Essential Papers on the Economics of Securities Law

Geoffrey P. Miller
New York University, geoffrey.miller@nyu.edu

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Abstract: This introduction to a compendium published by Edward Elgar (forthcoming) identifies and critically discusses leading research on the economics of securities law. Topics include the origins of securities regulation, the case for mandatory disclosure, the efficient markets hypothesis, insider trading, the fraud on the market theory, portfolio theory, capital assets pricing, takeover bids, regulatory design, shareholder voting, behavioral finance, and comparative research in securities markets and regulation.

Introduction

Any compilation of research on the economics of securities law must confront a question of scope. The topic has to do with the law pertaining to securities. But what is a “security”? The legal definition is influenced by factors exogenous to the economic literature, including matters such as the influence of interest groups, the value of commercial certainty, the need for qualitative distinctions to describe quantitative differences, the influence of institutional and business practices, and the limitations of ordinary language. These and other factors drive a wedge between economic fundamentals and legal terminology.

Definitions of “security,” found (with slight variations) in the Securities Act of 1933,1 the Securities Exchange Act of 1934,2 the Investment Advisers Act of 19403 and the Investment Company Act of 19404 are maddeningly circular (“any interest or instrument commonly known as a ‘security’”), or frustratingly inbred (references to industry usages such as “note,” “stock” or “bond” which themselves have uncertain meanings). Even when judges attach functional meanings to the statutory terms, the results are not very enlightening. The Supreme Court defines an “investment contract” as an investment of money with an expectation of profits.

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1 15 U.S.C. § 77b-1
2 Id. § 78c(a)(10)
3 Id. § 80b-2(a)(18)
4 Id. § 80a-2(a)(36)
arising from a common enterprise that depends solely on the efforts of others.⁵ Taken literally, this gloss appears both under-inclusive (people obtain financial claims by supplying value other than money, and it would seem strange to rule out an instrument as a security if the investor contributed even slightly to the operation of the enterprise)⁶, and also over-inclusive (it might encompass ordinary bank loans). In practice, application of the legal definition often depends on what is specifically excluded (e.g., government bonds and short-term notes). But defining something on the basis of what it is not seems questionable as a path to fundamental understanding.

More progress is made if we look, not to formal definitions, but rather to the goals of securities regulation. Two such goals are paramount: facilitating the effective functioning of capital markets and protecting investors. Taking account of these goals, and recognizing that any definition will be imperfect around the edges, I define a security for purposes of this collection as a **risky claim on assets and/or income stream of a firm, acquired and held under conditions of imperfect and asymmetric information and distributed to investors along with other functionally identical instruments**. This definition relates the goals of securities regulation to the criterion of economic efficiency. If investors are not protected against fraud or not given the information necessary to make good decisions, they will invest less and demand greater protections for the investments they do make. The volume and liquidity of trading will decrease and prices will less faithfully reflect informed judgments about value.

A word is in order about the criteria I have employed for selecting articles. The papers were chosen for any of three reasons. Some represent fundamental contributions that shaped later thinking. Others, even if not seminal in themselves, illustrate approaches that have proven durably influential. Still others challenge prevailing views; these are included because they provide balance, stimulate thought, or offer an alternative point of view. In this regard, I have

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⁶ Subsequent judicial decisions have softened the requirement that profits must be solely from the efforts of others; some managerial involvement by the investor will not necessarily be disqualifying.
included papers from several “Chicago School” critics of securities regulation -- not only because of the intrinsic merit and interest of these works, but also because they challenge and illuminate the views of thinkers more favourably inclined towards government intervention.

While I have made best efforts to identify papers that satisfy the inclusion criteria set forth above, it is impossible to reproduce all of the excellent contributions; the selection of some is not in derogation of many others that, but for reasons of space, would have been worthy components of this collection.

**Origins**

In law as in life, things contingent in origin often come to seem inevitable. History provides an antidote. In the case of securities law, the history of administrative regulation – at least in the United States – begins at the state level with the enactment of so-called “blue sky” statutes. Jonathan Macey and Geoffrey Miller’s 1991 paper, “Origin of the Blue Sky Laws,” argues that the principal supporters of the first blue sky laws were the owners of state-chartered banks who feared competition for deposits. A regulatory entrepreneur, Kansas Banking Commissioner J.N. Dolley, promoted securities regulation within Kansas and across the nation, with the ostensible purpose of protecting the public but the collateral benefit of enriching the banks he was supervising. The Macey-Miller paper disputes the standard account that explains blue sky laws as a response to abuses in securities sales during the first decade of the Twentieth Century. Although frauds and other misconduct no doubt occurred, Macey and Miller argue that interest group politics played a larger role.

State blue sky laws are still in place, but the most important source of regulation today is the federal securities laws – especially the Securities Acts of 1933 and 1934. George E. Bates

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8 The origin of the term “blue sky law” has long been debated. Rick A. Fleming has identified an account by Dolley, published in 1935, which claims that the term refers to the activities of Chicago fraudsters who, promising to make rain fall from the blue sky, sold an expensive rainmaking machine to credulous Kansas farmers during a drought and then absconded with the proceeds. Rick A. Fleming, 100 Years of Securities Law: Examining A Foundation Laid in the Kansas Blue Sky Law, 50 Washburn L.J. 583, 585-86 (2011).
and William O. Douglas’ 1933 paper, “The Federal Securities Act of 1933,” offers a contemporaneous analysis of the first of these laws. The authors approve of the investor-protection goal but criticize the law for not going far enough: “There is nothing in the Act which would control the speculative craze of the American public, or which would eliminate wholly unsound capital structures. There is nothing in the Act which would prevent a tyrannical management from playing wide and loose with scattered minorities, or which would prevent a new pyramiding of holding companies violative of the public interest and all canons of sound finance. All the Act pretends to do is to require the ‘truth about securities’ at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.” Bates and Douglas would have preferred to see a merit-based approach under which regulators could exclude from the market securities deemed to be unsafe. However, given that Congress had opted for disclosure rather than merit regulation, they recommend that courts and administrators enforce the law vigorously – a task to which Douglas himself contributed as an SEC Commissioner and later as a long-serving Justice of the U.S. Supreme Court.

Disclosure

Several papers in this compendium analyze fundamental questions about disclosure regulation. We begin with contributions by Chicago School economists. A seminal work is George J. Stigler’s “Public Regulation of the Securities Markets” (1964). Stigler, winner of the 1982 Nobel Prize in Economics, compares returns to investors in securities issued prior to mandatory disclosure with returns from securities issued after mandatory disclosure became law. Delighting some and irritating others, Stigler found few differences. Based on his study, Stigler questioned whether mandatory disclosure provides significant public benefits.

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George J. Benston’s 1973 paper, “Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934,”\textsuperscript{11} observes that issuers often revealed material information to investors even before the advent of mandatory disclosure. They shared information because fuller and more credible disclosures made their securities more attractive. Given this history, Benston suggests that mandatory disclosure is not necessary. It can even make things worse. For example, fearing liability for false disclosures, issuers may adopt overly conservative disclosure policies and thus deceive the market into undervaluing their securities. Benston provides empirical support for these concerns: he found that the disclosure requirements of the 1934 Act had no measurable positive effects. Thus, in his view, there was little basis for this legislation and no evidence that it was either necessary or desirable.

Gregg A. Jarrell’s 1981 paper, “The Economic Effects of Federal Regulation of the Market for New Security Issues,”\textsuperscript{12} updates the Stigler paper using more advanced methodological tools. Jerrell studied the systematic and unsystematic returns for the securities of manufacturing concerns issued between 1926 and 1939. He found that the five-year abnormal return performance of pre-SEC new issues was superior to that of the post-SEC new issues. Jarrell also found that mandatory disclosure reduced the portfolio risk of the of new debt and equity securities, a result he attributes to substitution effects (the issuer of risky securities might opt for an unregistered private offering, thus removing a high-volatility issue from the sample).

The Chicago School critique sparked vigorous and effective defenses of the existing system, notably by Joel Seligman\textsuperscript{13} and Irwin Friend and Edward Herman.\textsuperscript{14} These and other authors argued that Stigler and his followers were overly credulous in assuming issuers would voluntarily disclose bad news, and overly dismissive of the risks posed by unregistered securities.

\textsuperscript{13} Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1 (1983).
\textsuperscript{14} E.g., Irwin Friend & Edward Herman, The SEC Through a Glass Darkly, 37 J. Bus. 382 (1964).
The papers that emerged in the aftermath of this battle between advocates and opponents of mandatory disclosure gradually moved towards more balanced positions. Among these papers, the closest to the pure Chicago School approach is Frank H. Easterbrook and Daniel R. Fischel’s “Mandatory Disclosure and the Protection of Investors” (1984). Although these authors doubt that mandatory disclosure offers much value, and thus sympathize with the classic Chicago School critique, they also recognize that nontrivial public interest rationales can be advanced in support of this sort of legislation.

John C. Coffee, Jr.’s “Market Failure and the Economic Case for a Mandatory Disclosure System,” offers several efficiency-based rationales for mandatory disclosure. Coffee observes that the amount of information available to investors is lower than the social optimum due to the fact that information is a public good. Mandatory disclosure can make up some of the deficit. Coffee further argues that mandatory disclosure may be separately justified as a means for facilitating portfolio risk management.

Paul G. Mahoney’s 1995 article, “Mandatory Disclosure as a Solution to Agency Problems,” offers an alternative efficiency-based rationale. Mahoney argues that mandatory disclosure reduces the cost of monitoring promoters’ and managers’ use of corporate assets for selfish purposes. Mahoney’s paper is an important contribution to a literature that considers securities laws as serving a corporate governance function.

Douglas W. Diamond’s 1985 paper, “Optimal Release of Information by Firms,” explores the issue of information disclosure from a technical point of view. Under the specifications of his model, Diamond demonstrates that firms will voluntarily disclose information relevant to investors. Firms will disclose such information because the joint benefit

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to the firm and investors exceed the costs. These benefits are twofold: with voluntary disclosure by firms, investors will avoid inefficient duplication of research, and the public availability of information will reduce volatility by causing informed traders to operate with more convergence of opinion.

**Efficient Markets**

During the 1960s and 1970s finance economists became interested in the idea that markets such as the New York Stock Exchange were effective mechanisms for incorporating information into price. Eugene F. Fama’s 1970 paper, “Efficient Capital Markets: A Review of Theory and Empirical Work,” is an early summary of research. The author, winner of the 2013 Economics Nobel Prize, distinguishes three tests of market efficiency. Weak form tests ask whether prices adjust efficiently to information about past prices; semi-strong form tests examine the market’s response to public information; and strong-form tests evaluate the impact of all information including non-public information controlled by insiders.

Over time, enthusiasm for efficient markets was tempered by recognition that the ideal of market efficiency did not always align with evidence. A number of cases were identified in which market prices did not behave as predicted. Michael C. Jensen’s paper, “Some Anomalous Evidence Regarding Market Efficiency” (1978), illustrates how advocates of the efficient markets hypothesis responded to this empirical challenge. Notwithstanding the new evidence, Jensen stoutly defends the efficient markets hypothesis: “there is no other proposition in economics which has more solid empirical evidence supporting it.” He believes that the conflicting observations are due to inadequacies in the current state of knowledge rather than to any fundamental flaw in the theory. Jensen’s paper represents a high-water mark for believers in efficient markets, but also a portent of the future because, contrary to Jensen’s expectations,

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finance economists were not, in fact, able to explain all the anomalous observations within the
framework of the theory.

Charles M.C. Lee, Andrei Shleifer and Richard H. Thaler’s “Investor Sentiment and the
Closed-End Fund Puzzle” (1991), investigates one anomaly in detail. Closed-end funds hold
portfolios of securities. Unlike open-end funds, investors cannot cash out of a closed-end fund by
redeeming shares at net asset value. If an investor wants to exit a closed-end fund, she must sell
her shares on the market. The anomaly is that market prices of closed-end funds refuse to equate
to the net asset value of the fund portfolios. In other words, if the fund were liquidated,
shareholders would receive more (or sometimes less) than the pre-liquidation trading value of the
fund’s shares. Lee, Shleifer and Thaler test the hypothesis that rational investors interact with
“noise traders” whose decisions are based on irrelevant information (“noise”) rather than
economic fundamentals. The noise trader idea preserves the idea of efficient markets, but at a
cost: it recognizes that irrational traders sometimes drive prices away from efficient levels.

Some researchers formulated more fundamental critiques. Sanford J. Grossman and
argues that deviations from pricing efficiency are not limited to anomalous cases but instead are
inherent in markets themselves. The authors’ basic point is unassailable. If markets are
perfectly efficient then arbitrages could not exist; but without arbitrages no one would perform
the research needed in order to drive prices to efficient levels. The authors posit an equilibrium
in which inefficient prices incentivize arbitrageurs to perform research that in turn keeps prices
from being even more inefficient.

Faith in the efficiency of securities markets collided with experience during the financial
crisis of 2007-2009. It turned out that subprime mortgage-backed securities had been overpriced

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23 Stiglitz won the 1990 Nobel Prize for his work on market imperfections.
during much of the decade of the 2000s. More generally, the volatility manifested during the period of market turmoil challenged the notion that prices always reflect fundamentals. Ronald J. Gilson and Reinier Kraakman’s 2014 study, “Market Efficiency after the Financial Crisis: It’s Still a Matter of Information Costs,”\(^{24}\) concludes that problems brought to light by the crisis did not impeach the efficient markets hypothesis as originally formulated.\(^{25}\) Instead, the apparent conflict between the hypothesis and the testimony of experience was due to the misuse of the hypothesis by overenthusiastic academics and politicians who inflated it into something it was not. Viewed properly as a moderate, empirically grounded academic theory, the efficient markets hypothesis, in the authors’ view, not only emerged unscathed from the crisis, but even attained greater salience for an invigorated debate about how financial markets should be regulated in order to avoid a repeat of the disaster.

**Asset Pricing and Diversification**

Complementing the concept of market efficiency are fundamental and important theories concerning portfolio diversification and asset pricing.

The notion that the risk of a portfolio can be reduced by spreading investments across instruments with uncorrelated returns is as old as finance itself. Devotees of Shakespeare will recall Antonio’s explanation, in *The Merchant of Venice*, for why he was not anxious about his investments: “My ventures are not in one bottom trusted, nor to one place, nor is my whole estate upon the fortune of this present year. Therefore my merchandise makes me not sad.”\(^{26}\) Portfolio theory lends precision to the idea of diversification and also establishes one of the foundation stones of modern finance: by diversifying a portfolio, an investor can reduce risk without sacrificing expected return. If investors are risk-averse (as most are), then diversification can unambiguously enhance both their welfare and the welfare of society.

\(^{24}\) Ronald J. Gilson and Reinier Kraakman (2014), ‘Market Efficiency after the Financial Crisis: It’s Still a Matter of Information Costs’, *Virginia Law Review*, 100 (2), April, 313–75

\(^{25}\) These authors had previously written an influential summary during the heyday of market efficiency. Ronald J. Gilson and Reinier Kraakman (1984), The Mechanisms of Market Efficiency, *Virginia Law Review*, 70 (4), May, 549–644

Harry Markowitz’s 1952 paper, “Portfolio Selection,”27 is a fundamental contribution to the literature on portfolio diversification. Markowitz, who received the 1990 Economics Nobel Prize for his contributions to the portfolio theory, here sets forth the principle that efficient diversification does not mean investing in many securities but rather investing in securities that have low co-variances. The author establishes that an investment strategy is not one that maximizes expected return but rather one that considers both the risk and the return of the entire portfolio. These ideas, now second-nature for portfolio managers, were not widely understood in 1952 when Markowitz published his paper.28

The theory of portfolio diversification is an ingredient of the capital asset pricing model outlined in William F. Sharpe’s “Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk” (1964)29 (Sharpe shared the 1990 Economics Nobel Prize with Markowitz). Sharpe’s paper was an important step in the development of the capital asset pricing model, which predicts the rate of return on an asset as a function of the risk-free rate of return and the security’s volatility relative to the market. Although it has been partially superseded by more sophisticated approaches, the capital asset pricing model introduced by Sharpe and others remains an essential part of the toolkit of modern finance.

**Securities Class Actions**

As originally enacted, the securities laws contemplated that they would be enforced by the SEC but said little about private enforcement. Courts, however, have recognized implied private rights of action to enforce these laws. The problem for private enforcement is the reliance requirement. Common law fraud requires proof that the plaintiff relied to her detriment on the defendant’s misrepresentations. Many securities fraud plaintiffs are unable to supply such proof because they have no records. Even if they could prove reliance, moreover, they face a second

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problem: whether they can join in a class action. Federal law allows damages class actions only when issues common to the class predominate over issues pertaining to individual plaintiffs. This requirement would not be satisfied if each and every plaintiff had to prove that she relied on the defendants’ misrepresentations. But in the absence of class action treatment, many valid claims would go unrewarded because the costs of bringing a separate action overwhelm the expected recovery.

In *Basic, Inc. v. Levinson*,\(^{30}\) the Supreme Court provided a way out of these problems. It endorsed the so-called “fraud-on-the-market” theory under which a plaintiff is presumed to have relied on the market price. The presumption relieved plaintiffs of the need to supply proof of reliance and also provided a means for satisfying the predominance requirement: individual issues did not swamp out the common issues if reliance was presumed as to each plaintiff.

Several papers address issues presented by the *Basic* decision. Jonathan R. Macey and Geoffrey P. Miller’s 1990 article, “Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory,”\(^{31}\) critiques the opinion for imposing liability on corporate managers who had arguably done nothing other than serve the best interests of their company (executives had attempted to maintain the secrecy of merger negotiations by falsely representing that no such negotiations were underway). More generally, the Macey-Miller paper suggests the potential benefits of a broader theory that would combine principles of corporate finance and considerations of economic efficiency. As yet, however, no such comprehensive theory has emerged.

John C. Coffee, Jr.’s 2006 study, “Reforming the Securities Class Action: An Essay on Deterrence and its Implementation,”\(^{32}\) offers an important critique of the fraud on the market doctrine. Coffee observes that if a securities fraud case generates a judgment payable by the

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issuer, much of the damages will flow to shareholders who purchased during the class period. The recovery is circular in that there is significant overlap between the parties who pay the damages (shareholders whose investments lose value due to the cost of satisfying the judgment) and the parties who receive the payment (many of the same shareholders). The problem of circularity, in Coffee’s view, is a serious flaw in the securities fraud class action – one that undermines both its compensation and the deterrence rationales. In place of the existing system, Coffee would impose greater liability on the individuals who caused the harm.

Donald C. Langevoort’s 2009 paper, “Basic at Twenty: Rethinking Fraud on the Market,” is an insightful effort by a legal scholar to make sense of Basic v. Levinson and later cases. A core problem, in Langevoort’s view, stems Justice Blackmun’s decision to cite the efficient markets hypothesis as a basis for crafting the presumption of reliance. The citation was unnecessary because the presumption could have been justified under traditional judicial doctrine. And it was problematic because the idea of efficient markets, although employed in Basic to justify a plaintiff-friendly rule on reliance, also supports plaintiff-unfriendly rules on other elements of the securities fraud cause of action such as materiality and loss causation. Langevoort’s analysis proved prescient given the Supreme Court’s 2014 decision in Halliburton II, which allowed defendants at the class certification stage to introduce evidence on price impact (whether the defendant’s misstatements materially affected price).

Takeovers

We now move from a consideration of prices and markets to the topic of corporate governance. The economic theory of corporate law has long recognized that managers of public companies are subject only to weak shareholder discipline. Because shareholders are numerous and disorganized, they only rarely act in concerted fashion to vote managers out of office.

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Boards of directors, moreover, are often allies of the chief executive officer and therefore are ineffective monitors of management’s performance.

One possible device for limiting the agency costs of management is the corporate takeover. The standard law-and-economic account posits that if a firm’s management is performing poorly, the share price will be lower than if the assets were more efficiently deployed. A corporate takeover, if successful, transfers management rights to a new team that can (or believes it can) make more profitable use of the assets. Because the firm is expected to be worth more under new management, the takeover bidder is able to offer a premium over current market price.

Henry G. Manne’s 1965 article, “Mergers and the Market for Corporate Control,” is a seminal contribution. Manne starts with a common assumption that mergers are per se undesirable because they reduce competition in a relevant market. While not disputing the importance of competition, Manne identifies a countervailing benefit. Takeovers, which Manne calls the “market for corporate control,” are valuable mechanisms for controlling the agency costs of management.

In response to Manne’s article, opponents of hostile takeovers pointed to the potential benefits of managerial resistance. They observed that the bidder’s first offer is usually not its reservation price. Thus, unless the target’s board is equipped to haggle, bidders can pick off companies at bargain prices. Moreover, the first bidder may not be the most efficient user of the assets. The first bidder may be better than the incumbent managers, but some other group, as yet unknown, may be better still. Accordingly, economic efficiency may dictate that incumbent managers be empowered to resist or even reject takeover bids.

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Frank H. Easterbrook and Daniel R. Fischel’s 1981 article, “The Proper Role of a Target’s Management in Responding to a Tender Offer,” responds to this critique. The authors recognize that resistance to takeovers may trigger a bidding contest that increases the takeover premium, but conclude nevertheless that managers should not engage in defensive tactics. The authors argue that the benefits of a bidding contest for the target’s shareholders are outweighed by the social costs of discouraging bids in other cases. Easterbrook and Fischel recommend that the proper role of management in responding to a takeover bid is to remain passive – neither to encourage the bid nor to undertake defensive measures to ward it off. Because managers never encourage hostile bids – otherwise the bid would not be hostile – their article essentially proposes that managers should be disabled from resisting hostile bids.

Lucian A. Bebchuk’s 1982 essay, “The Case for Facilitating Competing Tender Offers,” takes issue with the Easterbrook-Fischel position. While Easterbrook and Fischel recommend board passivity, Bebchuk argues that managers should be empowered to facilitate competing bids. Such actions would benefit shareholders while not unduly reducing incentives for bidders in other cases. Bebchuk’s approach is similar the one adopted in the European Directive on Takeover Bids, which requires managers to abstain from actions that may influence the outcome of a takeover other than measures designed to extract a higher bid.

Much of the early literature on takeover bids was based on theoretical considerations. But since takeover bids actually occur, their effects can be measured. Is the market for corporate control beneficial for shareholders and the public, as Manne argued, or is it a dangerous distraction for management and a pernicious spur to short-term thinking, as detractors claimed?

Michael C. Jensen and Richard S. Ruback’s “The Market for Corporate Control: The Scientific Evidence” (1983), summarized the evidence compiled to the date of their paper. They found

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that corporate takeovers generate positive gains for the target firms. Meanwhile shareholders of bidding firms did not lose. Although generally supportive of takeovers, the Jensen-Ruback paper presented a puzzle. Why are the gains from takeover bids unequally distributed as between targets and bidders; and why are managers of bidding firms so keen on pursuing takeovers when the expected returns to their shareholders are negligible? A possible inference is that managers of bidding firms pursue goals unrelated to shareholder benefit, such as empire building. But their actual motivations have never been fully explained.
Insider Trading

We defined a security as a risky claim on assets and/or income stream of a firm, acquired and held under conditions of imperfect and asymmetric information and distributed to investors along with other functionally identical instruments. Implicit in this definition is the possibility that insiders with material information about firm value, unless barred by contract or law, can profit at the expense of uninformed traders. Commentators generally have viewed insider trading as undesirable – harmful to uninformed traders and unduly generous to those who are informed. A minority of commentators associated with the Chicago School dissented. Henry G. Manne’s 1966 article, “In Defense of Insider Training,” is a seminal contribution. Manne argues that insider trading does not harm uninformed investors, who would have sold anyway and who obtain a better price when insiders are buying. Meanwhile, the right to trade on inside information incentivizes entrepreneurship in a way that more conventional forms of compensation do not.

Dennis W. Carlton and Daniel R. Fischel’s article, “The Regulation of Insider Trading” (1982), argues that regulation of insider trading should be left to the issuing firm. If the firm concludes that objections to insider trading are valid, it will prohibit the practice. If it concludes that the objections are not valid or that the benefits of insider trading outweigh the costs, it will allow the practice. Because the private sector can effectively police against any harm, the law should not intervene.

David D. Haddock and Jonathan R. Macey’s 1986 paper, “A Coasian Model of Insider Training,” builds on the Carleton-Fischel article. In a world without transactions costs, insider trading restrictions would be unnecessary because affected parties (shareholders and managers)
would bargain for mutual advantage and thereby arrive at the socially efficient solution.

Haddock and Macey argue that the bargaining process would result in contracts under which managers are allowed to trade (but receive lower direct compensation) in cases where shareholders do not have access to the information that results in trading profits.

The Chicago critique provoked a spirited response from commentators who endorsed the traditional view. An example is James D. Cox’s 1986 paper, “Insider Training and Contracting: A Critical Response to the ‘Chicago School.’” Cox observes that insiders benefit from unanticipated losses as well as gains and thus have a perverse incentive to cause the firm to under-perform if insider trading is allowed. He argues that firms have alternatives other than insider trading if they wish to compensate managers for entrepreneurship. As for the argument that firms can prohibit insider trading, Cox claims that even if such a contract were possible, it could not be efficiently written because the key information about costs and benefits is vested in managers whose self-interest will skew their reports. Beyond this, Cox argues that a prohibition on insider trading is essential for effective governance: shareholders need to know how managers are compensated and require assurance that managers will focus on maximizing shareholder value rather than on maximizing opportunities for trading profits.

A technical study with implications for insider trading is Lawrence R. Glosten and Paul R. Milgrom’s, “Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders” (1985). The authors model a market hosting informed traders, uninformed traders and uninformed market-makers (specialists). They demonstrate that one reason for the bid-ask spread is that the specialist knows she may be transacting with an informed trader. The bid-ask spread compensates the specialist for this risk. The size of the spread is a function of the frequency of insider trades. An implication of the Glosten-Milgrom paper, more fully developed in later work, is that insider trading can adversely affect market liquidity – for the obvious reason

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that uninformed traders shy away from the market if they know they are likely to encounter an informed party on the other side.

Behavioral Finance

Beginning in the 1980s, a new approach to corporate finance assumed prominence in academic and policy circles. Behavioral finance expands on neoclassical finance by modeling imperfectly rational investor behavior. This discipline gained momentum when it became apparent that neoclassical theory could not satisfactorily explain certain aspects of financial markets. The prestige of behavioral finance skyrocketed as a result of doubts triggered by the financial meltdown of 2007-2009. This collection includes several examples of behavioral analysis.44

Malcolm Baker, Jeffrey Wurgler and Yu Yuan’s 2012 paper, “Global, Local, and Contagious Investor Sentiment,”45 investigates a topic alien to a pure form of neoclassical finance. The idea of “sentiment” suggests that investors’ trading decisions can be based, not on an abstract analysis of risk and return, but rather on emotions – positive or negative – that affect market participants in common ways. Recognizing the difficulty of measuring sentiment, the authors construct and validate a measure based on observable proxies. They study “twins” – pairs of securities with equal cash flows that trade in different markets at different prices. Baker, Wurgler and Yuan find that when sentiment is high, future returns are low on difficult-to-arbitrage and difficult-to-value stocks. In addition, the authors provide evidence for the propagation of investor sentiment through the mechanism of capital flows.

David Hirshleifer’s 2001 paper, “Investor Psychology and Asset Pricing,”46 takes up the issue of asset pricing from a behavioral perspective. The foundational work by Sharpe and others modeled asset pricing as a rational exercise based on risk and return. In Hirshleifer’s account,

assets should be valued based on considerations of risk and misvaluation – mistaken estimates made by imperfectly rational investors. Hirshleifer catalogues biases that may impair an investor’s ability to value securities accurately – phenomena such as heuristics, self-deception, and lack of emotional control. Although not all economists would agree with Hirshleifer that the field of asset pricing is in “vibrant flux” due to the advent of behavioral finance, the view presented in this paper is a serious challenge to more conventional approaches.

Robert J. Shiller’s 2003 paper, “From Efficient Market Theory to Behavioral Finance,” provides an intellectual history of behavioral economics, including an account of the author’s own journey away from the neoclassical approach. Shiller’s description is reminiscent of Thomas Kuhn’s model of scientific revolutions. A paradigm dominates a field of study (neoclassical finance). Over time, observations accumulate that seem to contradict the predictions of the paradigm (e.g., the anomalies observed in connection with the efficient markets hypothesis). The profession deals with the problems by incorporating them into the paradigm (e.g., “noise traders”) or discounting them as experimental errors. Eventually a new generation of researchers arises, not wedded to the old approach, and a new paradigm comes to be accepted – usually retaining much of the old model, but refining and revising it in fundamental ways (behavioral finance). Whether behavioral finance will succeed at replacing the dominant approach remains to be seen; but bright economists such as Shiller believe this is a consummation devoutly to be wished.

An indication of the inroads behavioral finance has made in economic thinking is found in Stephen J. Choi and A.C Pritchard’s 2003 article, “Behavioral Economics and the SEC.” Although Choi and Pritchard are skeptical about the magnitude of behavioral effects, their paper begins by stating a set of propositions that twenty years earlier would have been controversial:

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“there is no shortage of evidence that many investors’ decisions are influenced by systematic biases that impair their abilities to maximize their investment returns. . . . And we are not just talking about widows and orphans here. There is evidence that supposedly sophisticated institutional investors – mutual funds, pension funds, insurance companies – suffer from similar biases that impair their decisions. These biases are not merely isolated quirks, rather, they are consistent, deep-rooted, and systematic behavioral patterns. Apparently even the considerable sums at stake in the securities markets are not enough to induce market participants to overcome these cognitive defects on a consistent basis.” Comments such as these, coming from scholars not strongly associated with the behavioral approach, illustrate how deeply the new paradigm has affected contemporary thinking.

Choi and Pritchard examine the implications of behavioral biases for regulatory practice. They ask whether shortcomings in investor rationality provide a basis for enhancing the SEC’s regulatory authority. Here, the authors adopt a cautious attitude. Investors are not the only ones affected by cognitive biases: regulators are equally prone to mistakes. Indeed, regulatory errors may even more problematic: “Markets deal harshly with fools; our cynical side worries that government affords a safe haven.” Choi and Pritchard conclude, therefore, that regulations designed to limit individual investment choices on behavioral grounds require strong justification. The authors are more favorably disposed towards programs, such as investor education initiatives, designed to assist investors in overcoming behavioral biases.

**Regulatory Design**

The Choi-Pritchard paper segues into the next topic, namely the optimal design of regulation. Roberta Romano’s 1998 study, “Empowering Investors: A Market Approach to Securities Regulation,”50 argues that authority over securities transactions should be distributed to governments on a competitive basis. She recommends that participants in this market could select among fifty states, the District of Columbia, the SEC, and other nations. Choice of law

rules for securities transactions would be revised to follow the issuer’s securities domicile rather than the site of the transaction. Romano argues that competitive federalism of this sort would improve regulation because the regulator selected by issuing firms would likely be the one offering the most efficient terms.

Jennifer H. Arlen and William J. Carney’s 1992 paper, “Vicarious Liability for Fraud on Securities Markets: Theory and Evidence,”51 considers an important issue in the law of compliance: to what extent should penalties for misconduct be imposed on the misbehaving organization, and to what extent should the penalties be imposed on the individual employees whose actions caused the violation? Breaking with the conventional account, which favored vicarious liability for the organization, the authors argue for penalizing the culpable officials. They observe that these officials act in their own self-interest even if their conduct in office has a sufficient connection with their official responsibilities. Moreover, fines assessed against institutions effectively penalize shareholders who are innocent of misconduct but who must bear the financial burden. The authors call for a rule of agent liability, supplemented as appropriate by criminal penalties against the offending employees. In advocating for enhanced individual responsibility for corporate misconduct, Arlen and Carney set forth an argument that has gained traction in the decades since this paper appeared.

The Role of Shareholders

Securities are important, not only as investment vehicles, but also as devices for corporate control. The next section of this collection thus moves to a consideration of the role of securities in governance. John C. Coffee, Jr.’s 1991 article, “Liquidity versus Control: The Institutional Investor as Corporate Monitor,”52 discusses the potential as well as the limits of institutional investor monitoring of corporate managers. The author’s principal observation is that institutional investors face a tradeoff between liquidity and control. If they want to preserve

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liquidity – the ability to exit a corporation whose performance or prospects they dislike – then they will hesitate to accept control and the risks that come with it. An institutional investor with a block of stock sufficiently large to exercise meaningful influence on management is also an investor who has sacrificed liquidity because selling block ownership cannot be accomplished without sacrifice. Overall, Coffee doubts that institutional investor monitoring will accomplish much by way of overcoming agency costs. History has to some extent validated Coffee’s predictions. Although institutional investors have acquired an even larger share of U.S. listed securities in the years since this article was written, they have not, in general, emerged as active monitors of corporate management. On the other hand, extreme skepticism on this score has proved unwarranted. Activist investors today exercise substantial influence on target firms (for better or worse) and proxy advisory firms such as Institutional Shareholder Services coordinate votes of institutional investors in ways that were not foreseeable in 1991.

A matter of current debate is the topic of proxy access: the power of shareholders to nominate candidates for the board of directors. Advocates for an enhanced shareholder role in governance promote proxy access as a desirable method for controlling self-interested behavior by managers. Marcel Kahan and Edward Rock’s 2011 paper, “The Insignificance of Proxy Access,” takes a skeptical view. These authors argue that enhanced proxy access will generate few shareholder nominations, most nominees will be defeated, and nominees who are elected will have little impact. Kahan and Rock recognize that enhanced proxy access may shake up poorly performing boards and generate modest increases in company value. But these benefits are likely to be offset by costs: proxy access would increase companies’ expenses and could amplify the influence of shareholders whose interests are not aligned with those of the firm. Overall, Kahan and Rock predict that the net effect of proxy access will be close to zero.

Shareholder voting is also the subject of Henry T.C. Hu and Bernard Black’s 2006 study, “Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications and Reforms.”\(^{54}\) Hu and Black examine and analyze an intriguing development in the area of shareholder voting. Although corporations generally operate on the principle of “one share, one vote,” sophisticated financing techniques permit the decoupling of voting and economic ownership. In some cases this takes the form of what the authors call “empty voting” – voting power without a parallel economic interest; in other cases it takes the form of “hidden” or “morphable” ownership – an ownership interest that exceeds current voting power. The authors observe that the decoupling of voting and ownership can cause problems because voting decisions are no longer tied to the best interests of the company. Hu and Black view these developments as troubling and offer solutions. In the short run, they recommend simplifying and partially consolidating disclosure rules. They also sketch out longer-term responses. Whether the Hu-Black proposal sparks actual reforms probably depends on circumstances: if bad things happen that can be tied politically to decoupled voting, then legislatures or regulators are likely to act; if no such bad results occur, the Hu-Black paper may be remembered as an interesting exercise without long-term policy consequences.

**Comparative Perspectives**

In the past few decades, scholars have focused intensively on comparative work on the economics of securities law. The challenges are daunting given differences in language, varying institutional and constitutional settings, and limitations of data. Notwithstanding these and other obstacles, interesting and provocative papers have emerged from this comparative enterprise.

Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer’s 2006 article, “What Works in Securities Laws?”\(^{55}\) is an example of the potential, as well as the limitations, of comparative work. The authors examine rules on new public equity issues under the securities

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laws of 49 countries – a heroic feat of data gathering. They reject the hypothesis that securities laws do not matter: unregulated financial markets performed worse than markets in countries with robust regulation. The type of regulation mattered as well: laws performed best when they facilitated private contracting rather than when they provided for public enforcement. Extensive disclosure requirements and standards of liability facilitating investor recoveries were associated with larger stock markets. On the other hand, the independence of the regulator did not make much difference. Overall, the La Porta, Lopez-de-Silanes and Schleifer study suggests that U.S.-style regulation works better than more paternalistic systems.

Conclusion

The readings in this collection offer a multi-faceted view of the economics of securities law. Viewed from above, a common pattern emerges. The early days of research adopted a pro-regulatory philosophy born of the stock market crash and Great Depression. The conspicuously bad performance of securities markets during those years led many to believe that their toxic qualities could only be contained and neutralized by vigorous regulation. At the same time, the pro-regulatory attitude of the early years was tempered by a recognition that developed economies rely on markets to generate social wealth, and that overly intrusive government regulation – such as the merit regulation found in some state blue-sky laws – was likely to do more harm than good.

From the late 1960s through the 1980s, a new attitude emerged among scholars associated with the Chicago School. These researchers were both brilliant and dedicated to the proposition that existing regulatory arrangements imposed unhealthy restrictions on market ordering. Their faith in the efficacy of free markets generated fundamental critiques of many regimes of regulation – critiques that have had a lasting effect on how regulation of securities markets has been conceptualized. Yet the pure Chicago School philosophy would not hold. Over time, the approach was softened by scholars who took account of both its considerable strengths and its notable limitations.
In recent years, behavioral economics has offered a new approach. It is yet unclear whether the behaviorist challenge will topple the prevailing model or merely add color and nuance to the structure now in place. The odds are on the latter outcome: unless behaviorists can supply greater precision to their models, the prevailing approach is likely to remain grounded in a model of rational action. Even so, behavioral economics will almost certainly be acknowledged as having contributed substantially to the discipline.

Meanwhile, markets continue to misbehave. The financial crisis of 2007-2009 embarrassed nearly everyone. Believers in efficient markets were hard-pressed to explain how securities whose price depended on thousands of private mortgages could have lost so much of their value in a matter of months. Proponents of regulation were equally hard-pressed to explain why governments had so egregiously failed to recognize or prevent the crisis. It can hardly be doubted that events this traumatic will influence the next generation of researchers in the economics of securities law.