that the "effective distribution of massive amounts of information" in the stock market does not come cheaply and discussing the corporate costs of SEC-mandated disclosure).

[192] Easterbrook & Fischel, *supra* note 49, at 707.

[193] *See* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 942 (1998) ("Compliance costs are not trivial in the United States, and more regulations inevitably increase the costs of compliance."). Another problem with requiring more disclosure may be its chilling effect on risk-taking. *See* Paredes, *supra* note 68, at 446 n.133 ("Disclosing more and more information . . . might also be ill-advised because more disclosure increases compliance costs, can chill risk-taking, and increases the cost to process information.").

regulation to protect the public may be unwise. Perhaps we have overestimated what disclosure can do to enable people to protect themselves, and we need to put more stringent measures in place to provide appropriate levels of investor protection. Disclosure has always seemed to be the most palatable form of regulation because it constitutes a compromise: requiring disclosure is better than doing nothing at all, but it does not go so far as to regulate substantive conduct directly.[194] However, in the aftermath of so many corporate scandals and frauds, it may be time to think hard about the benefits of more substantive regulation. Disclosure is really only an indirect way of providing investor protection, and it is not an entirely effective remedy for abuses. Disclosure is the easy way out, the least controversial way of trying to get corporations to behave properly. The SEC, however, has ignored the problem of too much disclosure and the limits on investor attention.[195] Congress and the SEC always seem to tackle thorny problems of corporate governance with some variant of disclosure rather than face the merits of these problems head-on. "Every crisis of confidence in the securities markets is met with a raft of new disclosure requirements . . . ; seldom, if ever does the [SEC] subtract from the laundry list of disclosure requirements."[196] This is in large part what Congress and the SEC did in the Sarbanes-Oxley Act. By adding more and more disclosure requirements, the Sarbanes-Oxley Act relies on disclosure as the cure for the securities markets, and regulators have avoided the more difficult issues. The Sarbanes-Oxley Act's demand for increasingly more disclosure may simply result in more information being buried in disclosure documents with little likelihood that future fraud will be prevented. Because disclosure may not provide as much investor protection as regulators often assume, more substantive rules of law may be in order.

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[194] Choi & Pritchard, *supra* note 4, at 23 ("Perhaps disclosure's continued allure for the SEC stems from its being a 'compromise' solution, midway between doing nothing and regulating substantive conduct.").

[195] *Id.* at 47 ("The SEC . . . presently pays no attention to the problem of limited investor attention. The SEC has virtually ignored the problem of too much disclosure."); *see supra* Part III.A (discussing information overload). Political choice theorists have argued that the SEC's actions are intended to benefit the interest groups from which the SEC derives support and that the agency maintains too close a tie to the industry it is charged with watching. *See* James D. Cox, *Regulatory Competition in Securities Markets: An Approach for Reconciling Japanese and United States Disclosure Philosophies*, 16 HASTINGS INT'L & COMP. L. REV. 149, 153 (1993) (describing political choice theory's view of SEC action).

[196] Choi & Pritchard, *supra* note 4, at 47–48.

The following section proposes that we consider fashioning rules that will regulate conduct more substantively and directly.

V. SUBSTANTIVE SECURITIES REGULATION

A. Utilizing Substantive Rules

The limitations of disclosure as a regulatory device suggest that other approaches to securities regulation should be explored. One alternative is to supplement disclosure regulation with substantive legislation that governs corporate behavior in a much more direct manner. Substantive regulation would involve mandating certain corporate conduct that we decide is beneficial and prohibiting particular conduct that we believe is unfair and improper. The goal of this type of regulation is to directly affect economic behavior, and not just demand the disclosure of information about that behavior. The difference between substantive regulation and disclosure regulation is that conduct-enforcing standards must be obeyed, whether or not the compliance is disclosed. The consequences for corporations that violate these substantive rules would be government enforcement sanctions and liability for damages.

This type of legislation requires deeper analysis into the actual merits of the conduct at issue. For example, we might decide that certain conflicts of interest for corporate executives or auditors should not be permitted, even if they are disclosed, because the existence of the conflict itself poses the risk that any disclosure of the conflict will be false, misleading, or incomplete.[197] Substantive rules that prohibit these conflicts of interest go beyond mere disclosure of the conflict; instead, these rules flatly proscribe the conduct because we have concluded that the conduct giving rise to the conflict cannot be tolerated.

Section 16(b) of the Securities Exchange Act of 1934 is a good example of a substantive rule that can be used as a model.[198] This provision prohibits directors, officers, and shareholders who hold more than ten percent of the corporation's shares from profiting by buying and selling the

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[197] Lamo de Espinosa, *supra* note 19, at 326 (arguing that conflicts of interest "are not something which shall be permissible if disclosed, because their mere existence imply [sic] that disclosure may be vitiated"). Even if the principal method of regulation is disclosure, there are certain situations in which a conflict of interest can render disclosure about the conflict insufficient. *Id*. at 419.

[198] Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2000).

corporation's securities within a six-month time period.[199] Any insider who makes such short-swing profits within six months must disgorge those profits back to the corporation.[200] Rather than requiring mere disclosure of these trades and letting investors decide whether they wish to invest in companies whose insiders engage in short-swing trading, the rule imposes a substantive prohibition on the activity at the outset. The rule deals directly with the merits of the trading behavior and makes a clear judgment about the impropriety of short-swing profits. Congress enacted this "flat rule [to] tak[e] the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great."[201] Thus, section 16(b) constitutes substantive regulation that prohibits certain activity whether or not it is disclosed. Although critics may argue that rules such as section 16(b) are arbitrary and over inclusive, it is also agreed that such rules take the guessing game out of questionable conduct and avoid the previously discussed problems associated with disclosure-based regulation.

Substantive legislation seems to take a back seat to disclosure as the preferred philosophy in securities regulation. The current federal securities laws, including the recent Sarbanes-Oxley Act, are filled with measures that require disclosure of conduct while avoiding substantive regulation of the conduct itself. Perhaps this is because of the difficulty of reaching a consensus on what conduct should be prohibited, leaving disclosure as the easy way out, the convenient fallback measure. It is beyond the scope of this Article to point out every instance of disclosure regulation that should be transformed into substantive regulatory prohibitions or mandates. However, certain areas of regulation can be identified to illustrate how substantive regulation would differ from current disclosure rules and would provide for more direct control over economic conduct or misconduct.

For example, Item 404(a) of Regulation S-K requires directors and officers of a corporation who have a material interest in any transaction with the corporation that exceeds $60,000 to publicly disclose the transaction and their interest in it.[202] The intent is to reveal the insiders'

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[199] *Id.*

[200] Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 234 (1976). The rule imposes strict liability on the insider for short-swing profits. *See* Alexander Hamilton Frey, *Federal Regulation of the Over-the-Counter Securities Market*, 106 U. PA. L. REV. 1, 30 (1957) ("Since the intent of this section is prophylactic, *i.e.*, to prevent rather than to cure, an absence of actual unfair use of inside information is no defense to the issuer's action to recover profits.").

[201] Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972).

[202] Regulation S-K, 17 C.F.R. § 229.404(a) (2005).

personal interest in the transaction and prohibit insiders from hiding their conflict of interest. Once investors are informed of the insiders' material personal interest in the transaction, investors can decide whether the securities of a corporation whose insiders are engaged in related-party transactions are worth the investment. However, this is just one item of information among thousands of pieces of information that must be disclosed in Regulation S-K. The problems posed by information overload and the many cognitive biases that prevent investors from processing information efficiently and accurately lessen the probability that disclosure of these related-party transactions will benefit investors that much. Moreover, the optimistic and overconfident biases of corporate insiders themselves suggest that the mere existence of the conflict poses the risk that the disclosure of the conflict will be insufficient or manipulated in a way to minimize its effect on investors. Thus, disclosure alone may not be the ideal form of regulation. If the SEC truly believes that such related-party transactions are improper, then it may make better sense to prohibit the conduct rather than simply require its disclosure. In other words, the SEC could transform the disclosure rule into a substantive rule that prohibits any insider from engaging in a transaction with the corporation that exceeds $60,000 in which the insider has a material personal interest.

Some may argue that prohibiting such relationships and business transactions would be imprudent and that there are advantages to allowing insiders to engage in such transactions with the companies they manage. That may be true in certain instances, and it would be beneficial to take those considerations into account. In doing so, however, we would be engaging in a discussion about the merits of the conduct itself and attempting to formulate a substantive rule that would address the costs and benefits of permitting certain conflicts of interest. That is a very different exercise than simply opting for the disclosure approach that is currently taken by the rule. Formulating a substantive rule on the merits is a much more arduous and time-consuming exercise, but one that may well be worth the effort in light of what we know of the limitations of disclosure as a regulatory strategy.

The Sarbanes-Oxley Act repeatedly falls short of dealing directly with these difficult issues head-on and instead conveniently falls back on disclosure to solve problems with improper corporate behavior.[203] For example, when it comes to ensuring the competence of the board of directors, the Act requires corporations to disclose whether they have at least one financial expert (as described by the statute) on the audit committee of the board, and if the corporation does not have such an expert, the corporation must disclose why not.[204] The rule imposes no substantive duty whatsoever. It simply instructs companies to adopt a practice of including a financial expert on the audit committee, or explain to investors why the company has not done so. It is merely an adopt-or-disclose approach to encouraging competence on audit committees. However, if it is important to ensure such competence or some minimum level of expertise, the Act should simply do so through substantive regulation, rather than adding to the already voluminous amount of disclosure that is issued by the corporation. Such a conclusion would require deeper analysis of the costs and benefits of mandating certain memberships on boards of directors. There may not be widespread consensus on the issue of the ideal composition of the corporate board, but a well-considered, thoughtfully reasoned substantive rule on point may ultimately prove far more instructive than the weak and timid method of compliance-or-disclosure currently taken by the Act.

While disclosure has its place in a well-functioning securities market, the direct, substantive regulation of conduct may be a more effective method of deterring fraudulent and unethical practices.[205] The ubiquitous corporate corruption and misconduct that led to the many scandalous

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[203] To be sure, the Sarbanes-Oxley Act does enact substantive rules in certain areas of corporate governance and, thereby, goes beyond basic disclosure regulation. *See supra* notes 12–15 and accompanying text (describing bans on insider loans and non-audit services).

[204] Sarbanes-Oxley Act § 407(a), 15 U.S.C. § 7265(a) (Supp. II 2002). The statute directs the SEC to define the term "financial expert" considering a person's education and experience as a public accountant or auditor, along with her knowledge of generally accepted accounting principles, financial statements, audit committee functions, and internal accounting controls. *Id.* § 407(b), 15 U.S.C. § 7265(b) (Supp. II 2002).

[205] *See* Anderson, *supra* note 52, at 343 (noting the SEC's recognition that disclosure can be effective for informational purposes but "direct regulation of conduct may be the best means of deterring fraud and undesirable practices"). Although disclosure is a helpful disinfectant, "[d]isinfectants are not, after all, a universal panacea, sometimes surgery is required." Coffee, *supra* note 52, at 1115. Former SEC Chairman William Douglas was doubtful that disclosure could adequately protect investors, and he preferred more substantive regulation on matters that involved the heart of corporate governance issues, including management power, capital structure, and the rights of minority shareholders. *See* Douglas, *supra* note 179, at 528.

corporate collapses in recent years have caused investors to lose confidence in the securities markets and in the current disclosure-based philosophy of regulation. "Today, restoring [investor] confidence might be the most important thing that the SEC and Congress can do, just as it was the top priority during the crisis of confidence following the 1929 stock market crash."[206] In order for the securities markets to work, it is critical to maintain investor trust in the integrity of the market because this trust is the foundation on which the markets are built.[207] Without a broad-based investor perception of legitimacy, people will not invest in the market, but put their money elsewhere, in "gold or real estate, or under their mattresses."[208] Therefore, promoting investor trust and confidence must be a primary goal of securities regulation. The securities laws are designed to foster fair play, protect investors, and keep the market honest.[209] Securities regulation that is substantive and that prohibits improper behavior can help revive investor trust. Investor confidence increases, not decreases, with

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[206] Paredes, *supra* note 68, at 469; *see also* Estreicher, *supra* note 44, at 291 (noting that after the "Crash of 1929" it was "essential that government somehow restore investor confidence"); Steve A. Radom, *Balkanization of Securities Regulation: The Case for Federal Preemption*, 39 TEX. J. BUS. L. 295, 299 (2003) (asserting that when the stock market crashed in October 1929, Congress searched for ways to restore investor confidence in the capital markets). "A similar crisis of investor confidence exists today due to the bursting of the technology stock market bubble and the corporate financial scandals of Enron Corp., Worldcom, and other companies." Karmel, *supra* note 35, at 545.

[207] Steinberg, *supra* note 50, at 354 ("Investor confidence and market integrity are key components underlying the primacy of the U.S. securities markets."). Investors take it as a matter of faith that the money they invest in the market will purchase real shares of real companies that will make real profits. *See* Stout, *supra* note 3, at 419. "Because they have faith, American investors buy trillions of dollars of corporate equities each year, even when they are not quite sure what it is that they are buying." *Id.*; *see also id.* at 408 ("Investor trust provides the foundation on which the American securities market has been built.").

[208] Stout, *supra* note 3, at 408; *see also* Frankel, *supra* note 3, at 448 (arguing that once investors' trust is lost, they will flee the stock markets and turn to other types of investments that "they can see, evaluate and guard for themselves"); Manning Gilbert Warren III, *Legitimacy in the Securities Industry: The Role of Merit Regulation*, 53 BROOK L. REV. 129, 132 (1987) ("Without a broadly-based investor perception of legitimacy, capital formation cannot be effectively accomplished in the securities markets.").

[209] Welle, *supra* note 24, at 534–35 (noting that the policies of the securities laws are to protect investors, eliminate manipulative and deceptive practices, foster fair play, and insure the integrity of the markets); *see also* Choi & Guzman, *supra* note 193, at 941 ("One of the most cited and intuitive goals of the securities laws is the protection of investors."); Stout, *supra* note 51, at 621–22 (describing the traditional goals of securities policy as "investor protection or fair and honest markets").

strong rules that go beyond mere disclosure to govern corporate conduct directly because such rules impose sanctions for non-compliant behavior, whether or not the non-compliance is disclosed and whether or not investors accurately process the disclosure.[210] Investors might not trust in the corporate insiders themselves, but they rely on the efficacy of strong regulation of the corporate insiders.[211] Investors place their trust in the nonhuman system of the law to ensure the integrity of the market and to guard their interests.[212] Disclosure regulation alone may be insufficient to restore investor confidence; the more substantive approach to regulating corporate behavior may be the most effective strategy for achieving that goal.

B. Some Criticisms of Substantive Regulation

Critics of this shift in regulatory strategy toward substantive regulation may argue that adopting substantive regulation is paternalistic and violates our cherished values of investor autonomy, free market economics, and private ordering. Respect for individual autonomy, responsibility, and decision-making is deeply entrenched in our culture and law.[213] We believe that people can order their own economic affairs and, given sufficient information, can make their own personal assessments of the risks and

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[210] *See* Prentice, *supra* note 64, at 1500–01 (explaining that legal sanctions can bolster trust in the securities market).

[211] *See* Ribstein, *supra* note 9, at 25 (asserting that investor trust in insiders is more likely the result of a "calculation that, given high levels of regulation of securities markets, insiders were unlikely to lie or steal").

[212] *See* Stout, *supra* note 3, at 420 (noting that people would not invest unless they believed that the legal system somehow constrains market participants from engaging in opportunistic behavior). "[Investors] must believe that the regulators are regulating, and the watchdogs are watching. In other words, investors may not need to trust people before they are willing to give up their hard-earned dollars. But they must at least trust *the system*." *Id*. Evidence suggests that "people can trust not only their fellow human beings, but also nonhuman actors—including systems and institutions," like the law or the stock market. *Id*. at 427.

[213] *See* Alexander Morgan Capron, *Informed Consent in Catastrophic Disease Research and Treatment*, 123 U. PA. L. REV. 340, 364 (1974) (noting that the traditional concern in western societies is that "the autonomy of each person be respected"); Fanto, *supra* note 37, at 119 (arguing that American culture "significantly limit[s] paternalism because the culture favors, promotes and thus determines a preference for individual responsibility and decision-making"); Schuck, *supra* note 161, at 924 ("The autonomy principle is deeply entrenched in our culture and law; few exceptions to it . . . have been recognized."); Bruce J. Winick, *On Autonomy: Legal and Psychological Perspectives*, 37 VILL. L. REV. 1705, 1707–08 (1992) ("Respect for individual autonomy is deeply rooted in American constitutional history and tradition.").

benefits of transactions.[214] Our legal system values self-determination and respect for individual choice.[215] The philosophy of disclosure in securities regulation is rooted in the notion that in a democratic society, the government should not be so paternalistic as to mandate or prohibit certain corporate behaviors and certainly should not tell people what they can or cannot invest in.[216] The securities rules reflect the economist's view that "society will be better off if willing and informed investors are permitted to take on whatever degree of risk they choose."[217] Because the autonomy principle values individual choice and responsibility, critics would argue that disclosure laws are preferable to substantive rules that inhibit corporate activity and paternalistically overprotect investors.

These arguments stem from a very private-oriented, as opposed to a public-oriented, view of the securities markets. The capital markets can be seen as the product of private ordering or as the subject of broader public interests.[218] On the one hand, if market activity is defined in purely private terms, then primary deference should be given to the role of freedom of contract, self-reliance, individual risk-taking, and autonomous decision-

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[214] *See* Fanto, *supra* note 37, at 119 (observing that "in American culture, individuals look to, and expect to rely upon, their own efforts for many achievements, including saving and investing success"); Winick, *supra* note 213, at 1754 ("In our society, the individual is substantially free to order his or her economic affairs as he or she chooses."). The entire principle of freedom of contract is based on the belief that autonomous individuals have the ability to order their own affairs. *See id*. at 1753–54.

[215] Paula Walter, *The Doctrine of Informed Consent: To Inform or Not to Inform?*, 71 ST. JOHN'S L. REV. 543, 545–46 (1997) (observing that the "concept of self-determination, which assures that man is master of his destiny, is deeply rooted in our legal system and is the legal mirror of the Western values system, which exalts the individual" and asserting that the "fundamental principle of autonomy incorporates the notion that a person has the right to control his or her choice").

[216] Sommer, *supra* note 40, at 88 (discussing the rationales for the disclosure method of securities regulation). The securities disclosure laws "generally reflect the economist's bias in favor of investor autonomy." Jackson, *supra* note 46, at 333.

[217] Jackson, *supra* note 46, at 333.

[218] The debate over the public/private distinction permeates a wide range of legal issues and is subject to varying degrees of analysis. *See generally Symposium on the Public/Private Distinction*, 130 U. PA. L. REV. 1289 (1982). The public/private distinction "explicitly and implicitly structur[es] thought about the nature of corporate activity" itself. David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 201. The tension between public and private orientations is part of a much larger, ongoing debate about the fundamental nature and purposes of corporations. *See* Lawrence E. Mitchell, *Private Law, Public Interest?: The ALI Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871, 877–80 (1993) (discussing contrasting public and private views of the nature of the corporation and of corporate law).

making.[219] This laissez-faire perspective prefers private ordering of the market and resists paternalistic governmental interference in the economic activities of private organizations.[220] Over-regulation is viewed as a threat to entrepreneurship.[221] Instead, proponents of a private-oriented regime argue that private contract and market-based approaches are superior methods of maintaining efficient markets.[222] Indeed, recent years have seen an emergence of academic proposals for deregulation of the securities markets and privatization of the set of rules that govern market behavior.[223]

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[219] *See* Welle, *supra* note 24, at 574–75 (arguing that proponents of private ordering appeal to the deeply ingrained American values of private preferences, freedom of choice, and economic freedom). The view that individuals should be given the freedom to strike their own bargains and to structure their lives according to their own preferences is, in part, rooted in a contractarian view of society. David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1382 (1993).

[220] The ideology of privatization has deep roots in political and economic laissez faire theory. *See* Joan Williams, *The Development of the Public/Private Distinction in American Law*, 64 TEX. L. REV. 225, 225–26 n.5 (1985) (book review) (discussing laissez faire theorists' antagonism toward government interference with the private sphere of economic activity). Adam Smith voiced concern with intrusive government regulation and argued that restraining people from entering voluntary transactions "is a manifest violation of that natural liberty which it is the proper business of law, not to infringe, but to support." ADAM SMITH, THE WEALTH OF NATIONS 308 (1937). The "rhetoric of individualism and self-reliance . . . reflect[s] diminished expectations of government and heightened skepticism regarding public programs and public institutions." Sage, *supra* note 44, at 1707; *see also* Schuck, *supra* note 161, at 901 ("As a matter of political rhetoric, the state may overcome this presumption in favor of private ordering only by explicitly justifying the intrusion of public law.").

[221] Langevoort, *Expectations Gap*, *supra* note 11, at 1141 (describing politically conservative distaste for over-regulation and preference for a "lean regulatory environment"); *see also* Ribstein, *supra* note 9, at 61 (arguing that increased regulation has its costs, including the reduction of incentives of insiders and monitors to increase shareholder value).

[222] *See* Ribstein, *supra* note 9, at 3 (arguing that "contract and market-based approaches are more likely than regulation to reach efficient results"). It is argued that "regulatory responses to corporate fraud are unlikely to do much good and may do harm," and it was the markets, in fact, not regulators, that uncovered the problems associated with the recent corporate fiascos. *Id*. at 47–48.

[223] *See, e.g.*, Choi & Guzman, *supra* note 193, at 907 (recommending "a regulatory regime that focuses on regulatory competition and gives issuers and investors the ability to choose the law that governs their transactions" or allows them to opt out of any regulatory regime in favor of private contractual protection); Palmiter, *supra* note 45, at 4 (proposing "an enabling legal structure in which issuers can choose the disclosure level appropriate for their securities offerings" and making registration of securities optional); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2362–63 (1998) (advocating "elimination of the exclusive mandatory character of most of the federal securities laws" and

On the other hand, in a more public-oriented view of securities markets, certain social policies of fairness, protection of investors, public confidence in the markets, deterrence of fraud, and promotion of ethical standards are fundamental.[224] In order to uphold these policies, certain regulatory restraints on free enterprise may be necessary. Even in systems that espouse a laissez-faire philosophy, there are components of socially redistributive policies.[225] The goal is to minimize externalities and enforce redistributive norms so that society does not have to bear the welfare costs of caring for large numbers of investors who suffer devastating financial losses, or lose their entire retirement savings, in the stock market due to market crashes or improper corporate behavior.[226] We have a public interest in the nation's general economy and in the prevention of market crashes like that of 1929 that can have crippling effects on economic activity.[227] If legislative controls are necessary to prevent exploitation, discourage unfair dealings, and correct market failures, then some government regulation of the market is justified.[228] Where the disclosure system of regulation and reliance on sophisticated investors prove insufficient, more substantive rules may be appropriate.

Based on what we know about the limits on the effectiveness of disclosure as a regulatory device, the purely private, non-interventionist

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making parties free to select alternative jurisdictions to govern their transactions). These proposals are part of a broader, growing trend toward private governance, deregulation, and decentralization in several sectors of the society. *See* Welle, *supra* note 24, at 525 (noting movement toward privatization and contractualization in fields such as schools, prisons, dispute resolution, and family structures).

[224] *See* Welle, *supra* note 24, at 521.

[225] Jackson, *supra* note 46, at 337 (noting that one can find examples of redistributive policies even in the laissez-faire regime of securities regulation).

[226] Similar concerns are often apparent in the consumer product market where hazard warnings are oriented toward the unsophisticated consumer for the benefit of society at large, which prefers not to have to bear the welfare burden of caring for people who suffer severe losses from product defects. *See* Stephen D. Sugarman, *Assumption of Risk*, 31 VAL. U. L. REV. 833, 865–66 (1997); *cf*. Jackson, *supra* note 46, at 335 (asserting that the public pays for the failure of financial intermediaries because general welfare programs have to support individuals who lose resources through such intermediary failures). Risk regulation that is more paternalistic addresses the fear that society will need to assume the costs "(through welfare payments or otherwise) if public investors suffer losses on their core savings." *Id*. at 335 n.22.

[227] J. William Hicks, *Securities Regulation: Challenges in the Decades Ahead*, 68 IND. L.J. 791, 805 (1993) (noting that the public interest in securities markets is clear because the markets can "affect the nation's general economy and well-being, as they did in 1929 and 1987").

[228] *See* Welle, *supra* note 24, at 575.

view of securities regulation seems incomplete. Individual autonomy and economic freedom are undoubtedly important goals. However, if cognitive and psychological biases inhibit accurate information processing and effective decision-making, then the notions of autonomy and self-reliance are somewhat illusory.[229] Investors may need substantive legislative rules, rather than disclosure regulation alone, to protect against securities fraud and inequitable practices. Moreover, "[s]ubstantive law is an important contributor to market creation" because it delineates clear rights and obligations among market participants and thereby creates certainty in expectations.[230] Substantive regulation plays a part in making markets work and bolstering investor confidence.[231] To argue that such regulation would be paternalistic misses the point to some degree. The securities laws are very much already and originally paternalistic to the extent that they forbid investors from waiving the protections that are afforded by the securities rules.[232] As a philosophical matter, we decided long ago when the securities acts were first enacted that investors are never in a position to contract out of the protections of the securities laws.

As much as we cherish the values of private ordering and freedom of contract, it must be acknowledged that market activity has enormous public and social consequences that go beyond merely private, economic dealings. Regulation of the securities markets is intended to facilitate the free market but also to protect the public investor who trusts that the free market will

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[229] *See* discussion *supra* Part III (discussing cognitive and behavioral biases, constraints, and heuristics); *see also* Merz & Fischhoff, *supra* note 123, at 323 ("If people cannot make decisions well, then the current notion of autonomy is just an illusion."). Acknowledgement of these biases leads to a sort of "anti-antipaternalism" that recognizes the benefit of paternalism. *See* Choi & Pritchard, *supra* note 4, at 4. For a discussion of the efficiency justifications for paternalism, see generally Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229 (1998). One manifestation of this anti-antipaternalism is the belief that "[o]nly government intervention can protect investors from their own cognitive defects." Choi & Pritchard, *supra* note 4, at 5.

[230] *See* Lamo de Espinosa, *supra* note 19, at 425. This is the idea that law matters. *Id*.

[231] *Cf*. Sage, *supra* note 44, at 1805 n.389 (noting that "substantive regulation of brokers, dealers, and exchanges" played a role in "restor[ing] faith in the overall fairness of capital investment processes").

[232] Under section 14 of the Securities Act of 1933, a buyer of securities cannot waive the protections of the statute, even if the buyer wants to. The Act provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this [Act] or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (2000).

operate in a fair and orderly fashion.[233] No market can exist without some substantive rules to guide expectations and behavior. "[I]f we are going to have [the] rule of law . . . [then] we will have to have some law."[234] Substantive law is necessary to preserve private ordering. "Without the law of property, there would be no private property rights. Without the law of contract, there would be no freedom to contract."[235] The law, therefore, should not be seen as an intrusive device that inhibits market activity, but an organizing mechanism that promotes robust market participation. The coercive force of substantive law creates orderly markets which then facilitate individual transactions.[236] The private and public components of the securities markets and the laws that regulate them do not necessarily have to be in conflict; they can function together to maintain investor confidence and strengthen the markets. The issue, then, is not regulation versus the free market; but rather, what type of regulation should we have to best preserve the operation and growth of our securities markets?[237] Our analysis thus far indicates that disclosure alone is not entirely effective, but stronger, more substantive rules of law may provide a helpful approach.

The substantive regulation proposed here is not a form of merit regulation that forbids individual investors from buying certain securities.[238] Rather, the substantive law is intended to regulate corporate behavior—to prohibit certain corporate actions that cannot be countenanced, or to mandate conduct that we feel is essential to the ethical and proper functioning of corporate activity. The substantive rules would constrain

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[233] *See* Welle, *supra* note 24, at 545 ("The securities laws, thus, are intended to protect the parties to the transaction and to protect the public in general by establishing basic ground rules that apply to all securities transactions.").

[234] Martin Mayer, *Comments on Lynn A. Stout's The Investor Confidence Game*, 68 BROOK L. REV. 449, 456 (2002).

[235] Welle, *supra* note 24, at 575.

[236] *Id*. Markets themselves can be seen as "legally constructed instruments, created by human beings hoping to produce a successful system of social ordering." CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 384 (1997). In this light, one might argue that markets constitute a form of government intervention and therefore depend on government regulation for their existence. *See id*.

[237] Welle, *supra* note 24, at 551.

[238] Merit regulation refers to state regulation that authorizes state securities administrators to approve or deny the offering of securities based on their quality, i.e., whether the offering is fair, just, and equitable. *See* HAZEN, *supra* note 17, at 401–03 (discussing state blue sky law laws); Goodkind, *supra* note 36, at 80 (describing the "fair, just and equitable" registration standards); Sargent, *supra* note 44, at 1039–44 (discussing state merit regulation).

corporate behavior rather than investor behavior. The expressive function of the law would make a statement about how corporations are supposed to behave, reflecting certain social values and shaping norms of conduct.[239] One way of looking at it is to say that the law goes beyond imposing sanctions, but also transforms ethical norms. Legislation can change "what people believe about approval patterns in their society and because people value approval, their new beliefs affect their behavior."[240] Therefore, when substantive laws that flatly prohibit certain improper actions are put in place, "unfair and inefficient acts become less acceptable, and people become less likely to engage in them for both legal and moral reasons."[241]

The private-oriented view of the securities markets favors private ordering and distrusts government interference. However, concentrated corporate power raises just as much suspicion as concentrated government power, and Americans have always had a strong distaste for an unregulated Wall Street.[242] Substantive regulation that plays an active role in restraining improper corporate conduct may provide the investor with a greater sense of confidence in the securities market.

One criticism that might be lodged against a movement toward more substantive regulation is that the securities laws simply should not be in the business of trying to regulate corporate conduct. Issues of corporate governance and behavior belong in the realm of state corporations law, not federal securities regulation. If individual states wish to implement more detailed corporate standards of conduct, it is within their power and jurisdiction to do so. The federal securities laws, the argument goes, should be focused mainly on disclosure and leave the substantive regulation of corporations to state law. This criticism raises a "long-standing" and "contentious" issue in the history of securities regulation: "whether

[239] For discussions of the expressive function of law, see generally Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503, 1531–64 (2000) and Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996).

[240] Prentice, *supra* note 64, at 1503.

[241] *Id*.

[242] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 28–30 (1994) (describing Americans' distrust for accumulations of centralized power in government and in big business, especially on Wall Street); Sage, *supra* note 44, at 1707 (noting that Americans' "suspicion of government [is] matched only by their distaste for concentrated corporate power").

corporate and securities law should be seen as separate spheres" or "part of a unitary enterprise" that cannot be divided.[243]

The problem with trying to segregate issues of corporate governance from securities law is that it is "difficult, if not impossible, to slice away the securities aspects of corporate law when the securities themselves are the corporate pieces that form the whole."[244] The two areas of law overlap significantly and are unavoidably intertwined. For example, the current federal securities laws regulate the very core of corporate governance through proxy rules that direct the shareholder voting process.[245] Disclosure rules themselves have impacts on important corporate governance issues.[246] Securities law is simply one of many forms of corporate law that complement the regulation of corporate behavior. To say that substantive securities regulation is inappropriate because state corporate law should be the sole regulator of corporate governance issues seems to miss the big picture. Federal securities law today has become "the new corporate law."[247] More direct, substantive regulation would simply supplement the already established set of securities laws that aim to stop self-dealing and over-reaching corporate conduct.

In the final analysis, the current philosophy of disclosure underlying the securities rules is designed to disclose serious risks to investors so that they can decide whether to invest in the securities market. However, an alternate approach may be to eliminate some of those risks altogether by prohibiting

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[243] Langevoort, *Seeking Sunlight*, *supra* note 15, at 450.

[244] Warren, *supra* note 32, at 507; *see also* Amir N. Licht, *Stock Exchange Mobility, Unilateral Recognition, and the Privatization of Securities Regulation*, 41 VA. J. INT'L L. 583, 608 (2001) ("From a substantive point of vie[w], the distinction between corporate law and securities regulation is extremely tenuous."); Paredes, *supra* note 68, at 423 n.17 ("Although matters of disclosure generally fall within the scope of the federal securities laws, whereas the substantive regulation of corporate governance is principally left to state corporation law, features of the federal securities law do impact corporate governance.").

[245] *See generally* Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n (2000) (regulating proxies). "Indeed, since voting rights are so fundamental to the process of corporate governance, there are few areas of securities regulation where both the interplay and the tension between federal securities law and state corporation law are as vivid." COX ET. AL., *supra* note 144, at 1005.

[246] *See* Sargent, *supra* note 44, at 1044–46 (discussing several examples of SEC disclosure rules that are used to influence corporate behavior); *see also* Paredes, *supra* note 68, at 423 n.17 ("For example, the federal securities laws regulate proxies, shareholder proposals, and tender offer bids.").

[247] Joel Seligman, *The New Corporate Law*, 59 BROOK L. REV. 1, 2 (1993).

corporate conduct that is sufficiently objectionable to warrant substantive regulation. Strong substantive rules may help to restore the investor confidence that is so crucial to the health and growth of the securities markets.

VI. CONCLUSION

Disclosure rules have always been the hallmark of American securities regulation, and in all likelihood, disclosure requirements will continue to increase as Congress and the SEC respond to emerging concerns that threaten the securities markets over time. Indeed, the passage of the Sarbanes-Oxley Act after the recent wave of corporate and accounting scandals is a good example of legislators' tendency to turn to disclosure as the regulatory antidote to the ills that plague the capital markets. However, it is unclear how effective the Act's adopt-or-disclose approach to many matters of questionable corporate conduct will be. As we have seen, disclosure rules are not without their costs and weaknesses. The disclosure philosophy's assumption that investors are rational actors who can process all disclosed information accurately and efficiently has its flaws. The cognitive and behavioral biases that tend to constrain the decision-making processes of all individuals—whether corporate executives, sophisticated market professionals, or unsophisticated individual investors—can weaken the efficacy of disclosure. When drafting securities laws, legislators and regulators should not ignore the accumulating psychological research that reveals how investors process information. The bounded rationality of the market and of its participants creates inefficiencies that are not always easy to overcome with information alone.

The intent of this discussion has not been to contend that disclosure is an altogether inappropriate method of securities regulation; rather, it is to highlight some of the weaknesses with disclosure rules and to identify the dangers of over-confidence in the disclosure solution. Securities regulation is a work in progress, and finding the right balance of regulation is a complex, multifaceted issue that requires ongoing thought and deliberation. A rush to increase disclosure requirements in the wake of every market crisis does not reflect the conscientious balancing of costs and benefits that is necessary to achieve the most effective regulatory system. Care must be taken to ensure that disclosure-based regulation is not idealized simply because we started with a disclosure-based regime, especially if it results in an abdication of substantive responsibility to protect investors and the integrity of the market.

In light of the weaknesses associated with disclosure regulation, substantive regulation that shapes corporate conduct much more directly may be helpful. Such regulation naturally requires far more thought and analysis of the merits of each rule. Reasoned judgments will have to be made about the costs and benefits of allowing or prohibiting certain forms of corporate conduct—the type of judgments that do not have to be made in rules that merely require disclosure of the conduct. Perhaps it is time, however, to engage in that type of soul-searching analysis, rather than reacting to every crisis of confidence in the securities markets with more and more disclosure. One of the fundamental purposes of securities regulation is to promote investor confidence and provide investor protection. Substantive regulation that seeks to ensure fair and honest corporate conduct may help achieve that mission.