William & Mary Law Review

Volume 56 (2014-2015)
Issue 2

Article 3

11-1-2014

Reconsidering the Institutional Design of Federal Securities Regulation

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RECONSIDERING THE INSTITUTIONAL DESIGN OF FEDERAL SECURITIES REGULATION

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ABSTRACT

The institutional design literature is interested in the optimality of particular legal institutions, for example, judicial review of agency actions, corporate federalism, and environmental policy. This Article brings such an analysis to bear on federal securities regulation and argues that we could improve upon the current institutional structure. In particular, the Article proposes that the Securities and Exchange Commission (SEC) be given even more decision-making authority than it currently has under the statutory scheme, effectively authorizing the agency to create disclosure rules for any firm that operates in interstate commerce. At the same time, the Article proposes that we place greater controls on the risk of regulatory error at the SEC by creating a statutory scheme that would place limits on the level of regulatory costs that the agency is permitted to impose on the firms that it regulates. By granting the expert agency more decision-making authority, while at the same time controlling the risk of error inherent in the SEC's complicated regulatory task, the Article argues that we could create an institutional structure that generates disclosure rules that are both smarter and less error-prone. The Article also sketches a possible policy approach along these lines.

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INTRODUCTION

The Securities Exchange Act of 1934 (Exchange Act) created the Securities and Exchange Commission (SEC) and the modern framework for regulating the securities markets.[1] As is the case with questions of institutional design more generally,[2] two central goals of the regime are allocating decision-making authority to the most expert institution and minimizing the costs of policy error. This Article argues that these two facets of the institutional design of federal securities regulation need to be reconsidered.

With respect to the allocation of decision-making authority, this Article argues that there are likely benefits to be reaped from giving the SEC even more decision-making authority than the statute already does.[3] This claim is likely to be surprising to many, if not most, securities law practitioners and scholars. After all, the delegation that Congress made to the SEC in the Exchange Act is expansive to say the least. Regarding what are typically referred to as "reporting" or "public" firms, the SEC is empowered to require all, some, or none of those firms to disclose whatever information the SEC decides is "necessary or appropriate in the public interest or for the protection of investors."[4] However, the grant of decision-making authority is not absolute. This is because Congress retains the all-important task of determining what types of firms are subject to the SEC's regulatory decisions. In other words, it is Congress that determines the contours of the divide separating the public (regulated) market from the private (unregulated) one.[5]

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1. 15 U.S.C. §§ 78a, 78d (2012).
2. *See infra* notes 18-28 and accompanying text.
3. *See infra* Part II.C.
4. 15 U.S.C. § 78*l*(b)(1).
5. *See, e.g.*, Milton Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966); Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151 (2013); Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013); Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179 (2012); A.C. Pritchard, *Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999 (2013).

Yet, Congress's line drawing in this context increasingly seems arbitrary in light of subsequent developments in the economic analysis of law. When Congress created this public-private divide in 1934, it was largely concerned with placing non-disclosing or under-disclosing firms on an equal footing with those firms that were already disclosing information or that were disclosing a higher quality of information prior to the creation of the mandatory regime.[6] Public choice theory offers reasons to question whether this fairness concern was just political window dressing to mask an attempt by larger firms to place their smaller rivals at a competitive disadvantage through costly regulation.[7]

Furthermore, the economic case for mandatory disclosure implies that the optimal public-private divide is probably much more complex than the current one. The current divide is predicated on three factors: whether a firm's securities are listed on a national securities exchange, whether a firm has made a public offering of securities under the Exchange Act, or whether a firm has more than 2,000 shareholders of record.[8] If a firm can answer all of these questions in the negative, then it escapes the mandatory regime and is part of the private, unregulated market; otherwise, the firm is subject to the mandatory disclosure regime.[9]

However, the modern economic case for mandatory disclosure implies that these disclosure triggers are probably too crude, if not irrelevant altogether. The modern economic case posits that mandatory rules are necessary to correct market distortions caused by the benefits that disclosure creates for third parties.[10] The optimal public-private divide, therefore, would target mandatory disclosure rules at those firms or industries where the third-party effects of information are most significant; and it would do so in reliance on various metrics—for example, accounting profits, concentration ratios, and measures of vertical integration—that come from the accounting and industrial organization literature.[11] The SEC's relative expertise makes it the best institution for making these

6. *See infra* notes 71-83 and accompanying text.
7. *See infra* notes 90-92 and accompanying text.
8. *See* 15 U.S.C. §§ 78*l*(a)-(b), 78*l*(g), 78o(d) (2012).
9. *See id.*
10. *See infra* Part II.A.2.
11. *See infra* notes 137-44 and accompanying text.

types of determinations. And consequently, the SEC, and not Congress, should be the one that determines the contours of the public-private divide.[12]

Not only might we benefit from allocating this additional decision-making authority to the SEC, but there are also benefits likely to be gained from adopting additional measures for minimizing the risk of policy error inherent in the SEC's regulatory task. The Exchange Act does not currently do much to deal with this problem, other than subjecting SEC rules to judicial review under the Administrative Procedure Act.[13] But while judicial review is commonly thought to help protect against agency error and bias,[14] it is at best an imperfect tool for minimizing the risk associated with the different sources of error that beset the SEC, which include errors resulting from psychological biases, public choice dynamics, sophistication deficits, and epistemic limitations.[15] For these reasons, additional error-reducing mechanisms may be necessary.

The centerpiece of the Article is a policy proposal that attempts to operationalize these two principles of increased decision-making authority and more robust error management. In particular, the proposal seeks to amend the Exchange Act to eliminate the public-private divide that Congress has created, instead leaving it to the SEC to determine the fundamental question of whom to regulate.[16] But the proposal also seeks to rein in the risk of error at the SEC by limiting the costs that the agency can impose on firms through

12. *See infra* notes 144-49 and accompanying text.

13. 5 U.S.C. §§ 702-706 (2012) (setting forth the operative provisions governing judicial review of federal rule making).

14. *See* Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385, 1387-96, 1452 (1992) (noting that judicial review can "perform a necessary 'quality control' function"); Nina A. Mendelson, *Agency Burrowing: Entrenching Policies and Personnel Before a New President Arrives*, 78 N.Y.U. L. REV. 557, 573-74, 584, 593 (2003); Thomas Merrill, *Capture Theory and the Courts: 1967-1983*, 72 CHI. KENT L. REV. 1039, 1039 (1997); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1205-06 (2003); Sidney A. Shapiro & Richard E. Levy, *Heightened Scrutiny of the Fourth Branch: Separation of Powers and the Requirement of Adequate Reasons for Agency Decisions*, 1987 DUKE L.J. 387; Cass R. Sunstein, *Factions, Self-Interest, and the APA: Four Lessons Since 1946*, 72 VA. L. REV. 271, 276-78 (1986). *But see* William N. Eskridge, Jr. & John Ferejohn, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical View*, 87 CORNELL L. REV. 616 (2002).

15. *See infra* Part III.A.

16. *See infra* Part IV.A.

disclosure rules.[17] Under this aspect of the proposal, Congress would charge an advisory committee with the task of reviewing (on a periodic basis) the disclosure costs that the current regime imposes on firms. This committee would then advise Congress on whether the SEC should take some action—or refrain from taking an action in an effort to bring disclosure costs in line with the costs of a theoretically optimal disclosure regime. Depending on the advisory committee's findings, the expectation would be for Congress to intervene at the SEC. If disclosure costs seem to be higher (or lower) than what one might think is the theoretically optimal range, the SEC might be required to address this issue before taking any further regulatory (or de-regulatory) action that would add to (or subtract from) disclosure costs. The SEC would therefore face a strong incentive to bring its rules in line with the theoretically optimal level of disclosure costs, as determined by the advisory committee, because refusal would thwart the SEC's agenda, regardless of whether that agenda is of the regulatory or de-regulatory variety. By expanding the SEC's decision-making authority while at the same time constraining error, the policy proposal is intended to result in disclosure rules that are both smarter and less error-prone.

The Article proceeds as follows: Part I provides a brief overview of how the Exchange Act allocates decision-making authority and seeks to control the risk of regulatory error. Part II provides a critique of how the statute allocates decision-making authority, arguing that the policy choices that Congress has made in crafting the public-private divide are problematic in light of the modern economic case for mandatory disclosure, and that the SEC is probably better situated in any case to make the determinations that likely are required of that economic justification of the regime. Part III provides a critique of how the statute seeks to manage the risk of regulatory error that inevitably accompanies the expansive grant of decision-making authority. It argues that judicial review alone cannot possibly address the varied types of errors that beset an agency like the SEC. Part IV develops the policy proposal that seeks to operationalize the principles of increased decision-making

17. *See infra* Part IV.B.

authority and more robust error management developed in the previous parts. That proposal would task the SEC, and not Congress, with the determination of what firms are exempt from the mandatory disclosure regime. At the same time, the proposal would require Congress, through the use of an advisory committee, to limit the SEC's discretion to a permissible range determined by reference to the costs that disclosure imposes on regulated firms.

I. ALLOCATING DECISION-MAKING AUTHORITY AND MANAGING ERROR IN THE EXCHANGE ACT

This Article concerns the institutional design of federal securities regulation. The institutional design literature primarily addresses how to allocate decision-making authority across different institutions while taking into account questions of comparative institutional competence and the risk of decision error.[18] This Part describes how the Exchange Act addresses two fundamental principles of institutional design: decision allocation and error management. At a basic level, the idea is that decision-making authority should be allocated to minimize the sum of decision costs

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18. This literature is voluminous. *See, e.g.*, NEIL K. KOMESAR, IMPERFECT ALTERNATIVES 3-13 (1994); Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 74-75 (2008); Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15 (2010); Mariano-Florentino Cuéllar, *Rethinking Regulatory Democracy*, 57 ADMIN. L. REV. 411, 490-97 (2005); Philip P. Frickey & Steven S. Smith, *Judicial Review, the Congressional Process, and the Federalism Cases: An Interdisciplinary Critique*, 111 YALE L.J. 1707, 1713-16 (2002); Elizabeth Garrett & Adrian Vermeule, *Institutional Design of a Thayerian Congress*, 50 DUKE L.J. 1277, 1279-86 (2001); Jacob E. Gersen, *Designing Agencies*, *in* RESEARCH HANDBOOK ON PUBLIC CHOICE AND PUBLIC LAW 333, 347 (Daniel A. Farber & Joseph O'Connell eds., 2010); Clayton P. Gillette, *Expropriation and Institutional Design in State and Local Government Law*, 80 VA. L. REV. 625, 631-35 (1994); Nina A. Mendelson, *A Presumption Against Agency Preemption*, 102 NW. U. L. REV. 695, 717-22 (2008); Jide Nzelibe & John Yoo, *Rational War and Constitutional Design*, 115 YALE L.J. 2512, 2514-16 (2006); Jeffrey J. Rachlinski, *Bottom-Up Versus Top-Down Lawmaking*, 73 U. CHI. L. REV. 933, 934-37 (2006); Mark Seidenfeld, *Who Decides Who Decides: Federal Regulatory Preemption of State Tort Law*, 65 N.Y.U. ANN. SURV. AM. L. 611, 640-49 (2010); Catherine M. Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 GEO. WASH. L. REV. 449, 484-90 (2008); Matthew C. Stephenson, *Information Acquisition and Institutional Design*, 124 HARV. L. REV. 1422, 1424 (2011) [hereinafter Stephenson, *Information Acquisition*]; Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 126-43 (2005); Cass R. Sunstein & Adrian Vermeule, *Interpretation and Institutions*, 101 MICH. L. REV. 885, 914-19 (2003).

and error costs.[19] The term "decision costs" refers to the costs associated with reaching a particular decision, while the term "error costs" refers to the costs that result if the decision-maker turns out to be wrong.[20] We typically accomplish this goal, everything else equal,[21] by allocating decision-making authority to the most competent institution[22] with respect to the question at issue.[23] And we sometimes add additional error-reducing mechanisms, like judicial review[24] or specific types of cost-benefit requirements.[25]

19. Todd M. Henderson, *Two Visions of Corporate Law*, 77 GEO. WASH. L. REV. 708, 715 (2009) (characterizing the debate over whether the federal government or the individual states should make corporate law as one involving an assessment as to which design will minimize the sum of decision and error costs); Thomas A. Lambert, *Dr. Miles is Dead. Now What?: Structuring a Rule of Reason for Evaluating Minimum Resale Price Maintenance*, 50 WM. & MARY L. REV. 1937, 1942 (2009) (advocating for a proposed antitrust rule on the basis that it minimizes the sum of decision and error costs); Arden Rowell, *Allocating Pollution*, 79 U. CHI. L. REV. 985, 994-95, 1000 (2012) (discussing decision and error costs in the context of pollution policy); Adam M. Samaha, *Regulation for the Sake of Appearance*, 125 HARV. L. REV. 1563, 1596 (2012) ("Societies face trade-offs when designing each institution and even more trade-offs when allocating decisions among institutions. The standard advice from theorists is to compare decision costs along with error costs across different institutional designs and institutional options.").

20. *See* Daniel B. Kelly, *Toward Economic Analysis of the Uniform Probate Code*, 45 U. MICH. J.L. REFORM 855, 865 (2012).

21. Of course, everything may not be equal. In particular, reducing error costs might lead to an increase in decision costs. *See, e.g.*, *id.* For a discussion of how the Article's proposal for reducing the error costs of disclosure regulation might affect decision costs, see *infra* Part IV.B.

22. The notion of "institutional competence" typically connotes "expertise and access to information." Stephenson, *Information Acquisition*, *supra* note 18, at 1424.

23. This view is associated with the legal process school of jurisprudence. *See* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS 168-74, 696, 1009-10, 1111 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994); William N. Eskridge, Jr. & Philip P. Frickey, *An Historical and Critical Introduction to* THE LEGAL PROCESS, in HART & SACKS, *supra,* at li, lx-lxi, xci-xcvi. The legal process school of jurisprudence was effectively a response to legal realism, which itself was a criticism of legal formalism's view that legal reasoning was untainted by political considerations. The legal process school attempted to salvage the legitimacy of legal institutions from the realist critique with the argument that even if society might not be able to agree on the substantive outcomes produced by legal reasoning (because such outcomes are influenced not solely by legal doctrine but by political predilections as well), we might be able to agree on underlying processes for determining such outcomes. For a list of modern works in the legal process vein, see Stephenson, *Information Acquisition*, *supra* note 18, at 1424 n.2.

24. For a discussion and critique of judicial review's error correction function, see Chad M. Oldfather, *Error Correction*, 85 IND. L.J. 49 (2010).

25. *See, e.g.*, Cass R. Sunstein, *Cost-Benefit Default Principles*, 99 MICH. L. REV. 1651 (2001).

These principles are used to explain many common institutional structures, including agency rule making,[26] state-made corporate law,[27] and even the distribution of rules and standards in judicial decision making.[28] The thesis of this paper is that it is possible to make smarter, less error-prone securities disclosure regulation by reconsidering the institutional design of the federal securities laws. This Part discusses how the Exchange Act allocates decision-making authority and attempts to minimize decision error.

A. Allocating Decision-Making Authority in the Exchange Act: The Public-Private Divide

In the United States, the federal securities laws regulate the capital markets primarily through a mandatory disclosure regime.[29] Congress authorizes the SEC to create rules requiring companies to disclose information about themselves for the benefit of investors and the market more generally.[30] These rules are numerous and varied, but they require issuers to disclose, among other things, audited financial statements, a detailed description of the issuer's business, the compensation of top executives and the reasoning underlying this compensation, and a discussion of trends and developments expected to affect the issuer in the future.[31] The accuracy of these disclosures is then enforced through anti-fraud provisions, which make issuers liable for materially misleading misstatements or omissions.[32]

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26. JERRY L. MASHAW, GREED, CHAOS, & GOVERNANCE: USING PUBLIC CHOICE TO IMPROVE PUBLIC LAW 148-52 (1991).

27. *See, e.g.*, Henderson, *supra* note 19, at 715-16.

28. Jonathan S. Masur & Eric A. Posner, *Against Feasibility Analysis*, 77 U. CHI. L. REV. 657, 668-70 (2010).

29. Other jurisdictions, including, for example, state securities regulators in the United States, go further than this, and consider a company's fundamentals before certifying it to sell securities. The original draft of the federal securities laws incorporated a form of such "merit review," but this proposal was ultimately replaced with a purely disclosure-based regime. *See* S. 875, 73d Cong. § 6(c), (e), (f) (1933), *reprinted* in 3 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 13-15 (1973).

30. *See* 15 U.S.C. § 78*l*(b)(1) (2012).

31. *See* U.S. SEC. & EXCH. COMM'N, FORM 10-K, pt. II, at 7-9, *available at* http://perma.cc/7FP6-3222; *see also* Form 10-K for Annual and Transition Reports Pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934, 17 C.F.R. § 249.310 (2013).

32. The primary anti-fraud provision under the Exchange Act is Rule 10b-5, which

Under the Exchange Act, Congress delegated a significant amount of decision-making authority to the SEC to administer this complex disclosure regime.[33] In fact, the day President Roosevelt signed the act into law, Ferdinand Pecora, who was Chief Counsel to the Senate Banking Committee and would become one of the first commissioners of the SEC, remarked that "[i]t will be a good or bad law depending upon the men who administer it."[34] The reason for the significant delegation of authority was largely political. Lobbying by the New York Stock Exchange (NYSE), combined with general opposition to the New Deal,[35] resulted in a political climate that favored agency delegation.[36]

But even though the SEC's decision-making authority under the statute is undoubtedly expansive, it is not absolute. Congress retained for itself the determination of a central feature of the regime—the divide that separates those companies that are eligible for mandatory disclosure from those that are automatically exempt from the SEC's regulatory reach.[37] After several decades, Congress finally settled on the three disclosure triggers that are the pillars of our current disclosure regime. In essence, the statute provides that a company must make the required periodic disclosures called for by the Exchange Act and adopted by the SEC if any one of the following conditions is satisfied: first, if the company has a class of

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imposes liability for misstatements of material fact, or misleading omissions of material fact, in connection with the purchase or sale of a security. *See* Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5(b). Under this provision, a company is liable for any material misstatement or omission included in a report filed under the Exchange Act. *See, e.g.*, William K. Sjostrom, *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 646-47 (2009).

33. *See* 15 U.S.C. § 78*l*.

34. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 100 (3d ed. 2003).

35. *See id.* at 97 (describing the role played by the NYSE and Senator Carter Glass, the Democratic Senator from Virginia and co-sponsor of the Glass-Steagall Act, in weakening the Exchange Act).

36. *See, e.g.*, *id.* at 99 ("On most controversial substantive issues, Congress had been stalemated. Rather than providing the new Commission with a clear mandate, the legislators had granted the agency authority to study the controversy or issue its own rules. In effect, Congress had broadly defined the Commission's areas of expertise and invited it to forge its own mandate.").

37. *See* Cohen, *supra* note 5, at 1354; Guttentag, *supra* note 5, at 152-53; Langevoort & Thompson, *supra* note 5, at 343; Pollman, *supra* note 5, at 187-89; Pritchard, *supra* note 5, at 1000-01.

securities listed on a national securities exchange;[38] second, if the company has assets in excess of $10 million and a class of equity securities held by at least 2,000 record holders;[39] and third, if the company has filed a registration statement under the Securities Act of 1933 that has become effective.[40]

Thus, Congress made a decision to focus the disclosure regime on firms that make public offerings, that are listed on exchanges, or that have a significant shareholder base.[41] Together, these disclosure triggers prevent the SEC from creating disclosure rules for non-exchange-listed firms that have made no registered offering of securities and that have fewer than 2,000 shareholders of record.[42] With respect to all other firms, the SEC has substantial decision-making authority. Congress effectively determines the domain of disclosure—what types of information must be included in an Exchange Act report[43]—and then leaves it up to the SEC to create the corresponding rules.[44]

Although it does not appear that this public-private divide was the result of a particularly sophisticated theory of line-drawing, and what reasons that were offered for these three disclosure triggers

38. *See* 15 U.S.C. § 78*l*(a) (requiring registration of securities listed on a stock exchange by prohibiting brokers and dealers from transacting in any exchange-listed security that is unregistered).

39. *See id.* § 78*l*(g). The JOBS Act increased the statutory threshold from 500 to 2,000 shareholders. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, sec. 501, § 12(g)(1)(A), 126 Stat. 306, 325 (2012) (codified as amended at 15 U.S.C. § 78*l*(g)(2)(A)).

40. *See* 15 U.S.C. § 78o(d).

41. With respect to this last trigger, the principal constraint is the shareholder threshold, since even many small businesses satisfy the $10 million asset requirement. Also, it is important to emphasize that the shareholder threshold is a standard based on record ownership, not beneficial ownership. Because even large firms may have relatively few record shareholders, this standard is much more difficult to satisfy than it might first appear.

42. *See id.* § 78*l*(g)(1)(A). However, under the rule, there can be no more than 499 shareholders that do not qualify as "accredited investors" without triggering the disclosure requirements. *Id.* The rule excludes from these calculations people who obtained equity under the company's equity compensation plans and investors who purchased securities pursuant to the crowdfunding exemption. *See id.* § 78*l*(g)(2).

43. *See id.* § 78*l*(b) (setting forth a description of the information to be contained in a report filed with the exchange).

44. Although the SEC does not have the authority to exempt firms that are swept into the regime by virtue of sections 12(b) or 15(g) of the Exchange Act—the disclosure triggers pertaining to securities listed on a national securities exchange or for public offerings—the SEC does have such exemptive authority with respect to section 12(g), the disclosure trigger pertaining to the number of record shareholders in the firm. *See id.* § 78*l*(h).

are considered in more detail below,[45] the three-stage evolution of the divide is well documented.

The public-private divide was created, in its initial form, in 1934 with the adoption of the Securities Exchange Act, which for the first time imposed disclosure obligations on companies on a continuing basis.[46] Because the Exchange Act's focus was on improving the transparency of national securities exchanges,[47] it is perhaps not surprising that the companies Congress originally targeted for disclosure in the Exchange Act were those listed on a national securities exchange.[48] Two years later, in the Exchange Act Amendments of 1936 (1936 Amendments),[49] Congress extended the mandatory disclosure regime created in the Exchange Act to companies that make a registered offering under the Securities Act, thereby making Securities Act registration a second determinant of the public-private divide.[50] In many quarters, the 1936 Amendments were viewed as simply the completion of what had been started in 1933, because even then many expected there to be ongoing disclosure obligations of firms that made a public offering under the Securities Act.[51] The 1936 Amendments were justified in part on the basis that "most of the benefits from requiring disclosure by firms at the time of offering their securities publicly would continue once the securities of the firm were publicly traded."[52] Of course, this is not entirely obvious considering that 1933 Act reporting seems to be particularly concerned with the aggressive

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45. *See infra* Part II.A-B.

46. *See* Cohen, *supra* note 5, at 1340-41.

47. The ultimate law that was adopted was a watered down version of a bill that would have radically altered the practices of exchanges. For example, the earlier version would have set fixed margin requirements. It would have also completely revolutionized stock exchange membership by eliminating floor traders, prohibiting specialists from trading for their own accounts, and barring brokerage firms from acting as dealers or underwriters. *See* SELIGMAN, *supra* note 34, at 86. The battle over the Exchange Act was largely fought on these fronts rather than on the issue of disclosure.

48. *See supra* note 38.

49. Act of May 27, 1936, ch. 462, 49 Stat. 1375 (codified as amended in scattered sections of 15 U.S.C.).

50. 15 U.S.C. 78o(d) (2012).

51. *See* SELIGMAN, *supra* note 34, at 142-43 (explaining how the Securities Act left it to the SEC to study the issue of the regulation of the over-the-counter markets and to propose legislation in light of the study).

52. Guttentag, *supra* note 5, at 165.

sales tactics involved in primary offerings,[53] tactics that are absent in the case of secondary trading. So, it is questionable how justifiable this reason was, but regardless, it was one of the reasons given for the change.

It was not until 1964 that the third determinant of the public-private divide, the shareholder threshold of section 12(g), was added to the Exchange Act.[54] This change was in large part spearheaded by President Kennedy's new SEC Chairman, William Cary, who had made it his goal to complete the unfinished business of the New Deal, including filling in perceived gaps in the securities disclosure regime.[55] To this end, Cary commissioned a study (Cary Study) by a group of prominent practitioners and academics on how to improve securities regulation in the United States.[56] That study observed that the current regime overlooked a whole class of firms in the over-the-counter market that, although seemingly indistinguishable from their counterparts on the national securities exchanges, escaped disclosure obligations simply because they were not listed on those exchanges.[57] The study concluded that a shareholder threshold test was the best means of identifying which of these firms should be subject to disclosure obligations.[58]

The structure of the public-private divide has remained the same since the 1964 amendments, although there have been a few changes on the margins. The most important of these took place through the legislative vehicle of the JOBS Act of 2012, in which Congress increased the shareholder threshold of section 12(g) from 500 to 2,000 shareholders of record.[59] Although the legislative history is not particularly illuminating as to the reasoning underlying this

53. *See* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573, 1585-86 (2013).

54. Securities Acts Amendments of 1964, Pub. L. No. 88-467, § 3(c), 78 Stat. 565, 566-67 (codified as amended at 15 U.S.C. § 78*l*(g) (2012)).

55. SELIGMAN, *supra* note 34, at 293.

56. *See* U.S. SEC. & EXCH. COMM'N, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 3, at 1-2 (1963).

57. *See id.* at 1.

58. *See id.* at 56.

59. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

change,[60] the statute as a whole was justified as an attempt to improve economic growth by fostering the growth of small businesses.[61] By increasing the disclosure trigger under section 12(g), the JOBS Act would arguably serve that goal by allowing smaller firms more time to gestate before having to submit to costly disclosure under the Exchange Act.[62]

B. Managing Regulatory Error in the Exchange Act: Reliance on Judicial Review

Given the expansive decision-making authority that the Exchange Act affords the SEC, one might assume that the statute also provides important mechanisms for controlling the risk of regulatory error. However, the Exchange Act does not explicitly address the risk of regulatory error, nor does the statute's legislative history reflect a concern for this issue.[63] Indeed, the Exchange Act was a piece of New Deal legislation, and the need for administrative

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60. *See, e.g.*, H.R. REP. NO. 112-406, pt. 2 (2012).

61. *See* Editorial, *Start 'em Up: The Legitimate Goals—and Overblown Claims—of the JOBS Act*, WASH. POST, Mar. 24, 2012, at A14 (explaining the reasoning behind the JOBS Act as creating an "engine of growth"); Edward Wyatt, *Senate Seeks to Toughen a Bill Aimed at Start-Ups*, N.Y. TIMES, Mar. 20, 2012, at B2 (characterizing the House bill as attracting "widespread support on Capitol Hill and from the White House for its promise of attracting small-business investment and allowing businesses to hire workers"); Barack Obama, President of the United States, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), http://www.whitehouse.gov/photos-and-video/video/2012/04/05/president-obama-signs-jobs-act#transcript [http://perma.cc/QN9H-KFEZ] (President Obama said upon signing the bill that it would make it easier for companies to go public, which is a "major step towards expanding and hiring more workers"); Andrew Ross Sorkin, *JOBS Act Jeopardizes Safety Net for Investors*, N.Y. Times (Apr. 3, 2012, 9:10 PM), http://dealbook.nytimes.com/2012/04/02/jobs-act-jeopardizes-safety-net-for-investors/?_php=true&_type=blogs&_r=0 [http://perma.cc/QY9F-XL74] (characterizing the statute as being "aimed at making it easier for small-businesses to find investors early and to continue to grow in the public markets by lowering some of the bureaucratic barriers").

62. The House Committee on Financial Services recommended amending section 12(g) of the Exchange Act in this way in order to allow companies to accomplish their financing needs without risking becoming subject to the increased regulatory costs of being a public company. *See* H.R. REP. NO. 112-327, at 2 (2011).

63. As discussed in greater depth below, the statute does not contain the type of cost-benefit requirements typically included in legislation that is concerned with reigning in regulatory error. *See infra* Part III. For a taxonomy of these cost-benefit mechanisms, see generally Cass R. Sunstein, *Cost-Benefit Default Principles*, 99 MICH. L. REV. 151 (2001).

discipline was a distinctly post-New Deal concern.[64] Accordingly, it should not be too surprising that the way the Exchange Act ended up dealing with the risk of regulatory error at the SEC was not through any statutory mechanism, but rather through reliance on judicial review of agency rules.

Judicial review has long been viewed as a potential tool for correcting agency errors and bias.[65] The enactment of the Administrative Procedure Act itself was in part motivated by this goal.[66] And the development of the doctrine of hard look review,[67] which increased the level of scrutiny to be applied to agency rules, was based on similar concerns.[68] However, as explained in Part III, courts cannot be expected to control for all of the types of error inherent in the regulatory task faced by the SEC.[69]

Thus, the Exchange Act makes a significant, although not absolute, delegation of authority to the SEC while leaving courts to manage the regulatory error risk associated with this expansive delegation. The following two Parts argue that we could benefit from even more delegation to the SEC combined with more of an effort to manage the risk of error associated with such delegation.

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64. *See, e.g.*, Thomas J. Miles & Cass R. Sunstein, *The Real World of Arbitrariness Review*, 75 U. CHI. L. REV. 761, 809 (2008) (identifying the post-New Deal period as one characterized by attempts to place controls on agencies whose decisions were viewed as "distinctly susceptible to the influences of self-interested private groups, or otherwise a product of bias and confusion").

65. *See* McGarity, *supra* note 14, at 1452 (noting that judicial review can "perform a necessary 'quality control' function"); Mendelson, *supra* note 14, at 656; Merrill, *supra* note 14, at 1039; Rachlinski, *supra* note 14, at 1206; Shapiro & Levy, *supra* note 14, at 430; Sunstein, *supra* note 14, at 289. *But see* Eskridge & Ferejohn, *supra* note 14 at 627 (doubting the efficacy of judicial review).

66. Miles & Sunstein, *supra* note 64, at 810.

67. Hard look review refers to the standard that courts apply in reviewing agency rule making. In other words, to survive hard look review, the agency "must articulate a 'satisfactory' explanation for its actions that does not 'run counter to the evidence before the agency' and that demonstrates a 'rational connection between the facts found and the choice made.'" Merrick B. Garland, *Deregulation and Judicial Review*, 98 HARV. L. REV. 505, 545 (1985) (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983)).

68. *See id.*

69. *See infra* Part III.

II. CRITIQUING THE STATUTE: ALLOCATING DECISION-MAKING AUTHORITY

Congress's delegation to the SEC to craft disclosure rules seems relatively unobjectionable from an institutional design perspective. The SEC is clearly the more expert institution to deal with such regulatory minutiae.[70] However, Congress's determination to retain decision-making authority with respect to the public-private divide is slightly more difficult to evaluate, if only because it requires a proper understanding of the underlying goal of disclosure regulation. This Part makes three observations. First, the few original justifications advanced for the public-private divide that Congress created with this authority are highly questionable in light of subsequent developments in public choice theory and the economic analysis of the law. Second, more recent revisionist attempts to justify Congress's line-drawing in light of the dominant case for disclosure regulation similarly fall short. And third, the dominant case for disclosure regulation, which is based on the third-party effects of information, suggests that the optimal public-private divide is probably much more complex than our current definition and draws on highly specialized inquiries into accounting and industrial organization. The implication is that we could probably benefit from having the SEC, and not Congress, decide this crucial issue.

A. Critiquing the Original Justifications for the Public-Private Divide

Congress did not base the public-private divide in federal securities law on a particularly sophisticated theory of the optimal approach to line-drawing in this context. However, there are at least two principles that seem to have motivated the lines that Congress ultimately decided to draw.

The first principle is a concern with fairness, and in particular the need to draw the public-private divide so as to level the playing field

70. *See infra* notes 144-49 and accompanying text.

between firms that were already disclosing information and those that were not.[71] This was certainly the case with the original adoption of the Exchange Act in 1934. Since at least the late 1800s, some but not all, firms on the NYSE had been disclosing information to their investors and agitating for the exchange to impose mandatory rules requiring all of its members to fall in line.[72] In response, the NYSE adopted a mandatory disclosure regime that seemed to achieve fairly substantial, although apparently not complete, compliance by the time the Exchange Act was enacted in 1934.[73] However, firms could still avoid the NYSE's mandatory disclosure rules by simply choosing to trade on the New York Curb Exchange, the precursor to the American Stock Exchange,[74] which did not impose any disclosure requirements on its participants.[75]

The Exchange Act's mandatory disclosure regime effectively placed all exchange-listed firms on the same footing, meaning that it solved whatever latent compliance problems existed at the NYSE while at the same time addressing the regulatory arbitrage problem created by the existence of exchanges like the New York Curb Exchange.[76] Once that cohort of exchange-listed firms was required to make certain disclosures, any extension of the disclosure regime was then predicated on the basis that firms similar to the already disclosing firms should also be subject to the regime in order to "level the playing field."[77] This argument was used to justify the 1936 Amendments, which extended the disclosure rules to companies that had made public offerings,[78] as well as the amendments in 1963

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71. Michael Guttentag was the first to identify this underlying principle. *See* Guttentag, *supra* note 5, at 168.

72. *See id.* at 160 (citing John C. Hilke, *Early Mandatory Disclosure Regulation*, 6 INT'L REV. L. & ECON. 229, 231 (1986)).

73. Professor Seligman has identified a number of roadblocks that prevented complete compliance with the NYSE's disclosure rules. Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 54-55 (1983). But others have suggested that regardless, by the 1910s, most firms were complying with the NYSE's disclosure requirements. *See* John C. Hilke, *Early Mandatory Disclosure Regulations*, 6 INT'L REV. L. & ECON. 229, 231 (1986).

74. *See* SELIGMAN, *supra* note 34, at 47.

75. *See id.*

76. For a discussion of regulatory arbitrage more generally, see Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010).

77. *See* S. REP. NO. 74-1739, at 3 (1936).

78. Guttentag, *supra* note 5, at 165-66 (indicating that one goal of the amendment was

to include large companies as measured by the size of the shareholder base.[79] The problem with this argument, however, is that it only makes sense to level the playing field if we think that the players are similarly situated and that the original rules were based on sound reasoning. The public choice version of this story calls both of these factors into question, as discussed below.[80]

The second principle that seems to have influenced the development of the public-private divide was the view that the divide was simply another application of the philosophy that disclosure was necessary for investor protection. For example, the Cary Study was motivated primarily by investor protection concerns. In justifying their use of a criterion based on the number of shareholders instead of alternative criteria, the study concluded that alternative criteria were not as tailored to the investors' interests that needed protection.[81] Further, the Congresses that adopted the Cary Study and the 1963 Amendments clearly understood the Exchange Act as being about investor protection generally.[82] And the Exchange Act itself evidences the statute's preoccupation with investor protection.[83]

Both of these principles—the expansion of the disclosure regime in order to level the playing field and mandatory rules as a necessity for the protection of investors—became questionable with subsequent developments in the economic analysis of law.

1. Critiquing the Leveling the Playing Field Justification

As mentioned previously, the original Exchange Act provision imposing a mandatory disclosure regime on all exchange-listed firms was supported by the New York Stock Exchange, which had been trying (with substantial but not total success) for decades to

"an endeavor to create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets" (citing S. REP. NO. 74-1739, at 3 (1936)).

79. *Id.* at 166-67.

80. *See infra* Part II.A.1.

81. Guttentag, *supra* note 5, at 167 n.86.

82. *See id.* at 165-68 ("There is no convincing reason why the comprehensive scheme of disclosure that affords effective protection of investors in the exchange market should not also apply in the over-the-counter market" (citing S. REP. NO. 88-379, at 9 (1964))).

83. Michael Guttentag has pointed out that the terms "'protection of investors' or 'investor protection' appear over 200 times" in the Exchange Act. *See* Michael D. Guttentag, *Protection From What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 212 (2013).

impose mandatory disclosure rules on all of its member firms.[84] One commentator has noted that the NYSE's frustrated effort was "likely the result of pressure from firms already providing high-quality disclosures."[85] In evaluating this attempt to level the playing field, the crucial question to ask is why did some of the NYSE-listed firms decide to disclose while others did not? Or why did some firms choose to list on the NYSE and submit to mandatory disclosure while others preferred to trade on the New York Curb Exchange and thereby avoid such rules? There are two potential answers to that question: a supporting one that favors Congress's attempt to level the playing field, and a critical one—provided by public choice theory—that substantially undermines it.

The supporting narrative is that the firms that were already providing high-quality disclosure on a more or less voluntary basis[86] were doing so because they were high-quality firms with nothing to lose and a lot to gain—at least from investors—by disclosing information. Under this view, it would be reasonable for these high-quality firms to support mandatory disclosure rules in order to avoid a market for "lemons".[87] This occurs when investors are unable to distinguish between high- and low-quality firms and therefore treat all firms as if they are of average quality, which has the effect of penalizing the high-quality firms.[88] At the extreme, if high-quality firms are unable to distinguish themselves in the eyes of the consumer, the unwarranted discount they receive from such undiscriminating buyers may force them to exit the market entirely.[89] Thus, under this supporting narrative, leveling the

84. Seligman, *supra* note 73, at 56-57.

85. Guttentag, *supra* note 5, at 160.

86. I say "more or less" because it is not clear how many of these exchange-listed firms were disclosing on a purely voluntary basis prior to the NYSE's efforts to implement mandatory disclosure rules. However, considering that the NYSE's subsequent efforts seemed to allow many listed firms to refuse compliance with little or no penalty, I think it is reasonable to view the disclosure choice as a largely voluntary one, even if the NYSE technically had disclosure rules in place. Additionally, since other venues existed for trading securities, like the New York Curb Exchange, that did not require disclosure, the decision to list with the NYSE was effectively a voluntary decision to disclose.

87. *See* George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanisms*, 84 Q.J. ECON. 488, 488 (1970).

88. *See id.*

89. *See id.* at 488, 499-500 (discussing how consumers may retaliate when displeased with the quality of purchased goods if other comparable goods are available).

playing field by requiring all exchange-listed companies to submit to the same disclosure rules might make sense, because it avoids the market for lemons and provides investors with the ability to make distinctions between high- and low-quality firms.[90]

Even though the lemons problem justification is plausible, there is an alternative view of this attempt to level the playing field that is comparatively less favorable to that undertaking. This critical account emerges from public choice theory, which attempts to explain political outcomes by analyzing the incentives of legislators and interest groups.[91] Under the cost predation model of public choice theory, larger, more established firms in an industry lobby for additional laws, the costs of which will be borne by all industry participants but will weigh disproportionately on the lobbying group's smaller, less established competitors.[92] This cost predation version of public choice theory offers a different, less supportive view of Congress's attempt to "level the playing field" through mandatory disclosure. Under this view, the firms that were already making voluntary disclosures desired a mandatory disclosure regime not in an attempt to avoid a potential market for lemons; rather, these firms lobbied for mandatory disclosure in an attempt to increase the costs of their comparatively smaller competitors who

90. *See, e.g.*, Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418-19 (2003); Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 676 (2002).

91. *See* DENNIS C. MUELLER, PUBLIC CHOICE II 1 (1989) ("Public choice can be defined as the economic study of nonmarket decision making, or simply the application of economics to political science. The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voting behavior, party politics, the bureaucracy, and so on. The methodology of public choice is that of economics, however."); *see also* FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION 14 (1997); Peter H. Aranson, *Theories of Economics Regulation: From Clarity to Confusion*, 6 J.L. & POL. 247, 249-50 (1990); Guy Halfteck, *Legislative Threats*, 61 STAN. L. REV. 629, 632 (2008); Michael E. Levine, *Why Weren't the Airlines Reregulated?*, 23 YALE J. ON REG. 269, 272 (2006); Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 169-70 (1990); Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101, 101-02 (1987); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 213 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 335-36 (1974); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3 (1971).

92. *See, e.g.*, MCCHESNEY, *supra* note 91, at 14-15.

had decided that it was not cost-effective to make the same disclosures as their larger, more established rivals.

If this type of cost predation story is what underlies the account, then we should be very concerned that the original decision to mandate disclosure of all exchange-listed firms was not justifiable. And if that decision was not justifiable, then the attempts to "level the playing field" by extending the regime to all similarly situated firms, including those in the over-the-counter market, also lacked justification. In other words, there is good reason to question the first of the two principles upon which Congress seemed to base its creation of the public-private divide.

2. *Critiquing the Investor Protection Justification for the Public-Private Divide*

There are also reasons to question the second principle that motivated Congress's view of the public-private divide, that the divide reflects the goal of investor protection. The modern case for mandatory disclosure maintains that disclosure rules should not be designed solely with investors in mind, and advances a view of how investors benefit from disclosure that is radically different from the one that would have influenced Congress's creation of the public-private divide during the New Deal.

This modern case for mandatory disclosure began to emerge in the 1960s, when a group of economic-minded legal academics began questioning the normative desirability of mandatory disclosure in general by pointing out that if disclosure was so valuable to investors, then investors should be willing to pay for it, and in return issuers should be willing to provide it.[93] And as evidence of such a market for disclosure, these same commentators pointed to a long history of disclosure practice that predated the federal securities

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93. George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 132 (1973); George J. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, *in* ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (Henry G. Manne ed., 1969); George J. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515, 515-16 (1969); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 117, 133 (1964). *See generally* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); HENRY G. MANNE & EZRA SOLOMON, WALL STREET IN TRANSITION (1974).

laws, including the history of voluntary disclosure among NYSE-listed firms.[94] The weight of opinion[95] ultimately converged on the notion that mandatory disclosure is necessary to protect investors,[96] but only in order to correct distortions that arise as a result of the benefits that non-investors[97] receive from disclosure.[98] In particular,

94. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 289 (1991) ("Firms have been disclosing important facts about themselves—and certifying these facts through third parties—as long as there have been firms.").

95. In truth, there are other justifications for mandatory disclosure. *See, e.g.*, Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. L. REV. 123, 178-91 (2002). I focus here on the interfirm externalities justification because of its prominence in the literature. However, my ultimate argument—that the SEC, and not Congress, should decide the domain of securities regulation—only requires that the interfirm externalities justification be a reason (but not necessarily the sole reason) for mandatory disclosure, and that this justification should play a role in determining the domain of securities regulation.

96. *See* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999) (acknowledging that by the mid-1980s a "rough consensus" had been reached regarding the need for mandatory disclosure) [hereinafter Fox, *Retaining Mandatory Disclosure*]; Merritt B. Fox, *The Issuer Choice Debate*, 2 THEORETICAL INQUIRIES L. 563, 563-64 (2001) [hereinafter Fox, *The Issuer Choice*]; Guttentag, *supra* note 95, at 125-26. However in the late 1990s, a new group of mandatory disclosure critics emerged who argued in favor of allowing issuers to choose which international disclosure regime would apply to their securities. *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 907 (1998); Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 228-32 (1996); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361-62 (1998) [hereinafter Romano, *Empowering Investors*]; Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 388 (2001) [hereinafter Romano, *The Need for Competition*].

97. Firms may fail to capture one particular benefit of disclosure even when it primarily benefits its own investors, and that is with respect to disclosure's reduction of agency costs. In order to capture the agency cost-reducing benefits of disclosure, the firm might need to make an ex ante commitment to investors that it will make periodic disclosure in the future, and it may be unable to make that type of commitment. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1363-65, 1367-68.

98. On occasion, it is argued that mandatory disclosure is necessary to overcome the collective action problem faced by disparate shareholders in a corporation. Collective action problems arise when an efficient result fails to materialize because of a group's failure to organize in order to take the necessary actions to bring about the desired result. Although individuals as a group value the result enough to justify its realization, no single individual's valuation is sufficient to justify its existence. Therefore, no single individual has an incentive to realize the result. And because of the costs of organization, the group fails to act collectively, resulting in inaction.

In the corporate context, a collective action problem typically arises when shareholders desire some outcome that management has no incentive to help bring about, for example, the

the literature focuses on "interfirm externalities," or externalities that occur when a firm's disclosure confers a competitive advantage upon its competitors, suppliers, or customers.[99] For example, disclosure of a firm's material contracts might provide a firm's supplier with insights that will help the supplier gain the upper hand in future negotiations.[100] Or disclosure of the profitability of particular business segments might induce competitors to enter the market and therefore pose a competitive threat to the firm.[101] The disclosing firm fails to take into account these third-party benefits—and in fact views them as private costs of disclosure—and

election of a non-management nominated director or the adoption of a management-hostile governance feature. Although shareholders as a group might value the result enough to justify it, no single individual shareholder's valuation of that result is sufficient to justify its existence. Consequently, collective action issues prevent the result from taking place.

But the collective action problem, as it might now be apparent from these examples, cannot possibly be a justification for mandatory disclosure. This is because unlike in the case of shareholder voting, management has incentives in the disclosure context to provide the result demanded by investors because managers can increase firm profits by doing so. In other words, in the disclosure context, management itself solves that collective action problem faced by investors because it has incentives to provide disclosure in exchange for lower capital costs. In this sense, collective action is no more a barrier to issuers providing investors with desired disclosure than collective action is a barrier to companies providing consumers with desired products. To be sure, it might cost the issuer to determine what exactly the investors want in the way of disclosure, just as it might cost a company to figure out what their consumers want in their products. And it is true that mandatory disclosure would effectively subsidize those verification costs; but creating a federal mandatory disclosure regime is a high price to pay simply to subsidize management's costs in verifying the level of disclosure that its investors demand.

Thus, the agency cost issue and collective action concerns are not particularly persuasive justifications for mandatory disclosure.

99. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1345-46; *see also* EASTERBROOK & FISCHEL, *supra* note 94, at 291 (theorizing that issuers will take into account the costs that disclosure imposes on their competitive position); Guttentag, *supra* note 95, at 130, 136. Some commentators have suggested that if shareholders are diversified, disclosing firms will not take into account these pecuniary externalities because shareholders of the disclosing firm will also be shareholders of the third-parties that are on the receiving end of these third-party benefits. *See, e.g.*, Romano, *Empowering Investors*, *supra* note 96, at 2368. Thus, these common shareholders will pay more for the disclosing firm's disclosures, thereby creating the necessary incentives to produce those disclosures. But it is not at all clear how many of these common shareholders there will be in light of the relatively few investments that one must hold in a portfolio in order to reap the benefits of diversification. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1352. Also, many of these third party firms will be closely-held private companies, making it less likely that there will be common shareholders.

100. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1345.

101. *See id.*

consequently produces less disclosure than it would in the absence of these costs.[102] Both the theoretical and empirical literature suggest that such interfirm externalities are potentially significant.[103]

The literature also recognizes other third-party beneficiaries of voluntary disclosure, including analysts[104] and society at large.[105] Regardless of the nature of the third-party effect in question, however, the argument is the same: Under a voluntary disclosure regime, the disclosing firm fails to take into account the benefit of disclosure to these third-parties, resulting in a sub-optimal level of disclosure and harm to investors.[106] Even though ultimately this

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102. *See id.* at 1345-46.

103. *See, e.g.*, Guttentag, *supra* note 95, at 147-49, 158-59, 162-63.

104. *See* EASTERBROOK & FISCHEL, *supra* note 94, at 290 ("The information produced by one firm for its investors may be valuable to investors of other firms .... Because they cannot be charged, the information will be underproduced."); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 757-58 (2006); *see also* Guttentag, *supra* note 95, at 136 (identifying third-party beneficiaries of disclosure as including "investors, some of whom may use disclosed information despite not owning shares in the disclosing firm").

105. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1358 ("A second social benefit of disclosure is an improved choice among proposed new investment projects in the economy."); Guttentag, *supra* note 95, at 136 (identifying third-party beneficiaries of disclosure as including "the economy as a whole, which could benefit from an improved allocation of assets"); Langevoort & Thompson, *supra* note 5, at 378 ("As public law scholars have been pointing out for some time, there are certain norms of social legitimacy increasingly placed not only on government actors, but on private institutions that exercise substantial power and have the capacity to inflict considerable harm on society. These norms include a reasonable degree of transparency, some level of accountability, and an openness to external voices. We believe that any rule of securities regulation that promotes any of these norms is likely to be motivated, at least in part, by that inchoate sense of the public responsibility of 'private' institutions."); *cf.* Lucian Arye Bebchuk & Robert Jackson, *Shining Light on Corporate Political Speech*, 101 GEO. L.J. 923 (2013) (arguing in favor of rules for corporate political speech).

106. The third-party effects justification for mandatory disclosure assumes that the information externalities in question are positive and therefore that the market generates too little disclosure. Professor Romano has challenged this claim, arguing that in reality the opposite could be true. *See, e.g.*, Romano, *The Need for Competition*, *supra* note 96, at 387, 464-93. However, as Merritt Fox has pointed out, it is difficult to think of an example where a firm's disclosure would have a negative effect on the cash flows of third-party firms. *See, e.g.*, Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1350 n.25. One example involves information about a new patent for a valuable new technology that, when disclosed, causes the stock price of the disclosing firm's competitors to fall. Fox, *The Issuer Choice*, *supra* note 96, at 570-73; *see* Romano, *The Need for Competition*, *supra* note 96, at 387, 432, 464-93. But as Professor Fox has explained, in that example, the disclosure itself does not actually cause the decline in the price of the competition's stock. That was inevitable upon the obtaining of the patent. Rather, the disclosure simply informed the market of this fact sooner than would

theory concludes that investors might benefit from mandatory disclosure,[107] this is a very different theory of how this happens than the one that would have motivated the New Deal concept of the public-private divide.[108] Thus, while it makes sense to base the public-private determination on an investor protection principle, the modern view of how mandatory disclosure goes about protecting investors is likely to yield a very different result than the one that Congress seized upon in the Exchange Act.

Thus, the modern case for mandatory disclosure is based on the view that mandatory disclosure is necessary to correct market distortions by focusing on the third parties that benefit from disclosure. Under this view, mandatory disclosure rules only benefit investors to the extent that the rules target market distortions that arise from the third-party effects of information. Nor should mandatory disclosure rules be designed solely with the investor in mind, since third parties benefit from these rules as well. This view of mandatory disclosure and its relationship to investors is radically different from the one that would have influenced Congress's creation of the public-private divide over the thirty-year period beginning in 1933.[109] For this reason, that divide may be in need of re-thinking. However, one might nevertheless try to justify the public-private divide that Congress gave us based on this modern case for mandatory disclosure. The next Section considers such revisionist justifications and concludes that none of the determinants of the public-private divide that Congress has given us follow inexorably from the modern economic case for mandatory disclosure.

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have otherwise occurred. *See* Fox, *The Issuer Choice*, *supra* note 96, at 573-74. One possibility is where a firm has information that it has obtained about one or more of its competitors that once disclosed would harm its competitors more than it would harm itself. But such disclosure would have to be able to be made without incurring substantial civil or criminal penalties, or the firm would not voluntarily disclose it. It is exceedingly difficult to come up with a plausible scenario along those lines. For these reasons, I tend to agree with Professor Fox.

107. *See* Guttentag, *supra* note 95, at 159 (setting forth a simple numerical example illustrating how investors lose when the third-party effects of information cause a firm to voluntarily disclose less information than is optimal).

108. This point is implicit in the economic critique of mandatory disclosure that emerged in the 1960s, which took as a given that the dominant pro-disclosure paradigm assumed that disclosure would not take place in the absence of mandatory rules. *See supra* note 93 and accompanying text.

109. *See supra* Part I.A.

B. Critiquing the Revisionist Justifications for the Public-Private Divide

Is it possible to defend the Exchange Act's public-private divide in light of the modern case for mandatory disclosure? The first challenge lies in having to explain why any firm should be excluded from a mandatory disclosure regime under a view rooted in the third-party effects of information, since all firms must experience such effects to a certain degree. All firms have some current or potential competitor, or possibly a supplier, who might benefit from disclosure and therefore cause the firm to make sub-optimal disclosures. And most firms have at least the potential of an analyst following if only the firm would internalize those benefits and make more disclosures.[110] However, in light of regulatory resource constraints, it may nevertheless make sense to exclude some group of firms from the regime to focus disclosure efforts on those firms for which the market failure arising from the third-party effects of information is thought to be particularly acute.

And in fact, one can discern in the literature a fairly recent attempt to justify the public-private divide in light of the modern case for mandatory disclosure along precisely these lines.[111] Not surprisingly, commentators differ on the question of which type of third-party effect is the most salient for purposes of making this determination. While these arguments are intriguing and more or less plausible, they nevertheless have a distinctly post hoc feel to them. In other words, they suggest that the current incarnation of the public-private divide, which Congress has given us, does not follow inexorably from the modern economic case for mandatory disclosure.

110. *See* Goshen & Parchomovsky, *supra* note 104, at 756-57 ("In sum, the misalignment between the private and social value of information justifies mandatory disclosure. These arguments seem to prove too much, however, given that they also support mandating disclosure by closely held corporations. Information regarding corporations that are not publicly traded is also a public good that will be underproduced by the market. If society gains from closing the gap between social and private values through mandatory disclosure, why limit mandatory disclosure to publicly traded corporations?").

111. *See, e.g.*, *id.* at 711; Guttentag, *supra* note 5, at 151; Langevoort & Thompson, *supra* note 5, at 336.

The first revisionist justification to consider, articulated by Zohar Goshen and Gideon Parchomovsky, is that the most important beneficiaries of disclosure are information traders who attempt to profit by trading on superior information that they have gathered through costly research efforts.[112] According to this view, these third-party beneficiaries of disclosure are particularly important because they are the primary drivers of market efficiency, the promotion of which Goshen and Parchomovsky view as the main goal of the federal securities laws.[113] Mandatory disclosure places the search costs that would otherwise be incurred by such information traders on the issuers themselves, who can provide it more cheaply than the traders.[114] Additionally, mandatory disclosure allows information traders to exploit the economies of scale and scope that are only realized if a critical mass of firms discloses the optimal amount of information.[115] Because these information traders do not trade on information—and therefore are not shareholders of the disclosing firm—before they have that information, the benefits they receive from disclosure are grouped among the "positive externalities"[116] discussed earlier. And consequently, in the absence of mandatory disclosure, disclosing firms will lack proper incentives to make the disclosures demanded by these information traders.[117]

But if this information trader view is the correct one, then it is questionable how well the current structure of the public-private divide furthers this goal. Nearly 30 percent of all firms listed on the NYSE, Nasdaq, and AMEX (now the NYSE MKT) have no "meaningful" analyst coverage.[118] Analyst coverage of firms on the

112. Goshen & Parchomovsky, *supra* note 104, at 715-16.

113. *Id.* at 713, 715, 716 & n.11.

114. *See id.*

115. *See id.*

116. *See supra* notes 99-103 and accompanying text.

117. *Cf.* Ronald J. Gilson & Reinier Kraakman, *Clark's Treatise on Corporate Law: Filling Manning's Empty Towers*, 31 J. CORP. L. 599, 609 (2006) ("[D]isclosure obligations are not exclusively—or even primarily—for the benefit of current shareholders of the company, but are also for the benefit of outside investors who might consider purchasing the company's shares. Thus, the interests of future shareholders may be as important as the interest of present shareholders in evaluating the disclosure obligations of corporate managers.").

118. *See* KEATING INVESTMENTS, ANALYZING THE ANALYSTS: A SURVEY OF THE STATE OF WALL STREET EQUITY RESEARCH 10 YEARS AFTER THE GLOBAL SETTLEMENT 1 (2006), *available at* http://perma.cc/Z473-AZV9. In the report, "meaningful" is interpreted to mean at least one analyst affiliated with one of the one hundred research firms ranked by two well-known trade

other national securities exchanges is even more sparse.[119] Thus, the exchange-listed disclosure trigger of section 12(b) of the Exchange Act is substantially over-inclusive if the goal of the divide is to identify firms with significant analyst coverage. Nor does the public-offering disclosure trigger fare much better, because that is basically the same group as those firms listed on the NYSE, Nasdaq, and AMEX.

The shareholder size disclosure trigger of section 12(g) potentially holds out greater promise, since analyst coverage is likely to be positively correlated with the amount of trading by institutional shareholders in the issuer's securities. Analyst compensation is at least in part determined by the amount of institutional trading that analysts drive toward their brokerage houses, and there is some evidence that institutional traders tend to reward good research by executing their trades at the brokerage house that produced the research in question.[120] Thus, analysts may decide to cover firms that have a significant amount of institutional trading, and in fact empirical studies suggest as much.[121] However, the size of a firm's shareholder base, although probably correlated with institutional trading volume, is nevertheless a crude proxy for such trading. And in fact, when studies of the determinants of analyst coverage attempt to measure the effects of analyst compensation on coverage considerations, they inevitably use the more obvious proxy of trading volume.[122] More importantly, these studies suggest that other factors, like a firm's accounting fundamentals, may be as important, if not moreso, than a firm's institutional trading volume in determining analyst coverage.[123] And yet, the Exchange Act does not attempt to address these factors. And of course, if this information trader view is the right one, then the most obvious disclosure

magazines. *Id.*

119. *See id.*

120. *See* Boris Groysberg, et al., *What Drives Sell-Side Analyst Compensation at High-status Investment Banks?* 49 J. ACCT. RES. 969, 994 (2011); Rachel Hayes, *The Impact of Trading Commission Incentives on Analysts' Stock Coverage Decisions and Earnings Forecasts*, 36 J. ACCT. RES. 299, 299 (1998).

121. *See, e.g.*, John Shon & Susan M. Young, *Determinants of Analysts' Dropped Coverage Decisions: The Role of Analyst Incentives, Experience and Accounting Fundamentals*, 38 J. BUS. FIN. & ACCT. 861, 863 (2011).

122. *Id.*

123. *Id.*

trigger would be one that attempts to measure directly a firm's analyst coverage.[124]

A contrasting revisionist view of the public-private divide is provided by Robert Thompson and Donald Langevoort, who believe that the greatest beneficiary of mandatory disclosure is society as a whole, and that society benefits the most when disclosure is imposed upon particularly large companies.[125] These scholars emphasize the analogy between large corporations and governments and argue that the same social norms that apply to the latter should apply to the former as well.[126] These social norms include "a reasonable degree of transparency, some level of accountability, and an openness to external voices," and are furthered to a certain extent by mandatory disclosure.[127] These scholars tend to emphasize the importance of a reporting status trigger that tracks the size of firms, such as section 12(g), which deals with the number of a firm's shareholders of record.[128]

But the number of a firm's shareholders is probably not particularly closely correlated with its social footprint. After all, there are widely held companies that are nevertheless rather insignificant from a social standpoint, because, for example, they are rather small in terms of revenue or operate in an industry with relatively few environmental spillovers, or because they are not engaged in political lobbying. On the other hand, there are many closely held companies with a large social footprint. For example, as of 2013, there were 224 private firms in the United States with over $2 billion in annual revenue.[129] This list includes firms, like Koch Industries, with a significant environmental impact and substantial political lobbying.[130]

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124. Note that I have been focused on sell-side analysts here. Goshen and Parchomovsky also mention buy-side analysts. *See* Goshen & Parchomovsky, *supra* note 104, at 273. It is unclear why the disclosure triggers would be any more justifiable when disclosure is viewed as a subsidy for buy-side analysts than when it is viewed as a subsidy for sell-side analysts.

125. Langevoort & Thompson, *supra* note 5, at 376.

126. *Id.* at 378.

127. *Id.*

128. *Id.* at 351-52.

129. *America's Largest Private Companies*, FORBES, http://www.forbes.com/largest-private-companies/list [http://perma.cc/HCP2-LLGY] (last visited Sept. 28, 2014).

130. *Id.*

A more promising revisionist theory in favor of shareholder numerosity as a basis for determining the domain of securities regulation is suggested by the work of Professor Michael Guttentag.[131] In one part of a larger project outlining a policy approach for repairing perceived shortfalls in the JOBS Act, Guttentag suggests that the shareholder numerosity trigger may play a role in identifying those firms that, in the absence of mandatory disclosure, may disclose too little due to concerns over the positive externalities that such disclosure might have with respect to competitors, suppliers, or customers.[132] Recall that because some types of disclosure could place disclosing firms at a competitive disadvantage vis-à-vis third parties, the disclosing firm may be reluctant to make these disclosures.[133] And yet in making this decision, the disclosing firm fails to take into account the offsetting competitive advantages that such disclosures produce with respect to these same third parties. This leads to less disclosure than is optimal from a social welfare perspective.[134] Guttentag argues that firms with fewer shareholders are less likely to take into account these costs of disclosure because a smaller shareholder base implies less risk that the disclosure will leak out to competitors or suppliers.[135]

Although this is a reasonable defense of using the size of a firm's shareholder base as a disclosure trigger, Guttentag's argument nevertheless leaves some lingering questions. After all, diversified investors do not want the firms in which they invest to take into account these interfirm costs because they know that if the firms do so, it will lead to a sub-optimal amount of disclosure. Thus, as long as shareholders are relatively sophisticated and diversified, there is no reason to believe that there is much of a risk of information leakage on the part of shareholders. And it stands to reason that

131. Guttentag, *supra* note 5, at 207-08.

132. *See id.* at 207 ("The likelihood that a firm's disclosure policies will be distorted by positive interfirm externalities also increases as the number of shareholders entitled to receive the firm's disclosures increases, because the only way to avoid distortions from positive interfirm externalities is to assure the firm that disclosed information will be made available only to the firm's investors, and not the firm's competitors. Such an assurance is easier to provide if the number of shareholders is small.").

133. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1345-46.

134. *See supra* Part II.A.2.

135. *See* Guttentag, *supra* note 5, at 207.

firms themselves, in the absence of mandatory disclosure, would have incentives to try to deliver disclosure in a way that would make it difficult to share beyond shareholders. Thus, if we were trying to formulate a disclosure trigger that would weed out those firms that are less likely to take into account these costs of disclosure, we might gravitate not toward a shareholder numerosity trigger, but rather toward some type of sophisticated diversified investor requirement.

These revisionist theories therefore do not seem to follow inexorably from the modern case for mandatory disclosure. To be sure, this observation should not be taken as a criticism of the distinguished scholars who have advanced these revisionist justifications. Rather, it should be viewed as a criticism of the public-private divide itself, which, as we have seen, lacked much if any, theoretical justification to begin with. And what little justification that was offered lacks grounding in the economic theory that emerged after the statute's enactment and its various amendments. Moreover, as this Section demonstrates, the modern case for mandatory disclosure suggests a public-private divide that is quite different from the one that we currently have. These possibilities are explored further in the next section.

C. Expanding the SEC's Decision-Making Authority

If these revisionist justifications of the public-private divide are not entirely compelling, then what does the modern case for mandatory disclosure imply about how to draw the boundary between reporting and non-reporting firms? If one were to remake the public-private divide from scratch, the economic case for mandatory disclosure points to a number of possible ways that one might create that divide that differ dramatically from the way in which the statute currently operates.[136]

For example, one might make the case that the most significant third-party distortion comes from issuers failing to take into account

136. It is worth noting the way in which I am using the "interfirm externalities" justification for mandatory disclosure here. Notice that I am not suggesting that this justification explains our current disclosure regime as a descriptive matter. Rather, I am arguing that it should play a role in describing the ideal disclosure regime as a normative matter.

the disclosure benefits that redound to competitors. In that case, one might decide to focus the disclosure regime on those firms that operate in particularly competitive markets. Accordingly, one might argue in favor of a disclosure trigger based on an industry's level of fragmentation or consolidation, depending on one's view of a firm's utility function for a rival's information.[137] One could capture this intuition through a disclosure trigger based on well-known industry concentration ratios, like the Herfindahl index.[138]

Or one might argue that the most significant distortion comes from issuers taking into account the disadvantages that disclosure of supplier-friendly information (like material contracts) might have on future negotiations, even though such costs are not social costs.[139] In that case, one might wish to pursue a disclosure trigger based on the level of vertical integration exhibited by a firm. The economics literature suggests a number of different candidates for such a trigger, including measures like a firm's value added ratio.[140]

Alternatively, one might argue, as Professors Goshen and Parchomovsky do, that the most important third-party beneficiary of disclosure are analysts, and therefore that disclosure should focus on those firms with significant analyst followings.[141] A disclosure trigger based on this approach would likely take into account the most important determinants of analyst coverage, such as the

137. In other words, the question seems to be whether such information is more valuable in an industry that is highly competitive or in an industry that is highly oligopolistic.

138. The Herfindahl index is a measure of industry competition defined as the sum of the squares of the market share of the fifty largest firms in an industry, where market share is expressed as the fraction of the market that a given firm produces. *See Herfindahl-Hirschman Index*, U.S. DEP'T OF JUST., http://www.justice.gov/atr/public/guidelines/hhi.html [http://perma.cc/JM2U-USBM] (last visited Sept. 24, 2014). An alternative measure of industry competition is simply the sum of the market shares captured by the four or eight largest firms in an industry. *See, e.g.*, Stephen Calkins, *The New Merger Guidelines and the Herfindahl-Hirschman Index*, 71 CALIF. L. REV. 401, 402 n.4 (1983) ("A concentration ratio is the sum of the market shares of a specified number of firms (conventionally four).").

139. *See* Fox, *Retaining Mandatory Disclosure*, *supra* note 96, at 1345.

140. The value added ratio is the ratio of the firm's added value to its sales revenue. *See, e.g.*, OLIVIER FURRER, CORPORATE LEVEL STRATEGY: THEORY AND APPLICATIONS 124 (2011). In this context, added value is defined as the sum of depreciation, amortization, fixed charges, interest expense, labor and related expenses, pension and retirement expenses, income taxes, net income and rental expense. This ratio is intended to measure the portion of a firm's sales that are generated by activities conducted within the boundaries of the firm, and hence serves as a measure of vertical integration. *See id.*

141. Goshen & Parchomovsky, *supra* note 104, at 716-18.

number of shares outstanding or accounting measures like the consistency of accounting earnings,[142] or possibly even a direct measure of analyst coverage itself.

Finally, if one shares the view of Professors Thompson and Langevoort that we maximize the benefits of disclosure when disclosure focuses on firms with the largest social footprint,[143] one might favor a reporting trigger based on a firm's number of employees, its potential environmental impact, or its political lobbying expenditures.

This rough sketch of some of the possibilities suggested by the economic case for mandatory disclosure strongly implies that wherever the optimal public-private divide lies, it is likely to be very different and probably more complicated than the relatively simplistic version that we currently have. It also suggests that the optimal public-private divide probably makes use of measures drawn from the accounting and industrial organization literatures, like the value added ratio and the Herfindahl index.

This observation leads to the first of two conclusions[144] that this Article draws regarding the institutional design of the federal securities laws: we might benefit by re-allocating decision-making authority in the federal securities disclosure regime in favor of the SEC, so that the SEC, and not Congress, determines the contours of the public-private divide.

There are several obvious objections to this claim that should be addressed at the outset. First, one might argue that criticism of Congress's public-private line-drawing makes little sense because the modern economic case for securities disclosure could just as easily by applied to the SEC. That criticism alone, one might argue, should not be an argument in favor of giving greater decision-making authority to the SEC. To be sure, there is some truth to this objection. After all, the SEC, within the sphere of decision-making authority afforded it by Congress,[145] could tailor disclosure rules to conform more closely to the economic case for disclosure. In other words, the SEC could exempt from disclosure rules those firms that

142. *See, e.g.*, Shon & Young, *supra* note 121, at 866-69.
143. *See* Langevoort & Thompson, *supra* note 5, at 342.
144. For the second of these two conclusions, see *infra* notes 150-53 and accompanying text.
145. *See supra* notes 29-40 and accompanying text.

fall on the "public" side of the public-private divide, but nevertheless do not exhibit very high third-party effects of information, however the SEC might define that category. But the SEC has never done anything like this; thus, one might argue that the SEC is every bit as guilty as Congress for not taking the economic case for disclosure regulation seriously.

Even though this is true, this critique misses an important aspect of the argument that I am making here. I am not arguing that Congress has done such a bad job in drawing the public-private divide that we should see if the SEC can do better. If that were the case, then my argument would indeed be susceptible to the criticism that the SEC does not seem to have done any better than Congress in creating exemptions for firms in light of the economic case for mandatory disclosure. But that is not the argument I am making here. Rather, my argument for giving the SEC greater decision-making authority in this area is based on the nature of the private-public decision itself—it requires the type of fine-grained determinations that are more efficiently made by an expert agency rather than by Congress.

The second objection is related to the first and is likely to come from those commentators who tend to believe that the SEC favors too much regulation.[146] If we give the SEC more decision-making authority, these critics might argue, then the obvious result will simply be too much regulation applied to too many firms. But this is not necessarily correct. The argument I am making here is that securities regulation needs to be rethought so that it more closely aligns with the dominant (economic) case for disclosure rules. So I share the intuition of these critics that the status quo is problematic, although perhaps we disagree about the underlying reasons.[147]

146. *See, e.g.*, Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 20-36 (2003); Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1006; A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 978 & n.225, 983 (1999).

147. These other commentators tend to focus on factors like behavioral features that may cause the SEC to tend toward overregulation. *See* sources cited *supra* note 146. While I agree that this may be the case, I argue that we might be able to constrain these tendencies through regulatory cost controls of the type that I propose in Part IV. Thus, my argument takes the following form: Assuming that we can control the error risk inherent in the SEC's regulatory task, it would make sense to give the SEC greater discretion over the domain of securities

In fact, I make this concession in discussing the first objection above. But my argument is that if we are to take up this project to rethink securities regulation so that it is more closely aligned with the economic case for disclosure regulation, then we probably want to give greater decision-making authority to the SEC since that modern case requires fine-grained, technocratic determinations along the lines discussed above that the SEC is simply better equipped to deal with than Congress.

A third objection might concede that the SEC is better equipped to make the fine-grained determinations inherent in the private-public determination, but at the same time view as overly optimistic the assumption that the SEC would be willing to undertake a project to reconsider that divide in light of the economic case for disclosure. Critics who fall into this camp might point to theories of regulatory empire building, which argue that regulators like the SEC are more concerned about the size of their bureaucratic domain than the accuracy of their policy decisions.[148] If that is indeed the case, then it would be futile to afford the SEC greater deference since it could not be expected to use that deference to craft better policy. But regardless of whether such a theory of empire building is warranted with respect to the SEC,[149] there are ways of addressing this concern other than scrapping a reform project altogether. And indeed, better error management controls, discussed in greater detail in Parts III and IV, might go a long way toward such a goal.

In this Part, I have argued that it may be beneficial to give greater deference to the SEC by allowing the SEC to determine the scope of the public and private markets. But if it is indeed true that we should defer to the SEC regarding that question, it is natural to ask exactly how the SEC's authority would be cabined, if at all, under the statute. The next Part argues that this expansion of SEC decision-making authority under the Exchange Act should be

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regulation than is the case under the current institutional structure.

148. *See, e.g.*, Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922 (1994).

149. For example, John Coates suggested that Congress has been successful in acting as a check against the SEC's tendency for empire building. *See* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 559 (2001).

accompanied by a statutory mechanism to manage the risk of regulatory error that is inherent in the SEC's regulatory task.

III. CRITIQUING THE STATUTE: MANAGING RISK OF REGULATORY ERROR

In the institutional design literature, the problem of how best to allocate decision-making authority turns largely on the question of comparative institutional competence, and Part II developed the argument that, given the proper understanding of the nature of that inquiry, the SEC is probably more expert than Congress with respect to the question of the optimal public-private boundary. Institutional design is also concerned with reducing error costs. Although allocating decision-making authority to the most expert institution itself serves to reduce error costs, it is often desirable, if possible, to put in place additional error reduction measures. Judicial review is one such example.[150] Specific cost-benefit rules are another.[151]

In this Part, I argue that while we might reap benefits from giving the SEC greater decision-making authority—at least with respect to the question of the optimal public-private divide—we might also benefit by putting in place more robust error reduction measures. Does it make sense for Congress to defer more to the SEC, but also be more skeptical about the agency's ability to carry out regulatory tasks without error? That is essentially the argument that I develop here: the SEC is more expert than Congress and is better situated to draw the fine lines that separate the public from the private market. But at the same time, Congress should be realistic about the complexity of the regulatory task that the SEC faces and attempt to control for the risk of error inherent in that task. Judicial review alone cannot be expected to address these concerns of regulatory error.

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150. *See, e.g.*, McGarity, *supra* note 14, at 1452 (characterizing judicial review as a "quality control" mechanism).

151. *See, e.g.*, Robert B. Ahdieh, *Reanalyzing Cost-Benefit Analysis: Toward a Framework of Function(s) and Form(s)*, 88 N.Y.U. L. REV. 1983, 2010-16 (2013) (discussing theories of how cost-benefit analysis might improve decision making).

This Part considers four sources of regulatory error at the SEC that, it is argued, merit greater attention under the Exchange Act. These sources include: (1) psychological biases; (2) public choice dynamics; (3) sophistication constraints; and (4) epistemic limitations. This Part then argues that while judicial review may correct for some types of psychological biases and may minimize interest group influence on the margin, in general, it does not do a particularly good job correcting for the regulatory errors identified here.

A. Four Sources of Error

1. Psychological Biases

The "psychological model" of regulatory error emphasizes the advantage that expert agencies have over governing laypersons, but recognizes that this expertise itself has its own sources of error. Two sources of error are emphasized in the literature.[152] The first source of error is overconfidence. "Experts fail to look beyond the factors that their training and experience predispose them to consider; they tend not to test thoroughly their assumptions. Experts are right more often than laypersons, but not as often as they think."[153] The second source of error is a certain myopia that arises from the self-selection that determines the personnel of administrative agencies. This lack of perspective can lead to mistakes.[154]

2. Public Choice Dynamics

Public choice theory provides another independent source of regulatory error at the SEC. Public choice theory applies the rational actor model of neoclassical economics to the political sphere in an attempt to model legislative or regulatory outcomes.[155] The theory conceives of the political process as a market for law, where

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152. *See* Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 579-80 (2002); Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486, 508 (2002).

153. Rachlinski & Farina, *supra* note 152, at 579.

154. *Id.*

155. *See* Levine, *supra* note 91, at 273.

the producers are the legislators or regulators, and the consumers are the public.[156] Interest groups promise lawmakers some sort of future career support (for example, reelection, reappointment, or future employment) in exchange for laws that benefit them.[157] Under this theory, errors arise because regulators maximize their own self-interest rather than maximizing social welfare. While creating efficient rules might be consistent at times with maximizing a regulator's self-interest, at other times it will be inconsistent with that goal. In those cases, regulators will be maximizing something else, what the literature typically refers to as "career support,"[158] which will be inconsistent with maximizing the efficiency of disclosure rules. Many features of securities regulation have been explained over the years within a public choice framework.[159]

3. Sophistication Constraints

Another potential source of error at the SEC is the agency's lack of economic sophistication; in its analyses this lack of sophistication leads to a higher risk of error.[160] One reason may have to do with the

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156. *See id.*

157. *See id.* Scholars have characterized what legislators and regulators seek to maximize in a number of different ways, including "power," "budget," and "political slack." *See* MUELLER, *supra* note 91, at 36-85. One advantage of Levine's concept of "career support" as the maximand is its breadth (it takes into account goals as varied as "reelection, reappointment and post-regulatory employment") and its intuitive appeal. *See* Levine, *supra* note 91, at 273.

158. *See* Levine, *supra* note 91, at 273.

159. For example, Professors Jonathan Macey and David Haddock have relied on public choice theory to explain the SEC's failure to pursue Congress's national market system. Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 315. These authors have also developed public choice explanations for insider trading regulation. Jonathan R. Haddock & David D. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 311 (1987). Additionally, former SEC Chief Economist Gregg Jarrell has relied on public choice theory to explain why the SEC may have expressed a preference for a departure from fixed commission rates on the stock exchanges in the 1970s. Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation,* 27 J.L. & ECON. 273, 273-74 (1984).

160. *See* Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 YALE J. ON REG. 289, 325 (2013) ("Despite a history of prominent senior SEC staff economists dating back to 1935, the SEC has not traditionally held itself out as an agency with particular expertise in economics—in contrast to other financial regulators like the Federal Reserve Board, which is led and staffed by economists."); *Wiesel Lost "Everything" to Madoff*, UPSTART BUS. J. (Feb. 26, 2009, 9:00 AM), http://upstart.bizjournals.com/executives/

fact that the SEC has never been subject to the executive orders that impose rigorous cost-benefit analysis on executive agencies.[161] Since the 1970s, however, the SEC has voluntarily disclosed the estimated costs and benefits of each new rule,[162] and SEC commissioners have repeatedly committed to Congress to conduct economic analysis with respect to proposed rule making.[163] Furthermore, with the passage of the National Securities Markets Improvement Act (NSMIA) in 1996, the SEC became required to consider the impact of its rules on "efficiency, competition and capital formation."[164]

However, in practice, neither the SEC's voluntary cost-benefit analysis nor its considerations under the NSMIA have proven to be particularly rigorous. Indeed, the section of SEC releases dealing with the NSMIA considerations has rarely translated into more than an invitation to comment on the proposal's effects on efficiency, competition, and capital formation, terms that the SEC has never defined.[165] And the SEC's voluntary cost-benefit analysis has rarely consisted of more than "[a repetition of] policy arguments made elsewhere in the release, and supplied no additional information or analysis."[166]

To be sure, there are indications that the SEC is undertaking efforts to improve the sophistication of its economic analysis. For example, the agency is hiring more economists,[167] and it has recently issued a series of guidelines to follow in conducting economic

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2009/02/26/Elie-Wiesel-and-Bernard-Madoff.html?page=all [http://perma.cc/X75W-EUCV] (quoting former SEC Chairman Harvey Pitt as saying that there is a "lack of real sophistication" at the SEC).

161. The executive order in question—Executive Order No. 12,866—exempted "independent regulatory agencies," like the SEC, from the OIRA review process. Exec. Order No. 12,866, 3 C.F.R. 638 (1993).

162. *See* Kraus & Raso, *supra* note 160, at 296.

163. *See id.* at 297. Commentators have speculated about why, as a tactical matter, the SEC decided to take this approach. *See id.*

164. 15 U.S.C. §§ 78c(f), 80a-2(c) (2012) (requiring that whenever "the Commission is engaged in rulemaking" it consider "whether the action will promote efficiency, competition, and capital formation").

165. Kraus & Raso, *supra* note 160, at 298.

166. *Id.* at 297.

167. Julie Goodman, *SEC RiskFin to Boost Staff, Economic Analysis*, COMPLIANCE INTELLIGENCE (July 26, 2012), http://www.complianceintel.com/Article/3067140/Rules-Pipeline-Archive/SEC-RiskFin-To-Boost-Staff-Economic-Analysis.html [http://perma.cc/E4JA-XD97] (reporting that the SEC's Division of Risk, Strategy, and Financial Innovation would increase its staff from sixty to ninety members by the end of summer 2012).

analysis.[168] But these guidelines simply reflect how basic the SEC's economic analysis is in practice. For example, the guidelines equate the benefits of a rule with gains in economic efficiency, and articulate the need for the SEC to "determine as best it can the economic implications of the rule."[169] The guidelines also emphasize the importance of using third-party empirical research in the SEC's analysis, including the need to explain why some studies are deemed to be more persuasive than others.[170] Although the guidelines do not address it, in the absence of relevant studies on a given issue, the SEC is typically allowed to engage in informed conjecture,[171] although the D.C. Circuit has been somewhat contradictory with respect to this point.[172]

These guidelines are no doubt an important step toward more reliable and more rigorous economic analysis, but they are unlikely to dramatically reduce the error inherent in the regulatory task of designing efficient disclosure rules. To see this, consider the regulatory task faced by the SEC in light of the aspirational cost-benefit analysis reflected in the SEC's 2012 guidelines. That task consists of two integral parts: correcting for the distortions that occur in determining optimal disclosure levels when an issuer takes into account externalities that should not be taken into account because they are not social costs—for example, the competitive disadvantages with respect to suppliers and competitors; and the externalities that should be taken into account because they are social benefits—for example, the benefits of disclosure that accrue to non-investors, like analysts and the public at large.

In assessing a given rule, the SEC would need to analyze both the costs that the issuer incurs in producing the disclosure in question,

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168. U.S. SEC. & EXCH. COMM'N, CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKINGS (2012), *available at* http://perma.cc/7F8S-ZFSS.

169. *Id.* at 3, 10.

170. *Id.* at 14.

171. Chamber of Commerce v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005).

172. *See* Kraus & Raso, *supra* note 160, at 316. *Compare Chamber of Commerce*, 412 F.3d at 142 (noting that the court is "acutely aware that an agency need not—indeed cannot—base its every action upon empirical data; depending upon the nature of the problem, an agency may be 'entitled to conduct ... a general analysis based on informed conjecture'"), *with* Bus. Roundtable v. SEC, 647 F.3d 1144, 1150 (D.C. Cir. 2011) (characterizing the SEC's assumption that not all shareholder nominees under the SEC's proxy access rule would be opposed as "mere speculation").

and the benefits that investors and various non-investor constituents place on that disclosure. The costs consist not only of out-of-pocket costs, but also of management's opportunity costs. The former is relatively straightforward, whereas the latter is most definitely not.

In carrying out this task, the SEC might—as its guidelines suggest—try to rely on academic studies to consider how these various constituencies value information. However, the academic literature is unlikely to be helpful in generating these various valuations. That literature is largely focused on broad questions, like the extent to which disclosure affects an issuer's analyst following or institutional ownership, and how disclosure relates to a firm's cost of capital.[173] And even though there are some studies that attempt to quantify the value investors place on disclosure in general,[174] these studies are virtually useless to an SEC that is trying to figure out how investors value specific proposed disclosure rules. And even these studies do not attempt to quantify non-investors' value of disclosure, even generally.[175]

To be sure, in adopting a disclosure rule, the SEC typically follows the notice and comment rulemaking process, which allows for the public, including the various beneficiaries of mandatory disclosure, to provide the SEC with input regarding how these groups value a particular rule.[176] But interest groups may have incentives to act strategically and misreport how much they value disclosure.[177] And even if interest groups are honest in reporting these valuations, the notice and comment process is hardly a scientific exercise that results in reliable, quantifiable valuations.

173. *See, e.g.*, Paul M. Healy et al., *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405 (2001).

174. *See* Tatiana Popova et al., *Mandatory Disclosure and Its Impact on the Company Value*, 6 INT'L BUS. RES. 1, 1 (2013) (analyzing mandatory disclosure rules in the United Kingdom).

175. *See, e.g.*, *id.* (avoiding addresing non-investor value of disclosure).

176. *See* Mark Seidenfeld, *Demystifying Deossification: Rethinking Recent Proposals to Modify Judicial Review of Notice and Comment Rulemaking*, 75 TEX. L. REV. 483, 484 (1997).

177. This is particularly true under public choice theory's cost predation model in which larger firms have an incentive to over-value regulation to the extent that it puts its smaller rivals at a competitive disadvantage. *See* Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 770 (2013).

4. *Epistemic Limitations*

Finally, the SEC is subject to epistemic limitations that can also lead to regulatory error. These epistemic limitations emerge from the nature of valuing externalities and the difficulties of conducting experiments in this context.

First, the externalities. The economic case for mandatory disclosure tells us that the SEC's job is primarily concerned with valuing the externalities of information in order to create disclosure rules that are cost-justified and that would not be produced by the market. In other contexts involving similar regulatory challenges, such as intellectual property, it is almost an article of faith that measuring externalities is an extraordinarily difficult, if not impossible, undertaking, possibly requiring complicated economic studies.[178]

These studies themselves are the second source of error. Assuming that the SEC can overcome its sophistication limitations, the types of studies that the SEC might conduct to measure the benefits of disclosure rules are themselves replete with error risk. Consider a simple, stylized example of such a study. Assume that we have identified a disclosure rule that we think lacks any positive externalities, although investors are likely to place a positive value on it.[179] The market might not produce such disclosure because firms take into account the competitive costs that it might produce. So, in assessing the economic efficiency of such a rule, we need to correct this distortion by comparing how investors would value the rule to the operational costs—but not the interfirm costs—of producing such disclosure. And for simplicity's sake, we are assuming that there are no other third parties that would benefit from such a rule. How might we conduct such a study, and what might the sources of error be in such a study?

One possibility would be for the SEC to set up a regulatory experiment adopting a new disclosure rule on a temporary basis for

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178. *See, e.g.*, Brett Frischmann, *Spillovers Theory and Its Conceptual Boundaries*, 51 WM. & MARY L. REV. 801, 816 (2009) (discussing how externalities that are difficult to identify or capture also tend to be externalities that are difficult to measure, and observing that "[t]alking about externalities may seem akin to academic hand waving").

179. It is hard to imagine what such a rule would look like, but let us make the assumption anyway for ease of explication.

the purpose of generating data that could be used to craft a better permanent rule. In that case, the SEC could design an event study that looks at how the valuation of companies varies during a window of time surrounding the date when the new disclosure rule becomes effective.[180] Such an approach would be dramatically more sophisticated than the SEC's current approach to economic analysis. But it is unclear that it would be a significant improvement in the risk of error inherent in the analysis. First, the issuers or investors might behave differently if they know that the rule is only experimental in nature.[181] Second, there are several sources of error built into event studies themselves.[182] The researcher must be able to identify when the market first learned of the proposed regulation in order to run such a study, and that sort of determination can be very imprecise when regulatory processes are long and complicated.[183] Because the results of these studies are extremely sensitive to the dates that the researcher chooses to focus on for purposes of the study, this determination is fraught with the potential for error.[184] Additionally, regulation often occurs at the same time as other potentially market-changing events, including technological changes and general economic fluctuations, and these other events can make it difficult to sort out the effects attributable to the regulatory change.[185]

180. For a study that takes a similar approach with respect to voluntary disclosure, see Bryan T. Kelly & Alexander Ljungqvist, *The Value of Research* (Eur. Fin. Ass'n 2008 Athens Meeting Paper, 2007), *available at* http://perma.cc/8WUB-KUGL.

181. *See* Jacob E. Gersen, *Temporary Legislation*, 74 U. CHI. L. REV. 247, 268-70, 277-78 (2007); Zachary J. Gubler, *Experimental Rules*, 55 B.C. L. REV. 129, 148-49 (2014); Rebecca M. Kysar, *Lasting Legislation*, 159 U. PA. L. REV. 1007, 1036-37 (2011).

182. Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001) (noting methodological problems with event studies).

183. J. Harold Mulherin, *Measuring the Costs and Benefits of Regulation: Conceptual Issues in Securities Markets*, 13 J. CORP. FIN. 421, 424 (2007).

184. *See id.*

185. *See id.* at 424, 432.

B. Judicial Review's Inadequacy as a Tool for Managing Administrative Error Arising from These Four Sources

Judicial review of agency rules is intended to play an error management role. However, it is extremely unlikely that courts can reduce all types of regulatory error, including many of those described above.

Hard look review requires agencies to demonstrate that they have followed a specific procedure, including that they "ha[ve] responded to significant points made during the public comment period, ha[ve] examined all relevant factors, and ha[ve] considered significant alternatives to the course of action ultimately chosen."[186] In this sense, courts can serve an accountability function, which some commentators have suggested may minimize errors resulting from certain psychological biases, particularly those that emerge from logical shortcuts and a lack of self-critical thinking.[187] However, these same commentators acknowledge that judicial review may actually amplify other psychological biases, like the confirmation bias, where an individual seeks out evidence to confirm her initial hypothesis.[188] In that context, accountability can cause individuals to spend that much more time and effort seeking out such confirming evidence.

Modern standards of judicial review of agency action, including the doctrine of hard look review, were developed in part in an effort to minimize the effects of agency capture.[189] If agencies were required to demonstrate a sound procedural basis for their decisions, the logic went, then it would be more difficult for agencies to be captured by interest groups.[190] For this reason, one might think that judicial review is particularly effective with respect to the types of errors discussed above that may result from public choice dynamics at agencies.

186. Garland, *supra* note 67, at 527.

187. *See* Seidenfeld, *supra* note 152, at 508-09 (explaining that the psychological literature suggests that accountability can correct psychological biases and that judicial review satisfies, to a certain extent, these accountability requirements).

188. *See id.* at 509.

189. *See* Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L.J. 2, 34-35 (2009).

190. *See id.*

However, judicial review's effectiveness at addressing these types of problems is the subject of intense debate.[191] The problem is that there is typically enough flexibility in the administrative record for an agency to justify the process underlying the regulatory outcome, even though it may be the result of interest group capture.[192] For this reason, some courts have interpreted hard look review to additionally include a substantive component, whereby the court must review the agency's explanations and conclusions to ensure that they are reasonable.[193] Although this version of hard look review

191. *Compare* Frank B. Cross, *Pragmatic Pathologies of Judicial Review of Administrative Rulemaking*, 78 N.C. L. REV. 1013, 1054-55 (2000) (arguing that "quality rulemaking is ... undermined" by the judiciary's lack of expertise), McGarity, *supra* note 14, at 1452 (observing that there are "clear limits to judicial competence in the area of highly scientific and technical rulemaking"), Richard J. Pierce, Jr., *Seven Ways to Deossify Agency Rulemaking*, 47 ADMIN. L. REV. 59, 69-70 (1995) (identifying how the judiciary's lack of expertise can frustrate agency action), *and* Martin Shapiro, *Administrative Discretion: The Next Stage*, 92 YALE L.J. 1487, 1507 (1983) ("Courts cannot take a hard look at materials they cannot understand nor be partners to technocrats in a realm in which only technocrats speak the language."), *with* Colin S. Diver, *Policymaking Paradigms in Administrative Law*, 95 HARV. L. REV. 393, 409-21 (1981), Jim Rossi, *Redeeming Judicial Review: The Hard Look Doctrine and Federal Regulatory Efforts to Restructure the Electric Utility Industry*, 1994 WIS. L. REV. 763, 811, 818-20, Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1570 (1992), Seidenfeld, *supra* note 152, at 514 ("In short, hard look review performs a valuable function by encouraging agencies to think through the full implications of their policies."), *and* Cass R. Sunstein, *On the Costs and Benefits of Aggressive Judicial Review of Agency Action*, 1989 DUKE L.J. 522, 527-29 ("It is also possible to show that aggressive judicial review has often provided significant benefits both in bringing about desirable regulatory initiatives and in preventing unreasonable or unlawful regulation.").

192. *See* Rachlinski & Farina, *supra* note 152, at 588 ("Even under the regime of hard-look review, an agency determined to adopt a policy favoring a particular political constituency has abundant opportunities, in how it creates the record and explains its decision, to disguise its pandering. Only in the marginal case in which the interest-group-favoring policy cannot be even plausibly justified within the typically capacious boundaries of the statutory delegation and the typically conflicting contents of the administrative record, will public participation and judicial review defeat agency capture.").

193. *See* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (ratifying the procedural and substantive aspects of hard look review); Citizens to Pres. Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971) (explaining that, in order to survive arbitrary and capricious review, the agency's decision must be based on a consideration of the "relevant factors"—the procedural element—and be free of any "clear error of judgment"—the substantive element). Note that most commentators agree that the Supreme Court ratified the procedural and substantive aspects of hard look review in *State Farm*. *See, e.g.*, M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1418 (2004) ("This so-called 'hard look review' developed mainly in the lower courts, especially the D.C. Circuit, but the Supreme Court ultimately endorsed it in 1983."); Miles & Sunstein, *supra* note 64, at 763 (explaining that the *State Farm* decision was "widely taken to ratify both

provides courts with greater ability to vacate or remand rules that they believe are the result of capture, it does not necessarily provide the court with greater information about whether that is in fact the case.[194] To be sure, there might be some cases where the interest group influence is so extreme and the administrative record so obviously contrary to the dominant interest group's preferred outcome, or the outcome itself so obviously unreasonable, that judicial review may defeat public choice dynamics. But it seems that this will likely be the exception rather than the rule.

Even though judicial review may at times correct regulatory errors arising from psychological biases or from public choice dynamics, the types of errors that courts are least likely to correct are those stemming from sophistication deficits or epistemological limitations, both of which seem to be major concerns at the SEC, as discussed above. The courts[195] and commentators[196] are acutely aware that generalist courts lack the expertise of the agencies they review. If that is true, then it is unreasonable to expect courts to correct errors that in part stem from concerns over expertise, such as errors emerging from sophistication deficits and epistemic limitations.

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procedural and substantive components of the hard look doctrine"); Sidney A. Shapiro & Richard E. Levy, *Heightened Scrutiny of the Fourth Branch: Separation of Powers and the Requirement of Adequate Reasons for Agency Decisions*, 1987 DUKE L.J. 387, 423 ("The Court's application of the arbitrary and capricious standard of review in State Farm gave it new substantive content."); Cass R. Sunstein, *Deregulation and the Hard-Look Doctrine*, 1983 SUP. CT. REV. 177, 210 ("The *State Farm* decision expressly endorses the primary elements, both substantive and procedural, of the hard-look doctrine."). *But see* Scott A. Keller, *Depoliticizing Judicial Review of Agency Rulemaking*, 84 WASH. L. REV. 419, 424, 452-57 (2009) (contending that the Supreme Court's 2009 decision in *FCC v. Fox Television Stations, Inc.* implicitly rejected the hard look doctrine and corresponding *State Farm* dicta, and also that APA arbitrary and capricious review simply asks whether the agency reasons were "rational" (citing FCC v. Fox Television Stations, Inc. 556 U.S. 502, 517 (2009))).

194. Hard look review may, however, provide the court with other valuable information about the regulatory process. *See* Matthew Stephenson, *A Costly Signaling Theory of "Hard Look" Judicial Review*, 58 ADMIN. L. REV. 753 (2006) (suggesting that requiring agencies to engage in costly defenses of their rules informs courts of the value that the government places on the policies in question).

195. *See, e.g.*, Norton v. S. Utah Wilderness Alliance, 542 U.S. 55, 66 (2004) (noting the danger of judicial review going too far and the need "to protect agencies from undue judicial interference" and "to avoid judicial entanglement in abstract policy disagreements which courts lack both expertise and information to resolve").

196. *See, e.g.*, Frank B. Cross, *Realism About Federalism*, 74 N.Y.U. L. REV. 1304, 1332 (1999); McGarity, *supra* note 14, at 1452.

For these reasons, an increase in the SEC's decision-making authority, as advocated for in Part II, should probably be accompanied by stronger controls for the risk of regulatory error. And such controls might even be desirable regardless of whether the SEC's decision-making authority is expanded.

IV. POLICY IMPLICATIONS

Part II argued that there are likely benefits to be reaped from granting the SEC greater authority to determine the precise boundary that separates the private (unregulated) securities market from its public (regulated) counterpart. Part III argued that the SEC's regulatory task is fraught with the risk of regulatory error that is not particularly well managed by judicial review, and that we therefore might benefit from additional mechanisms aimed at reducing the risk of such error costs. In this Section, I consider how one might translate these two arguments into policy. Any such policy would consist of two components, one that attempts to provide greater decision-making authority to the SEC, and a second component that attempts to constrain the regulatory costs of SEC action.

A. Deferring to the SEC on the Public-Private Divide

The first component of any policy proposal that seeks to operationalize the analysis set forth above would be to give the SEC the decision-making authority to decide which firms should be subject to disclosure rules and which firms should not.[197] We could easily accomplish this goal by simply eliminating sections 12(b) and 15(d) of the Exchange Act, thereby creating a rule that says that any issuer engaged in interstate commerce must file a registration statement with the SEC that sets forth whatever information the SEC deems necessary. As discussed in Part II, the SEC currently can only write disclosure rules for firms that are large—as measured by size of shareholder base—listed on exchanges, or that have

197. A number of additional sections of the Exchange Act would need to be eliminated or amended to account for the absence of sections 15(d) and 12(d); however, these changes would largely be an exercise in cleaning-up and rationalizing, and as such are not discussed here.

made registered offerings.[198] Yet, the original justifications that were advanced for these particular triggers are problematic in light of developments in the economic analysis of disclosure that have occurred since those triggers were created in the 1930s and the early 1960s. And these disclosure triggers, while arguably consistent with the modern economics case for mandatory disclosure, do not follow inexorably from that economic theory.

Perhaps even more importantly, however, this policy proposal not only reflects a need to rethink the public-private divide in light of modern economic theory, but it also reflects the judgment that the SEC, and not Congress, is probably better situated to take on this rethinking project. Under modern economic theory, the mandatory disclosure regime should focus disclosure efforts on those firms for which the market failure arising from the third-party effects of information is thought to be particularly acute. A cursory attempt to imagine how we might redraw the public-private divide in light of that inquiry suggests that the optimal rules are likely much more complicated than the current divide, that the policy choices may turn on very fine-grained judgments having to do with various aspects of accounting and industrial organization, and that the SEC, as the expert agency, is more competent from an institutional perspective to make these decisions.[199]

One potential objection is that this approach would create a certain disconnect between the Securities Act and the Exchange Act. After all, this approach would eliminate section 15(d) of the Exchange Act, which creates a disclosure obligation for any firm that has made a registered offering under the Securities Act.[200] Thus, under the current regime, a public offering itself is a trigger for continuous disclosure under the Exchange Act.[201] By eliminating section 15(d), this approach would open up the possibility that a firm could make a public offering under the Securities Act, but then make no further disclosures under the Exchange Act if the SEC has refused to adopt any disclosure rules that would apply to that particular firm. This is certainly a possibility, and in this sense, the

198. *See supra* notes 38-40 and accompanying text.
199. *See supra* Part II.
200. 15 U.S.C. § 78o(d) (2012).
201. *See id.*

approach could create a disconnect between the two statutes. However, this disconnect is less disconcerting if one adopts the view that the Securities Act is attempting to address a very different problem from that addressed in the Exchange Act. The Securities Act is primarily concerned with the selling pressures that accompany an initial distribution of securities, and it uses disclosure to accomplish this goal.[202] The Exchange Act, by contrast, is concerned with trading transactions in the secondary market, which do not involve the same selling pressures.[203] So, the fact that there is a disconnect between the two statutes is not particularly surprising.[204] Additionally, even under the scenario where no Exchange Act rules apply to a firm that has already made a public offering, that firm will likely continue to make some voluntary disclosure, even if it is less than the mandatory disclosure that it was obligated to make under the Securities Act.

B. Controlling for Regulatory Error at the SEC

The second component of a policy proposal modeled after the analysis set forth above would need to attempt to minimize the risk of regulatory error implicit in the SEC's task of crafting efficient disclosure rules. To this end, consider a policy[205] that would charge a special advisory committee to Congress with the task of analyzing—on a periodic basis—the disclosure costs the current regulatory regime imposes upon firms. The advisory committee would then recommend, in light of those costs, whether the SEC should take some action or forbearance.[206]

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202. *See* Thompson & Langevoort, *supra* note 53, at 1578-79.

203. *See id.* at 1581, 1585-86.

204. *See id.* at 1585-86 ("What makes a public offering special in terms of investor protection is the business-driven need to induce increased demand so as to absorb a large number of shares suddenly coming to market—work typically done by financial intermediaries (underwriters and dealers). It is the combination of that need and the issuer's self-interest that justifies the registration requirement.")

205. I am grateful to Professor Langevoort for suggesting how one might translate the thought experiment below into this more practical solution.

206. This is a variation of cost-benefit analysis, to be sure. The problem with mandating that an agency like the SEC engage in cost-benefit analysis in the hope of reducing regulatory error is that the same pathologies that we believe might lead to regulatory error in the first place are also likely to affect the agency's cost-benefit analysis. In an effort to remedy this, one might have another entity conduct the cost-benefit analysis or at least establish the

In order to understand the desirability of this sort of proposal, let us first consider how we might achieve this regulatory error management goal under "nearly ideal" circumstances, which will then allow us to consider how the proposal summarized above approximates this near ideal in the real world. For purposes of this thought experiment, consider a world in which we are relatively confident that we are able to identify—at least in terms of a range—the regulatory costs that a theoretically optimal disclosure regime would impose on firms. In other words, we are relatively confident in saying that we think the theoretically optimal disclosure regime would impose disclosure costs no greater than x percent and no less than y percent of a given firm's total costs, revenues, income, or some other income statement metric. Let us also assume that we cannot quantify the benefits of that theoretically optimal regime—that is why this is merely the "near ideal" case. Let us further assume that we are fairly confident that we can quantify the regulatory costs that we are imposing on firms subject to the current disclosure regime. Under these circumstances, what type of regulatory error cost control mechanism might we adopt?

Under such circumstances, we might have Congress place statutory limits—both in terms of an upper- and lower-bound—on the costs that the SEC could impose on regulated firms through disclosure rules, effectively creating an allowable range of disclosure costs. It would be important to establish both an upper- and lower-bound because although the analysis in Part II suggests several reasons to believe that the SEC will err in designing disclosure rules, those reasons suggest that the agency will not consistently err in one particular direction.[207] Congress might fine-tune this approach by dividing issuers into groups based on size, perhaps determined by operating income or the like, and then establishing

parameters that the agency should rely on in conducting such an analysis.

207. To be sure, the type of public choice model that has typically been applied to the SEC—the cost predation model—does suggest a tendency on the part of the SEC to over-regulate. If one accepts that model as the best predictor of SEC behavior at all times, then one might conclude that SEC error tends in the direction of over-regulation. However, if the public choice model is not always the primary driver of error at the SEC—and as an aside, that assumption seems reasonable—the three other sources of error identified in Part III all allow for the possibility of error in either direction.

an allowable disclosure cost range for each of these company size groups.[208]

The expectation would be that the SEC or an advisory committee would periodically measure the actual disclosure costs of companies, and calculate the average disclosure cost for a given company size group, all, of course, in light of parameters[209] established by Congress.[210] To be sure, the costs of gathering the company-specific data needed to make these calculations, and the subsequent costs of the calculations themselves, would be significant. But the SEC or advisory committee could probably reduce these costs by only considering a sample of firms in each company size group.

Armed with these calculations, the SEC or advisory committee could then compare these actual disclosure costs to the allowable cost range that Congress has established for the various company size groups. The SEC could then use the results of this exercise to help determine whether further action is necessary. As long as the disclosure costs for a given company size group fall within the applicable statutory cost range, the SEC would likely have no further obligations. If, on the contrary, the disclosure costs were to fall outside of the applicable range, either because the SEC's current rules are excessively costly or not costly enough—in other words, because there is too much or too little regulation as measured by costs—the SEC would have to make regulatory adjustments to bring these costs back into line with the statutory ranges. To ensure compliance, Congress could prohibit the SEC from taking any further regulatory action until it had taken reasonable steps to address the cost under- or over-run. And even if current disclosure costs fall within the allowable cost ranges, perhaps the SEC would be required to indicate in its adopting release for a given regulatory

208. This aspect of the thought experiment resembles other analyses calling for some sort of tiered disclosure. *See, e.g.*, Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531 (2012); Thompson & Langevoort, *supra* note 53.

209. These parameters would, for example, include how to measure firm-specific disclosure costs.

210. It is important to have a third party set the parameters of the cost-benefit analysis if the purpose of the cost-benefit analysis is to reduce the regulatory error inherent in the agency's regulatory task. If the agency is given carte blanche with respect to the cost-benefit analysis, then it is likely that the same pathologies that lead to the risk of regulatory error in the first place will affect the agency's cost-benefit analysis.

action why it believed that the adopted action will not push disclosure costs outside of the allowable cost ranges.

Thus, under this approach, if the SEC wished to pursue a de-regulatory or regulatory agenda, it would be prohibited from taking that action without justifying in the action's adopting release why it believed that such action would not push the disclosure regime outside the bounds of the relevant allowable cost ranges. Similarly, if it were to conclude that the disclosure costs of the current regime fall outside the bounds of the relevant allowable cost ranges, the SEC would be prohibited from pursuing any further deregulatory or regulatory policies without first bringing the current regime in line with respect to the allowable cost ranges. The SEC would therefore face a strong incentive to bring its rules into line with what Congress would have determined to be socially optimal disclosure costs, since refusal would thwart the SEC's agenda, regardless of whether that agenda is of the regulatory or de-regulatory variety.

This approach would be fairly effective at managing the risk of regulatory error at the SEC, provided that the assumptions underlying our thought experiment hold true. Before considering those assumptions, however, let us address one obvious question: Does this approach really address the risk of regulatory error? After all, just because we are controlling the costs of disclosure does not mean that we are necessarily addressing regulatory error. The SEC could still adopt inefficient rules whose costs exceed benefits, even though the costs might be limited.

In an ideal world, we would control regulatory error by comparing the benefits and costs of a rule. The problem is that the benefits of disclosure are extraordinarily difficult to value for the reasons stated in Part II, and the SEC does not even have a consistent practice of attempting to quantify these benefits. For example, an approach based on verifying that there is, a margin of error between costs and benefits seems utterly unrealistic at this point in the evolution of United States securities regulation and the SEC. And for that reason, I have assumed as much for purposes of the "nearly ideal" world of my thought experiment. Under my thought experiment, as long as we think that we have created reasonable cost ranges, we are at the very least making inefficient rules less likely by controlling costs, and reducing the costs of such rules in the event that they do occur. Thus, even in the nearly ideal world of our thought experiment, this approach merely reduces the likelihood of regulatory error—and the effects of such error—but it certainly does not eliminate it altogether.

Thus, this cost-reduction approach might actually work to rein in the risk of regulatory error at the SEC—regardless of the direction toward which we think that error is biased—so long as the assumptions that underlie the thought experiment hold true. Of course, those assumptions are probably not realistic. In actuality, we are probably not that confident about being able to establish, on an ex ante basis, the range of disclosure costs that an optimal disclosure regime would impose on regulated firms. And we are also probably not particularly confident that we can calculate the level of disclosure costs that the current regime imposes on regulated firms.

However, we might be able to come close. Perhaps not close enough to justify a regime, like the one outlined above, in which everything is settled ex ante through bright-line statutory rules established by Congress that are enforced through a mechanism that incentivizes the SEC to take some action or forbearance in the case of a cost under- or over-run. But perhaps we could accomplish something similar through an advisory committee that reports directly to Congress, and that is specifically charged with analyzing disclosure costs, which brings us back to the policy proposal summarized above.

While SEC advisory committees exist,[211] there are none currently charged with the task of managing the costs of regulatory error. Such a committee could basically perform the analysis outlined above, identifying allowable cost ranges and calculating actual disclosure costs based on sampling. But, unlike the bright-line, ex ante

211. For example, there is currently an advisory committee jointly commissioned by the SEC and CFTC whose task is to "develop recommendations on emerging and ongoing issues relating to both agencies." *See CFTC-SEC Joint Advisory Committee*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/About/CFTCCommittees/CFTC-SECJointAdvisoryCommittee/index.htm [http://perma.cc/V5J5-ND4H] (last visited Sept. 28, 2014). Other recent advisory committees include the Advisory Committee on Small and Emerging Companies and the SEC Investor Advisory Committee. *See Advisory Committee on Small and Emerging Companies*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/info/smallbus/acsec.shtml [http://perma.cc/W6CQ-ZF39] (last visited Sept. 28, 2014); *Investor Advisory Committee*, U.S. SEC. & EXCHANGE COMM'N, http://www.sec.gov/spotlight/investor-advisory-committee-2012.shtml [http://perma.cc/N4M7-MY8T] (last visited Sept. 28, 2014).

approach taken in our thought experiment, under this second best approach the advisory committee could also make clear its level of confidence with respect to these various estimates. And Congress would then have discretion to act by requiring some SEC action or forbearance in accordance with the advisory committee's findings. The downside of this approach would be that it would not necessarily have the effect on regulatory action that the thought experiment would have, because this approach would require Congress to act before the SEC has any obligation to act or forbear. And Congress might refrain from acting even when the advisory committee has a high level of confidence that Congress should intervene at the SEC to help manage the risk of regulatory error. In other words, this proposal would not have the self-enforcing aspect of our thought experiment. The virtue of this approach is that it would address the data concerns that plague the ex ante bright-line approach taken in the thought experiment, and it would hold out the likelihood—perhaps not as certain as in our thought experiment, but a likelihood nonetheless—that regulatory error costs would indeed be limited.

C. What About Decision Costs?

This Article has argued that we might draw on institutional design principles to create a structure for securities regulation that yields smarter, less error-prone laws. In particular, this Article has argued that we might reduce error costs in the securities regulation context by granting the SEC greater decision-making authority while at the same time implementing a system for controlling the regulatory costs that the SEC is able to impose on the firms that are subject to its regulations. One question left unaddressed regards the decision costs associated with this policy proposal. Analyses of institutional design typically focus on not only error costs, but on decision costs as well. These are the costs involved in making a decision, including the costs of data collection, experimentation, analysis, and the like.[212] Typically, there is a tradeoff between error costs and decision costs.[213] The expert might make half as many

212. *See* Kelly, *supra* note 20, at 865.
213. *See id.*

errors as the layman but spend twice as much in resources to reach his decision.

Thus, the analysis is incomplete if it focuses solely on error costs associated with a proposed institutional structure. It is also necessary to take into account the necessary decision costs. That inquiry is always very speculative. However, I think it is a little less speculative in this case if we can agree on the relevant baseline against which to measure the decision costs associated with this proposal.

Specifically, I have argued that the public-private divide should be determined by reference to those firms or industries where the third-party effects of disclosure are particularly high. The economic case for disclosure regulation implies that these environments exhibit high third-party effects, and therefore mandatory disclosure is likely to be superior to market-provided disclosure. The question is not how the decision costs of the status quo compare to the decision costs of this proposal, because the status quo does not ask how the public-private divide should be drawn in light of the economic case for mandatory disclosure rules. Rather, once we have decided that the public-private divide must be drawn in light of the economic case for mandatory disclosure, the question becomes whether the decision costs are less if we have the SEC or Congress engage in that line-drawing exercise. It is not at all clear that the decision costs would be greater if we had the SEC undertake that task, especially when one takes into account the fact that there are typically a greater number of interest groups involved at the congressional, rather than the agency, level.[214] Thus, at worst, it seems that the decision costs will be the same for the SEC. But if this is the case—that the decision costs of drawing the public-private divide are relatively the same regardless of whether the SEC or Congress is doing the line-drawing—then I think this weighs in favor of concluding that granting the SEC greater authority on this decision would be efficient. As I have argued above, the error costs of having the SEC decide this issue are likely to be much less.

214. *See* Gubler, *supra* note 177, at 790-92.

The efficiency of the second aspect of my proposal—the regulatory cost control mechanism—is substantially more speculative. The decision costs associated with this regulatory cost control mechanism are undoubtedly very high compared to the appropriate baseline, which is simply the status quo without a cost-control mechanism. The question there is whether the reduction in error costs outweighs the increase in decision costs associated with creating the regulatory cost control mechanism in the first place. And, unfortunately, that question is impossible to resolve without some sort of empirical data or, perhaps, policy experimentation.[215] I will leave that for another day. What I hope to have accomplished in this Article is to make the case for greater error cost controls and propose one possible solution.

Conclusion

Questions about the optimal allocation of decision-making authority among Congress and agencies, including how to minimize the risk of decision error in delegated decision-making, are perennial questions in the institutional design literature. In the securities regulation context, these questions were settled long ago, at a time when the policy justifications for a mandatory corporate disclosure regime were strikingly different from those that tend to dominate the scholarly debate today. And yet, these policy justifications are integral to our institutional design choices. For these reasons, this Article has argued that it is time to reassess these questions in the context of securities regulation. That reassessment implies that we might benefit by giving the SEC greater decision-making authority over securities regulation's domain—in other words, which firms are subject to the mandatory disclosure regime in the first place. This approach would allow the SEC to make the type of fine-tuned regulatory determinations that are called for by the dominant justification of mandatory disclosure today, which holds that mandatory rules are necessary to correct for market failures arising from the third-party effects of information. At the same time, however, it might be desirable to put in place greater controls for

215. *See* Gubler, *supra* note 181, at 129.

the risk of decision error that is inherent in the SEC's complicated regulatory task. The upshot is a regime based on greater trust, but also greater verification. The policy proposal outlined in this Article is one attempt at putting these policy goals to work. There is no doubt that such a policy proposal is ambitious, but the possibility of achieving a smarter and less error-prone regulatory structure may be worth the heavy lifting.