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THE HYDRAULIC THEORY OF DISCLOSURE REGULATION AND OTHER COSTS OF DISCLOSURE

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INTRODUCTION 473
THE FUNDAMENTALS OF DISCLOSURE REGULATION 478
A. The Value and Limits of Disclosure 479
B. The Existing Criticisms 481
THE "HYDRAULIC THEORY" OF DISCLOSURE REGULATION 485
A. The Basic Theory 485
B. The Role of Institutional (In)Competence 488
C. The Hydraulic Theory of Executive Compensation Disclosure Regulation 493
1. Behavioral Hydraulics: Substitution Among Types of Compensation 494
2. Pool Hydraulics: Substitution Among Types of Managers 497
TOO MUCH DISCLOSURE: THE COSTS OF INFORMATION 503
A. The Limited Benefits of Information Disclosure 503
B. The Affirmative Costs of Information Disclosure 505
1. Corporate Governance and the Cost of Information 505
2. Market Costs: Efficient Markets and Information 508
CONCLUSION 511

INTRODUCTION

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

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

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1. The list is long and distinguished. Among the many articles supporting the SEC's mandatory disclosure regime or else advocating for additional mandatory disclosures are Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004); Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?,"* 20 CARDOZO L. REV. 135 (1998); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983); Randall S. Thomas, *Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information*, 38 ARIZ. L. REV. 331 (1996).

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

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

It is worth pointing out, however, that evidence of the *efficacy* of mandatory disclosure is also ambiguous. Several empirical studies have attempted to evaluate the economic impact of the various reporting requirements of the U.S. and other securities regimes. The results are mixed, at best. *See, e.g.*, George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 151 (1973) (finding no difference in the post-enactment effect of the 1934 Securities Exchange Act on firms that voluntarily disclosed information prior to enactment and those that did not); Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613, 624-50 (1981) (assessing the difference between registered and unregistered securities after the 1933 Securities Act); Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006) (collecting data from forty-nine worldwide securities markets and concluding that mandatory disclosure rules improve stock market performance); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295, 313 (1989) (finding no effect on abnormal returns for seasoned or NYSE-traded firms resulting from the 1934 Securities Exchange Act but finding some effect on unseasoned, non-NYSE-traded firms); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) (finding no effect on market-adjusted returns for new issues resulting from the 1933 Securities Act); Robert Daines & Charles M. Jones, *Mandatory Disclosure, Asymmetric Information and Liquidity: The Impact of the 1934 Act* (AFA Boston Meetings Paper, Mar. 15, 2005), *available at* http://ssrn.com/abstract=686888 (finding no differential effect on bid-ask spreads of the 1934 Securities Exchange Act between firms that voluntarily disclosed information prior to enactment and those that did not); Allen Ferrell, *Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market* (Harvard Law & Econ. Discussion Paper No. 453, Dec. 2003), *available at* http://ssrn.com/abstract=500123 (finding a reduction in volatility and abnormal returns resulting from the extension of the Securities Acts' disclosure requirements to OTC firms); Paul G. Mahoney & Jianping Mei, Mandatory vs. Contractual Disclosure in Securities Markets: Evidence from the 1930s (Feb. 2006), http://ssrn.com/abstract=883706 (finding "almost no evidence that the new disclosures required by the securities laws . . . reduced informational asymmetry . . . [nor] that earnings reports were more informative after enactment of the securities laws" compared to disclosure under existing NYSE rules).

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

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

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

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

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

7. *See, e.g.*, Benston, *supra* note 3, at 152-53 (concluding that the assumptions for revealing information to shareholders—namely, timeliness and usefulness—are not born out by empirical research); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681 (1984) (critiquing the public interest rationale of information in the mandatory disclosure regime).

8. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (arguing that incentives created by the competition for investors explains "why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports"); *see also* Stephen A. Ross, *The Economics of Information and the Disclosure Regulation Debate*, *in* ISSUES IN FINANCIAL REGULATION 177, 184-85 (Franklin R. Edwards ed., 1979) ("[I]n a competitive market (with no mandated disclosure), the managers of firms . . . will have a strong self-interest in disclosing relevant information . . . ."); Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 421 (2003) ("Critics . . . argue that a company will voluntarily disclose information that investors demand in order to reduce its cost of capital and avoid any discount that the market might apply to the company's stock price if investors think that they have too little information to evaluate the company and its securities properly or, worse yet, if investors think that the company is hiding something.").

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

But the proponents of disclosure regulation (and even many of its critics) treat regulated behavior as static in fairly important respects; that is, they assume a considerable degree of behavioral constancy, even as some behavior becomes more expensive through regulation. In many cases, the question analyzed by commentators is simply and narrowly one of quantity: Will regulation induce the production and dissemination of more valuable information? In this context, "valuable" connotes deterrence: Will the forced disclosure of information deter undesirable forms of behavior about which information must now be disclosed?[11] But while commentators and regulators recognize that behavior made more expensive will become less common, they fail to consider that more nuanced behavioral responses may accompany this reduction.

For example, some defenders of executive compensation information disclosure contend that CEOs would receive less compensation if amounts were more effectively disclosed.[12] But many of these same critics do not consider that the *form* of compensation, rather than the *level*, may shift in response to disclosure.[13] What is consistently left out of these analyses is a

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

10. *See, e.g.*, Paredes, *supra* note 8, at 421-22 ("Supporters of mandatory disclosure counter that because information has public good aspects, voluntary disclosure will result in too little disclosure. Further, because investors, securities analysts, brokers, and other securities market professionals do not internalize all the benefits of information they gather and analyze, they will invest too few resources in research and analysis. . . . In addition, companies might have an incentive to withhold competitively sensitive or proprietary information in order to keep it out of their competitors' hands. Finally, even if companies have an incentive to disclose good news, managers may have an incentive to withhold negative information in the hope that things will turn around for the company or that the market otherwise will not uncover the bad news.") (footnote omitted).

11. There may be other, somewhat different reasons for disclosure as well. Information disclosure may efficiently enhance accuracy and thus lower a firm's cost of capital. *See, e.g.*, Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity and the Cost of Capital*, 46 J. FIN. 1325 (1991). Where this is true, however, we should expect to see voluntary disclosure unless countervailing self interest intervenes. Disclosure may also reduce a firm's agency costs. *See, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995). Agency cost reduction is an important potential justification for mandatory disclosure, and one which does not turn directly on a deterrence rationale. Nevertheless, the same analysis holds: If managers receive a benefit from nondisclosure, forced disclosure may deter whatever behavior inures to the manager's—but not the firm's—benefit. More recent work by Mahoney casts some doubt on the efficacy of increased mandatory disclosure, however. *See* Mahoney & Mei, *supra* note 3. For more on the proffered justifications for mandatory disclosure, see *supra* Section I.A.

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

13. An important exception (although flawed for other reasons) is Bebchuk and Fried, whose arguments are, in fact, aimed at changing the *form* and not merely the *level* of executive compensation. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF

recognition that managerial responses to regulation may be complex and unanticipated. CEOs may simply take less compensation, but they instead may shift the difference into non-pecuniary compensation, for example.[14] They may work less hard; they may exit the market entirely; they may expend resources to camouflage their compensation. The response to regulation is not simply a matter of the cost of engaging in the behavior subject to disclosure. It is also a matter of what substitutes are available for the regulated behavior and the degree of elasticity between them.[15]

Disclosure regulation makes some forms of behavior more expensive relative to others. Rational actors will respond by shifting some conduct into the comparatively cheaper outlets. And these alternative behaviors may actually be less beneficial than the regulated, deterred behavior. In essence, disclosure regulation effectively *proscribes*, it does not *prescribe*. Thus, depending on the availability and viability of other behaviors, forced disclosure may induce unwanted responses.[16]

While we can surely anticipate that corporate agents will expend some resources in order to circumvent information regulation, it is difficult to know in advance what these efforts will look like or how costly they will be.[17] The regulation of complex economic entities frequently results in unintended and costly consequences. Appropriately evaluating the desirability of disclosure rules requires accounting for the cost of efforts to circumvent those rules, however, along with the more attenuated cost of other unintended consequences. It is insufficient either to ignore unanticipated conse-

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EXECUTIVE COMPENSATION 189 (2004) ("Thus, the problems of executive compensation can be fully addressed only by adopting reforms that would confront boards with a different set of incentives and constraints."). Bebchuk and Fried go on to describe these reforms throughout the chapter, including: "[r]educing [w]indfalls in [e]quity-[b]ased [p]lans," "[p]lacing a [m]onetary [v]alue on [a]ll [f]orms of [c]ompensation," increasing disclosure of "the extent to which their top five executives have unloaded any equity instruments received," and increasing generally the information disclosed to "investors and reformers." *Id.* at 190, 193-94, 200. Nevertheless, Bebchuk and Fried do commit an analogous error in failing to consider the possibility that undesirable behavioral shifts may result from their proposals rather than the advantageous ones they prefer.

14. *See generally infra* notes 78-119 and accompanying text (explaining that the use of non-pecuniary compensation such as perks will increase with more regulation of executive compensation).

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

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

17. These efforts may be both costly and, ultimately, unavoidable. As Larry Ribstein notes, "fraudsters are highly motivated, they'll find a way around all this." Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2006/01/complying_with_.html (Jan. 20, 2006, 09:34 CST).

quences or to presume that the only relevant effects will be the salutary, intended ones.

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

> (1) Behavior made more costly to insiders by disclosure may be deterred by disclosure, but insiders may shift into *less*—not more—desirable alternative activities.
>
> (2) The pool of entrants into a regime governed by mandatory disclosure may shift in an undesirable direction in response to the regime.
>
> (3) Regulation by a federal disclosure regime substitutes federal regulator and enforcer biases for the limitations of market enforcement, often to the detriment of investors.
>
> (4) Disclosure of information may induce too much participation by investors in corporate governance and may imperil corporations' competitive governance schemes.

The Article explicates these insights and attempts to put them into a useful framework. I identify two broad concepts that encapsulate these dynamics. First, I develop a "hydraulic theory" of securities disclosure regulation. Under this theory, disclosure regulation triggers behavioral hydraulics that may lead to an undesirable shift in underlying behavior as well as an undesirable shift in the pool of candidates for corporate executive positions. Second, I develop an information cost theory of securities disclosure regulation. Under this theory, mandated disclosure is both unnecessary to market efficiency and affirmatively harmful to firms' schemes of corporate governance. Accurate assessment of our securities regulatory regime must evaluate and account for these dynamics.[18]

THE FUNDAMENTALS OF DISCLOSURE REGULATION

Our securities regulatory regime is a disclosure regime,[19] and large, publicly traded corporations are under considerable obligation from multi-

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18. For a brief presentation of many of the ideas contained in this Article, along with some related discussion and links, see Posting of Geoffrey Manne to Truth on the Market Blog, http://www.truthonthemarket.com/2006/01/28/on-disclosure-the-hydraulic-theory (Jan. 28, 2006, 13:39 EST).

19. *See, e.g.*, 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29 (3d ed. 1998) ("Then, too, there is the recurrent theme throughout [federal securities law] of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But 'The truth shall make you free.'"); *see also* George J. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, *in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23, 23-24 (Henry G. Manne

ple legislative and regulatory sources to disclose information.[20] This Part canvasses the fundamental justifications for, and criticisms of, disclosure regulation.

A. The Value and Limits of Disclosure

A regulatory regime rooted in disclosure of information must have an explicit or implicit theory of the value of disclosure. In the main, disclosure regulation is explained in three interrelated ways.[21] First, investors will make better investment decisions (and managers will more likely act in investors' interest) when those decisions are considered in the light of otherwise undisclosed, relevant information.[22] Second, required disclosures will cause stock prices better to reflect underlying firm value, thereby enhancing market accuracy.[23] And third, fraud will be deterred because "[s]unlight is

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ed., 1969) ("[T]he primary purpose of the Securities Act of 1933 and an important part of the Securities Exchange Act of 1934 is to assure the disclosure of financial accounting information . . . ."); Easterbrook & Fischel, *supra* note 7, at 670 ("The dominating principle of securities regulation is that anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain."); Henry G. Manne, *Economic Aspects of Required Disclosure under Federal Securities Laws*, *in* WALL STREET IN TRANSITION 21, 23 (Henry G. Manne & Ezra Solomon eds., 1974) (citing 1 LOUIS LOSS, SECURITIES REGULATION 127 (2d ed. 1961)) ("For over fifty years now, the American legal and financial communities have experienced the application and elaboration of a concept of securities regulation known as 'the disclosure philosophy.'").

20. "The federal securities laws require companies to make extensive disclosures in annual reports, quarterly reports, current reports, proxy statements, and other filings with the Securities and Exchange Commission." Paredes, *supra* note 8, at 418. The sources of corporate disclosure regulation have been well-catalogued elsewhere (and far more extensively than is practical here). *See, e.g.*, 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 21-27 (5th ed. 2005); *see also* Regulation S-K, 17 C.F.R. § 229.10-.702 (2006).

21. In fact, some have provided a fourth, less charitable explanation: early disclosure regulation, far from serving the public interest, was a means employed by established firms to hamstring new rivals. *See* Manne, *supra* note 19, at 33-36.

22. *See, e.g.*, Homer Kripke, Disclosure Beyond Accounting Disclosure: An Unsatisfied Need, Saxe Lecture in Accounting (April 22, 1980), http://newman.baruch.cuny.edu/digital/saxe/saxe_1979/kripke_80.htm ("Although the original intention was a little uncertain, unquestionably the SEC's rhetoric has tended more and more toward claiming the value of disclosure for securities decisions."); *see also* Fox, *supra* note 1, at 1364 ("Disclosure assists in the effective exercise of the shareholder franchise and in shareholder enforcement of management's fiduciary duties."); Guttentag, *supra* note 1, at 133 ("The more information a company discloses, the more effectively investors can evaluate how well the company's management is exploiting opportunities available to the firm.").

The logic is that by arming investors with information, mandatory disclosure promotes informed investor decision-making, capital market integrity, and capital market efficiency. Once they are empowered with information, the argument goes, investors can protect themselves against corporate abuses and mismanagement, and there is no need for the government to engage in more substantive securities regulation—"merit review" in the securities patois. The underlying logic is troubling, however. *See infra* notes 132-144 and accompanying text.

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

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

said to be the best of disinfectants."[24] On this theory, the threat of disclosure of undesirable activity will deter that activity ex ante, particularly through the oversight of appointed gatekeepers or experts who closely monitor those subject to disclosure regulation.[25] A growing body of literature also avers that mandatory disclosure benefits competitors and the market more broadly by disseminating socially valuable information to competitors, which is, for obvious reasons, privately costly to the firms that create the disclosure.[26]

Of course, coupled with available civil and criminal penalties for failure to comply with the disclosure regulations, the regime is not entirely dependent on any of these fundamental justifications; rather, the threat of prosecution for violation of the regulations becomes itself a significant source of potential improvement (or at least alteration) in underlying behavior.[27]

At the same time, there must be a limit to the extent and scope of required disclosure. From the point of view of information recipients, the additional disclosures provide diminishing returns and increasing costs, some of which may be born directly by the recipient, most notably when the recipient is a stockholder in a company subject to the disclosure regulation.[28]

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24. BRANDEIS, *supra* note 4, at 92.

25. *See, e.g.*, Seligman, *supra* note 1, at 9. Seligman actually adduces five justifications for the mandatory disclosure regime. Although all five can be effectively collapsed into the three I have mentioned here, it is worth quoting Seligman in full:

> Historically, the proponents of the SEC's mandatory corporate disclosure system have advanced five principal arguments to justify the system. First, in the absence of a compulsory corporate disclosure system some issuers will conceal or misrepresent information material to investment decisions. Second, in the absence of a compulsory corporate disclosure system, underwriting costs and insiders' salaries and perquisites will be excessive. Third, in the absence of a mandatory corporate disclosure system, there will be less "public confidence" in the markets. Fourth, in the absence of the laws creating a mandatory corporate disclosure system, neither state laws nor private associations such as the New York Stock Exchange can ensure the optimal level of corporate disclosure. Fifth, in the absence of a mandatory corporate disclosure system, civil or criminal actions will not ensure optimal levels of corporate disclosure.

Id. at 9. In particular contrast to this Article, Seligman here asserts that executive perquisites will be kept in check by the mandatory disclosure system. In the portion of his article defending this argument, however, he does not maintain the distinction between "salaries" and "perquisites." *Id.* at 45-51.

26. *See, e.g.*, Fox, *supra* note 1, at 1345 ("For example, if an issuer discloses that a given line of business is particularly profitable, other firms may be attracted to enter the same market, driving prices, and hence the issuer's profits, down."); Guttentag, *supra* note 1, at 136 ("There are several benefits from the disclosure of information that the firm making the disclosure may not be able to fully capture. . . . These externalities can be categorized based on the different third-party beneficiaries identified, including . . . a company's competitors, who may benefit from the disclosure of proprietary information . . . .").

27. *See* Franco, *supra* note 9, at 266 ("The possibility of government civil and criminal actions further adds to the deterrence effects of the antifraud provisions. The threat of government actions is effective not only because it increases the penalty imposed on would-be violators, but because government authorities face significantly different litigation incentives than private litigants."); *see also* Manne, *supra* note 19, at 38 (noting that although it may not serve its putative purpose, disclosure regulation does provide the SEC "with an enormously powerful 'enforcement' device").

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

28. Easterbrook & Fischel, *supra* note 7, at 696 ("Information is costly, and the costs are borne in large part by investors. Whether investors benefit by more information depends on whether the marginal

At the same time, additional disclosure also imposes increasing costs on firms, and even if we accept the argument that firms voluntarily *under*-produce information, an optimal information disclosure regime would surely not require disclosure of *all* private information. Optimal disclosure is not maximal disclosure.[29]

Many commentators, however, seem to take for granted that increased disclosure is beneficial—and cheap—and therefore recommend disclosure regulation even where they would shun more intrusive regulation. For example, in a recent review of Lucian Bebchuk and Jesse Fried's book, *Pay Without Performance*, John Core, Wayne Guay, and Randall Thomas impressively critique Bebchuk and Fried's central claims, effectively hobbling the justifications for Bebchuk and Fried's policy recommendations.[30] Nevertheless, although critical of Bebchuk and Fried's more intrusive policy proposals,[31] the authors "agree that better disclosure on the value of executive pensions and the exercise and sale of options and shares would be beneficial."[32] They provide no independent justification for the concession (and the entire article is devoted to criticizing Bebchuk and Fried's justifications) and note only that "some of [Bebchuk and Fried's] proposals seem sensible."[33] As this Article suggests, however, mandatory disclosure has important and ill-considered consequences; it is not merely regulatory "chicken soup."[34]

B. The Existing Criticisms

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

(1) Mandatory disclosure is ineffectual or even counterproductive because

(a) the most useful information is already being disclosed;[35]

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benefits of increments to knowledge exceed the marginal costs."); *cf.* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 215 (1961) (noting that search for price information yields diminishing returns as a function of minimum price).

29. "Ignorance is like subzero weather: by a sufficient expenditure its effects upon people can be kept within tolerable or even comfortable bounds, but it would be wholly uneconomic entirely to eliminate all its effects." Stigler, *supra* note 28, at 224.

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

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

32. *Id*. at 1182.

33. *Id.*

34. "Look at [disclosure regulation] as regulatory chicken soup: it won't do any good, but it [sic] least it can't hurt." Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2006/01/the_sec_and_exe.html (Jan. 10, 2006, 06:14 CST).

35. "Investors know something that the SEC still ignores—that macroeconomic conditions can render insignificant the most careful firm-oriented disclosure, especially backward-looking disclosure."

> (b) the regime that focuses attention on shareholders' access to *and use of* information suffers from its own success. Shareholders may, in fact, attempt to make use of disclosed information, but it (and the conduct underlying it) may prove too complicated, and they may do so to their own detriment;[36] or
>
> (c) share price accuracy will be impaired, rather than aided, by mandatory disclosure rules.[37]
>
> (2) Mandatory disclosure is inefficient. It makes otherwise efficient behaviors less cost-effective and thus raises the cost of capital to new firms and prices some investors out of the market.[38]

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

Thus, while the direct costs of the federal securities regulatory apparatus is surely positive,[39] the *indirect* costs of regulations may be far more substantial. Regulation may induce firms to engage in less efficient activities if optimal conduct requires impermissible secrecy.[40] Moreover,

> [f]irms may cease disclosing some category of useful information and switch to some obfuscatory (but complying) information. Firms

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HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 29 (1979).

36. *See, e.g.*, Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 5-6 ("In Enron, for example, there is no dispute that the *existence* of the SPE-transactions was generally disclosed to Enron's investors. The disclosure itself, however, was ultimately said to be inadequate. Although this inadequacy might have been intentionally fraudulent, the better explanation is that Enron's structured transactions were so complex that disclosure either would have had to oversimplify the transactions or else provide detail and sophistication beyond the level of both ordinary and otherwise savvy institutional investors in Enron securities.") (footnotes omitted).

37. *See* Kitch, *supra* note 23, at 770-72 (noting that disclosure does not necessarily enhance accuracy).

38. *See* KRIPKE, *supra* note 35, at 107-39; Benston, *supra* note 3, at 153. Obviously there is significant overlap between the two criticisms.

39. However, "[t]he marginal direct cost of mandatory disclosure may be small." Easterbrook & Fischel, *supra* note 7, at 708. As Easterbrook and Fischel note, it is difficult to know what disclosure-related costs firms would bear *voluntarily* in the absence of mandatory disclosure, an amount that must be subtracted from the nominal cost of regulation to identify its real cost. *See also* Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH U. L.Q. 815, 816 (1997) ("[T]he cost of transmitting, storing and manipulating data is a very minor component of the social cost of mandatory corporate disclosure . . . .").

Moreover, the direct costs may be growing. The SEC's recently proposed executive compensation disclosure rule threatens to impose substantial new costs on public companies. "Experts estimate that roughly 25% of the 500 biggest public companies in the U.S. now disclose more about executive pay than current rules require. . . . [But compliance with the new rules] 'will take real preparation.'" Joann S. Lublin & Kara Scannell, *They Say Jump: The SEC Plans Tougher Pay Rules*, WALL ST. J., Jan. 11, 2006, at C1 (quoting Jesse Brill, a securities and compensation lawyer).

40. Easterbrook & Fischel, *supra* note 7, at 708.

> may become more cautious and leaden on paper, switching the important disclosures to discussions with analysis or other oral exchanges that will be less precise and less widely disseminated. Poorly understood or "coded" disclosures will be decoded imperfectly (and at some cost). In the extreme, a mandatory disclosure system's specification of what to say may stop firms from conveying categories of information altogether.[41]

Meanwhile, outsider opportunists (like plaintiffs' attorneys and competitors) may use litigation of regulatory compliance to their own advantage and quite often to the substantial costs of target firms.[42]

So imposing restrictions on the manner and content of disclosures may, perversely, have the effect of reducing the overall amount of disclosure, assuming firms would have disclosed voluntarily anyway.[43] Less dramatically, it may alter the form of material disclosure from broadly distributed (and regulated) paper disclosures to less precise (and less controllable) oral disclosures—notably, to the detriment of those further outside a corporation's inner circle.[44] Even more dramatically, however, it may detrimentally alter underlying business decisions.[45]

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41. *Id.* at 709. Note that this claim is more complicated post-Regulation FD, but the basic point still holds. *See* Regulation FD, 17 C.F.R. § 243.100(a) (2006); *see also* Joseph A. Grundfest, *Enron: Can We Craft an Efficient Disclosure-Based Policy Response?*, Jan. 29, 2002, http://www.fed-soc.org/Publications/White%20Papers/enrondraft.htm ("While it is entirely appropriate to complain about Enron's alleged failure to comply with GAAP, the far greater problem may be the extent to which Enron could have modified its behavior, ever so slightly, so as to comply with GAAP (or at least with an aggressive interpretation of GAAP), and thereby potentially have continued to conceal its true financial condition from the market for many more months or even years. Enron's conduct also underscores the extent to which issuers may be willing to engage in financially questionable transactions that comply fully with GAAP only because those transactions generate desirable accounting treatments under GAAP.").

42. The litigation risk is substantial and, it must be noted, not necessarily correlated with market optimality. *See, e.g.*, Mahoney, *supra* note 39, at 818 ("Liability will . . . sometimes attach to statements that were not intentionally or recklessly misleading ex ante, but merely incorrect ex post. Any corporate disclosure—even though made in good faith and after appropriate verification efforts—therefore carries with it a price tag. The price, or expected liability, is a function of the probability that the statement will turn out to be incorrect, the probability that a court will erroneously find that the statement was intentionally or recklessly false given that it is incorrect, and the expected damage award."); *see also* Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2006/01/the_costs_of_ex.html (Jan. 11, 2006, 06:22 CST) ("There will be the lawsuits against the companies that get it wrong. Plaintiffs in these suits must, of course, prove that the misrepresentations and non-disclosures are material. Here we have the makings of a whole new subclass of securities jurisprudence.").

43. The assumption is warranted. *See, e.g.*, Benston, *supra* note 3, at 133 (noting that at the end of 1933—the calendar year before the Securities Exchange Act was passed—all New York Stock Exchange "corporations were audited by CPA firms, all listed current assets and liabilities in their balance sheets, 62 percent gave their sales, 54 percent the cost of goods sold, and 93 percent disclosed the amount of depreciation expense"). *See generally* Easterbrook & Fischel, *supra* note 7. For empirical evidence that exactly this happened in response to the increased disclosure obligations under the '33 and '34 Acts, see Mahoney & Mei, *supra* note 3.

44. As one prominent commentator and critic of the SEC has noted, "[S]ecurities values are the consensus of unverifiable estimates, and their exclusion [by SEC rules from prospectuses] limited the utility of the SEC's disclosure process for securities decisions." KRIPKE, *supra* note 35, at 17. Although the SEC has softened its resistance to forward projections and other "unverifiable estimates" since Kripke penned those words, *see, e.g.*, Safe Harbor for Forward-Looking Statements, Securities Act

Of key importance to understanding these consequences is the realization that forced disclosure deters the creation or collection of information that is valuable when kept secret, but that loses its value when disclosed.[46] As one commentator has noted:

> [T]here are two basic reasons why accuracy enhancement cannot be achieved, one internal to the statutes themselves and the other inherent in the world in which issuers do business. The internal reason is that the securities laws themselves reduce the amount of information that is provided by issuers because they impose significant liability for the production of misinformation. . . . The insight, so accepted in the free speech area, that high standards of liability for the production of erroneous information will, as one of its effects, reduce the production of any information, is unacknowledged in the securities area. But unacknowledged or not, the liability structure of the securities laws reduces the production of information.
>
> The second reason why accuracy enhancement cannot be achieved—the reason inherent in the world in which issuers do business—is that information is power, including the power to compete effectively. . . . Information is a weapon, and issuers have strong incentives to make disclosures consistent with their success in rivalry with competitors and other adversaries rather than to enhance the accuracy of the prices at which their publicly issued secu-

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Release Nos. 33-7101; 34-34831; 35-26141; 39-2324; IC-20619, 57 SEC Docket 1999 (Oct. 13, 1994), there remains a disconnect between the official information contained in a corporation's required disclosures and the less formal information that permeates the market.

At the same time, of course, the SEC has attempted to regulate even this less-formal dissemination of information. *See supra* note 41; *infra* notes 163-165 and accompanying text (discussing Regulation FD). Regulation FD may mitigate this effect, but the resulting regulatory squeeze is obviously problematic.

45. *See also* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 424 (1983) ("Requiring firms to disclose [firm information] . . . may affect the willingness of the firm to undertake the conduct at issue. . . . [M]anagers may simply decide that the costs of disclosure may exceed the expected benefits from the activity."); Manne, *supra* note 19, at 28-29 ("Advocates of disclosure-type securities laws have long claimed that[] . . . disclosure does not interfere with legitimate business decisions. . . . In fact, however, the argument that required disclosure is generally nonregulatory is . . . mythical . . . ."). *See generally infra* notes 47-59 and accompanying text.

46. *See, e.g.*, Mahoney, *supra* note 39, at 818 ("Opportunity cost is the difference between the value of the information to the company if kept secret and its value to the company if publicly disclosed. Many forms of corporate information are more valuable if they are kept secret. Obvious examples include trade secrets, ideas for new products, plans to enter new markets, and similar information that competitors could use. There are also less obvious examples. A company may have contracts with other firms pursuant to which both parties have made project-specific investments. Those investments give each firm market power vis-à-vis the other. In that situation, information about Party *B*'s valuation of the contract can enable Party *A* to gain a greater share of the gains from trade, and vice versa. Thus, any given company at any given time likely has a considerable amount of internal information that would, if made public, result in wealth transfers from the company to its competitors, suppliers or customers.") (footnote omitted).

rities are bought and sold. It is no accident that securities documents are opaque.[47]

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

THE "HYDRAULIC THEORY" OF DISCLOSURE REGULATION

Where information is valuable if secret, mandatory disclosure regulation imposes a cost on creating (or searching for) the information subject to disclosure. Where this information is incidental to a particular behavior, the existence of the rule thus deters the underlying behavior because of both the direct cost of compliance and the costly consequences of widespread dissemination.[48] A problem arises, however, where unwanted conduct is not merely deterred but also *redirected*.

A. The Basic Theory

The hydraulic theory of disclosure rules holds that, as disclosure rules impose costs on behavior subject to disclosure, where behavior can be altered at a lower cost than the cost of disclosure, disclosure rules will induce behavioral changes rather than increased information flow.[49] Where it is more costly to alter behavior—where the full costs of disclosure are either sufficiently low or sufficiently externalized—disclosure rules may be effective in their behavioral aims. But where the costs of disclosure may be avoided at lower cost by substituting other, unintended behavior, the effect is, at best, ambiguous.[50]

47. Kitch, *supra* note 23, at 770-72.

48. If information about a particular behavior is not voluntarily disclosed, it may be because more public acknowledgement (either by shareholders or by various gatekeepers) would reduce the value of the behavior or vitiate some important aspect of it. Thus if, as some contend, public outrage would attend clearer disclosure of some executive pay packages, the value to executives of their pay would be reduced by required disclosure. *See* BEBCHUK & FRIED, *supra* note 13, at 65 ("The more widespread and strong these [public] negative reactions are—that is, the greater the outrage—the larger the costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favor."); *id.* at 68 ("There is evidence that directors and executives are indeed influenced—in compensation and other types of decisions—by strong outside criticism and outrage."). This reduction could occur because the level or type of compensation could not be maintained in the face of public outrage or because enduring the outrage itself (moral opprobrium or social castigation) extracts a cost from some executives. The outrage argument is, however, contested. *See, e.g.*, Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 850 (2002) (amassing historical data "starkly at odds" with the outrage theory).

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

50. *See* William J. Stuntz, *Christian Legal Theory*, 116 HARV. L. REV. 1707, 1747 (2003) (book

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

Proponents of securities disclosure regulations must hope that the regulations will make undesirable conduct too expensive relative to desirable, alternative conduct, thus inducing a shift from the former to the latter. And to some extent, the proponents are surely correct: All else equal, if individually-remunerative-but-socially-costly conduct is made expensive enough so that alternative, socially desirable conduct becomes at least as individually remunerative, the socially undesirable conduct will be deterred. But it is not always the case that the alternative conduct is, in fact, socially desirable. Frequently, unintended consequences mar even the most well-intended regulation.[51] The argument is not (only) that the deterred conduct has unforeseen, socially desirable functions;[52] rather, the argument is that the effort to deter even manifestly *undesirable* behavior may induce a shift to *even less desirable* conduct.

For example, it is well understood that proponents of laws requiring the use of seat belts in cars intend for those laws to reduce the incidence of serious injury and death from automobile accidents.[53] It is also well understood,

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review) ("Legal threats produce some compliance . . . but they also produce resistance, as regulated actors invest in finding loopholes and evading detection."). Cain, Loewenstein, and Moore make a conceptually analogous point regarding the disclosure of conflicts of interest:

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

Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 6-7 (2005).

51. *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, 36 (2002) ("Designing firms' contracts to maximize the net benefits of employing agents obviously is a complex, multidimensional task that requires consideration of each firm's characteristics, and the fact that regulation can affect firms in unpredictable ways."); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 421-23 (1990) (demonstrating how well-intentioned laws aimed at redistribution, such as warranties of habitability, minimum wage increases, and labor safety laws, are in effect self-defeating because "the group particularly disadvantaged by the[se] regulation[s] will typically consist of those who are already most disadvantaged").

52. This is a common (and well-taken) criticism of regulation. *See* Ribstein, *supra* note 51, at 40-41 (noting that deterring certain behavior to combat fraud also has the effect of increasing information costs to the firm).

53. *See generally* Alma Cohen & Rajeev Dehejia, *The Effect of Automobile Insurance and Accident*

however, that this result has proved somewhat elusive.[54] Drivers seem willing to undertake a certain amount of risk, and if one risky behavior among numerous actions that might contribute to the likelihood of an accident is made more expensive (by threat of a fine, for example), then drivers will simply reduce their self-imposed risk avoidance in other ways—apparently by driving less carefully. To the extent that the laws do not alter drivers' overall risk preferences, they are unlikely to significantly reduce injuries.[55] And importantly, the shift from one set of behaviors to another, even with the *same* risk profile for drivers, does not impose the same risk on, say, pedestrians, who now suffer the ill effects of more reckless driving but earn none of the benefit of "safer" accidents.[56]

The regulation of corporate behavior evinces the same dynamic. The SEC has adopted, in compliance with Section 406 of the Sarbanes-Oxley Act,[57] a rule requiring companies to disclose waivers of their codes of ethics.[58] The implicit assumption is that disclosure to shareholders will deter inappropriate waivers, inducing better compliance with the underlying code

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Liability Laws on Traffic Fatalities, 47 J.L. & ECON. 357, 357 (2004) (following Peltzman in an analysis of "how economic incentives and liability regulation influence driver behavior and, in turn, traffic fatalities"); Sam Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 677 (1975) (analyzing the unintended consequences flowing from mandatory automobile safety regulation).

54. The argument is not that seat belt laws do not reduce the cost of motor vehicle accidents; it is that offsetting behaviors could theoretically dissipate all of the gains and that they have, empirically, dissipated some of the gains. *See, e.g.*, Cohen & Dehejia, *supra* note 53, at 388 ("The evidence indicates that compulsory insurance rules do deliver their intended effect, which is a significant reduction in the incidence of uninsured motorists. The evidence also indicates that increasing the incidence of insurance produces an increase in the number of fatalities. . . . While the switch by some motorists to become insured increases fatalities, this is at least partly offset by the effect of compulsory insurance on those drivers who chose to remain uninsured.").

55. That is, mandatory seat belt laws force drivers to consume more safety, thereby lowering the price of risky driving. Unless, I suppose, the cost of seat belt use was so large that it induced drivers to stop driving, the fundamental law of demand holds that drivers will "consume" more risky driving as the price decreases. *See generally* ALCHIAN & ALLEN, *supra* note 15, at 60 ("Any person's consumption rate for any good will be increased . . . if the price is lowered . . . sufficiently." (internal quotation marks omitted)).

It is worth noting, however, that a growing body of literature does suggest that laws can alter preferences—even risk preferences—in such a way that this effect may be mitigated. *See, e.g.*, Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 958-59 (1996) ("Much legal regulation . . . consist[s] of direct coercion, designed to generate good norms or to pick up the slack in their absence. . . . The[se laws] do this in large part because there is a general norm in favor of obeying the law. The relevant laws help to inculcate both shame and pride; they help define the appropriate sources of these things. . . . They readjust the personal calculation, making what is rational, and what is in one's self-interest, different from what they were before.").

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

57. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406(b), 2002 U.S.C.C.A.N. (116 Stat.) 745, 789 (to be codified at 15 U.S.C. § 7264(b)) ("The Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.").

58. Disclosure Required by Section 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5117-18 (Jan. 31, 2003) (amending 17 C.F.R. § 249.308). The rule adds Item 5.05 to Form 8-K, requiring disclosure (within five days) of a description of the nature of any waiver for a firm's senior officers from the corporate code of ethics.

of ethics.[59] But that assumption must be animated by a further assumption that some conduct will be relatively static—that codes of ethics will not themselves be rewritten and relaxed in response to the rule. In fact, however, the more likely outcome is that codes of ethics will be (and have been) rewritten to minimize the need for waivers, in this event actually stemming rather than improving the flow of information. "The disclosure rules will lead companies to make different decisions . . . . And perversely, those decisions may directly undermine the goals of section 406 and of Sarbanes-Oxley more generally."[60] In other words, disclosed waivers are (privately) costly, and it may be less (privately) costly to amend codes of ethics than to seek and publicize waivers. Underlying behavior of the sort requiring waivers may not change, or it may even deteriorate. And either way, *less* of it will be disclosed.

B. The Role of Institutional (In)Competence

Some commentators argue that the benefit of a mandatory disclosure regime policed by the SEC is that it permits corporations to make credible commitments, otherwise difficult to come by, with respect to conduct that is difficult to monitor.[61] But as long as there exist alternative behaviors to

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59. The adoption (or non-adoption) of a code of ethics also must be disclosed (and explained, if a code of ethics is not adopted). Section 406(a) of the Sarbanes-Oxley Act requires this disclosure, and it is implemented via Items 406(a) of Regulation S-K and Item 16B(a) of Form 20-F. As one commentator puts it, "[t]he theory here is that if Enron had been forced to notify the market that it had waived its code of ethics, the market might have investigated the [suspicious] transactions more closely." John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 120 (2005).

60. Note, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2136 (2003). The author continues:

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

Id. at 2137-38 (footnotes omitted).

61. *See* Franco, *supra* note 9, at 277-304 (arguing that "mandatory disclosure performs an important function by enabling candid issuers to provide more credible firm-specific disclosure"); Edward Rock, *Securities Regulation As Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 684-91 (2002). *But see* Easterbrook & Fischel, *supra* note 7, at 674 ("There are ways by which the sellers of high quality securities can identify themselves. One is to disclose information demonstrating quality. The buyer can verify some of this information, and this verification will lend credence to the rest. Verification will not work perfectly, though. Sometimes a firm must withhold information in order to avoid giving commercially valuable secrets to rivals. A firm thus will be hard pressed to convince buyers of the value of some secret production process or new but unreleased product. The other problem is that low quality sellers can mimic the disclosure of ascertainable facts while making bogus statements about things buyers cannot verify. The low quality firms erode the informational content of the disclosures of other firms, and again consumers cannot identify the high quality investments."). The problem of credible commitment is real but perhaps mitigated fairly well by market mechanisms. Easterbrook and Fischel here mention one. Another is independent organizations with their own reputational capital at stake; another still is advertising or other bonding mechanisms. On the for-

those subject to mandatory disclosure, and the value of the new behavior without disclosure outweighs the value of the old with disclosure, no mandatory disclosure regime can deliver *either* full disclosure *or* completely credible commitment. Both high-value and low-value securities issuers may thrive in the regulated environment: The former by disclosing and the latter by evading disclosure. In other words, even a mandatory regime may not impose costs sufficient to enable sorting between types.[62] And in such a case the imposition of costs may be particularly inefficient. The costs of compliance are themselves wasteful, but in addition, the mandatory regime may garner undeserved credibility, conferring a false imprimatur on malfeasant corporate actors.[63]

To be sure, in part this hydraulic effect is caused by the SEC's institutional incompetence. Mandatory disclosure of "legitimate" compensation does not necessarily induce disclosure of "illegitimate" compensation, which is the sort about which we worry.[64] And as I have argued, even in the face of market or regulatory punishment, illegitimate compensation will be comparatively more attractive where legitimate compensation is made comparatively more costly. But this does turn in part on the SEC's limited ability to police fraud (to catch and prosecute "illegitimate" compensation via theft or perk-taking)—an ability that could, presumably, be bolstered in the future.

But the institutional problems run deeper. Because the SEC's and investors' interests are not perfectly aligned,[65] more effective SEC enforcement

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mer, see generally Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227. On the latter, see generally Pauline M. Ippolito, *Bonding and Nonbonding Signals of Product Quality*, 63 J. BUS. 41 (1990).

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

63. And perceived-effective government protection may crowd out private protections, to the detriment of all. *See, e.g.*, James Andreoni & A. Abigail Payne, *Do Government Grants to Private Charities Crowd Out Giving or Fund-raising?*, 93 AM. ECON. REV. 792, 811 (2003) (finding that government grants to private charities reduce such groups' fund-raising).

64. Jeff Gordon has recently proposed strengthening the compensation disclosure regime (which is already fairly robust, *see* Regulation S-K, 17 C.F.R. § 229.10 *et seq.* (2006)):

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

Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 689 (2005); *cf.* Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 292-99 (1999). The SEC seemingly agrees with these claims and has proposed more rigorous disclosure rules for executive compensation. *See* SEC Proposed Rule 33-8655 on Executive Compensation and Related Party Disclosure (Jan. 27, 2006), *available at* http://www.sec.gov/rules/proposed/33-8655.pdf.

65. *See, e.g.*, Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L.

may be harmful to investors' interests (and, correspondingly, the SEC's failures may in fact inure to the benefit of investors). It is undoubtedly the case that investors desire some measure of "illegitimate" compensation, either because it is not worth the cost of policing or because, in some instances, it is the most efficient form of compensation.[66] Any SEC effort to restrict this compensation might, therefore, harm investors. Mandatory disclosure of all compensation elements coupled with more effective SEC enforcement may doubly harm investors: First, by imposing reporting costs and by shifting compensation too far toward inefficient sources (which the SEC is unable to police effectively), and then by indiscriminately imposing costs on those (difficult-to-identify) alternative compensation regimes that are in fact desirable to investors.

So if, on the one hand, SEC enforcement garners more reliable compliance with valuable commitments (and thus more commitments) than we could otherwise expect (because government enforcement is costly and unavoidable[67]), it might improve the market's efficiency. But if compliance with government-required and enforced disclosure exceeds market requirements, or if SEC enforcement deviates significantly from shareholders' enforcement preferences, compliance may be merely costly.

Of course, this highlights the hydraulic nature of SEC regulation itself: Regulatory efforts will be directed not necessarily where investors most desire but primarily where the SEC can exercise its comparative competence. Thus, some have argued that a mandatory disclosure regime is by its very nature a second-best regulatory regime, perhaps worse even than a purely market-based governance system. Both markets and governments are imperfect, and it is not a foregone conclusion that the particular incompetence of one is better than the other.[68]

REV. 1, 33 (2003) ("[T]he SEC may engage in self-serving inferences, choosing to view investors in the light most supportive of the need and importance of the SEC. The SEC's insistence that investor attitudes mirror views among SEC commissioners and staff may lead the agency toward ill-advised regulations. The SEC often uncritically states that it seeks to protect investors—and in particular, that absent the SEC's efforts, investor confidence in the market will deteriorate. Rarely, however, does the SEC verify that its assumptions are correct.") (footnote omitted); *see also* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1058 (2000).

66. Jensen & Meckling, *supra* note 8, at 308 ("However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the 'residual loss.'") (footnote omitted). As I have noted, for the rational shareholder, *optimal* enforcement is not *maximal* enforcement.

67. *See* Rock, *supra* note 61, at 686-91 (explaining how SEC regulation of disclosure is mandatory in two senses and thus "unavoidable").

68. *See* Harold Demsetz, *Information and Efficiency: Another Viewpoint*, *in* MARKET FAILURE OR SUCCESS: THE NEW DEBATE 107, 107 (Tyler Cowen & Eric Crampton eds., 2002) ("The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing 'imperfect' institutional arrangement. This *nirvana* approach differs considerably from the *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements."); *see also* Coase, *supra* note 6, at 18 (concluding that "[t]here is, of course, a further

This story does not turn on—but is potentially bolstered by—the informational limitations of both regulators and regulated (and investors).[69] Regulators are limited in their ability to predict the effects of their regulations, and they are subject to forces that may induce them to turn intentionally from socially desirable regulation in the first place.[70] Even well-intended regulation is bound to have unintended consequences, some of which may be less desirable corporate behavior. At the same time, corporate actors also are constrained, and even targeted efforts to direct their behavioral responses in the "right" direction may fail.[71]

The point is worth stressing because the imperfect efforts by regulators to effect behavioral changes also demonstrate a similar dynamic of unintended consequences. Thus, efforts by the SEC and other regulatory bodies to control corporate behavior by penalizing undesirable conduct have met with problematic results. For example, Congress adopted Internal Revenue Code section 162(m) in an effort to deter "excessive" executive pay packages by limiting the deductibility of non-performance-based compensation above $1 million.[72] Instead, however, "section 162(m) has had the perverse effect of causing many companies to increase executive salaries to the $1 million cap or, alternatively, causing companies to pay their executive with stock option grants worth many times the limit because option grants are deemed performance-based compensation."[73] Regulation like section 162(m) is bound to have undesirable hydraulic effects because the regulatory cut-off (here $1 million) is arbitrary; it is impossible to apply such a

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alternative, which is to do nothing about the problem at all . . . [because] the costs involved in solving the problem by regulations . . . will often be heavy . . . [and] it will no doubt be commonly the case that the gain which would come from regulating the actions which give rise to the harmful effects will be less than the costs involved in [g]overnment regulation").

69. *See* Choi & Pritchard, *supra* note 65, at 2-6 (describing the various informational shortcomings that both investors and regulators evince). There remains considerable disagreement over the validity and the reach of the behavioral critique, however. For a comprehensive critique of behavioral economic analysis of corporate law, see Forum, *Behavioral Analysis of Corporate Law: Instruction or Distraction?*, 10 LEWIS & CLARK L. REV. 1 (2006).

70. *See* Bainbridge, *supra* note 65, at 1058 ("A welfare economics model that posits legal intervention as a solution to market failure ignores the fact that regulators are themselves actors with their own self-interested motivations. The capital, product, and labor markets give corporate directors incentives to attract capital at the lowest possible cost. Voluntary disclosure thus should be designed to meet specific firm needs relating to monitoring and information transmission. In contrast, the incentives of legislators and regulators are driven by rent-seeking and interest group politics, which have no necessary correlation to corporate profit-maximization. Accordingly, mandatory disclosure is likely to be driven by the political concerns of the governmental actors drafting the mandates.") (footnote omitted).

71. *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 30-32 (1985) (explaining that principals and agents are "subject to bounded rationality, whence behavior is '*intendedly* rational, but only *limitedly* so'" (quoting HERBERT A. SIMON, ADMINISTRATIVE BEHAVIOR xxiv (2d ed. 1961) (1947))). Thus a regulatory effort to "correct" these actors' behaviors may fail by bumping up against those limitations.

72. I.R.C. § 162(m) (2000). The exception for non-performance-based pay is in § 162(m)(4)(C).

73. Jill E. Fisch, *Teaching Corporate Governance Through Shareholder Litigation*, 34 GA. L. REV. 745, 761-62 (2000) (citing James R. Repetti, *Accounting and Taxation: The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 708-09 (1997)). For further discussion of the regulation of executive compensation, see *infra* Section II.C.

narrow constraint to all firms; and, as noted, the regulators are limited in their ability to assess the consequences of their regulations.

At the same time, to the extent that market success is a product of systemic forces rather than individual intention, the relatively inefficient firm (which is to say, the relatively less profitable firm) will tend to fail.[74] If managerial conduct renders a firm less profitable than its peers, it will be punished in the market regardless of whether the conduct is clearly detrimental. Where corporate managers are subject to powerful market constraints on their behavior, seriously deleterious activity is unlikely to occur, and those who do engage in it are likely to be punished in the market.[75] Each manager orders his behavior according to his own preferences and motivations, and the "impersonal market system" essentially "selects survivors: those who realize *positive profits* are the survivors; those who suffer losses disappear."[76]

The limitation here, of course, is the case where managerial conduct inures sufficiently to the benefit of the managers that even the expectation of eventual failure in the market is insufficient to outweigh the manager's gains.[77] In other words, within the range where managerial behavior is sufficiently insulated from market forces (or effective regulation), even managers responding to market incentives can be expected to engage in some undesirable conduct. At the same time, managers may succeed in hiding their excesses from boards of directors and auditors,[78] preventing intermediate corrective measures (most notably employment termination).[79]

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

74. For an application of this point to antitrust law, see Geoffrey A. Manne & E. Marcellus Williamson, *Hot Docs vs. Cold Economics: The Use and Misuse of Business Documents in Antitrust Enforcement and Adjudication*, 47 ARIZ. L. REV. 609, 619-26 (2005).

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

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

77. *See, e.g.*, Ribstein, *supra* note 51, at 36 ("On the one hand, agency costs can be associated with agent behavior that is too cautious, as well as with behavior that is too risky from the principal's perspective. On the other hand, nonowner agents who do not bear even the small burden of failure that is borne by diversified owners might have an incentive to invest the firm's assets in projects with poor expected returns. Optimal agency contract design involves encouraging the agent to take the owners' interests into account, but not forcing the agent to bear so much of the firm's risks that she is more cautious than the owners would want her to be."). But note, too, that to the extent that managers have significant firm-specific investment, they may be overly concerned about the firm's solvency.

78. This is not an argument for more disclosure of the sort in which the SEC deals; it is only a recognition that boards are imperfect monitors of managerial behavior. It is clear that shareholders are not in a position to do a better job, even if they did have access to more information. *See infra* notes 132-144 and accompanying text.

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

the extent that actors must find "second-best" vehicles for illegitimate compensation or fraud in the wake of regulation, we must suppose that the return on the new vehicle is lower than the return on the old vehicle absent regulation or else the actor already would have been employing the new mechanism.[80]

C. The Hydraulic Theory of Executive Compensation Disclosure Regulation

Recent attention focused on the size of some corporate managers' compensation packages has yielded new disclosure regulation aimed, ultimately, at curbing the level of executive compensation by requiring more consistent accounting and expanded disclosure.[81] Both performance-based (options and bonuses) and non-performance-based (salary and other benefits) compensation are suffering increased scrutiny, but particular attention has been paid to bonuses and other forms of compensation tied to accounting-based performance targets.[82] If incentive-based compensation comes under increased investor and regulator scrutiny, more managerial compensation may shift into non-incentive-based forms. Many of the proponents of regulation seem to hope and expect, however, that the size of compensation will simply decrease—not that it will be shifted into another form.[83] And in large part, proponents base their expectation on the presumed decoupling of performance and pay and the assumption that scrutiny will rein in managers'

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

81. *See* Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A; 34-54302A; IC-27444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006)), *available at* http://www.sec.gov/rules/final/2006/33-8732a.pdf; *see also* Roberta S. Karmel, *Realizing The Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 100 (2005) ("Perhaps making high-ranking corporate officers individually responsible for a corporation's financial statements will lead to more accurate and more meaningful financial disclosure. Probably executive greed has become so completely out of control that substantive regulation of executive compensation is the only way to curb management remuneration.").

82. *See* BEBCHUK & FRIED, *supra* note 13, at 95 ("As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to postretirement payments and benefits as ways to compensate managers."); *id.* at 102 ("Deferred compensation is a second technique used to transfer large amounts of mostly performance-insensitive value to executives without attracting much shareholder attention."); *id.* at 109 ("[C]onsulting contracts provide substantial value to retired executives. They usually offer the retiring CEO an annual fee for 'being available' to advise the new CEO for a specified amount of time per year. . . . These consulting arrangements provide flat, guaranteed fees . . . rather than payment for work actually done . . . ."); *see also* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing BEBCHEK & FRIED, *supra* note 13). It must also be noted that even across-the-board scrutiny would seem to "favor" more esoteric forms of compensation. It is difficult to disguise the bottom line of an annual salary whose value must be disclosed; it is far easier to disguise the value of in-kind compensation or complex bonus schemes.

83. *See, e.g.*, GEORGE BENSTON ET AL., FOLLOWING THE MONEY: THE ENRON FAILURE AND THE STATE OF CORPORATE DISCLOSURE 70 (2003) ("[T]here is at least some prospect that the new NYSE and NASDAQ listing rules, which require shareholders to approve executive compensation packages, will reduce the size of those packages . . . ."); *see also* Comments on Proposed Rule 33-8655: Executive Compensation and Related Party Disclosure, http://www.sec.gov/rules/proposed/s70306.shtml (last visited Jan. 13, 2007).

ability to maintain this disconnect.[84] But the evidence supporting these expectations is weaker than its proponents suggest.[85]

In fact, the frequently decried history of sharply increasing managerial compensation seems to track managerial performance quite well and does not merit an assumption of executive malfeasance. A recent working paper by Gravaix and Landier employs a sophisticated model to find that:

> [T]he role of average firm size provides a novel explanation of the rapid surge in US CEO pay since 1980. While previous papers attribute this trend to incentive concerns or managerial entrenchment, we show that it can be explained by the scarcity of CEO talent, competitive forces and the six-fold increase in firm size over the same period.[86]

And this is consistent with an institutional criticism of the managerial power hypothesis at the heart of executive disclosure regulation: Executive power has, in fact, been decreasing over this period of rapidly-increasing pay.[87]

If this is true—if, that is, evolving market conditions and fierce competition for scarce talent magnified by firm size (rather than managerial entrenchment) are driving CEO pay—then regulation aimed at reducing pay by expanding the disclosure of information will not change the competitive conditions underlying the market and thus will not significantly alter compensation levels. Instead, such regulation will induce only efforts to minimize the ancillary impact of disclosure. Such regulation may alter the form or the timing of compensation, but there is no reason to believe it will alter the net magnitude of executive pay.

1. Behavioral Hydraulics: Substitution Among Types of Compensation

Increased mandatory disclosure of executive compensation information, if disclosure is costly to managers,[88] will, in the first instance, induce man-

84. *See, e.g.*, BEBCHUK & FRIED, *supra* note 13, at 65-66 (citing the example of how Jack Welch responded to scrutiny by trying "to protect the approval and esteem he had earlier enjoyed at the expense of his narrow economic interests"; the authors suggest that scrutiny, especially in the form of "outrage," may constrain executives' compensation).

85. *See generally* Bainbridge, *supra* note 82, at 1615-19; Gordon, *supra* note 64; Jensen & Murphy, *supra* note 12; Murphy, *supra* note 48; Daniel Akst, Op-Ed, *Why Rules Can't Stop Executive Greed*, N.Y. TIMES, Mar. 5, 2006, at 4BU ("Although more disclosure and pay-for-performance requirements won't dampen runaway C.E.O. compensation, both are useful for illustrating a larger lesson: that it's naïve to place too much faith in the power of rules to limit human behavior."); Tyler Cowen, *Nice Work if You Can Get It*, WALL ST. J., Dec. 23, 2004, at D8.

86. Xavier Gabaix & Augustin Landier, Why Has CEO Pay Increased So Much (Jan. 8, 2007), http://econ-www.mit.edu/faculty/download_pdf.php?id=1293; *see also* Bengt Holmstrom, *Pay Without Performance and the Managerial Power Hypothesis: A Comment*, 30 J. CORP. L. 703, 707 (2005) ("A CEO that is doing well and is trusted can be worth billions of dollars more than the second best alternative. Yes, I said billions.").

87. Holmstrom, *supra* note 86, at 704.

88. And there is some reason to believe that it is. *See, e.g.*, Kevin J. Murphy, *Reporting Choice and the 1992 Proxy Disclosure Rules*, 11 J. ACCT. AUDITING & FIN. 497 (1996) (providing empirical evi-

agers to minimize its consequences. Thus it is not surprising that, following the SEC's large-scale 1992 executive compensation disclosure reforms,[89] corporations altered the process by which they awarded compensation by expanding the use of compensation consultants and forming compensation committees on their boards of directors. There is no evidence that these costly procedural reforms reduced overall compensation levels, however.[90] But more interesting is that efforts to hide or mitigate compensation in response to its regulation are demand-driven changes in the form of compensation itself.

In the abstract, each of the various forms of compensation has independent justification along with related problems. Fixed (i.e., non-performance-based) compensation may drive a wedge between managerial and investor preferences,[91] but some measure of fixed compensation clearly induces risk-averse, would-be managers to enter the race in the first place by offering a minimum level of secure compensation.[92] Incentive-based compensation may induce better performance,[93] but it also may not.[94] Perks and other non-pecuniary compensation, finally, may serve to solve the difficult last-stage problem,[95] but they also facilitate camouflaged extraction of rents by managers.[96]

The problems become more acute if one considers marginal shifts among the types of compensation. Despite justification, moving from performance-based compensation to fixed compensation exacerbates the problem of relatively risk-averse managers. Moving from fixed to performance-

dence for the claim that managers bear non-pecuniary costs from high perceived levels of compensation).

89. Executive Compensation Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48,126, 48,138 (Oct. 21, 1992).

90. *See, e.g.*, Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 52 (2003) (noting the substantial increase in CEO pay between 1992 and 2000). Interestingly, Hall and Murphy attribute the increase predominantly to the expanded use of option-based compensation—a form of compensation unintentionally bolstered by Congress' efforts to stem the rise of CEO pay by limiting the tax deductibility of corporate salaries in excess of $1 million. *See supra* note 72 and accompanying text (discussing I.R.C. § 162(m)).

91. *See* Bainbridge, *supra* note 82, at 1634 n.110.

92. *See* BEBCHUK & FRIED, *supra* note 13, at 19 ("Because the company's performance will depend on some future factors beyond the executive's control, tying a manager's compensation to performance makes the level of compensation uncertain. Managers are generally risk averse—they value a dollar paid with certainty more than they value variable pay with an expected value of a dollar . . . .").

93. *See, e.g.*, Bainbridge, *supra* note 82, at 1632 ("It seems unlikely that performance-based compensation schemes deter an executive bent on self-dealing . . . [nor] do much to affect the degree of managerial slack."); Cowen, *supra* note 85 ("In any case there is little evidence, as the economist Kevin Murphy has noted, that CEOs perform better even when their pay is closely tied to earnings or other corporate-performance measures.").

94. *See* BENSTON ET AL., *supra* note 83, at 34-35 (arguing that compensation through stock-price-based incentives can lead to costly accounting manipulations); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 824-28 (2002) ("[F]irms take surprisingly few steps to prevent or regulate the unwinding of the incentives provided by the grant of options and restricted stock.").

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

96. *See, e.g.*, BEBCHUK & FRIED, *supra* note 13, at 102-09 (describing the ways in which retirement benefits are easily camouflaged).

based compensation raises the specter of more complex and therefore more easily abused compensation schemes. Inducing a shift from either to perks increases the likelihood of hidden and therefore abused compensation and increases the variance in compensation levels (because amounts are harder to pin down). At the same time, shifting compensation away from perks increases the likelihood of turnover among executives and reduces executives' dependence on continued employment as an agency-cost reduction device.[97]

For simplicity, we may reduce the forms of compensation available to corporate managers into two broad categories: pecuniary compensation (income, stock, stock options, bonuses, etc.) and non-pecuniary or in-kind compensation (prestige, fancy jets, expensive dinners, idiosyncratic work environments, light workloads, etc.). As Armen Alchian and Reuben Kessel have noted, the important distinction between the two types of compensation is that the former may be consumed at home and the latter largely only at work.[98] As a consequence, in-kind compensation is more restrictive than its pecuniary counterpart[99] but nevertheless valuable.[100]

Corporate managers (and firms) choose the mix of these two types of compensation that maximize their utility (and not merely their "profits"—a narrower conception of remuneration). Thus at-work compensation may at times and along some margins be more valuable to the manager (and the firm) than pecuniary compensation even though it is, on average, more restrictive.[101] For the firm, if the cost to the firm of providing the manager with non-pecuniary pay (say, plush surroundings) is less than the cost of providing the cash compensation he would require in its stead, the profit-maximizing firm will provide the non-cash compensation.

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

97. *See generally* Henderson & Spindler, *supra* note 95, at 1835.

98. *See generally* Armen A. Alchian & Reuben A. Kessel, *Competition, Monopoly and the Pursuit of Money*, *in* ALCHIAN, *supra* note 76, at 151, 151-76.

99. *Id.* at 161 ("For the total amount of resources used, these constrained expenditure patterns necessarily yield less utility than the unconstrained."). There is some spillover here, of course. Some in-kind compensation substitutes perfectly for goods the recipient would have chosen to purchase with the cash compensation, and some perks may, in fact, be consumed outside the workplace. Nevertheless, in-kind compensation is obviously more restrictive than cash compensation.

100. *Id.* at 154-56 ("[A] person . . . will choose to accept a lower salary or smaller rate of return on invested capital in exchange for non-pecuniary income in the form of, say, working with pretty secretaries, nonforeigners, or whites. . . . Presumably, the known sacrifice of pecuniary income is more than compensated for by the gain in non-pecuniary income." (citing GARY S. BECKER, THE ECONOMICS OF DISCRIMINATION (1957))).

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

> home pay is more fungible than is on-the-job consumption. If consumption at home is more efficient, then it will not take place on the job . . . .[102]

Thus, a shift in the price of non-pecuniary compensation relative to pecuniary compensation should occasion a corresponding shift in the use of each form of compensation. As Armen Alchian and Reuben Kessel note, "whatever [a manager's] preference patterns may be, the less he must pay for an increase in one [type of compensation], the more it will be utilized. This principle, of course, is merely the fundamental demand theorem of economics . . . ."[103]

The relevant question is not whether each form of compensation can be independently justified but whether the marginal increase in one form of compensation and corresponding decrease in another occasioned by a shift in regulation provides a net gain to shareholders. Unfortunately, the SEC does not appear to consider the relevant, marginal question. For example, although it is possible to identify abstract justifications for the expanded use of restricted stock grants in executive compensation,[104] it is not clear that, for any particular company, a regulatory policy that induced such an expansion would be desirable. The broad-brushed nature of federal regulation effectively precludes a firm-by-firm marginal analysis.

2. Pool Hydraulics: Substitution Among Types of Managers

By increasing the cost of one form of compensation relative to another, compensation disclosure regulation will have one of two overall effects: A firm may lower total (known) compensation to its managers but maintain the pre-regulatory distribution (among forms of compensation), or a firm may maintain total compensation at about the same level but alter the *form* of compensation.[105] The consequences depend ultimately on the utilities of the managers. By assumption, compensation prior to regulation was constructed to maximize manager utility within market limits.[106] A change (a reduction) in either level or form would price some of these managers out of the market. Assuming a rational and efficient market, the total level will not

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

103. Alchian & Kessel, *supra* note 98, at 153.

104. As many have recommended. *See, e.g.*, TIAA-CREF Policy Statement on Corporate Governance, http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf ("Equity-based plans should emphasize restricted stock awards. Restricted stock more closely aligns the interests of executives with shareholders . . . .").

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

106. But, of course, this may not be the case. Bebchuk and Fried have put forth a "managerial power" hypothesis which claims that, for various institutional reasons, managers often capture their compensating boards and receive compensation well in excess of any market limits. The hypothesis is superficially plausible, but it proves defective under close empirical and theoretical scrutiny. *See supra* note 98 (highlighting article that criticizes this theory).

drop much, but the form may shift. For the firm, although a higher proportion of compensation was paid in pecuniary form pre-regulatory shift, it may be more cost-effective post-regulation to shift more compensation into non-pecuniary forms because they remain more camouflaged even with more disclosure. Some firms and some managers will be better positioned than others to make this shift.[107]

It is of course the case that managers may be consuming more compensation of both or either type than the firm would prefer but that managerial control prevents the firm from adopting the appropriate remedy (whether through disclosure or direct governance). But then the question is whether mandatory disclosure will help or only alter the form of compensation further away from public scrutiny, at greater cost.

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

I hypothesize that there are, broadly speaking, two classes of prospective corporate managers: "pecuniarists" and "non-pecuniarists." Some people have a comparative advantage in taking compensation in pecuniary form, but there must also be people who are comparatively better than others at deriving utility from non-pecuniary sources.[108]

> The existence of alternative business organizations (meaning different capabilities for monitoring employee behavior) implies a predictable self-selection process, in which managerial talent (of a given quality) with a taste for on-the-job consumption will tend to manage firms that have chosen a high-monitoring-cost organization.[109]

This may be because they are better at convincing boards of the "necessity" of non-pecuniary compensation, because they enjoy more than average the sorts of perks obtained through non-pecuniary compensation, or because they are more successful in camouflaging illicit compensation. Regardless

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107. Demsetz, *supra* note 102, at 382 (discussing the difference between types of managers, their comparative working condition preferences, and maximization of firm value by owners).

108. "[P]articular employees may have a comparative advantage in the 'art' of shirking." HAROLD DEMSETZ, *Agency and Nonagency Explanations of the Firm's Organization*, *in* THE ECONOMICS OF THE BUSINESS FIRM: SEVEN CRITICAL COMMENTARIES 26 n.13 (1995). The point is not that anyone prefers *all* non-pecuniary compensation. Rather, the point is that, at the margin, some people are better than others at deriving utility from non-pecuniary sources.

109. Demsetz, *supra* note 102, at 384.

of the reason, however, the effect on the pool is the same: Those potential managers who perceive that they have a comparative advantage in receiving utility from non-pecuniary compensation will be more likely to enter the managerial market, and, at the same time, potential managers with a comparative disadvantage in receiving utility from non-pecuniary compensation will be induced to exit.

The net result is not, in the first instance, a shift in the *efficiency* of firms except perhaps insofar as the shift increases the likelihood of turnover.[110] While there should be some shift in the characteristics of corporate managers, what are the consequences?

This effect may or may not be socially harmful. It is impossible to infer from the mere existence of at-work compensation or any other form of compensation that a firm is not profit maximizing, and it is perhaps the case that firms systematically underestimate the retention benefits of payment in-kind and immediately-consumed compensation.[111] Perhaps the employment histories, management styles, education, and other characteristics of those executives who excel in at-work consumption correlate—unbeknownst to firms—with more effective management and higher returns. It may be the case that, ex post, continuity is improved and agency costs decreased along with more in-kind compensation. Alternatively and more likely, however, the effects may be costly.

In the first place, the characteristics of the non-pecuniarist might be expected to translate, on average, to the detriment of the corporation. Non-pecuniarists are likely to be relatively interested in shirking and, in general, distracted at work.[112] This should inure to the detriment of the corporation.

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

> If wealth cannot be taken out of an organization in salaries or in other forms of personal pecuniary property, the terms of trade between pecuniary wealth and non-pecuniary business-associated forms of satisfaction turn against the former. More of the organiza-

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110. Turnover can be costly, as continuity can be beneficial, although entrenchment might impose costs at the other end of the spectrum. *See infra* notes 117-119 and accompanying text.

111. *See* Henderson & Spindler, *supra* note 95, at 1863-64 (describing how perks serve to keep employees in the firm because in-kind payment "is a little bit like paying them in heroin: [i]t delivers a tremendous amount of utility in the short term, none of which can be saved until later periods," hindering managers from retiring sooner than optimal from the firm's perspective).

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

> tion's funds will now be reinvested . . . in ways that enhance the manager's prestige or status in the community. Or more money can be spent for goods and services that enhance the manager's . . . utility.[113]

This notion is premised on the assumption that the market for corporate managers is a relatively rational one—that managers are rewarded in a competitive market largely in accordance with their perceived productivity.[114] But this assumption may not be warranted. And if it does not hold, it is possible that a restriction on pecuniary pay will not result in an increase in non-pecuniary pay. That is, if compensation is proved by disclosure to be excessive, and managers have been successful at commanding above-market returns on their human capital, it is not necessarily the case that they will be as successful in rent seeking through non-pecuniary means. Rather, the heightened scrutiny, the inertia-overcoming regulatory shock, and the relative complexity of non-pecuniary compensation could result in a net reduction in management compensation without, even, a corresponding efficiency loss (in other words, the effect might be merely a redistribution from managers to owners).

Regardless, however, the existence of a mandatory disclosure regime means that, on the margin, only those potential managers who place a relatively high value on non-pecuniary compensation will compete effectively for management positions. Potential managers who place a relatively high value on pecuniary (now lowered) compensation are priced out of the market because the explicit salaries they require are too difficult to maintain in the face of their disclosure.[115]

A further complication here is the likely shift from more legitimate to less legitimate compensation. As sufficiently large legitimate (and largely pecuniary) compensation becomes harder to maintain in the face of regulatory and public scrutiny, it is more likely not only that less transparent forms of legitimate compensation will arise but also that more compensation will take illegitimate forms (with, presumably, a heavy emphasis on the non-pecuniary). To the extent that it is more expensive for both managers and directors to set compensation legitimately, directors may choose, instead, to permit more unauthorized compensation by policing it less.[116]

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113. Alchian & Kessel, *supra* note 98, at 161.

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

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

116. It is not clear, however, whether abstaining from monitoring is a winning proposition for boards, especially given post-Sarbanes-Oxley attention to internal controls and the ambiguities of the Disney

It is worth pointing out that in-kind, at-work consumption may not impose direct costs on the firm. To some degree, at-work consumption is incidental to employment and other compensation, and is neither significantly monitored, accounted for, nor paid by firms themselves. For example, the prestige associated with highly remunerative executive employment is a form of compensation which is neither paid by nor (likely) monitored by firms. In fact, the desire by managers to receive these psychic benefits will inure to the *benefit* of the firm, at least to the extent that they are correlated with the firm's success. [117] And we should expect similar benefits accruing to the firm from an executive's social connections, increased self-confidence, and other forms of so-called "psychic income."[118]

However, there may be a deleterious side to these forms of compensation. Unauthorized consumption in the form of shirking and perk-taking impose well-known costs on the firm.[119] But, likewise, psychic, at-work consumption may impose costs. There may be a conflict between the behavior conducive to the firm's interest and that necessary to capitalize on psychic income. For example, social distance among colleagues may to some extent impair the effectiveness of hierarchical management. But distance (superiority) is a source of psychic consumption for many, and one surely actively cultivated by some.[120] Likewise, managers who consume "dominance" over their subordinates surely often do so at the company's expense.[121]

But the larger problem is also the more subtle one. For it is not the case that the value to the executive of psychic income is independent of his own actions. Rather, it is quite the contrary: the recipient may actively cultivate

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litigation. *See* Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C.A. § 7262 (2002); *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

117. *See, e.g.*, Bainbridge, *supra* note 82, at 1632 (suggesting that executives are "motivated principally by other concerns such as ego, reputation, and social-effort norms"); *see also* James McConvill, Executive Compensation in Contemporary Corporate Governance: Why Pay for Performance is a Flawed Methodology (2005) (unpublished manuscript, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723521).

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

119. Although it is important to note that the costs of shirking born by the firm may be a cheaper form of compensation than the alternatives, and doubtless some shirking is an implicit (if not explicit) part of considered executive compensation. *See* Jensen & Meckling, *supra* note 8, at 327-28 ("The reduced value of the firm caused by the manager's consumption of perquisites . . . is 'non-optimal' or inefficient only in comparison to a world in which we could obtain compliance of the agent to the principal's wishes at zero cost or in comparison to a *hypothetical* world in which the agency costs were lower. But these costs (monitoring and bonding costs and 'residual loss') are an unavoidable result of the agency relationship. Furthermore, since they are borne entirely by the decision-maker (in this case the original owner) responsible for creating the relationship he has the incentives to see that they are minimized (because he captures the benefits from their reduction). Furthermore, these agency costs will be incurred only if the benefits to the owner-manager from their creation are great enough to outweigh them.").

120. *See, e.g.*, *Inconspicuous Consumption*, ECONOMIST, Dec. 24, 2005, at 66, 67 (discussing how in an attempt to maintain their class status as the super-rich, some high-earners are buying private jets not for their conspicuousness but for their distancing effect from the "masses … stuck . . . in a[n] [airport] security line" (quoting Virginia Postrel) (internal quotation marks omitted)).

121. *See, e.g.*, Demsetz, *supra* note 102, at 383 (describing Henry Ford).

the conditions that enable the maximization of psychic income *at the expense of the firm* (a form of rent seeking). In the first and most obvious instance, this effort entails shirking: Time spent cultivating social capital may not provide returns for the firm and is thus time not spent working for the firm's benefit. At the same time, the return on this effort makes the *value* of shirking to the shirker correspondingly greater, thus encouraging more shirking, reducing the returns to bonding and inducing more expenditure by the firm to prevent it. Firms are not without the ability to encourage the beneficial aspects of psychic consumption and to deter the deleterious, but it is costly to do so.

And managers' efforts to maximize psychic income may also tax the firm in still more subtle ways. The executive who effectively bolsters his reputation may become more attractive in the market for managers, leading to a decreased probability of retention, the threat of discontinuity,[122] and higher real compensation. Hubris derived from self-importance may lead to increased fiduciary litigation (and/or increased D & O insurance premiums) both because the manager is in fact more likely to breach duties and because he may be a more attractive or identifiable litigation target.[123] Similarly problematic is the phenomenon of "benchmarking," through operation of which executives' efforts to position themselves ahead of their peers leads to compensation creep,[124] thus providing ever-increasing return on efforts to jockey for position.

And finally, to the extent that disclosure regulation does lead to turnover (substitution from pecuniarist to non-pecuniarist managers), it may be inherently costly. There is a value in continuity, and "[i]t is efficient in many instances of teamwork to avoid switching personnel, not (only) because of transaction cost or opportunistic behavior but because task per-

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122. *See supra* notes 117-119 and accompanying text. Continuity in management may be inherently valuable to the firm; and thus, a manager's attractiveness in the market may command additional compensation above and beyond the manager's perceived value to the firm *qua* manager.

123. *See* Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 675 (2005) (explaining that CEO hubris ("overconfidence") exists because "people in powerful and influential positions with track records of success—qualities that typify CEOs, especially at large public companies—might particularly be overconfident and prone to believe that they are in control").

124. *See, e.g.*, Holmstrom, *supra* note 86, at 707 ("Benchmarking is an essential piece of the puzzle of why executive pay rose so dramatically in the 1990s. It does not alone explain the rapid rise in pay, but it makes it possible for pay to rise rapidly if there is a sudden external shock."); *see also* Akst, *supra* note 85 ("Any benefit from shining the cleansing light of day on executive greed will probably be outweighed by the inflationary effect of additional disclosure, which will provide more ammunition for executives and consultants seeking to justify additional increases."); Posting of D. Gordon Smith to Conglomerate Blog, http://www.theconglomerate.org/2006/01/_ yipee_more_exe.html (Jan. 10, 2006) ("If you don't remember the last time the SEC attacked executive compensation, it happened in 1992. The SEC mandated more transparent disclosure of executive compensation, which caused an immediate outbreak of *compensation envy* among America's business elite. The remedy for compensation envy—prescribed, strangely [sic] enough, by those most afflicted—was additional compensation, which had the perverse effect of transferring the malady to other executives. The result has been an upward spiral of executive compensation in the United States. (The process of comparing CEO pay is called 'benchmarking.')").

formance would be compromised."[125] In fact, this can go some way toward explaining seemingly extravagant executive compensation. Part of compensation may be a pecuniary transfer from shareholders to executives equal to (or less than) the cost of discontinuity. Similar reasoning might explain some portion of takeover premiums as well.

In this context it also helps to explain the perceived one-way ratchet of executive pay.[126] The value of continuity increases with longevity; there are, in other words, economies of longevity. Whether or not executive pay is tied to some observable performance measure, it should increase over time to reflect the increasing value of continuity. But because the value of continuity is in large measure a function of the length of tenure rather than the expenditure of effort, it is fairly sticky. A decrease in stock price that might reflect poor performance over time should not directly decrease executive pay because some pay is compensation for tenure rather than performance. Of course the executive's ability to capture this surplus must be dependent in part on his performance, and it is not at all surprising that there is *some* correlation between poor performance and decreasing compensation.[127]

TOO MUCH DISCLOSURE: THE COSTS OF INFORMATION

A. The Limited Benefits of Information Disclosure

Despite regulatory claims to the contrary, most of the information contained in mandated disclosures is of limited benefit to its intended recipients.[128] Although the SEC focuses on the importance of information for ordinary investment decisions, ordinary investors are rationally uninterested in such information.[129] It is well-known that stockholders are relatively un-

125. DEMSETZ, *supra* note 108, at 21.

126. *See* BEBCHUK & FRIED, *supra* note 13, at 71-72 (explaining the phenomenon of ratcheting in executive compensation as one where "CEOs who were initially paid below the median amount received larger than average pay increases, in both percentage and absolute terms, even when their firms had worse accounting and stock price performance" and referring to a study by Kim Clark, Dean of Harvard Business School, who calls ratcheting the "Lake Wobegon effect" because "in Lake Wobegon everybody is above average[,] [a]nd in a lot of companies the way the system works is most CEOs want to be at the 75th percentile . . . of compensation." (quoting Kim Clark, Dean of Harvard Bus. School, Prepared Remarks at the National Press Club: Corporate Scandals: Is it a Problem of Bad Apples or it is the Barrel? (Feb. 26, 2003) (internal quotation marks omitted)).

127. *See* Core et al., *supra* note 30, at 1174 ("Table Two illustrates the magnitude of equity incentives held by U.S. CEOs relative to their pay. The Table shows data on annual compensation and beginning-of-year portfolio value and incentive data for S&P 500 CEOs from 1993-2003 . . . . [W]e measure incentives as the increase (decrease) in the value of the CEO's stock and option portfolio that occurs when the stock price increases (decreases) by 1%. . . . Thus, . . . these CEOs can lose large amounts of their wealth when prices fall. Note that this $8.6 million decrease is larger than the median CEO's pay for 2003 of $6.6 million.").

128. *See, e.g.*, KRIPKE, *supra* note 35, at 86-87 ("If a market layman or an unsophisticated market professional determined from [disclosed] documents that a security were undervalued, he might or might not be wrong on the facts, but in any event he would be wrong on the timing.").

129. Rational voters are apathetic and ill-informed both for purposes of voting and for investing. On voting, see, for example, Easterbrook & Fischel, *supra* note 45, at 402, asserting that: "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."

informed and apathetic in their roles as "owners" of public companies: Small stakes, diversification, and attenuated influence render the acquisition and use of most firm-specific information far more costly than they would be worth.[130]

Moreover, the pragmatic value of the information disclosed subject to securities regulation may be quite low.[131] First, adherence to the standards of accounting can restrict an auditor's ability accurately to describe financial conditions for the sake of the standard's uniformity.[132]

Second, accounting information employed ex post for the benefit of the investing public may have been created in the first place using a different metric and for a very different purpose. Managers and executives use rough-hewn accounting data to facilitate internal cost allocations, for example. This information is included in its required disclosures, ostensibly for the benefit of well-informed investment decisions.[133] But, the divergence between the accounting assumptions inherent in each intended purpose may make the information of limited use to investors. In other words, the information need not be wrong for it to be misleading. "In particular, the assumptions made by an accountant in amassing, assessing and presenting . . . data for investors . . . yield results different than those that they would obtain with different assumptions."[134]

Furthermore, see also Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1439-44 (1964). On investing, see, for example, Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 696 (1995), which states that "[e]fficient capital markets theory and portfolio theory, which have become reasonably well-accepted in the investment community, argue strongly for a highly passive approach to investing. Indeed, their logical implication is that the best investment approach is passive indexing, a strategy now widely followed by individual and institutional investors."

130. As one commentator notes, commenting on the SEC's executive compensation proposal, "[w]hat the proposals assume is irrational non-apathy." Posting by Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2006/01/the_secs_compen.html (Jan. 18, 2006, 07:34 EST).

131. *See generally* Manne & Williamson, *supra* note 74, at 610-13.

132. "[C]ompulsory uniformity of standards or detailed rules constrains managers' ability to 'best' convey their superior knowledge about the past, present, and future. . . . Restricting [the manager's] choice to a single method or even to a specific menu of such methods limits his ability to convey truthful information if he has incentives to do so." Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited*, 8 STAN. J.L. BUS. & FIN. 39, 62 (2002); *see also* William T. Baxter, Accounting Standards: Boon or Curse?, Saxe Lectures in Accounting (Feb. 13, 1979), http://newman.baruch.cuny.edu/digital/saxe/saxe_1978/baxter_79.htm ("Accounting figures are not docile, and do not lend themselves to standardisation [sic]. Industries differ from one another. So do firms within an industry (or, very likely, straddling several industries). The same firm may change from year to year. And the needs of users vary.").

133. *See* Regulation S-K, 17 C.F.R. § 229.10(e)(1)(i)(A)-(B) (2006) (requiring, when non-GAAP financial measures are used in a filing, a comparison to financial measures presented in accordance with GAAP and a reconciliation thereof); *see also* George J. Benston, *The Regulation of Accountants and Public Accounting Before and After Enron*, 52 EMORY L.J. 1325, 1336-37 (2003) (discussing violations of Regulation S-K in the Enron scandal); David S. Ruder et al., *The Securities and Exchange Commission's Pre- and Post-Enron Responses to Corporate Financial Fraud: An Analysis and Evaluation*, 80 NOTRE DAME L. REV. 1103, 1135-36 (2005) (explaining the requirements of Regulation S-K).

134. Manne & Williamson, *supra* note 74, at 628. The divergence may not only be a function of legitimate, divergent assumptions and accounting methods but may also arise from manipulation. *See, e.g.*, George J. Benston, *The Validity of Profits-Structure Studies with Particular Reference to the FTC's Line of Business Data*, 75 AM. ECON. REV. 37, 40 (1985) ("[I]t may be that executives who manage lines of business with large market shares are compensated, in part, with a share of accounting profits. In a

Furthermore, because accounting data bears a tenuous relationship to economic reality,[135] interpreting the economic significance of even correctly focused accounting numbers can be tricky, even for experts.[136] As one prominent critic of the securities disclosure regime has noted, "differences between accounting measures and economic market values are likely to be significant and very difficult (in many important instances, impossible) to determine."[137]

B. The Affirmative Costs of Information Disclosure

Mandating disclosure, at least if penalties for nondisclosure are effectively administered, has the effect of removing an important signal from the market.[138] Although such signals are difficult to interpret, in an environment where the *fact* of disclosure can reveal information (about, for example, the firm's own assessment of the likelihood that its practices would be absorbed without incident by its shareholders or the investing public), removal of the choice to disclose or not also removes the signal. As with other potential costs outlined in this Article, it is surely the case that the value of information forcibly disclosed may outweigh the lost value of the informational signal.[139] But mandatory disclosure carries with it less ambiguous information costs, as well.

1. Corporate Governance and the Cost of Information

An important point, often overlooked in the disclosure debates, regards the role of disclosure in internal corporate management and accountability, and the problem for governance of "information overload."[140] The problem

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

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

136. But this does not mean the data are useless, of course. Experts do attempt the mental calculations necessary for interpretation, and firms do use accounting data for internal purposes. *See, e.g.*, Benston, *supra* note 135, at 211-15.

137. Benston, *supra* note 134, at 39; *see also* ALCHIAN & ALLEN, *supra* note 15, at 256 ("Regardless of what the accountant does, *we* must not take his final figure for 'profits or net earnings' to be a measure of the actual change in value of wealth.").

138. *See* George J. Benston, *Regulation of Stock Trading: Private Exchanges vs. Government Agencies*, 83 VA. L. REV. 1501, 1502 (1997) ("[T]he incentive for companies [is] to publish financial data to reduce their current and potential investors' costs or the 'signaling' incentive, whereby a company that does not disclose might be seen as hiding negative information compared to companies that do."). *But see* Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994).

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

140. *See* Paredes, *supra* note 8, at 419.

is the traditional lemons problem.[141] Managers determine the extent, form and contours of accountability information, taking into account the cost of production, the value of the data, and, importantly, the quality of the information. Requiring the disclosure of substantial quantities of additional information corrodes the decision-making value of information, as managers find it more difficult to distinguish between useful and useless information.

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

Troy Paredes skillfully explores the problem of cognitive limitations from the point of view of *investor* decisions.[142] But the problem is both more acute and more subtle from the point of view of internal accountability. It is more acute because the consequences of overload are not mitigated by a market (where more choice is better than less, not because each individual needs more information than less but because each individual needs different information). It is more subtle, because the overload problem stems not only from increased volume but also from the complication that information produced for one purpose (SEC-required mandatory disclosure for investors) is difficult for others (managers) to separate and to ignore.

At the same time that disclosure of "too much" information can impose decision-making costs on appropriate decision-makers, it can also impose costs on *in*appropriate decision-makers. This criticism fundamentally challenges one of the stated goals of the SEC's disclosure regime: specifically, the provision of information for well-informed investing by individual shareholders. It is precisely individual shareholders who are *not* in a position to evaluate complex information regarding, for example, executive pay packages. But it is also precisely these individuals at whom mandatory dis-

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

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

George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489 (1970).

142. *See* Paredes, *supra* note 8, at 419 ("The net result of having access to more information, combined with using a less accurate decision strategy as the information load increases, is often an inferior decision. In other words, people might make better decisions by bringing a more complex decision strategy to bear on less information than by bringing a simpler decision strategy to bear on more information. Borrowing Brandeis' terminology, in addition to being a disinfectant, sunlight can also be blinding.").

closures are directed.[143] As a result of such disclosures, shareholders will surely waste resources digesting unhelpful information.

But even more problematically, they may use resources in an effort to influence corporate decision-making if they perceive that the disclosed information merits a response.[144] The limits on shareholder action and influence in large, publicly held corporations remain, of course.[145] But the rise of institutional investors (and, more recently, hedge funds), along with increasing efforts to provide shareholder access to corporate proxies,[146] combine with cheap information to increase the influence of shareholders on corporate decisions. The danger is that the lower cost of access will induce increased expenditure even though the *benefits* of influence do not increase correspondingly.[147]

Firms competing for investment dollars make intentional and competitive governance choices. And just as firms choose the extent to which corporate directors and managers will monitor agents or subordinates, firms also choose a suitable level of available monitoring by shareholders.[148] The dynamic is slightly different: firms cannot generally control what shareholders will do if granted access to firm information, so rather than controlling the *level* of shareholder monitoring, firms must control the *level of access* in order to ensure that the appropriate level of monitoring is not exceeded.[149] Firms in different situations will find different degrees of share-

143. *See supra* note 21 and accompanying text.

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

145. "In general, shareholders of public corporation[s] have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents." BAINBRIDGE, *supra* note 16, at 37.

146. *See* Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors, Exchange Act Release No. 34-48301 (Sept. 10, 2003), *available at* http://www.sec.gov/rules/proposed/34-48301.htm ("Under the proposals, we would expand the disclosure that is currently required in company proxy or information statements regarding the functions of a company's nominating committee."); *see also* Press Release, SEC, SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors (Dec. 20, 2004), http://www.sec.gov/news/press/2004-176.htm (noting the SEC's enforcement of disclosure requirements). *But see* Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205 (2005) (discussing the importance of shareholder bylaws).

147. *See, e.g.*, Easterbrook & Fischel, *supra* note 45, at 419-21 (criticizing the inference that "if some voting is good, more disclosure and more voting must be better still").

148. *See id.* at 402 ("Because voting is expensive, the participants in the venture will arrange to conserve on its use.").

149. In other words, firms (and their shareholders) engage in "hands-tying," an effort to remove from shareholders ex ante the temptation and the ability to intervene when they might exercise it ex post. The concept of hands-tying as a commitment strategy originates with Thomas Schelling. *See generally* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960); THOMAS C. SCHELLING, *Strategies of Commitment*, *in* STRATEGIES OF COMMITMENT AND OTHER ESSAYS 1 (2006) ("I use 'commitment' to mean becoming committed, bound, or obligated to some course of action or inaction or to some constraint on future action. It is relinquishing some options, eliminating some choices, surrendering some control over one's future behavior. And it is doing so deliberately, with a purpose. The purpose is to influence someone else's choices. Commitment does so by affecting that other's expectations of the committed one's behavior."); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 686-87 (2003).

holder involvement to be competitively advantageous, and they may rationally choose levels of disclosure partly calculated to deter shareholder participation. Removing that deterrence makes monitoring more likely—to the detriment of some firms.

Disclosure regulation is premised on the notion that more monitoring—or at least the availability of more monitoring—by shareholders and gatekeepers is preferable for all firms. This is demonstrably false, and disclosure-induced expenditure of resources on shareholder monitoring may be bad for some firms.[150] It is in fact the case that the overall rise in shareholder influence (which correlates with access to information) since the 1980s is responsible for some of the worst perceived excesses, including that of executive pay.[151] At the same time, without limitations imposed by corporations or by law, the classic collective action dynamic nevertheless suggests that too much monitoring might occur anyway.[152] And although corporations have substantial leeway in foreclosing direct avenues of governance to their shareholders,[153] restricting or controlling information may be the most effective way to direct shareholder participation.

2. Market Costs: Efficient Markets and Information

A related criticism of expansive disclosure regulations is that users of information (including regulators as well as investors) are constrained—boundedly rational—in their ability to know what information is useful to them and how to use the information they receive to make optimal decisions.[154] These criticisms undoubtedly have some truth to them, and it is

150. *See* Easterbrook & Fischel, *supra* note 45, at 419 (arguing that the "behavioral assumptions underlying [disclosure] rules are . . . not supported by any evidence"). While *some* level of disclosure and monitoring may be necessary for all firms, they surely exhibit diminishing marginal returns, just like everything else. *See generally* ALCHIAN & ALLEN, *supra* note 15, at 391-93. Finally, corporations exhibit and profit from specialized, centralized decision-making. BAINBRIDGE, *supra* note 16, at 199 ("[G]reater accountability necessarily makes the decisionmaking process less efficient, while highly efficient decisionmaking structures necessarily entail nonreviewable discretion.").

151. *See, e.g.*, Holmstrom, *supra* note 86, at 707-10.

152. This may seem paradoxical, for usually collective actions problems are held to suggest that shareholders rationally *under*-invest in information gathering and monitoring. But here the problem is the familiar coordination problem. As long as shareholders have an incentive to invest *something* in these activities—particularly in the world of securities class actions—where their actions cannot be coordinated, there is the risk of over-investment. Moreover, the problem (if coupled with a lawsuit) can arise from even a single enthusiastic investor. So although shareholders may each under-invest on average, even a few forays by a few investors may be quite costly. The point is not that shareholders engage in lots of monitoring; it is, rather, that they engage in more than the optimal level (likely around zero), given specialization, bounded rationality, and other market constraints. The problem is analogous to the now-familiar "tragedy of the anti-commons." *See, e.g.*, Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998).

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

154. *See* Bainbridge, *supra* note 65, at 1056 ("[R]egulators must be treated as actors with their own systematic decisionmaking biases."); Choi & Pritchard, *supra* note 65, at 24 ("The SEC's inability to assess all market risks and prioritize among them (due to the bounded capabilities of the agency staff and commissioners) may help explain the SEC's difficulties in grappling with problems in the financial

particularly important to bear in mind the regulators' limitations when assessing the desirability of regulations. But at the same time, behavioral economics does not yet yield sufficiently robust predictions to rely on it in policymaking.[155]

But it is not clear that, even if accurate, such theories would have much bearing on the question of optimal disclosure regulation. The standard line has it that securities markets are efficient, if at all, because a multitude of investors, each making her investment decisions on the basis of her informed assessment of the relevant information and her knowledge of background economic conditions, bring diverse bits of information to bear on securities prices until the price reflects all or most available information.[156] On this theory, "[c]areful accumulation and skilled interpretation of . . . information is said to be the *sine qua non* of accurate evaluation of securities."[157] But in fact, it may be that traders need very little in the way of "accurate" information or unbiased decision-making in order to produce an informationally efficient market. It seems to be the case, in fact, that remarkably accurate prices may be obtained in markets with nothing more than sufficient volume, self-interested traders, and well-distributed, even if inaccurate, information.[158] If this is so, putative cognitive problems might have little effect on the ultimate accuracy of share prices.[159]

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markets.").

155. *See, e.g.*, Forum, *supra* note 69; Bainbridge, *supra* note 65, at 1059 (counseling caution and noting that "[a]s applied to U.S. capital markets, behavioral economics appears to offer little or no support for the mandatory regime").

156. *See generally* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 167-72 (1973); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

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

158. *See* Robin Hanson, *Combinatorial Information Market Design*, 5 INFO. SYSTEMS FRONTIERS 107 (2003) (explaining how financial markets are aggregates of information that create accurate price estimates, even though the participants operate under uncertainty and speculation). For example, if a price is an average of all active traders' estimations of a security's value, even if not a *single* trader has accurate information, a security's price might be quite accurate. *See* JAMES SUROWIECKI, THE WISDOM OF CROWDS 224-28 (2004). As Henry Manne has it:

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

Posting of Henry Manne to Ideoblog, http://busmovie.typepad.com/ideoblog/2005/12/toward_a_theory.html (Dec. 20, 2005, 10:54 EDT). One recent article presents a model of price formation in binary-contract information futures markets and finds that "while prediction market prices and mean beliefs may diverge, they are typically very close." Justin Wolfers & Eric Zitzewitz, Interpreting Prediction Market Prices as Probabilities, (Jan. 8, 2007) (*available at* http://bpp.wharton.upenn.edu/jwolfers/Papers/InterpretingPredictionMarketPrices.pdf).

159. *See* Robin Hanson, *Decision Markets*, IEEE INTELLIGENT SYS., May/June 1999, at 16, 18, *reprinted in* ENTREPRENEURIAL ECONOMICS 79, 82-83 (Alexander Tabarrok ed., 2002). Other implications would follow, as well. The fundamental justification for the entire range of disclosure-related regulations would come into question, for example.

At the same time, for most investors, the relevant trading information is contained in the stock price, along with some background macroeconomic assumptions.[160] So while it is true that share price information is "based, in part, on the information provided in financial reports,"[161] inaccuracy in this information may be less harmful than some contend; it is enough that some traders (insiders, for example) have accurate information or an estimate of *how much* misreporting is in financial reports so that these error estimates are incorporated into the stock price.[162]

Regardless of the mechanism by which information is incorporated into price, there is an argument that some disclosure regulations, in a misguided effort to broaden the scope of disclosure, actually impair the overall quality of public information. In particular, the SEC's Regulation FD requires that "[w]henever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to any [relevant] person . . . the issuer shall make [simultaneous or prompt] public disclosure of that information."[163] Of course, "companies are more likely to give candid reports if they can talk privately to selected analysts, and analysts will invest more in these conferences if they get some exclusivity."[164] The quality of information—and perhaps as importantly, the investment in the interpretation of that information—suffers, even while the nominal scope of dissemination may increase.[165] A related and final problem with mandatory public disclosure of firm information is that there is no easy way to limit the recipients of publicly disclosed information. Thus a blunt ex ante standard of disclosure is substituted for a firm's (perhaps self-interested and wrong) ad hoc determinations of the relative costs and benefits of disclosure. While the latter may, as suggested, be flawed (judged from the standpoint of social welfare), so may the former. There is no reason to be-

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160. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991).

161. BENSTON ET AL., *supra* note 83, at 20.

162. Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 649 (2003) ("In *The Mechanisms of Market Efficiency*, Gilson and Kraakman suggest an answer in their discussion of what they call 'uninformed' trading. They begin by recognizing that even if all investors had equal access and ability to use to all available information about securities' expected risks and returns, one important category of information remains fundamentally 'unavailable'—knowledge of what is going to happen in the future. As a result, investors can and do disagree in their forecasts. It is worth emphasizing that disagreement over the future is not a minor matter in a securities market. Securities are nothing more than claims to a stream of future income, so minor disagreements in predictions can lead to major disagreements about valuations. Nevertheless, Gilson and Kraakman suggest investors' divergent forecasts may not lead to inaccurate securities prices, so long as mistakes in forecasting are random. As they put it, 'the random biases of individual forecasts will cancel one another out, leaving price to reflect a single, best-informed aggregate forecast.'" (quoting Gilson & Kraakman, *supra* note 156, at 581) (footnotes omitted)).

163. Regulation FD, 17 C.F.R. § 243.100(a) (2006).

164. Posting of Larry Ribstein to Ideoblog, http://busmovie.typepad.com/ideoblog/2005/04/ibm_reg_fd_and_.html (Apr. 18, 2005, 06:54 EDT).

165. "Imposing a duty to disclose . . . because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts . . . ." Dirks v. SEC, 463 U.S. 646, 658 (1983); *see also* Patrick T. Morgan, *Regulation FD: Leveling the Playing Field for Some but Not for Others*, 66 MO. L. REV. 959, 979-81 (2001).

lieve that the costs imposed by the blanket standard, although different in nature, are any smaller in magnitude than the ones imposed by the firm's ad hoc decisions. This is particularly true when one considers not only the cost of inadvertent (or even required though unfortunate) release of proprietary, competitive information[166] but also when one considers the "benchmarking" phenomenon in executive pay.[167]

CONCLUSION

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

In the end, none of this means a mandatory disclosure regime is not the best form of securities regulation from among the set of imperfect alternatives.[168] But weighing the relative benefits of the alternatives requires a more systematic and thoughtful consideration of the costs.[169] Behavioral responses to regulation, even via mere disclosure, can be costly. Firms and managers will endeavor to circumvent costly regulations, regulations will have unintended consequences, and dynamic market shifts may undermine much of the regulations' force. That these effects eradicate the benefits of mandatory disclosure is not itself inevitable; that they exist, however, is.

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166. A problem ameliorated (although at a cost) by Rule 406 of the Securities Act and Rule 24b-d2 of the Securities Exchange Act (permitting a company to file a Confidential Treatment Request with the SEC that an otherwise-required disclosure be kept confidential). 17 C.F.R. § 230.406 (2006).

167. *See supra* note 116 and accompanying text.

168. In particular, it is worth noting that although substantive corporate governance regulation is traditionally outside the scope of federal regulation, the Sarbanes-Oxley Act of 2002 did include a number of substantive provisions. *See, e.g.*, Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (Supp. 2003). Several commentators roundly condemn these substantive incursions into the traditional state realm of corporate governance regulation and advocate for, at most, disclosure regulation instead. *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005); Larry Ribstein, *Sarbanes-Oxley After Three Years* (Univ. of Ill. Law & Econ. Research Paper No. LE05-016, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=746884.

169. For a similar conclusion, see BENSTON ET AL., *supra* note 83, at 92, asserting that: "[R]easonable people can differ on whether . . . the net social benefits from mandating disclosure exceed the cost thereof. More research into the cost issue will be required before policymakers can be confident about getting too heavily involved in mandating [changes to the disclosure regime]."