SHOULD CORPORATE DISCLOSURE BE Deregulated? Lessons From the US

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Abstract

Most publicly traded firms are subject to the periodic disclosure requirements of the securities laws. However, leading corporate governance academics argue that mandatory disclosure is unnecessary and should be eliminated: insiders taking firms public will voluntarily choose value-maximizing disclosure arrangements. I challenge this “deregulatory view” by examining the behavior of publicly traded US firms that were never subject to mandatory disclosure, and thus completely free to craft their own ongoing disclosure arrangements. I shows insiders taking such firms public could have used corporate law arrangements to commit, at their initial public offering (IPO), to provide adequate ongoing disclosure. However, since firms began selling shares to the public 150 years ago, such firms failed to commit at the IPO to provide ongoing disclosure. And, after going public, many of these firms offer little or no disclosure. The US experience suggests that deregulating disclosure would be undesirable. If anything, some form of mandatory disclosure should be extended to publicly traded firms currently beyond its reach. It also suggests that the market for corporate law arrangements is not, as these same deregulators argue, a race-to-the-top that yields optimal legal rules.

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INTRODUCTION

Most publicly traded firms in the U.S. are considered “reporting firms” subject to the mandatory periodic disclosure requirements imposed by the federal securities laws. Reporting firms must periodically provide the market financial information, as well as information about insiders’ self-dealing transactions and compensation arrangements. Reporting firms must also notify the market whenever there has been a material change in their financial condition or operations. Similar mandatory periodic disclosure rules have been adopted by other countries.

It is widely agreed that periodic corporate disclosure benefits the disclosing firm and its shareholders. Periodic corporate disclosure enables shareholders to better monitor managers, reducing agency costs. In particular, corporate disclosure can reduce inefficient self-dealing and – when there is no controlling shareholder – help constrain managerial slack and facilitate the transfer of the firm’s assets to better management teams. The reduction in agency costs, in turn,

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1 These periodic disclosure requirements are found in the Securities Act of 1933, the Exchange Act of 1934, and the Securities and Exchange Commission’s (SEC) regulations implementing these statutes. Companies are generally considered reporting companies subject to these requirements if they are listed on a national stock exchange, or are traded on NASDAQ or on certain other OTC (over-the-counter) markets. However, thousands of publicly traded companies, some of which may have thousands of beneficial owners, are not considered reporting companies subject to these requirements. See infra Part II.A.3

2 Reporting firms must disclose in their annual report detailed information on the firm’s financial results, its assets and financial condition, legal proceedings against the firm, and information on the firm’s officers and directors. See Item 303, Regulation S-K, Securities Exchange Act of 1934, 17 C.F.R. section 249.308a (2002).

3 See Form 8-K.


6 See, e.g., Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047, 1047 (1995) (arguing that periodic disclosure reduces the cost of monitoring managers’ use of corporate assets for self-interested purposes); Fox, Retaining Mandatory, supra note x, at 1355-69.

7 See Fox, Retaining Mandatory, supra note x, at 1355-69.
can increase firm value. Periodic disclosure also reduces shareholders’ information acquisition costs.\textsuperscript{8}

However, a number of leading legal academics and economists, including Professor Roberta Romano, have argued that there is no need for \textit{mandatory} periodic disclosure.\textsuperscript{9} They assert that markets are efficient: stock prices reflect, in an unbiased manner, all public information bearing on shares’ intrinsic value.\textsuperscript{10} Thus, insiders selling shares to the public would have an incentive to adopt periodic disclosure arrangements that might be called “firm-optimal”-ones that maximize firm value.\textsuperscript{11} Insiders failing to adopt such arrangements will simply get less for their shares.

Accordingly, these commentators assert, insiders -- not the government -- should choose firms’ disclosure arrangements. In particular, insiders should be permitted to select the disclosure regime that applies to the firm, just as they are permitted to choose the corporate law governing the firm.\textsuperscript{12} Jurisdictions, such as states or countries, could then compete to provide insiders with desirable disclosure regimes, much as American states (and other jurisdictions) currently compete in the corporate charter market.\textsuperscript{13}

This paper challenges the “deregulatory” approach to periodic disclosure -- that mandatory rules are unnecessary because insiders can be counted on to adopt firm-optimal disclosure arrangements. Part I describes the likely features of a firm-optimal periodic disclosure arrangement. It shows that insiders taking a firm public would be expected to offer, when they first sell shares to the public, an enforceable commitment to continue to provide more than a minimal amount of information to shareholders. Otherwise, insiders seeking to enrich themselves


\textsuperscript{10} See, e.g., Romano, \textit{Empowering Investors}, at 2366.

\textsuperscript{11} Romano, \textit{Empowering Investors}, at 2367.

\textsuperscript{12} Romano, \textit{Empowering Investors} at 2367; Choi and Guzman, \textit{Portable Reciprocity} at 903.

\textsuperscript{13} Roberta Romano, \textit{Empowering Investors} at 2367; Choi and Guzman, \textit{Portable Reciprocity} at 903.
at public shareholders’ expense could later choose to provide little or no disclosure in the secondary market.

Part I then shows that firms going public could create such an enforceable disclosure commitment even if they were outside of the securities laws’ mandatory disclosure regime. For example, firms could incorporate in a jurisdiction requiring a minimum level of disclosure. Alternatively, a firm could incorporate in a jurisdiction that does not require a minimum level of disclosure, but then put in their corporate charter a provision requiring such disclosure. In either case, shareholders would be able to hold the board liable if it failed to provide the designated level of disclosure.

Part II examines firms’ voluntarily chosen disclosure commitments at their initial public offering (IPO). It considers the thousands of publicly traded US firms that have never been subject to the securities laws’ mandatory disclosure rules and thus completely free, when going public, to choose their own periodic disclosure commitment. These firms include all the firms that went public before the enactment of the securities laws in the 1930s, as well as thousands of firms that sold shares to the public after the 1930s but, for one reason or another, were not considered reporting firms. Today, for example, public companies can escape the reach of the securities laws as long as they have fewer than 300 shareholders of record. For this purpose, the SEC defines “shareholder of record” as the brokerage house holding investors’ shares on their behalf. One brokerage house may hold shares for dozens or even hundreds of investors. Thus, a firm with thousands of shareholders that sells shares to the public can remain outside the mandatory disclosure regime as long as the shares are held by fewer than 300 brokerage houses and other shareholders of record.

Part II explains that the overwhelming majority (if not all) of these firms failed to commit, at their IPO, to provide periodic disclosure to investors. In the almost 150 years since U.S. corporations began selling stock to the public, no U.S. state has adopted (even as a default rule) a provision requiring widely-held firms not subject to the securities laws to periodically disclose a meaningful amount of information to shareholders. Nor is there any evidence that firms going public have placed such requirements in their corporate charters or taken any other step to commit to provide periodic disclosure.

Part III focuses on insiders’ disclosure choices – the level of disclosure chosen by insiders after their firm goes public. Not surprisingly, in the absence of an enforceable commitment to maintain a minimum amount of disclosure, insiders have frequently exploited their control over the level of disclosure to provide what is clearly less than the firm-optimal amount of disclosure. These firms

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14 Note that even firms that go public as reporting companies have some flexibility in their choice of disclosure commitment. For example, they could commit to voluntarily remain reporting companies even if the securities laws later permit them to exit the mandatory disclosure regime. However, my focus in this paper is on firms that were not considered reporting firms when they went public, and thus had no disclosure obligations other than the ones they created for themselves.
frequently do not provide basic financial information such as income statements. And they even more frequently refuse to supply information about executive compensation and self-dealing transactions to shareholders.

Part IV considers the implications of the paper’s finding for the desirability of deregulating disclosure. The failure of firms that were free to choose their own disclosure arrangements to voluntarily commit to maintain disclosure suggests that deregulating disclosure is likely to lead to less than the firm-optimal level of disclosure in many firms. Left to their own devices, firms can be expected to fail to commit to provide adequate information to investors, and many will subsequently provide little information to shareholders. Thus, from an economic perspective, it may be undesirable to allow insiders of firms that would otherwise be considered reporting firms to choose their own disclosure arrangements when selling shares to the public. Indeed, it may well be desirable to extend some form of mandatory disclosure to those publicly traded companies with hundreds (or thousands) of shareholders but fewer than 300 shareholders of record.

Part IV also discusses the implications of the paper’s analysis for a separate, but conceptually related, debate in corporate law: whether competition among states for corporate charters is likely to yield optimal legal rules. Many of the same proponents of deregulating disclosure law have argued that firms seek, and states compete to offer, value-increasing corporate law rules.15 This paper shows that a firm-optimal disclosure arrangement would entail a mechanism to prevent insiders from unilaterally choosing a low level of disclosure after the firm goes public. However, no U.S. state has ever adopted (even as a default rule) a provision requiring widely-held firms that are exempt from mandatory disclosure under the securities laws to provide more than a minimal amount of information to shareholders. Indeed, the most popular state for incorporations, Delaware, imposes no informational requirements. If state corporate law has failed to develop desirable periodic disclosure rules for these public companies, there is no reason to be confident that charter competition leads to optimal rules in other areas of corporate governance.

It is worth distinguishing my critique of the deregulatory view from those that have been offered by other commentators. The most sustained challenge to the deregulatory view, that offered by Merritt Fox, has a different basis: interfirm externalities. Fox agrees with Romano and others who favor deregulating disclosure that firms can be counted on to adopt firm-optimal disclosure arrangements.16 Nevertheless, he argues, mandatory disclosure is needed because disclosure creates significant externalities on other parties, including other firms.17 Thus, the arrangements adopted by firms, even though they are

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firm-optimal, are unlikely to be socially optimal. Those favoring regulatory competition accept Fox’s view that the desirability of legal rules and arrangements turns on their social optimality.\(^{18}\) However, they argue, there is no divergence between firm and socially optimal levels of disclosure.\(^{19}\) The firm optimal level of disclosure is the socially optimal level of disclosure.

My criticism of the deregulatory view goes much further than Fox’s. I show that insiders free to choose their own disclosure arrangements fail to offer even firm-optimal disclosure arrangements when taking their firms public. Thus, some form of mandatory disclosure is likely to be needed even if, as the deregulators argue, inter-firm disclosure externalities of disclosure are insignificant.

Another criticism of the deregulatory view is that insiders of firms that have already gone public cannot be counted on to offer an adequate level of disclosure.\(^{20}\) Thus, eliminating mandatory disclosure will hurt shareholders of firms that have already gone public. Indeed, as we will see, in the absence of an enforceable commitment to disclose, insiders will often provide little or no disclosure. My criticism, however, is that even firms that have not yet gone public cannot be counted on to offer firm-optimal disclosure arrangements when they go public.

In this paper, I abstract from the question of why firms going public fail to adopt firm-optimal disclosure arrangements. My own view, which I develop in other work, is that market pricing imperfections reduce and in some cases eliminate insiders’ incentives to adopt firm-optimal arrangements. Indeed, under certain market conditions, providing a firm-optimal amount of disclosure can reduce the price insiders get for their shares. In particular, when noise traders are expected to bid up the price of stock above its actual value, the provision of firm-optimal amount of disclosure may facilitate the entry of short-sellers whose trading will force down the price.\(^{21}\)

However, my sole purpose here is to show that, contrary to the claims of those seeking to deregulate disclosure (and even some of those, such as Professor

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\(^{18}\) As do I.

\(^{19}\) See, Romano, supra note x, at ____.


\(^{21}\) See Jesse M. Fried, Corporate Disclosure in Noisy Markets (working paper, 2007).
Fox who favor mandatory disclosure), firms cannot be counted on to adopt firm-optimal disclosure arrangements. Once scholars recognize that firms fail to adopt even firm-optimal arrangements, they may have a greater interest in trying to figure out why this “market failure” arises. My goal in this paper is to contribute to bringing about such a recognition.
I. FIRM-OPTIMAL PERIODIC DISCLOSE ARRANGEMENTS

Commentators proposing deregulation of disclosure argue that firms can be counted on to adopt firm-optimal corporate disclosure arrangements—those that maximize firm value. The purpose of this Part is to describe what a firm-optimal disclosure arrangement is likely to look like, and to show that firms could use corporate law mechanisms to achieve such an arrangement.

Before proceeding, it is important to define “firm value.” By “firm value,” I mean the total amount of value available to a firm’s insiders and public shareholders over time: the value flowing through the firm to insiders and public shareholders, less public shareholders’ trading costs, including the cost of acquiring information to make trading decisions. The firm-optimal arrangement is that which maximizes this value.

Section A briefly explains how a periodic disclosure requirement affects firm value. Section B shows that the firm-optimal disclosure arrangement is likely to provide more than a minimum amount of conflict information—information about insiders’ self-dealing transactions—as well as financial information about the firm. Section C explains why the firm-optimal disclosure arrangement would have a mechanism requiring insiders to provide a specified amount of information. It then describes corporate-law arrangements that could be used for this purpose.

A. Periodic Disclosure Requirement and Firm Value

A periodic disclosure requirement increases the amount of information available to current shareholders and potential buyers. This additional information, in turn, better enables current shareholders to monitor insiders, reducing agency costs and increasing firm value. A periodic disclosure requirement also reduces investors’ cost of acquiring information to make trading decisions. However, the provision of this additional information also imposes some costs on the firm and its shareholders. Thus, the firm-optimal amount of information is unlikely to include all firm-specific information that could be disclosed.

1. Increased Information

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22 See, e.g., Romano, Empowering Investors, supra note x, at 2367. Even some defenders of mandatory disclosure take this view. See, e.g. Fox, Issuer Choice, supra note x, at 567.

23 As indicated in the introduction, corporate disclosure can also give rise to externalities on parties other than the firm and its shareholders, such as other firms. My analysis abstracts from these externalities and focuses solely on periodic disclosure’s effect on the disclosing firm and its current and future shareholders.
The release of certain types of information can sometimes make insiders worse off. As I will discuss in more detail below, information about insiders’ self-dealing transactions and the firm’s financial condition enable shareholders to better monitor insiders, reducing insiders’ ability to engage in self-dealing and extract other private benefits. 

Accordingly, insiders cannot be expected to voluntarily share all relevant information about the firm with shareholders. Indeed, there is ample evidence that, to the extent insiders are not required to disclose information, they often suppress information whose release would hurt them.

Because insiders will not voluntarily share all information with public investors, a periodic disclosure requirement forces insiders to disclose information that they would otherwise suppress. It thus increases the amount of information available to current shareholders and the market.

2. Increased Information and Firm Value

The increased information provided by a periodic disclosure requirement can, in turn, affect firm value. As we will see, the increased flow of information generated by a periodic disclosure requirement can have both positive and negative effects on firm value.

a. Increased Information: Benefits

Two important benefits to a firm and its shareholders of the increased flow of information resulting from required periodic disclosure are (1) a reduction in agency costs and (2) a reduction in trading costs.

1. Lower Agency Costs

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24 By “insiders”, I mean the firm’s officers, directors and controlling shareholder (if any).

25 See infra Part I.A.2.a.1. The release of information can also affect the stock price in ways that hurt insiders. For instance, the release of “bad news” – information that would cause the stock price to fall – may hurt insiders about to unload their shares.

26 To the extent permitted by the securities laws’ relatively strict mandatory disclosure requirements, managers can and do suppress both good and bad news when it is in their interests. See S.P. Kothari, Susan Shu, and Peter Wysocki, Do Managers Withhold Bad News (working paper, 2005 at 13) (reporting that managers not only time the release of good and bad news, but stock prices behave as if managers succeed in influencing them to their benefit).

27 By “amount” of information, I mean not only the volume of information but also the quality of the information: its timeliness, accuracy, and transparency.
As is widely recognized, the separation of ownership and control in large public corporation gives rise to agency costs. The agent-managers of these firms, who have significant discretion, may take steps that hurt the principal-shareholders in ways that reduce the size of the corporate pie. For example, they may engage in inefficient self-dealing transactions or fail to make firm-optimal business decisions. Agency costs also arise in firms with controlling shareholders. In such firms, public shareholders’ biggest concern is that controlling shareholders will engage in self-dealing transactions that divert value from the public shareholders to themselves.

Corporate law provides a variety of tools for minimizing these agency costs. Fiduciary suits can be used to police self-dealing transactions. In the case of a widely-held firm, proxy challenges and the sale of shares to a hostile acquirer can be used to replace unscrupulous or incompetent managers. Indeed, the mere threat of replacement is likely to have a significantly disciplining effect on management.

However, all of these shareholder monitoring mechanisms require information. The threat of litigation will not deter managers and controlling shareholders from inefficient self-dealing if shareholders cannot easily determine that self-dealing is occurring. In widely held firms, shareholders cannot effectively use their ability to vote out directors without reasonably detailed financial information to assess their effectiveness. And potential hostile acquirers are less likely to make a bid if they lack the information necessary to ascertain the firm’s intrinsic value.

The additional information provided by a periodic disclosure requirement therefore assists shareholders in monitoring managers and controlling shareholders. Improved monitoring, in turn, reduces insider self-dealing, thereby increasing firm value. In widely held firms, the improved flow of information and better monitoring may actually facilitate the replacement of the management team with a better one. Potential acquirers are more likely to make a bid if they have an accurate and up-to-date picture of the firm’s financial and operating conditions. Thus, in both widely held and insider-controlled firms, required periodic disclosure can increase firm value by helping shareholders reduce agency costs.

2. Lower Trading Costs

By increasing the amount of information available to both the firm’s current shareholders and its future shareholder (those buying the stock), periodic

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disclosure also reduces the cost to these investors of acquiring information to make trading decisions.

Absent disclosure of certain information ("X"), each investor might incur costs attempting to learn or estimate X. The cost to an outside investor of learning or estimating X would be substantially higher than the cost to the company of revealing X (to which it has ready access).

Moreover, many investors may incur the cost of learning or estimating X. Thus the aggregate cost to investors of learning X would be even higher. Required periodic disclosure of X will thus substantially reduce trading costs of a firm’s shareholders.31

b. Increased Information: Costs

The additional information provided as a result of a periodic disclosure requirement imposes some costs on the firm. To begin, there are the direct costs of gathering and reporting the information. But the direct costs of reporting most firm-related information is likely to be very low: The firm already has, or should have, the necessary information.

More significantly, there could be indirect costs: disclosure might reveal information to competitors of the firm that these competitors can use to the firm’s disadvantage, reducing firm value.32 For example, the information may reveal that there are large profits to be made in the firm’s industry, causing other firms to enter and eroding the firm’s market power. Thus, the disclosure of additional information increases firm value only if the marginal benefit of this information exceeds the marginal cost.

B. The Value-Maximizing Amount of Required Periodic Disclosure

We saw in Section A that periodic disclosure requirement can increase the flow of information to the market, which in turn can affect firm value in various ways. The costs and benefits of disclosing different types of information vary from firm to firm. Thus, the firm-optimal amount of a firm’s periodic disclosure requirement may differ from firm to firm. It may even vary over time in a particular firm.

However, as I discuss in more detail below, the firm-optimal periodic disclosure arrangement is almost always likely to provide more than a minimal amount of two types of information: (1) ”conflict information” relating to transactions between insiders and the firm, such as self-dealing transactions and

31 See Coffee, Market Failure, supra note x, at 733-34; Goshen and Parchomovsky, supra x, at 738.

32 See Goshen and Parchomovsky, supra note x, at 756.
executive compensation; and (2) “financial information” relating to the firm’s financial condition and operating performance.33

1. Conflict Information

The firm-optimal amount of disclosure will almost always include conflict information – information about conflict-of-interest transactions and executive compensation. That is, the benefits of disclosing this information – primarily in reducing agency costs – will generally outweigh the costs to the firm and its shareholders.

a. Benefits

Disclosure of conflict information provides a benefit by reducing inefficient self-dealing. In particular, the disclosure of such information allows dispersed shareholders to more easily monitor for illegal self-dealing that could subject insiders to liability for breach of their corporate law fiduciary duties.34 It also enables shareholders to monitor for legal but objectionable self-dealing that, if uncovered, could lead to shareholder outrage that increases the likelihood of a control challenge.35 Disclosure of conflict information is thus likely to deter some forms of inefficient self-dealing that insiders would otherwise engage in, increasing firm value.

Importantly, the agency costs associated with self-dealing can be policed through the threat of derivative and direct litigation. The disclosure of conflict information is thus beneficial even if there is no threat of a proxy challenge or a hostile takeover. Thus, the disclosure of conflict information is likely to be beneficial whether or not insiders own a majority of the firm’s shares.

Indeed, the more power insiders have, the more likely they are to engage in self-dealing. As a result, the disclosure of conflict information will be even more beneficial for controlling agency costs in those firms where insiders have control. Thus, we would expect the benefits of such disclosure of conflict information in insider-controlled firms to be at least as high as in widely-held firms.

b. Costs

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33 See, e.g., Fox, Issuer Choice, at 567.

34 See, e.g., Goshen and Parchomovsky, at 717.

The costs of disclosing conflict information are likely to be very low.\(^{36}\) As indicated earlier, the direct costs of disclosing any type of firm-specific information are trivial. The indirect costs of disclosing conflict information are also likely to be minimal in most cases. Information about self-dealing transactions and executive compensation will generally not provide information to a firm’s competitors that can be used at the disclosing firm’s expense.

2. Financial Information

The firm-optimal amount of required disclosure will generally include at least some financial information, such as an income statement and balance sheet, along with at least some explanation for the methods used in constructing them. The value-increasing effect of disclosing at least some of this information will generally outweigh the value-decreasing effect on the firm.

a. Benefits

The disclosure of additional financial information is likely to reduce agency costs and trading costs in all firms, particularly in firms where insiders are vulnerable to a control challenge.

All Firms. Disclosure of financial information can increase firm value by facilitating shareholder monitoring of self-dealing and conflict transactions. Shareholders may find it difficult to determine the existence and magnitude of inefficient self-dealing without basic information about the firm’s operations and performance. For example, it would be difficult to know the damage done by a self-dealing transaction, and whether it is economically “material” relative to the value of the company, without financial information.

The required disclosure of financial information is also likely to reduce shareholders’ trading costs. Current shareholders considering whether to sell their shares, and potential buyers considering whether to buy shares, will wish to determine whether the stock is worth selling or buying at the current trading price. Such a determination will require considerable amounts of financial information. Required periodic disclosure can provide such information at low cost. Thus, the provision of financial information can reduce not only agency costs but also shareholder trading costs.

Widely-held Firms. If the firm is widely held and thus vulnerable to a control challenge, the provision of financial information will further reduce agency costs. In particular, it will help outsiders assess whether a takeover or proxy challenge would be worthwhile. This, in turn, increases the likelihood of a hostile takeover or proxy challenge if managers run the firm poorly.\(^{37}\) In firms where insiders do not own a control block of shares, periodic disclosure of financial information can thus increase firm value by reducing managerial shirking and entrenchment.

\(^{36}\) Mahoney, supra note x, at 1092.

\(^{37}\) Goshen and Parchomovsky, supra note x, at 742-43.
In such firms, disclosure of financial information can also increase intrinsic value through another channel: by facilitating replacement of the current managers with a better team. If managers are not competent, the threat of ouster may reduce managerial shirking but still not maximize intrinsic value. The only way to increase intrinsic value is to replace the managers with better ones. Potential acquirers are more likely to make a bid if they have an accurate and up-to-date picture of the firm’s financial and operating conditions.

b. Costs

The costs associated with the disclosure of financial information are likely to be higher than the costs associated with conflict information. The disclosure of financial information, like the disclosure of conflict information, gives rise to relatively small transaction costs: those associated with gathering and reporting the information disclosed. Thus, the direct costs are likely to be relatively low.

However, there are likely to be indirect costs of disclosing financial information. Such information can benefit third parties that, in turn, can use the information to reduce the firm’s value. For example, financial information may reveal that the firm has high margins in a particular market, causing competitors to enter and reducing the firm’s intrinsic value. These indirect costs, which may far outweigh the direct costs, are also likely to increase with the amount of disclosure. Nevertheless, given the large agency cost and trading cost benefits of the disclosure of financial information, the firm-optimal amount is likely to be more than minimal in most cases.

C. Enforceability of Disclosure

We have seen that the firm-optimal disclosure arrangement would include both conflict and financial information. As this Section explains, a second critical feature of a firm-optimal disclosure arrangement is a mechanism that ensures that insiders continue to provide a minimum amount of information to shareholders. Below I explain in more detail why insiders may have an incentive to provide less than the firm-optimal amount of disclosure after they have sold shares to public investors. I then describe several mechanisms firms could use to make it difficult for insiders to provide less than a specified amount of disclosure in the secondary market.

1. Insiders’ Incentive to Under-Disclose in the Secondary Market

38 See Fox, Retaining Mandatory at 1345-46 (arguing that certain firm disclosures will have effects on third parties, such as supplier and customers, that will not be internalized by the firm); Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom, 95 MICH. L. REV. 2498, 2562-69 (1997).
Proponents of deregulating disclosure often assume that insiders of a firm will voluntarily provide a desirable amount of disclosure in the secondary market. They argue that, absent such disclosure, the stock price will drop because of a “lemons problem”: buyers will fear that no news is bad news. \(^{39}\) Thus, insiders of public firms will have no choice but to offer an adequate amount disclosure in the secondary market.

As I argue elsewhere, it is far from clear that in real world markets a low level of disclosure will reduce the stock price. \(^{40}\) In the absence of sufficient information, “noise traders” might bid the price above the intrinsic value; more rational investors, lacking the information to determine whether the stock is overpriced, will decline to sell the stock short. As a result, the stock price can remain inflated. In such a setting, the provision of additional information can actually reduce the price of the stock.

However, even if the absence of sufficient information reduces the stock price, insiders could not be counted on to provide the firm-optimal amount of information. There are two situations in which insiders are better off with a low level of disclosure even though it leads to a lower stock price.

First, where sub-optimal disclosure leads to a lower stock price, the reduction in stock price may actually benefit insiders. Insiders are generally net sellers of stock and thus tend to prefer a higher price. However, insiders may sometimes wish to take the firm private or put together and sell a controlling stake to a third party. To the extent that reducing disclosure hurts the stock price by, for example, creating a lemons problem, insiders wishing to buy large amounts of stock may have an incentive to reduce disclosure in order to buy the stock more cheaply. \(^{41}\) Indeed, there is evidence suggesting that they do so. \(^{42}\)

Second, insiders may reduce disclosure to extract more private benefits. We saw that periodic disclosure reduces expected managerial agency costs by making it more difficult to engage in self-dealing and facilitating the market for corporate control. Reducing these costs will increase firm value. However,

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\(^{41}\) See Coffee, *Market Failure*, at 722 (1984) (noting that managers have an interest in acquiring the shareholders' ownership at a discounted price through insider trading or management buyouts).

\(^{42}\) See, e.g., Bernard Condon, *Don't Throw Me in That Briar Patch*, FORBES, Dec. 25, 2006 (reporting allegation that CEO with 15% stake deliberately suspended filing financial statements to force the stock price down shortly before increasing his stake to 22%).
periodic disclosure is likely to make insiders worse off ex post. In particular, under periodic disclosure insiders can expect to extract fewer private benefits and to enjoy less slack. By providing a low level of periodic disclosure, insiders can therefore increase their private benefits.

To be sure, when under-disclosure reduces the stock price, such under-disclosure may impose a cost on insiders seeking to sell shares: they may not be able to unload their shares at as high a price. In some cases, the cost to insiders of firm sub-optimal disclosure could outweigh the benefit from increasing private benefits. In those cases, insiders able to offer a low level of disclosure may choose instead to prefer a higher level of disclosure, even though providing a higher level of disclosure reduces their private benefits.

However, the possibility of a stock price decline may not always deter insiders from reducing the scope of disclosure. For example, insiders’ shareholdings may be small or the private benefits from low disclosure may be relatively large. In those cases, even if insiders would otherwise prefer a higher stock price, they may benefit from offering less than the firm-optimal level of disclosure.

2. Possible Enforcement Mechanisms

We have seen that, after a firm’s stock begins trading, insiders choose to offer a firm-suboptimal level of periodic disclosure in order to extract more private benefits or to buy back stock at a bargain price. By definition, this level of disclosure fails to maximize firm value. To the extent there is a risk of such disclosure opportunism, the firm-optimal disclosure arrangement would provide a mechanism that prevents insiders from unilaterally reducing the level of periodic disclosure below a specified amount.43

Some commentators who favor mandatory disclosure implicitly assume that firms cannot make a credible commitment to maintain a minimum amount of disclosure.44 They argue that, in the secondary market, insiders free to choose the level of disclosure cannot be expected to provide a firm-optimal amount of disclosure in the secondary market. Hence, mandatory disclosure is needed.

However, as I explain below, firms could easily use corporate law arrangements to prevent insiders from opportunistically reducing disclosure, or at least make it quite difficult for them to do so. In particular, insiders could incorporate the firm in a jurisdiction requiring periodic disclosure. Alternatively,

43 See Easterbrook & Fischel, Mandatory Disclosure, at 684 (1984) (noting that “a firm that wants the highest possible price when it issues stock must take all cost-justified steps to make the stock valuable in the aftermarket, so it must make a believable pledge to continue disclosing”). See also Edward Rock, Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure, 23 CARDOZO L. REV 675 (2002) (recognizing the importance of a commitment to maintain periodic disclosure).

44 See, e.g., Coffee, Market Failure; Goshen and Parchomovsky, Essential Role.
insiders could put a periodic disclosure requirement in the firm’s corporate charter before selling shares to the public.

Importantly, I am not claiming that these corporate law arrangements are the only possible arrangements for making a credible commitment to continue disclosing.⁴⁵ My point, rather, is that firms not subject to mandatory disclosure could make a credible commitment to maintain a certain level of disclosure using legal arrangements that have been available since long before the time firms began selling shares to the public in the 1800s.

**a. Corporate Law**

Insiders could commit to maintain a minimum level of disclosure by incorporating the firm in a jurisdiction requiring periodic disclosure of a minimum amount of information. A firm incorporated in such a jurisdiction could not terminate its disclosure obligations without either dissolving or merging into an entity incorporated elsewhere. Such actions, in turn, would generally require approval by a majority of the firm’s shareholders. This barrier would make it more difficult for insiders to unilaterally reduce the level of required periodic disclosure by exiting the jurisdiction.

To be sure, a majority shareholder approval requirement will not prevent insiders from reincorporating into a jurisdiction requiring less disclosure when the insiders control a majority of the outstanding shares. However, corporate law could easily provide protection for minority public shareholders in such a situation. For example, the law could require re-incorporation be approved by a majority of the minority public shareholders. Alternatively, the law could make such re-incorporations easier to challenge as a violation of the board’s fiduciary duty to shareholders absent such approval.

Obviously, firms’ ability to incorporate in a jurisdiction requiring a minimum amount of disclosure would depend on there being such a jurisdiction. But it is widely agreed that states provide corporate law rules that make the state attractive to those making incorporation decisions.⁴⁶ Thus, if those incorporating

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⁴⁵ Listing on a stock exchange could create a commitment to ongoing disclosure if (a) the stock exchange required periodic disclosure; (b) the firm could not be unilaterally delisted by insiders; and (c) insiders faced personal liability for refusing to provide the required disclosure. However, as I explain in Part II.B.2, U.S. stock exchanges have always allowed insiders to unilaterally delist firms.

⁴⁶ Indeed, there is some evidence that states have always “competed” for incorporations. See Ehud Kamar, Beyond Competition for Incorporations, 94 GEO. L. J. 1725 (2006). Some commentators have argued that the competition among states is not that vigorous. See Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 STAN. L. REV. 679 (2002) (arguing that only Delaware actively pursues incorporations); Lucian Bebchuk and Assaf Hamdani: Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters, 112 YALE L. J. 533 (2002) (same). However, all agree that, at least some states seek to attract incorporations by providing rules favorable to those making incorporation decisions.
firms sought such a disclosure requirement, at least some states would be expected to offer it.\footnote{As we will see in Part II.B.1, no state ever imposed periodic disclosure requirements on widely held firms (or offered it as a default or opt-in rule). We can infer from their failure to provide such disclosure arrangements that those taking firms public did not seek them. This conclusion is reinforced by the widespread failure of firms to adopt periodic disclosure requirements through corporate charter provisions.}

To be sure, shareholder voting may not be a failsafe mechanism for preventing insiders from inefficiently changing the level of disclosure by reincorporating the firm in another jurisdiction. Even if corporate law requires approval by a majority of public shareholders for disclosure-reducing transactions, if public shareholders are uninformed they may support, or at least not oppose, a value-decreasing change in a firm’s disclosure arrangement. However, a shareholder voting requirement would certainly make it much more difficult for insiders to reduce periodic disclosure below a specified level.

b. Corporate Charter

Insiders could also obligate themselves to provide a minimum amount of periodic disclosure by putting such a requirement in the firm’s corporate charter. The firm could eliminate this disclosure requirement only by amending its corporate charter. Such an amendment would ordinarily require approval of a majority of the firm’s shareholders. Insiders would thus find it difficult to unilaterally change the disclosure arrangement.

Again, such a charter provision would not prevent insiders from changing the disclosure requirement when they own a majority of the firm’s shares. However, the charter provision could stipulate that amendment requires approval of a majority of the firm’s public shareholders. Like a mandatory corporate law rule requiring majority of the minority approval, this mechanism could be employed in firms where insiders own a majority of the firm’s stock.

Importantly, insiders could use a corporate charter to commit to a minimum amount of periodic disclosure even if there were no jurisdiction requiring mandatory disclosure, or the jurisdiction requiring mandatory disclosure had other features that made it unsuitable for a particular firm. Any firm – no matter where it is incorporated – could put in place such a charter provision.
II. Periodic Disclosure Commitments in the Real World

Part I showed that the firm-optimal periodic disclosure arrangement is likely to provide (1) a reasonable amount of both conflict and financial information; and (2) a mechanism to ensure that insiders cannot unilaterally reduce disclosure below a specified level. Part I also explained that insiders could put in place such a commitment mechanism, either by incorporating a firm in a jurisdiction requiring periodic disclosure or by putting such a requirement in the firm’s corporate charter.

This Part considers whether publicly traded firms free to fashion their own disclosure arrangements actually adopt firm-optimal periodic disclosure arrangements before selling shares to the public. Section A describes the thousands of publicly traded firms in the U.S. that have never been subject to mandatory disclosure under the securities laws, and thus were completely free to choose their own periodic disclosure arrangements before their initial public offerings (IPOs). Section B examines these firms’ periodic disclosure commitments. It finds that insiders taking these firms public have not used corporate law arrangements or any other mechanism to make a binding commitment to maintain a specific level of disclosure.

A. Firms Always Exempt from Mandatory Disclosure

Publicly traded firms in the U.S. that have been completely free to choose their own disclosure commitments when selling shares to the public fall into two categories: (1) all firms that went public before the imposition of the federal securities laws in the 1930s (“All pre-1934 firms”); (2) thousands of over-the-counter (OTC) traded firms that sold shares to the public from 1930s to today that, for one reason or another, were not considered reporting companies at the time of their IPO.

1 All pre-1934 Firms

The securities laws imposing mandatory periodic disclosure were not enacted until 1934. Between the mid 19th century and the enactment of these rules in 1934, hundreds of firms went public. Before 1934, all of these publicly traded firms were thus free to choose their own periodic disclosure arrangements and practices.

2. OTC Firms 1934-1964

After 1934, mandatory periodic disclosure rules were imposed on all firms traded on the national exchanges (such as the NYSE and American Stock Exchange) and on certain OTC firms: those that had issued securities of sufficient
market value after 1936. Many OTC firms selling shares to the public did not fall into this category. Mandatory disclosure thus did not apply to most OTC firms. Until 1964, when mandatory disclosure was extended to a wider category of OTC firms, thousands of firms that traded on the OTC— including some relatively large firms—remained exempt from mandatory disclosure.\footnote{Greenstone, Oyer, Vissing-Jorgensen, Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments, \textit{Q. J. Econ.} (2006) (finding, in a sample of 1,033 OTC firms in 1963, that 532 (206) of these firms had a market capitalization that exceeded the 25th (50th) percentile market capitalization of firms on the NYSE and AMEX measured at the same time).} Like all firms that went public before the imposition of the securities laws, these OTC firms were free to choose their own disclosure commitments at the time of their IPO.

In 1964, mandatory disclosure was extended to a wider category of OTC firms. Under the 1964 amendments to the securities laws, a firm had to register with the SEC and become a “reporting company” subject to the mandatory disclosure requirements of the securities laws if either of the following two conditions is met: (1) the firm’s securities are listed on a national stock exchange; or (2) the firm had at least 300 shareholders of record.\footnote{If the firm has assets of less than $10 million, there must be at least 500 shareholders of record for mandatory disclosure to apply.} As a result, hundreds of previously exempt companies on the OTC became subject to mandatory disclosure.

The 1964 rules would have appeared to subject all firms with 300 or more shareholders to periodic disclosure requirements. However, for purposes of applying the mandatory disclosure rules, the securities laws do not define “shareholders of record” as the ultimate beneficial owners of the stock. Rather, “shareholders of record” are defined as the brokerage houses holding shares on their behalf.\footnote{See SEC Rule 12g5-1.} Each brokerage house thus counts as a single shareholder of record, even though it may hold shares on behalf of hundreds or even thousands of individual beneficial owners.\footnote{Michael K. Molitor, Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities, \textit{Ind. L. Rev.} 309, 315-16 (2006).} As a result, firms with several dozen (or hundred) shareholders of record may actually have thousands of individual shareholders. After 1964, such firms could still escape mandatory disclosure requirements under the securities laws as long as they did not trade on an exchange but rather in one of the over-the-counter (OTC) markets.\footnote{Molitor, supra note x, at 316-17. In 1999, firms not already subject to mandatory disclosure and trading on the most important OTC market—the OTC Bulletin Board (OTCBB)—were required to register with the SEC and become Exchange Act-reporting companies subject to mandatory disclosure. See http://www.sec.gov/divisions/marketreg/mrotc.shtml; http://www.nasd.com/PressRoom/NewsReleases/1999NewsReleases/NASDW_010106/. See also Paul Rose, Balancing Public Market Benefits, 41 \textit{WILLAMETTE L. REV.} 707, 717-18 (2006) (reporting that the SEC determined that it should bring small OTCBB companies, including those falling below the size and shareholder limits set out in the Exchange Act, under the same
Currently, several thousand such companies trade outside the mandatory disclosure system.\textsuperscript{53} While many of these companies are small, the market sees a considerable amount of trading activity. Trading volume is about $50 billion annually.\textsuperscript{54}

\section*{B. Firms' Periodic Disclosure Commitments at the IPO}

reporting standards applicable to larger public companies because of an upsurge in fraud among these companies).

However, most of these companies simply moved to another OTC market that does not require its firms to be reporting companies -- the so-called “Pink Sheet” market. Michael K. Molitor, \textit{Will More Sunlight Fade the Pink Sheets? Increasing Public Information about Non-Reporting Issuers with Quoted Securities}, 39 IND. L. REV. 309, 330 (2006). As a result, a widely held publicly traded company can still escape mandatory disclosure by staying off the stock exchanges and the OTCBB and keeping the number of shareholders of record below 300.

\textit{See} Michael Molitor, \textit{Will More Sunlight Fade the Pinksheets? Increasing Public Information about Non-Reporting Issuers with Quoted Securities}, 39 IND. L. J. 309, 311 & 329 (2006). Pink Sheet firms are subject to some other disclosure requirements. First, SEC Rule 15c2-11 requires the first “market maker” publishing unsolicited quotations for the stock of certain Pink Sheet firms to collect specified information on that issuer. But this information, when it is collected by the market maker, is generally not easily available to shareholders. Among other things, shareholders may have difficulty identifying the first market maker in the stock from whom they can request the information. Moreover, the information may be stale by the time the shareholder asks for it.

Second, in 2004, the Pink Sheets introduced a Disclosure Policy that requires some of the firms not covered by Rule 15c2-11 to provide information to the market in certain limited circumstances, such as when the firm’s shares are initially quoted. However, the Disclosure Policy does not require covered firms to provide information to shareholders except under these circumstances. Moreover, many Pink Sheet firms, such as those that were delisted from the stock exchanges or previously quoted on OTCBB, are subject neither to Rule 15c2-11 nor to the Disclosure Policy. The Pink Sheets is currently in the process of developing heightened voluntary disclosure standards for Pink Sheet firm. \textit{See [ ]}

\textsuperscript{53} \textit{See} Molitor, supra note x, at 329 (reporting that 4000 stocks trade exclusively on the Pink Sheets).

\textsuperscript{54} \textit{See} Molitor, supra note x, at 330. Among these publicly traded non-reporting firms are hundreds of formerly reporting firms that “went dark”—exited the mandatory disclosure system. In fact, hundreds of firms have exited the mandatory disclosure regime over the last several years while remaining publicly traded companies, with 200 exiting in 2003 alone. See Leuz, Triantis, and Wang, Why Do Firms Go Dark? Causes and Consequences of Voluntary SEC Deregistrations, 2 (working paper, 2004) (reporting that 200 companies deregistered in 2003 for reasons other than a merger, acquisition, liquidation, registration withdrawal, or going private transaction). These firms presumably went public as reporting companies but subsequently took whatever steps were necessary to escape mandatory periodic disclosure. This phenomenon suggests that firms going public as reporting companies are not making a credible commitment to continue disclosing. Cf Rock, supra note x (arguing that the securities laws create a credible commitment to maintain disclosure). (Such firms could make such a commitment by putting a provision in their charters requiring at least some level of disclosure, but they fail to do so.) However, in this paper I confine my attention to firms that were not considered reporting companies when they sold shares to the public.
We have seen that there have been thousands of publicly traded US firms that were completely free to fashion their own disclosure arrangements at the IPO because, at the time the firms were taken public, they were not subject to mandatory periodic disclosure under the securities laws. Did the insiders taking these firms public put in place firm-optimal periodic disclosure arrangements? I have shown that a critical feature of a firm-optimal arrangement is a mechanism to make it difficult for insiders to opportunistically reduce disclosure below a specified threshold. As this Section explains, most and perhaps all of these thousands of firms failed to commit to maintain a minimum level of disclosure when they sold shares to the public.

1. Corporate Law Arrangements

As Part I explained, corporate law arrangements can be used to make a credible commitment to provide disclosure. A firm can incorporate in a jurisdiction requiring a minimum amount of periodic disclosure. Alternatively, it can adopt a charter provision requiring periodic disclosure. Because reincorporation or amending the charter requires shareholder approval, these arrangements make it difficult for insiders to reduce or terminate disclosure.

However, as I explain in more detail below, in over 150 years of public markets, not one of the U.S. states has developed periodic disclosure rules suitable for companies with more than a handful of shareholders. There is also no evidence that many (or even any) companies put periodic disclosure requirements in their charters. As a result, firms that are free to choose their own disclosure arrangements generally have not taken steps to prevent insiders from unilaterally terminating or reducing disclosure, allowing managers to reduce the scope of disclosure at any time or eliminate disclosure completely.

a. Corporate Law

U.S. companies began selling shares to the public in the mid 19th century, around seventy years before the enactment of the federal securities laws. During much of this time states competed for corporate charters by offering laws that were favorable to those taking firms public. Indeed, the competition for corporate charters was often much more fierce than it is today.

One would have expected insiders to seek firm-optimal periodic disclosure rules suitable for public companies. States, in turn would be expected to offer such rules, at least as default provisions. By providing these desired arrangements, the states could have profited by attracting more incorporations.


56 Butler, supra note x, at 152-163; Christopher Grandy, New Jersey Corporate Chartermongering, 1875-1929, 49 J. ECON. HIST. 677, 685 (1989).
In fact, not one state provided mandatory periodic disclosure rules—even as a default provision—suitable for a public company. By 1900, forty years after the establishment of public markets, only half the states required any kind of financial disclosure to shareholders, usually some form of balance sheet. However, in those states requiring financial disclosure the contents of this disclosure were not specified, and firms did not need to provide income statements to shareholders. Nor were firms required to provide conflict information. Moreover, firms were generally not required to mail reports to shareholders. A shareholder who wanted the information had to attend the corporation’s annual meeting.

Corporate disclosure requirements in these states are little different today than they were in 1900. Strikingly, the state that has attracted the most incorporations of public companies, Delaware, has never required periodic disclosure of any information to shareholders.

To be sure, Delaware and other states have traditional shareholder inspection statutes. Under these inspection statutes, an individual shareholder can seek to examine the books and records of the firm. If access to such information were costless, and the information were complete, these inspection statutes would effectively provide periodic disclosure.

However, accessing corporate information through shareholder inspection statutes is quite difficult. Examinations are usually resisted by managers. Thus, such examinations are likely to require individual shareholders to incur expenses litigating for access to the information. Moreover, the information obtainable

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57 See Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 VAND. L. REV. 859, 867 (2003) (noting that “[m]ost state corporation statutes impose few mandatory disclosure obligations”). See also Mark J. Roe, Delaware’s Competition, 117 HARV. L. REV. 588, 611 (2003) (”[T]he states generally required no information to be disseminated, seeing the annual election as sufficient to induce incumbents to give out information sua sponte—although in practice, little information was sent out”).


59 States that have adopted a version of the Model Business Corporations Act may require corporations to mail annual financial statements to shareholders each year. See Model Bus. Corp. Act 16.20-21 (1984). But the content of these statements was not clearly specified. Moreover, this information was made available only once a year, leaving shareholders in the dark the rest of the year. And firms were not required to provide conflict information—information about self-dealing transactions.

60 See, e.g., 8 Del. C. § 220(b) (2006).

61 Id.

62 Randall S. Thomas, Improving Shareholder Monitoring and Corporate Management by Expanding Statutory Access to Information, 38 ARIZ. L. REV. 331, 349 (1996) (noting that shareholders hoping to get access to books and records may need to spend at least $20-50,000 in litigation fees).
through shareholder inspection is limited. Delaware statute does not even provide what information corporations should preserve for inspection. A shareholder who litigates for access to the records may thus find precious little there.

The inspection statutes of Delaware and other states may well be adequate for a small, closely-held company. In such companies, most shareholders are intimately involved in the business as employees and have day-to-day access to important information. In addition, each shareholder owns a relatively large stake in the company, and thus has an incentive to incur some costs monitoring. However, the inspection statutes, supplemented in some states by meager disclosure requirements, are unlikely to be adequate for a publicly traded firm with a constantly changing pool of hundreds or thousands of shareholders each of whom owns only a small fraction of the firm’s equity and holds similar sized positions in dozens of other companies.

In sum, state corporate law disclosure requirements have always been at best minimal. Insiders taking firms public thus never committed to provide a reasonable amount of periodic disclosure by incorporating in a particular state. Indeed, insiders appeared to favor incorporating in one of the many states that does not require firms to make any periodic disclosure to shareholders—such as Delaware.

b. Corporate Charters

We have just seen that even when the corporate law of some states required periodic disclosure, but that the extent of such disclosure made it essentially useless. However, firms could always subject themselves to more extensive disclosure commitments by putting such minimum disclosure requirements into their corporate charters. These provisions would have had the same effect as a statutory requirement. Shareholders could sue directors for failing to provide the disclosure required by the charter. And such a disclosure requirement could not be eliminated except with shareholder approval.

However, there is no evidence that firms free to fashion their own disclosure arrangement ever adopted such arrangements. There is no record of litigation relating to any such provisions. There is also no discussion of such provisions

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63 States that have adopted a version of the Model Business Corporations Act may require corporations to mail annual financial statements to shareholders each year. See Model Bus. Corp. Act 16.20-21 (1984). But the content of these statements was not clearly specified and did not contain conflict information. Moreover, this information was made available only once a year, leaving shareholders in the dark the rest of the year.

64 A search of all federal and state court cases in Lexis (looking for cases in which (a) the terms “certificate of incorporation” or “corporate charter” or “articles of incorporation” appeared in the same paragraph as (b) any word beginning with the letters “discl”) turned up approximately 1700 results, none of which dealt with disclosure provisions in corporate charters.
in the practitioner literature. And, as we will see in Part IV, many of the firms free to choose their own disclosure arrangements end up providing little or no disclosure to shareholders. This indicates that, at least in those firms, there was never a prior commitment in the corporate charter (or elsewhere) to maintain a minimum level of disclosure.

In short, neither corporate law nor charter provisions was ever used by firms selling shares to the public to commit to maintain a reasonable amount of disclosure in the secondary market.

2. Stock Exchange Listings

Decades before the enactment of the federal securities laws, the US stock exchanges imposed their own periodic disclosure rules. Some were more extensive than others. After the securities laws were enacted, all firms traded on these exchanges became subject to mandatory periodic disclosure that were at least as comprehensive as the most extensive imposed by the exchanges. Thus, the stock exchange disclosure rules became largely superfluous. However, before mandatory disclosure was imposed, the stock exchanges were the primary source of periodic disclosure rules.

During the 1920s, there were almost 20 stock exchanges in the US. The NYSE, home to the largest publicly traded companies, generally imposed the most stringent requirements. By the late 1920s, the NYSE imposed a reasonable amount of disclosure requirements. Indeed, the disclosure requirements imposed by the NYSE in the late 1920s were so extensive that the federal government essentially used them as the basis for the mandatory periodic disclosure rules. However, other stock exchanges imposed far fewer disclosure requirements.

Thus, it might be argued that, prior to the adoption of the securities laws, insiders listing on an exchange such as the NYSE firms made a credible commitment to provide disclosure. Obviously, there would be no need to incorporate in a state requiring periodic disclosure, or adopt a charter provision requiring such disclosure, if one could achieve the same result simply by listing on the NYSE. On this view, the failure of corporate law arrangements to create a commitment to periodic disclosure would thus be irrelevant—at least for NYSE-listed firms.

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65 A search of all law review articles and practitioner literature in Lexis (looking for articles in which (a) the terms “certificate of incorporation” or “corporate charter” or “articles of incorporation” appeared in the same paragraph as (b) any word beginning with the letters “discl”) turned up hundreds of results, none of which dealt with disclosure provisions in corporate charters.

However, firms listing on the NYSE exchange did not in fact make a binding commitment to provide an adequate amount of information to shareholders. First, the NYSE’s disclosure requirements were often not enforced. For example, it was thirty years before even one listed company fully complied with the requirements put in place by the NYSE in the 1860s. To preserve its business, the NYSE did not delist even the most noncompliant companies. Instead, it either allowed them to continue to trade as listed companies or put them in an unlisted securities department, which it established in 1885. This unlisted department was eventually abolished under pressure from the federal government. However, it is widely believed that NYSE’s continued to not enforce disclosure requirements for its listed companies.

Second, and importantly, even if the NYSE’s had enforced its disclosure requirements, listing on the NYSE would not have represented a credible commitment to maintain disclosure. Because shareholder approval was never required for delisting, insiders could always choose to voluntarily delist the firm. Alternatively, insiders could take steps that would trigger an involuntary delisting. In either case, the result would be the same: the firm would no longer be subject to the stock exchange’s disclosure requirements. The possibility of insider delisting was not merely hypothetical. Insiders in fact delisted their firms from the NYSE and had them trade elsewhere. Indeed, one reason the NYSE failed to enforce its disclosure regulations is that it feared firms would list elsewhere or any the unregulated OTC market or at a competitor exchange, such as the New York Curb Exchange (now the American Stock Exchange), or any of the 17 other exchanges that imposed much lower disclosure requirements.

67 The information in this paragraph is taken from Lawrence Mitchell, Squeezing Truth from Power (The New Era Ch. 4). It is not clear that compliance would have made much of a difference. The information contained in these reports (and other documents later sought by the NYSE) was apparently of little value and in any event was given to the exchange and not easily available to shareholders. See Robert Prentice, The Inevitability of a Strong SEC, 91 Cornell L. Rev. 775, 808 (2006).


70 See Seligman, J. Corp. L. at 54. A Senate Report found that the source of the NYSE’s difficulty was “the unwillingness of issuers to furnish adequate information, supported by the threat of withdrawal of their listings, and by the potential competition of exchanges having more lenient standards.” Id. (citing S. Rep. No. 792, 73rd Cong., 2d Sess. 5 (1934). See Jonathan R. Macey & Geoffrey P. Miller, Origins of the Blue Sky Laws, 70 Tex. L. Rev. 347, 352 (1991); Robert Prentice, Regulatory Competition, 66 Ohio State L.J. 1155, 1186 (2005) (noting that “the NYSE’s only
Third, even if listing on the NYSE created a commitment to maintain adequate disclosure, many of the exchange-traded firms were not listed on the NYSE. Hundreds were listed on other exchanges imposing very little in the way of disclosure requirements before the enactment of the securities laws. And hundreds more traded on completely unregulated OTC markets where they were subject to no disclosure requirements whatsoever. In short, before the enactment of the securities laws, publicly traded firms did not make a credible commitment to provide periodic disclosure by listing on a stock exchange.

3. The Pattern: Failure to Commit to Disclosure

We have seen that, when insiders are completely free to fashion the disclosure arrangements of the firms they take public, they generally do not commit, at the IPO, to provide a minimum amount of periodic disclosure in the secondary market. This pattern has persisted since the beginning of the public stock markets in the U.S. Before the enactment of the securities laws in the 1930s, all firms were free to choose their own disclosure arrangements. Insiders of these firms could have used corporate law arrangements to commit to a reasonable amount of periodic disclosure when taking their firms public. However, they chose not to. Indeed, insiders frequently incorporated in states--like Delaware--that imposed no disclosure requirement whatsoever.

One could argue that the practices of firms in the mid 19th century and first part of the 20th century may shed light on whether disclosure arrangements were desirable at the time, but shed little light on whether freely chosen disclosure arrangements would be desirable now. Markets today are radically different. They are populated by institutional investors, investment banks, and hedge funds that did not exist a century ago. Even individual investors are likely to be more sophisticated.

Nevertheless, among those publicly traded firms not subject to the mandatory securities laws, the widespread practice of failing to commit to provide adequate disclosure continued throughout the 20th and into the 21st century. Throughout the 20th century and even today, insiders taking firms public do not commit to provide a minimum amount of periodic disclosure to shareholders.

meaningful penalty was delisting and, naturally, it shied away from the attendant decrease in revenue that would follow if it actually enforced its own disclosure rules).

71 Roberta Romano, The Need for Competition in International Securities Regulation, 2 THEORETICAL INQUIRIES L. __, __ (2001) (noting that contemporary markets are dominated by institutional investors and there is far greater competition among financial intermediaries, producing more information about securities than there was seventy years ago”); see also Roberta Romano, Empowering Investors, at 2378.

72 Id.
To be sure, the failure to commit to provide adequate disclosure does not necessarily mean that insiders will subsequently provide inadequate disclosure. Insiders would offer adequate disclosure when such disclosure increases the stock price, and the benefits from a higher stock price outweigh the reduction in their private benefits. Thus, even absent such a commitment, insiders might find it in their own interest to provide firm-optimal disclosure. However, as we will see in the next Part, insiders free to choose the level of disclosure in the secondary market often choose what is clearly a firm-suboptimal level of disclosure.
III. Firms’ Periodic Disclosure Choices

Part II considered the disclosure commitments of firms that were completely free to choose their own disclosure arrangements when they sold shares to the public. It showed that these firms, when they went public, did not use corporate law arrangements, or any other mechanisms, to create a binding commitment to maintain a minimum level of periodic disclosure in the secondary market.

This Part now turns to consider insiders’ disclosure choices in the secondary market when they are free to choose the level of periodic disclosure. Section A explains why insiders free to choose the level of periodic disclosure may choose either an adequate or inadequate amount of disclosure. Section B shows that, in fact, some insiders choose to provide an adequate amount of disclosure, but many choose to provide a level of disclosure that is clearly firm-suboptimal. Section C identifies who bears the costs of inadequate disclosure.

A. The Possibility of Adequate or Inadequate Disclosure

Even in the absent of a commitment to maintain a minimum amount of disclosure, insiders may choose to offer firm-optimal level of disclosure in the secondary market. Suppose a firm-optimal level of disclosure leads to a higher stock price, and t insiders prefer a higher stock price to a lower stock price, even at the expense of their private benefits. In such a case, insider would be expected to choose to the firm-optimal level of disclosure.

And, if insiders in the secondary market always voluntarily provided the firm-optimal amount of disclosure, the firm-optimal disclosure arrangement need not include a mechanism to ensure a minimum level of disclosure. Such a mechanism would be completely redundant. Hence, the widespread failure to making a binding commitment to periodic disclosure at the IPO would not mean that insiders were adopting firm-suboptimal periodic disclosure arrangements. As we will see, however, when insiders are free to determine their firms’ level of disclosure in the secondary market, many choose to provide what is clearly less than the firm-optimal amount of information.

B. The Evidence

1 Pre-1934 Firms

As was explained, all publicly traded firms before 1934 were completely free to choose their own disclosure arrangements and practices. As we in saw in Part III, there is no evidence that any of these firms used corporate law arrangements or any other mechanism to commit to provide a minimum amount of disclosure.

73 See supra Part II.A.1.
of periodic disclosure. Did the insiders of these firms nevertheless voluntarily provide a firm-optimal amount of disclosure in the secondary market? This appears to be the claim of Roberta Romano, one of the leading academic critics of mandatory disclosure, who writes:

“There is little tangible proof of the claim that corporate information is "underproduced" in the absence of mandatory disclosure…. For instance, before the enactment of the federal securities laws in the 1930s, public corporations voluntarily disclosed financial statements, typically under a stock exchange listing requirement, that contained substantially all of the information subsequently required under the federal laws.”

To be sure, some firms chose to list on the NYSE and fully comply with its disclosure provisions, which by the late 1920s were substantial. Indeed, as proponents of deregulating disclosure point out, some firms went beyond the NYSE’s disclosure provisions, offering more information than was required. For example, many firms provided audited financial statements before the NYSE imposed that requirement on all its listed firms in 1926. According to the critics of mandatory disclosure, the NYSE’s experience in the late 1920s shows that firms free to choose their own arrangements will provide sufficient disclosure.

However, the question is not whether some NYSE firms voluntarily provided adequate information to shareholders during the decade leading up to the enactment of the securities laws. Rather, the question is whether public firms generally—not just those listed on the NYSE and complying with its disclosure requirements—provided firm-optimal information to shareholders during the seven decades between the formation of public securities markets and the enactment of the securities laws. And the answer to this question is clearly no.

Before 1900, during the first three or four decades of the public markets, it is widely agreed that public firms—including even those listed on the NYSE—provided little if any information to shareholders. Indeed, insiders were generally unwilling to disclose any financial information about their companies, even when it was required by the stock exchange on which they listed. For example, the NYSE began requiring companies listed on the exchange to provide some kind of annual report in 1866. But thirty years had passed before even one

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74 Romano, Empowering Investors, at 2373.

75 See supra note x.

76 Roberta Romano, The Need for Competition in International Securities Regulation, 2 THEORETICAL INQUIRIES L. __, __ (2001) (noting that the vast majority of NYSE firms’ financial statements were audited before the NYSE required the practice in 1932).

77 Romano, Empowering Investors, supra note x, at 2373.

78 Hawkins, supra note x, at 261-295; W. Ripley, Main Street and Wall Street 156-207 (1927).

79 See Lawrence Mitchell, Squeezing Truth from Power (The New Era Ch. 4).
listed company fully complied with the requirement.\textsuperscript{80} Income statements were generally not disclosed.\textsuperscript{81}

Between 1900 and the enactment of the securities laws, the NYSE’s disclosure requirements and corporate disclosure practices of its listed firms generally improved. However, many firms listed on the NYSE did not comply with its requirements, which the NYSE, fearing delisting, did not make much effort to enforce.\textsuperscript{82} Even those firms that complied often provided information that was of little value to investors. A 1935 study by the Twentieth Century Fund found that while the number of firms issuing quarterly shareholder reports between 1923 and 1933 had increased, the information is “often so meager as to be almost useless to the stockholder.”\textsuperscript{83} Firms did not provide information on gross income and the methodologies used in calculating depreciation and other items on the balance sheet and income statement.\textsuperscript{84} Hence, it was difficult to make sense of companies’ earnings reports. And these NYSE-listed firms were among the ones providing the best disclosure.

Other stock exchanges imposed far less extensive disclosure requirements, and there is no evidence that the hundreds of firms listed on those exchanges went beyond those requirements (or even complied with them). There is also no evidence that the hundreds of other firms traded over the counter (OTC), and thus not subject to any disclosure requirements, disclosed an adequate amount of information. Presumably, insiders listed firms on stock exchanges other than the NYSE or sold their shares OTC did so in part to avoid disclosing to shareholders whatever information the NYSE actually required its listed firms to disclose. If the disclosure of NYSE-listed firms was inadequate, it stands to reason that the disclosure practices of these other firms were even less adequate.

\textbf{2. OTC Firms 1934-present}

Recall that mandatory disclosure imposed on listed firms after 1934 did not apply to many OTC firms, including some relatively large firms with billions of

\textsuperscript{80} See \textit{Lawrence Mitchell, Squeezing Truth from Power} (The New Era Ch. 4). It is not clear that compliance would have made much of a difference. The information contained in these reports (and other documents later sought by the NYSE) was apparently of little value and in any event was given to the exchange and not easily available to shareholders. See Robert Prentice, \textit{The Inevitability of a Strong SEC}, 91 \textit{Cornell L. Rev.} 775, 808 (2006).

\textsuperscript{81} See \textit{Lawrence Mitchell, Squeezing Truth from Power} (The New Era Ch. 4).


\textsuperscript{83} Twentieth Century Fund, \textit{The Security Markets} 580 (1935).

\textsuperscript{84} Twentieth Century Fund, \textit{The Security Markets} 580-82 (1935).
dollars of assets and thousands of shareholders. In 1964, mandatory disclosure was extended to all firms with more than 300 shareholders of record. However, because of the definition of “shareholder of record,” thousands of firms continue to remain beyond the reach of the mandatory disclosure rules.

During the period between 1934 and 1964, the SEC occasionally surveyed the reporting practices of OTC companies that were not subject to mandatory disclosure. It found that many of these firms chose to provide little if any information to shareholders. Insiders of many firms during this period, like firms before the enactment of the securities laws, clearly did not provide firm-optimal amount of disclosure.

In 1946, the SEC was able to obtain and study the annual reports of 70 non-reporting companies that had at least $3 million in assets and at least 300 shareholders of record. None of the companies provided any information about self-dealing transactions. Little information about executive compensation was provided. Over half had material deficiencies in financial reporting. For example, 13% did not provide any income statement. Similar results were found in a 1949 follow-up study that included an additional 98 companies with at least $3 million in assets and 300 shareholders of record.

A 1957 report of 125 publicly traded insurance companies not subject to mandatory disclosure, some as large as $3 billion, found that almost 50% did not provide an income statement. Moreover, size did not appear to correlate with the quality of financial reporting.

In 1963, the SEC randomly sampled 20% of the OTC firms in which trades had been made during the last quarter of 1961. The overwhelming majority did not provide any conflict information to shareholders. More than 25% of firms did not provide any information on the firm’s financial position or results. The SEC separately studied 171 banks and 44 insurance companies traded OTC. It found that 20% of the banks did not provide any financial material to shareholders; 2/3 of banks that did provide financial material to shareholders did not include an income statement. Half of the insurance companies did not provide an income statement to shareholders; only 5% of the insurance companies provided financial statements that included explanatory notes and an income statement.

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85 See supra Part II.A.2.


87 See Seligman, supra note x, at 36.

88 See Seligman, supra note x, at 39.

89 See Seligman, supra note x, at 40.

90 See Seligman, supra note x, at 40.

91 See Seligman, supra note x, at 41.
Today, thousands of publicly traded firms remain exempt from mandatory disclosure because they have fewer than 300 shareholders of record—even though they may have thousands of beneficial owners. Although there has not been a formal study of the disclosure practices of these non-reporting firms, it appears that, like the firms that were subject of the SEC studies before 1964, these firms often fail to provide any conflict or financial information about themselves to shareholders and prospective investors other than the meager amounts sometimes required by corporate law.

4. Is Firm Disclosure Actually Sub-optimal?

One could argue that the disclosure practices described above—including the failure of firms to provide any information to shareholders—may be firm-optimal. However, firms that fail to provide conflict information and key financial information (such as an income statement) to investors are unlikely to be providing the firm-optimal amount of disclosure.

Conflict information is critical for helping shareholders control agency costs relating to self-dealing. The direct costs of providing such information are low. So are the indirect costs: disclosure of self-dealing transactions and executive compensation is unlikely to reduce firm value by helping its competitors. The failure to disclose conflict information, by itself, strongly suggests that the amount of disclosure freely chosen by insiders is not firm-optimal.

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92 See supra Part II.A.3.

93 See Molitor, supra note x, at 315-16. As indicated earlier, among these thousands of firms are hundreds of companies that were formerly reporting firms but were able to exit the mandatory disclosure regime by delisting and reducing the number of shareholders of record to less than 300. Nothing prevents these companies, having exited from mandatory disclosure, from continuing to voluntarily provide disclosure at the level required by the securities laws or some intermediate level. However, these companies, after exiting the regime, also provide little information to their public shareholders. Leuz, Triantis, and Wang, Why Do Firms Go Dark? Causes and Consequences of Voluntary SEC Deregistrations, 2 (working paper, 2004). Not surprisingly, the market reaction to news that a company is going dark is generally negative, with stock prices falling a market-adjusted 10% on average. Leuz, Triantis, and Wang, supra note x, at 22.

94 Indeed, Professor Romano comes close to making this very claim. See Romano, Empowering Investors, at 2376. However, she concedes that if subsequent imposition of the SEC’s disclosure requirements were found to have a significantly positive effect on stock prices, it would be “probative” that prior disclosure was inadequate. A study reporting such a finding was published several years later. See Michael Greenstone, Paul Oyer, and Annette Vissing-Jorgenson, Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments, __ Q.J.Econ. __ (2006) (reporting that firms newly subject to the securities laws’ mandatory disclosure requirements experienced abnormal stock price increases of about 10%).
The absence of meaningful financial information is further indication that a firm is not providing a firm-optimal level of disclosure. In those cases where insiders do not own a majority of the shares and control is thus contestable, such information can control agency costs of shirking, which are likely to be substantially larger than the agency costs of self-dealing. Moreover, whether or not insiders have a lock on control, the provision of financial information is likely to increase firm value by helping shareholders to better police self-dealing and by reducing investors’ information acquisition costs. Like the case of conflict information, the direct costs are low. To be sure, financial information may in some cases benefit competitors, indirectly reducing firm value. But even in those cases where disclosure benefits competitors, it is unlikely that the optimal level of disclosure of financial information is zero.

The problem of suboptimal disclosure is not necessarily limited to those firms disclosing very little or no information. The fact that a firm voluntarily provides more than a minimal amount of information on conflict transactions and financial results does not mean that the chosen amount is firm-optimal. In any given case, it is difficult to pinpoint the firm-optimal amount of disclosure would be. It is thus possible that all firms voluntarily disclosing more than a minimal amount of information are still providing less than the firm-optimal amount of periodic disclosure. However, the widespread practice of providing very little or no conflict information or financial information is highly unlikely to be firm-optimal.

Importantly, I am not claiming that insiders free to choose the level of their firms’ periodic disclosure always choose a sub-optimal amount. In fact, insiders sometimes voluntarily provide a relatively large amount of disclosure. Before the enactment of the federal securities laws, there were firms that chose to list or remain listed on the NYSE and adhere to its fairly extensive disclosure requirements. Today, there may well be firms today that choose to be reporting companies even if they could exit the mandatory disclosure regime. The critical point however, is that a large number of firms not subject to mandatory periodic disclosure rules fail to commit to provide a minimum amount of disclosure and then subsequently offer what is clearly less than a firm-optimal amount of periodic disclosure.

C. Who Bears the Costs of Under-Disclosure?

We have seen that, in real-world markets, insiders taking firms public do not commit to provide a minimum amount of periodic disclosure and subsequently sometimes choose to provide what is clearly less than the firm-optimal amount of disclosure. When insiders provide less than the firm-optimal amount of disclosure, agency costs and shareholder trading costs are higher than they would be otherwise. Hence, firm value—the amount of value available to insiders and public shareholders -- is lower.
While the failure of insiders to offer firm-optimal disclosure reduces firm value available to public shareholders and insiders, it must make insiders better off. Otherwise, they would offer a firm-optimal amount of disclosure. Thus, firm-suboptimal disclosure must make public shareholders worse off—at least relative to a world of firm-optimal disclosure.

Moving from a lower level of disclosure to a firm-optimal level of disclosure would not only increase the corporate pie but also reduce the absolute size of insiders’ slice. Thus, public shareholders would doubly benefit from a firm-optimal amount of disclosure. Not surprisingly, the imposition of mandatory disclosure on firms that were clearly offering less than the firm-optimal amount of disclosure increases the stock price.95

To be sure, a firm’s failure to provide firm-optimal amount of disclosure does not mean that public shareholders investing in that firm necessarily “lose” money on average. In aggregate, public investors in the firm could still make a positive profit from their investment in such a firm. However, their returns—even if they are positive—would less than they would be in a world where disclosure was firm-optimal.

Importantly, I am not claiming that it is “unfair” for insiders to under-disclose, even if public shareholders lose money as a result. Public investors who use their money to buy stock of companies with inadequate disclosure should not be surprised when they earn low or negative returns. Some of these investors may even know that they are likely to lose money but, like gamblers playing poker in Las Vegas, enjoy the thrill of the game.

From an efficiency perspective, however, insiders’ choice of firm sub-optimal disclosure is clearly undesirable. Even if disclosure had no interfirm externalities, firm sub-optimal disclosure reduces the size of the corporate pie that can be shared by insiders and the firm’s public shareholders.96 It thus undesirably reduces total social wealth.

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95 See Greenstone et al, Mandated Disclosures, at ___ (reporting that firms newly subject to the securities laws’ mandatory disclosure requirements experienced abnormal stock price increases of about 10%).

96 Not to mention third parties that would benefit from increased disclosure.
IV. POLICY IMPLICATIONS

This Part sketches out some implications of the paper’s analysis for two important debates in securities and corporate law: the need for mandatory disclosure (Section A); and whether competition among states seeking corporate charters is likely to yield desirable corporate law arrangements (Section B).

A. The Need for Mandatory Disclosure

A number of leading corporate governance scholars have argued that mandatory disclosure is unnecessary. Insiders taking firms public will adopt firm-optimal periodic disclosure arrangements—those that maximize the amount of value available to insiders and public shareholders. Such arrangements, they predict, would provide more than a minimal amount of information to shareholders. Thus, insiders taking firms public should be allowed to choose the securities regime governing their firm, just as they are currently permitted to choose their own state of incorporation.97 For example, a firm going public in the U.S. should be allowed to adopt the disclosure requirements of the US, a foreign country, a state or a stock exchange, even if those requirements are minimal.98

The analysis and evidence presented in this paper calls into question the assumption that insiders taking firms public can be expected to voluntarily adopt firm-optimal arrangements. This paper has shown that a firm-optimal disclosure arrangement is likely to include an enforceable commitment to provide periodic disclosure; otherwise, insiders seeking to enrich themselves at public investors’ expense will opportunistically offer too little or no disclosure. It has also shown that insiders could have made such an enforceable commitment by, for example, incorporating in a state requiring such disclosure in its corporate laws or by adopting such a requirement in the firm’s corporate charter.

We have seen, however, that the thousands of publicly traded firms that are or were exempt from the federal securities laws generally did not adopt such a commitment. Between the 1860s and the 1934, all public firms were free to choose their own disclosure regime. States and stock exchanges competed heavily for incorporations and listings respectively. Nothing prevented them from creating rules that allowed insiders to make credible commitments to maintain a reasonable amount of periodic disclosure. However, such rules did not emerge, and firms declined to put such requirements in their corporate charters. Not surprisingly, in the absence of such a commitment, the insiders of many of these firms subsequently chose to provide little if any disclosure to shareholders.

97 Romano, Empowering Investors; Choi and Guzman, Portable Reciprocity.

98 See, e.g., Romano, Empowering Investors, at 2364.
After 1934, thousands of publicly traded firms remained exempt from mandatory disclosure under the securities laws. States and stock exchanges remained free to create rules that allowed insiders to make credible commitments to maintain a reasonable amount of periodic disclosure. Again, such rules did not emerge, and there is no evidence firms put such requirements in their corporate charters. Today, the thousands of publicly traded companies that can avoid mandatory disclosure regime often choose to provide no disclosure to shareholders.

This study of firms’ actual disclosure arrangements and practices suggests that allowing insiders to choose their own disclosure arrangements will lead many firms to adopt firm suboptimal arrangements. The failure to maintain firm-optimal amount of periodic disclosure in the secondary market in turn reduces firm value and hurt public shareholders.

One criticism of the deregulatory view is that disclosure creates positive externalities, and thus a firm that adopts a firm-optimal disclosure arrangement will not necessarily adopt an arrangement that is socially optimal. This paper has shown that, even in the absence of interfirm externalities, many firms are unlikely to adopt socially desirable level of disclosure. The analysis and evidence presented suggest that it may well be desirable to impose minimum mandatory disclosure requirements whether or not disclosure creates externalities on other firms.

Indeed, it may well be desirable to extend some form of mandatory disclosure to firms that are not currently considered reporting firms. One approach might be to define “shareholder of record” as the beneficial shareholder rather than the brokerage house holding shares on its behalf. Such an approach would ensure that firms with at least 300 beneficial shareholders provide a reasonable amount of disclosure to their investors.

Importantly, I do not claim that the SEC’s current mandatory disclosure regime is the optimal disclosure regime. Some commentators have argued that the SEC requires more disclosure than is socially optimal, and that the regime imposes unnecessary costs on firms. They may well be correct. Rather, my claim is only that some form of mandatory disclosure is likely to be useful in increasing firm value.

B. Regulatory Competition in Corporate Law

This paper has focused on the periodic disclosure arrangements chosen by insiders taking their firms public who are free to fashion their firms’ disclosure arrangements. Although this issue is usually associated with securities regulation, the paper’s analysis and evidence also have implications for one of

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99 See, e.g., Fox, supra note x.
100 See, e.g., Romano, Empowering Investors at 2375 (discussing evidence suggesting that a number of the SEC’s disclosure mandates are unlikely to be cost-effective).
the oldest and most important debates in corporate law: the desirability of permitting firms to choose their state of incorporation and the corporate law governing the internal affairs of the corporation.

A number of commentators have argued that competition among states for corporate charters is a “race-to-the-top” that can be expected to lead to optimal corporate law rules.101 Firms will seek, and states will rush to provide, corporate law rules that maximize firm and social value. Others have disputed this view, suggesting that such competition leads to a “race-to-the-bottom,” at least with respect to those issues where insiders’ and public shareholders’ interests sharply diverge.102

In this debate, both sides generally assume that markets are efficient and will properly price a firm’s governance arrangements. Hence, insiders can generally be expected to seek -- and states can be expected to offer--firm-optimal corporate law arrangements. The disagreement among participants in the debate is thus generally over whether inter-firm externalities nevertheless lead to arrangements that inefficiently favor insiders at the expense of public shareholders.103 “Race-to-the-bottom” commentators argue that these market failures are large enough to make constraints on competition desirable; “race-to-the-top” commentators dispute this view.


103 See Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679 (2002) (arguing that network externalities may allow states to profit by offering sub-optimal corporate law). Certain contracting problems in the bargaining between the firm and initial public investors, such as information asymmetry, can also lead to sub-optimal corporate law arrangements. See Lucian A. Bebchuk, Asymmetric Information and Corporate Governance Arrangements, (working paper Harvard Law and Economics Discussion Paper No. 398, 2002). Some commentators have also argued that corporate governance arrangements chosen by a firm may impose negative externalities on parties other than managers and shareholders, such as creditors and employees. See Lewis Kornhauser, The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel, 89 Columbia L. Rev. 1449 (1989).
The evidence and analysis presented here casts further doubt on the race-to-the-top view. It is generally agreed, as I have argued in this paper, that the firm-optimal disclosure arrangement would provide more than a minimum of conflict and financial information to shareholders.\textsuperscript{104} I have shown, however, that insiders cannot be counted on to offer the firm-optimal amount of disclosure in the secondary market. Because such disclosure reduces their private benefits in various ways, they may have an incentive to offer too little or no disclosure. Hence, the firm-optimal disclosure arrangement would be expected to include a mechanism to ensure that insiders cannot unilaterally reduce disclosure below a specified level.

Corporate law has long offered a way to provide such a commitment. Indeed, a number of states require that insiders provide certain information to shareholders each year. The problem, we have seen, is that these disclosure requirements are woefully inadequate. Moreover, the state that has attracted the most incorporation and is thus considered to have won the “race”--Delaware--requires no disclosure whatsoever. Thus, corporate law has never supplied a disclosure-forcing mechanism that could substantially increase firm value.

Given states’ failure to supply firm-optimal periodic disclosure rules, there is no reason to believe that the other rules supplied to publicly traded firms are optimal. The right to receive information is not intrinsically different from other rights granted to shareholders by corporate law. Indeed, disclosure is deeply and inextricably connected to these other rights. Governance rights such as fiduciary duties and voting rights would be impossible to utilize if shareholders lack adequate information about self-dealing transactions and their firm’s financial condition. The failure of firms to seek and states to provide firm-optimal disclosure arrangements suggests that the market for corporate charters cannot generally be counted on to yield optimal corporate law rules for public companies.

\textsuperscript{104} See, e.g., Fox, supra note x, at __; Romano, supra note x, at __.
CONCLUSION

A number of leading corporate governance scholars have argued that mandatory disclosure is not needed. Insiders taking firms public can be counted on to adopt “firm-optimal” periodic disclosure arrangements: ones that maximize firm value. Accordingly, insiders taking firms public should be able to choose the disclosure regime governing their firms, just as they choose its corporate law.

This paper has described the likely features of a firm-optimal periodic disclosure arrangement. It shows that insiders taking a firm public would be expected to provide, when they first sell shares to the public, an enforceable commitment to provide more than a minimal amount of information to shareholders. Otherwise, insiders seeking to enrich themselves at public shareholders’ expense could later choose to provide little or no disclosure in the secondary market. The paper then showed that firms going public could create such an enforceable disclosure commitment even if they were outside of the securities laws’ mandatory disclosure regime. For example, firms could incorporate in a jurisdiction requiring minimum level of disclosure or incorporate such a requirement into their corporate charters.

The paper then examined the thousands of publicly traded U.S. firms that were not or are not subject to the securities laws’ mandatory disclosure rules and thus free to choose their own periodic disclosure arrangement. It has shown that insiders taking these firms public in fact failed to adopt firm-optimal periodic disclosure arrangements. In the almost 150 years since U.S. corporations began selling stock to the public, no U.S. state has adopted (even as a default rule) a provision requiring widely-held firms not subject to the securities laws to periodically disclose a meaningful amount of information to shareholders. Indeed, the state that has attracted the most incorporations, Delaware, does not require firms to provide any information to shareholders. Nor is there any evidence that firms going public have incorporated such requirements in their charters or taken any other step to commit to provide periodic disclosure.

Not surprisingly, insiders frequently exploited their control over the flow of information to provide what is clearly less than the firm-optimal amount of disclosure. These firms frequently do not provide basic financial information such as income statements. And they even more frequently refuse to supply information about executive compensation and self-dealing transactions to shareholders.

The paper’s analysis suggests that proposals to allow insiders to choose their own disclosure arrangements are undesirable. Insiders cannot be counted on to adopt even firm-optimal disclosure arrangements. Thus, a mandatory periodic disclosure may well be desirable.

The analysis also has implications for the desirability of state competition for corporate charters. For over 150 years, states could have— but failed to— offer firm-optimal disclosure mechanisms for publicly traded firms not subject to the
securities laws. To be sure, some states have required that insiders provide certain information to shareholders each year. But these disclosure requirements have been woefully inadequate. Moreover, the state that has attracted the most incorporation and is thus considered to have won the “race” for corporate charters—Delaware—requires no disclosure whatsoever. Given states’ failure to supply firm-optimal periodic disclosure rules to publicly traded firms, there is no reason to believe that the other rules supplied to publicly traded firms are optimal. The failure of firms to seek, and states to provide, firm-optimal disclosure arrangements suggests that the market for corporate charters may not yield optimal corporate law rules for public companies.