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Mandatory Disclosure in Primary Markets

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MANDATORY DISCLOSURE IN PRIMARY MARKETS

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Mandatory disclosure—the idea that companies must be legally required to disclose certain, specified information to public investors—is the first principle of modern securities law. Despite the high costs it imposes, mandatory disclosure has been well defended by legal scholars on two theoretical grounds: 'Agency costs' and 'information underproduction.' While these two concepts are a good fit for secondary markets (where investors trade securities with one another), this Article shows that they are largely irrelevant in the context of primary markets (where companies offer securities directly to investors). The surprising result is that primary offerings—such as an IPO—may not require mandatory disclosure at all. This profound insight calls into question the fundamental premises of the Securities Act of 1933 and similar laws governing primary offerings around the world. Reform of these rules could lead to a new age of simplified, low-cost primary offerings to the public, something that is already happening in New Zealand through its equity crowdfunding market.

I. INTRODUCTION

Mandatory disclosure—the idea that companies must be required by law to disclose certain information to the investing public—is the foundation of modern securities law, both for *primary markets*—where companies offer securities directly to investors—and for *secondary markets*—where investors trade securities with one another. Mandatory disclosure imposes significant costs—it costs millions of dollars to produce the necessary disclosures for an IPO (initial public offering), not to mention the ongoing costs of quarterly and annual reporting[1]—to the point that the rule effectively excludes startups and small businesses from going public. Indeed, the number of IPOs has sharply decreased in recent years for all businesses, with

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1 Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457, 1467–70, n.57 (2013) ("the process of going public costs millions of dollars").

even billion-dollar private companies (so-called 'unicorns') expressly declining to go public, in part due to the high and rising costs of mandatory disclosure, leading some to question the wisdom of the practice.[2]

At the same time, opposition to mandatory disclosure has come from a small but persistent group of legal scholars, including Roberta Romano and Paul Mahoney, who challenge mandatory disclosure on theoretical grounds.[3] These scholars generally rely on law-and-economics ideas suggesting that market incentives should be enough to induce companies to voluntarily provide investors with an appropriate level of disclosure, rendering mandatory disclosure wasteful, or at least unnecessary. For one thing, corporate promoters wishing to sell securities for their full value have an incentive to provide fulsome disclosure about the business; else potential investors will offer only a pittance per share.[4] For another, intermediaries such as stock exchanges, being repeat players who need to keep their customers (investors) for the long term, likewise have a financial interest in ensuring sufficient disclosure from companies.[5] As these scholars have shown, there are powerful private incentives for voluntary disclosure in securities markets, presenting a powerful challenge to the necessity of mandatory disclosure.

Rising to this challenge and responding on the very same law-and-economics terms as the skeptics, Professor John Coffee and many other scholars developed a sophisticated defense of mandatory disclosure that largely swept the field in the 1980s and remains the conventional wisdom to this day.[6] According to this modern

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[2] A 2011 report approximated around 6,700 large corporations were being actively traded at the time, and were responsible for a great portion of economic activity in the United States. *See* HOWARD M. FRIEDMAN, PUBLICLY HELD CORPORATIONS: A LAWYER'S GUIDE 1 (2011). That number has decreased significantly for both regular companies and unicorn billion dollar companies in recent years alongside falling IPO public offerings. *See* Eric Shumpeter, *Why the Decline in the Number of Listed American Firms Matters*, ECONOMIST (Apr. 22, 2017), https://www.economist.com/business/2017/04/22/why-the-decline-in-the-number-of-listed-american-firms-matters [https://perma.cc/VYB3-JALF]; Jason M. Thomas, *Where Have All the Public Companies Gone?*, WALL ST. J. (Nov. 16, 2017, 7:10 PM), https://www.wsj.com/articles/where-have-all-the-public-companies-gone-15108691 25 [https://perma.cc/3CND-J3YT]; *see also* Andy Kessler, *Unicorns Need IPOs*, WALL ST. J. (Jan. 7, 2018, 4:37 PM), https://www.wsj.com/articles/unicorns-need-ipos-1515361043 [https://perma.cc/K2PM-529D].

[3] *See, e.g.*, Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2373–81 (1998); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1465–70 (1997) (advocating a competitive regulatory approach to securities regulation).

[4] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 256 (1991).

[5] Mahoney, *supra* note 3, at 1459 ("Self-interested stock exchange members will produce rules that investors want for the same reasons that self-interested bakers produce the kind of bread that consumers want.").

[6] *See generally* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

theory, mandatory disclosure is an efficient response to two economic issues that market forces would not properly address on their own: (1) agency costs, and (2) the underproduction of information.[7]

"Agency costs" is the idea that, left to their own devices, corporate managers might pay themselves extravagantly, work as little as possible, or even steal from the company, all to the detriment of investors.[8] Under a regime of voluntary disclosure, where managers of a corporation have free rein to decide what the company will and will not disclose, they might decide to keep quiet about things that paint them personally in a bad light, even if the information would be relevant to the value of the company's securities. Mandatory disclosure can solve this problem by requiring companies to share information about managerial misbehavior even if it leads the stock price to fall. Mandatory disclosure also deters bad behavior in the first place, as managers can be expected to police their actions to avoid having to provide embarrassing disclosures later.[9]

"Information underproduction" refers to the unlikelihood that companies will voluntarily collect and disclose information that could be relevant to the value of other firms, even if investors would prefer disclosure.[10] To take but one example: McDonald's, which sells lots of soft drinks, presumably has information relevant to consumer demand for Coke, including its rate of growth and how it compares with competitors like Dr. Pepper and apple juice. This information on consumer demand is useful and therefore valuable to Coca-Cola's current and potential shareholders, who are constantly trying to gauge consumer demand for Coke as a component of their valuation of Coca-Cola stock. Unfortunately, McDonald's has little financial interest in tallying and reporting its Coke sales because doing so imposes some cost on McDonald's, but the benefit (of more accurate valuation) would flow to Coca-Cola and the market as a whole. Mandatory disclosure can remedy this problem by

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[7] Hence, they are sometimes called 'market failures.'

[8] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 4, at 9–10; ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[9] Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417, 463 (2003) ("The argument is that disclosure has a prophylactic effect by deterring corporate insiders from engaging in fraudulent or corrupt behavior or mismanagement . . . ."). *See generally* 1 JEREMY BENTHAM, PRINCIPLES OF PENAL LAW, in THE WORKS OF JEREMY J. Bentham 396, 402 (John Bowring ed., 1962) ("When a man perceives or supposes pain to be the consequences of an act, he is acted upon in such a manner as tends, with a certain force, to withdraw him, as it were, from the commission of that act."); A. A. Sommer, Jr., *Therapeutic Disclosure*, 4 SEC. REG. L.J. 263, 266–67 (1976) ("[I]f every instance of adultery had to be disclosed, there would probably be less adultery.").

[10] Coffee, *supra* note 6, at 721–23 (discussing securities research as having similar characteristics and problems that public goods have, the main example being undercollection.).

forcing all public companies to share certain types of information, thereby enhancing the accuracy of all securities prices on the public trading market.[11]

Thanks to these two powerful ideas, the modern theory of mandatory disclosure has achieved hegemony in the field. Nearly all scholars support the idea, both in the United States and around the world.[12] Only a very few academic "skeptics" continue to hold out in favor of voluntary disclosure.[13] Almost entirely overlooked in the discussion, however, is the simple distinction between primary and secondary markets. Understanding how mandatory disclosure operates differently in these two markets provides potential ground for reconciliation among these competing scholarly camps.

Secondary markets receive much more scholarly attention than do primary markets, despite their names.[14] Scholars' focus on secondary trading rather than primary offerings is understandable since many of the most important and interesting issues in the field of securities law arise in that sphere. These issues include insider trading, proxy contests, and hostile takeovers. When someone mentions "the stock market" or "how the market is doing," she likely means to refer to the secondary market, not the primary one. Unfortunately, this focus on secondary markets has led to a significant misunderstanding at the heart of modern securities law and theory. This Article aims to correct that error.

Focusing primarily on the aforementioned concepts of agency costs and information underproduction makes good sense in the context of secondary markets. But if the field shifts its gaze to the primary context, these two ideas become largely irrelevant, or so this Article shall claim.[15]

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[11] For another example, traders in Apple stock try to estimate the company's iPhone sales by reviewing disclosures made by other public companies that supply Apple with screens or other iPhone components. *See, e.g.*, Tripp Mickle, *Apple Shares Sink After iPhone Suppliers Lower Outlooks*, WALL ST. J., (Nov. 12, 2018), https://www.wsj.com/articles/apple-shares-sink-after-iphone-suppliers-lower-outlooks-1542061197 [https://perma.cc/XVM8-PD4E] ("Apple Inc. shares sank [more than 5%] on Monday, as investors' worries deepened about sales of new iPhones after two key suppliers for the device cut their earnings projections for coming months.").

[12] *See infra* Section I.B.

[13] Brent J. Horton, *In Defense of a Federally Mandated Disclosure System: Observing Pre-Securities Act Prospectuses*, 54 AM. BUS. L.J. 743, 745 (2017) ("[S]ome legal scholars have questioned the Congressional finding that corporations failed to provide investors with information; these scholars are referred to as 'skeptics . . . .'").

[14] Insider trading alone, just one of the many features of the secondary market, attracts more attention than IPOs, the key component of the primary market. To quantify this phenomenon, consider that a September 7, 2019, search of Westlaw's "Secondary Sources - Law Reviews & Journals" database returned 563 law review articles with "insider trading" in the title, but only 130 with "IPO" or "initial public offering" in the title.

[15] *See infra* Part II. The canonical article in support of the modern theory hinted at precisely this argument. Coffee, *supra* note 6, at 746 (noting that, while "the theory of voluntary disclosure" was not persuasive with regard to "secondary market trading," it "does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all

As discussed in Part II below, neither agency costs nor information underproduction holds much relevance in the primary context. Agency costs arise only after a company has already sold its securities and investors worry that management will begin to run the company in its own interest, rather than for the benefit of shareholders. This concept is irrelevant to the primary market, where promoters are trying to get investors to buy these securities at the outset, and thus do not have additional shareholders to worry about just yet. In the primary market, the board of directors, CEO, and other managers have not yet become agents, because agency is established by the presence of shareholders. Because management has not yet become an agent, there are no agency costs; they are a feature of the secondary market alone.

Information underproduction occurs when one company may have relatively easy access to information that would help participants in the secondary market more accurately assess the value of some other company or companies whose securities they trade. Information underproduction has almost nothing to do with primary offerings, because new issuers rarely have the same quantity or quality of relevant market information as existing public companies, and because a primary offering is merely a one-time event. Furthermore, promoters have powerful economic interests to divulge all the information that investors want. Thus, the public can likely view almost all relevant company information.[16]

This Article poses a direct theoretical challenge to the dominant view that mandatory disclosure—and all its attendant costs—is justified in the context of primary offerings. Contradicting the guiding principle of the Securities Act of 1933, it suggests that primary offerings—especially those not followed by secondary trading—may not actually require mandatory disclosure at all. This Article's novel distinction between primary and secondary markets thus provides theoretical support for a legal reform that would allow companies to make simple, low-cost primary offerings to the public.

Indeed, this is not only a theoretical possibility but a real one—at least in New Zealand. This small country, whose economy, population, and landmass is roughly comparable to one of the several states[17] and whose securities laws tend to mirror

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primary distributions").

[16] That said, the concept of information underproduction (unlike agency costs) is not totally irrelevant in the primary context. It is possible that the information provided in a primary offering could help traders value other securities already quoted on the secondary market. For instance, certain initial disclosures provided by electric-car maker Tesla at the time of its IPO probably were relevant to traders trying to value other car companies like Ford or GM, whose stock was already traded in the secondary market. In most instances, however, information production is of little practical importance in the context of primary issuance. *See* discussion *infra* Section II.A.2, and accompanying notes 108–113.

[17] Colorado and New Zealand both have about five million residents, similar size economies, and almost the exact same land mass. *QuickFacts Colorado*, U.S. CENSUS BUREAU, https://www.census.gov/quickfacts/CO [https://perma.cc/8GM3-UN5N] (last visited Sept. 18, 2019); CIA, *The World Factbook Australia – Oceania: New Zealand*,

our own,[18] was one of the first in the world to establish a legal framework for "equity crowdfunding."[19] This new form of internet-based public stock market is solely a primary market with no secondary trading.[20] This Article hypothesizes that a primary-only market such as this could succeed entirely based on voluntary disclosure. New Zealand put this claim to the test.

New Zealand's equity crowdfunding law, passed in 2013 and put into effect the following year, took the seemingly radical step of eliminating mandatory disclosure.[21] What to disclose is a voluntary decision made by the company issuing shares and the platform on which it lists its offering. By comparison, the crowdfunding law in the United States, enacted in 2012, is much more traditional because it imposes a set of specified mandatory disclosures.[22] The United States has thus premised crowdfunding on the modern theory of mandatory disclosure (even though that theory does not fit a primary-only market). By contrast, crowdfunding

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https://www.cia.gov/library/publications/the-world-factbook/geos/nz.html [https://perma.cc/3QWU-2H8B] (last updated Sept. 18, 2019).

[18] *See* Andrew A. Schwartz, *The Gatekeepers of Crowdfunding*, 75 WASH. & LEE L. REV. 885, 917–18 (2018) [hereinafter Schwartz, *Gatekeepers*].

[19] *Id.* at 919–21 (describing New Zealand's Financial Markets Conduct Act 2013 and regulations issued thereunder).

[20] This is not due to a legal restriction but rather a business decision by New Zealand's equity crowdfunding platforms not to organize a secondary market. *See* Sophie Boot, *Investors Not Yet Ready for Secondary Market in Crowd-Funded Equities, Platforms Say*, SCOOP (NZ) (July 12, 2017, 8:50 PM), http://www.scoop.co.nz/stories/BU1707/S00307/correct-investors-not-yet-ready-for-secondary-market.htm [https://perma.cc/4GWW-ARTN] ("Platforms with existing crowdfunding licences would need to apply to the FMA in order to operate a secondary market, but none have yet done so."); Nikki Mandow, *Snowball Effect Looks at Launching Secondary Market*, SCOOP (NZ) (May 9, 2018, 4:16 PM), http://www.scoop.co.nz/stories/BU1805/S00282/snowball-effect-looks-at-launching-secondary-market.htm [https://perma.cc/YHK6-FQZZ] (reporting that one platform is "looking at launching a secondary market," but has yet to do so). One platform in the UK does operate a secondary market, but that appears to be the lone exception worldwide. Mandow, *supra* ("UK-based equity crowdfunding platform Seedrs launched a secondary market in June [2017]. Its model involves opening its market on the first Tuesday of every month and closing it a week later.").

[21] Financial Markets Conduct Act 2013, sch 1, s 6(1)(a) (N.Z.) ("An offer of financial products to a person (A) does not require disclosure under Part 3 of this Act if the offer is through a licensed intermediary in the course of supplying prescribed intermediary services to (A)."); Financial Markets Conduct Regulations 2014, s 184(a) (N.Z.) (defining equity crowdfunding as a "prescribed intermediary service . . . .").

[22] 15 U.S.C. § 77d-1(b)(1)(A)-(I) (2012) (mandating various disclosures and authorizing the SEC to add to the list "such other information as the Commission may, by rule, prescribe, for the protection of investors and in the public interest . . ."); *see also* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 869 (2014) ("Congress employed traditional tools of securities regulation in composing the [JOBS] Act . . . ," including "mandatory disclosure rules . . . .").

in New Zealand is premised on this Article's thesis that a primary-only securities market may not need mandatory disclosure. Instead, this market could thrive solely based on voluntary disclosure. So, how are these markets performing?

This Article's author spent six months on the ground in New Zealand to study the country's crowdfunding law and marketplace. He conducted local qualitative research by interviewing entrepreneurs, platform operators, investors, lawyers, academics, and government officials (including the Minister of Commerce) about the subject. In addition, he conducted quantitative research by gathering publicly available data on equity crowdfunding in the United States, New Zealand, and other countries.[23]

Using this research, this Article's author provides an empirical report below that is consistent with the basic thesis of this Article. With the caveat that the United States is still in the early days and therefore should be cautious about drawing strong conclusions, New Zealand's equity crowdfunding market—a primary public stock market without mandatory disclosure—has indeed found financial success. Additionally, this market has greatly outshined that of the United States without any reported fraud. Scaled for the size of its economy and focusing on the first year in each jurisdiction, companies in New Zealand have conducted thirteen times as many crowdfunding campaigns and raised thirty times as much capital as their counterparts in the United States, with a much higher success rate (80% vs. 50%).[24] Furthermore, evidence from other jurisdictions shows that New Zealand has not only outshone the United States but has also become a worldwide leader in the field.[25]

The outsized success of New Zealand's liberal crowdfunding regime compared with that of the United States, along with the fact that fraud (or even business failure) is practically non-existent there, is consistent with this Article's claim. To reiterate, this Article claims that a primary stock market open to the public does not need—and in fact may be better off without—mandatory disclosure. Rather than government regulation, New Zealand's crowdfunding market relies upon private methods of governance such as gatekeeping and syndication, both of which this Article describes below.

The structure of this Article is as follows: Part I introduces the modern theory of mandatory disclosure and its foundations based on agency costs and information underproduction; Part II presents the Article's core theoretical contribution and claims that the modern theory of mandatory disclosure is generally inapplicable to

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[23] Other aspects of this research are reported and discussed in other papers. *See, e.g.*, Andrew A. Schwartz, *Social Enterprise Crowdfunding in New Zealand*, *in* THE CAMBRIDGE HANDBOOK OF SOCIAL ENTERPRISE LAW (Joseph Yockey & Benjamin Means eds., 2018); Schwartz, *Gatekeepers, supra* note 18, at 885 (2018); Andrew A. Schwartz, *Equity Crowdfunding in New Zealand*, 2018 N.Z. L. REV. 243; [hereinafter Schwartz, *Equity Crowdfunding in New Zealand*].

[24] Schwartz, *Equity Crowdfunding in New Zealand*, *supra* note 23, at 250–52.

[25] *Id.* at 253.

primary offerings, with the result that a primary market can succeed without mandatory disclosure; Part III presents empirical evidence from New Zealand's equity crowdfunding market that is consistent with the claim. A short Conclusion summarizes the argument.

II. THE MODERN THEORY OF MANDATORY DISCLOSURE

At least since the New Deal of the 1930s, the overwhelming consensus in the field of securities law has been that public securities markets (like the New York Stock Exchange) cannot regulate themselves.[26] Rather, because of their importance and potential danger, scholars generally agree that public securities markets must be carefully and comprehensively regulated.[27] This regulation is accomplished primarily through mandatory disclosure, both for primary offerings made to the public and for secondary trading markets open to the public.[28]

Mandatory disclosure imposes such significant costs that it deters many companies, especially small ones, from conducting an IPO in the first place.[29] Even so, nearly all scholars and policymakers support the policy based on what this Article refers to as the modern theory of mandatory disclosure.[30] This modern theory holds that economic forces will be insufficient to generate an optimal level of disclosure for public investors because of two market failures: agency costs and information underproduction. Thus, this modern theory posits that the law can solve these problems through mandatory disclosure.[31]

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[26] STEPHEN J. CHOI & A.C. PRITCHARD, ESSENTIALS: SECURITIES REGULATION 1 (2008) ("Generally, in a market economy, people are left to their own devices when deciding how to allocate their funds. If you want to use your money to buy a vacation or a fancy new car, the legal system will not stand in your way. . . . For securities, however, a dedicated federal agency, [the] SEC, enforces a broad array of federal statutes and regulations.").

[27] *Id.* at 4.

[28] Mahoney, *supra* note 3, at 1465 ("The most prominent feature of securities regulation in the United States is the mandatory disclosure system.").

[29] *See, e.g.*, Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 546 (2012) ("Representatives of smaller companies have complained repeatedly to Congress and the SEC about escalating costs and surveys indicate that compliance obligations are among the biggest concerns entrepreneurial firms have with going public. While it seems that companies gripe about the costs of compliance no matter the regulatory regime, in this case the concerns appear credible.").

[30] Kevin S. Haeberle & M. Todd Henderson, *Making a Market for Corporate Disclosure*, 35 YALE J. REG. 383, 390 (2018) ("The consensus story in the securities-law literature is that market forces alone are insufficient to bring about sufficient amounts of public-company disclosure.").

[31] *Id.* at 383 ("It has long been said that market forces alone will result in a problematic under-sharing of information by public companies.").

A. Mandatory Disclosure and Its Costs

Centuries ago, stock markets were small, private clubs where the members knew and dealt with one another on a regular and repeated basis.[32] The members also had a clear economic incentive to protect investors, since their livelihoods depended on their clients coming back to trade again in the future (and they would only do so if they felt they were treated fairly).[33] An entrepreneur seeking to finance a venture was a one-time player and in a position to mislead investors and then take the money and run. Yet the members of the exchange, as repeat players, were not willing to sacrifice the trust which investors placed in them. Under such conditions, club members came together and established a set of private rules, as well as private methods of enforcement (such as stripping violators of their membership), that proved fairly effective at preventing fraud and market abuse by entrepreneurs and other one-time players.[34] Legal regulation of securities was apparently not needed.[35]

By the twentieth century, however, things had changed. Stock exchanges were opened up to the public, and millions of ordinary Americans bought and sold stock through brokers at the New York Stock Exchange and similar venues, making self-

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[32] EDWARD PETER STRINGHAM, PRIVATE GOVERNANCE: CREATING ORDER IN ECONOMIC AND SOCIAL LIFE 21–26 (2015) (discussing the theory of 'club goods'); *id.* at 3 ("Without the ability to rely on external courts, [stock] brokers transformed coffeehouses into private clubs that created and enforced rules. Each club aimed to admit only reputable brokers, and those who broke the rules would be kicked out and labelled a 'lame duck.' The private club known as Jonathan's Coffeehouse eventually became the London Stock Exchange . . . .").

[33] *Id.* at 72 ("Fraud harms victims and diminishes future trade. London stockbrokers saw this problem and recognized that they could benefit by mitigating it."); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 690 (1984) [hereinafter Easterbrook & Fischel, *Protection of Investors*] ("Exchanges gain . . . by adopting rules that minimize the amount of deceit committed by listed firms, because investors who are misled are less likely to be repeat players."); Mahoney, *supra* note 3, at 1457 ("Exchanges should have strong incentives to adopt rules that benefit investors. I will not belabour the arguments because they are the same ones that apply to the incentives of any producer to supply goods or services that consumers desire . . . .").

[34] STRINGHAM, *supra* note 32, at 61–76; *cf.* Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 798–99 (2012) (explaining that when parties anticipate repeated future interactions, "the optimal move is always to cooperate" and discussing the 'prisoners dilemma') (internal quotation marks and citation omitted).

[35] Mahoney, *supra* note 3, at 1457 ("Stock markets, meaning organized markets in which professional, specialized intermediaries trade securities pursuant to a common set of rules, have existed since the seventeenth century. Governments paid attention to, and tried to restrict the activities of, these markets from the outset, but for most exchanges, comprehensive governmental regulation of rules and procedures is a twentieth-century phenomenon. For most of their history, then, exchanges have been the primary regulators of securities markets.").

regulation infeasible.[36] With stock trading now open to the public, the state and then federal governments began to impose mandatory regulations on the practice to protect investors. This imposition began in the 1910s when numerous state governments, led by Kansas and other states far from Wall Street, passed so-called "Blue Sky" laws.[37] These statutes required that sellers of securities file their securities with state authorities and have them approved prior to making any offers to state residents, thereby requiring state government regulators to provide a substantive "merit" review of every security for sale in the state. These merit reviews not only revealed information about the company but also determined whether the offering was fair for the buyer.

A few decades later—shortly after the devastating stock market crash of 1929 and amid of the Great Depression—the federal government enacted the Securities Act of 1933 (the 'Securities Act') and the Securities Exchange Act of 1934.[38] These sweeping statutes gave birth to the Securities Exchange Commission ("SEC") and imposed intense regulation and oversight on public securities markets.[39] The core feature of this federal regulatory regime was, and remains, mandatory disclosure. This feature represents a legal requirement that companies selling stock or other securities provide specified information to the SEC and the public.[40] In contrast with the Blue Sky laws, the federal system of mandatory disclosure did not call for merit review.[41] Rather, the goal was simply to give investors the relevant information about a company and let them make their own decision whether to invest.[42]

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[36] NEW YORK STOCK EXCHANGE, AMERICAN STOCK EXCHANGE, HISTORICAL TIMELINE, https://www.nyse.com/publicdocs/American_Stock_Exchange_Historical_Timeline.pdf [https://perma.cc/QW68-H4L3].

[37] *See generally* Rick A. Fleming, *100 Years of Securities Law: Examining a Foundation Laid in the Kansas Blue Sky*, 50 WASHBURN L.J. 583 (2011).

[38] LOUIS LOSS ET AL., FUNDAMENTALS OF SECURITIES REGULATION 47–65 (7th ed. 2018) (recounting the history and purpose of the Acts).

[39] *Id.*

[40] *Id.* at 50–54; Elisabeth de Fontenay, *Do the Securities Laws Matter? The Rise of the Leveraged Loan Market*, 39 J. CORP. L. 725, 726 (2014) (opining that mandatory disclosure is the "crown jewel and major innovation" of federal securities regulation.); Allen Ferrell, *Mandatory Disclosure and Stock Returns: Evidence from the Over-the-Counter Market*, 36 J. LEGAL STUD. 213 (2007) ("Mandatory disclosure requirements placed on publicly traded firms constitute the core of U.S. securities regulation."); Mahoney, *supra* note 3, at 1465 ("The most prominent feature of securities regulation in the United States is the mandatory disclosure system.").

[41] LOSS ET AL., *supra* note 38, at 50–53 (describing the "battle of the philosophies"—merit review versus mandatory disclosure—and noting that, in the end, "President Roosevelt chose the disclosure philosophy.").

[42] It is certainly true that many "ordinary" investors lack the time and expertise to actually read and understand securities disclosures. Even so, they can rely on summaries and reports from 'Wall Street' analysts who essentially translate the specialized language used in securities filings into plain English.

Under the Securities Act, a company seeking to sell securities to the public in a primary offering (often called an Initial Public Offering (IPO)) must first 'register' those securities with the SEC.[43] This registration process includes filing a massive disclosure statement with the SEC that details information such as bonus and profit-sharing agreements and financial statements from prior years.[44]

All this work can consume over 1,200 hours[45] and can take over six months to complete, even "under ideal conditions."[46] In addition to the direct cost of preparing this statement, companies incur the cost of distracted executives.[47] Moreover, companies are usually unable to fulfill these disclosure requirements entirely on their own. This inability forces companies to add the expense of external attorneys, accountants, and underwriters.[48] Generally, these additions add around 10% of the total offering amount to the price tag of an IPO.[49] Then, after companies prepare a registration statement, they must wait for the SEC to review and comment on the statement draft. Because this process can take months, the price at which a company anticipated issuing its securities may have changed due to fluctuating financial or economic conditions, adding even more cost to the process.[50]

Unfortunately, these burdens tend to fall most heavily on the companies who can afford them the least—small businesses with small offerings—because the costs of filing are not proportionate to the size of the offering.[51] As the costs of providing disclosure reach millions of dollars, disclosure becomes totally infeasible for startups and small businesses who have less capital to spend. Thus, the pragmatic response for some small companies is to seek an exemption from the registration requirements altogether.[52]

As the demands of mandatory disclosure have increased in recent years, in part because of the federal Sarbanes-Oxley[53] and Dodd-Frank Acts,[54] the United States

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[43] 15 U.S.C. § 77e(a)(1) (2012); LOSS ET AL., *supra* note 38, at 62.

[44] *See* 17 C.F.R. § 229 (2018) (providing instructions for filing registration statement).

[45] Schwartz, *supra* note 1, at 1469.

[46] Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & BUS. 1, 8 (2007).

[47] Schwartz, *supra* note 1, at 1469.

[48] Cohn & Yadley, *supra* note 46, at 9.

[49] *Id.* at 8 ("While a self-underwritten offering will cost less and, theoretically, can be completed in less time, results have not been positive for many non-underwritten offerings.").

[50] *Id.* at 8.

[51] Schwartz, *supra* note 1, at 1470.

[52] *See generally* Cohn & Yadley, *supra* note 46, at 12 (noting the numerous hurdles to qualifying for an exemption, including the fact that "[t]he private offering exemptions, Section 4(2) and Rule 506, impose 'sophistication' and 'experience' eligibility standards that substantially limit a small company's pool of potential investors").

[53] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

[54] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 5 U.S.C., 7 U.S.C., 12

has seen a sharp decline in IPOs: an average of over 300 IPOs per year between 1996 and 2006. Since then, the country has seen an average of about 125 per year.[55] Because companies tend to hire most after they go public,[56] this decline impacts not only the investing public, but also the working public. Though unfortunate in and of itself, this decline also has ramifications for the broader U.S. economy. As the American primary markets become less attractive to U.S. companies, they may choose to take their IPOs elsewhere, looking instead to markets in the United Kingdom or China.[57]

Despite these concerns, this basic framework of federal securities regulation, with its focus on costly mandatory disclosure, has remained in place for nearly a century.[58] During that time, the federal government has repeatedly demonstrated its continued faith in mandatory disclosure by expanding its scope and coverage.[59] The result is that the cost of providing all the mandatory disclosures in an IPO can run to several million dollars.[60] Despite this great expense, modern securities practitioners, regulators, and scholars overwhelmingly agree that mandatory disclosures are worth the cost.[61] This broad consensus is premised on what this Article refers to as the

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U.S.C., 15 U.S.C., 22 U.S.C., 26 U.S.C., 28 U.S.C.).

[55] *See 2017 IPO Report*, WILMERHALE 2 (2017), https://www.wilmerhale.com/-/media/fc4be2dd82d04a42ad7807f5e024d304.pdf [https://perma.cc/2DE5-URRM].

[56] H.R. REP. NO. 112-406, at 7 (2012).

[57] *Id.* It bears noting that 2019 may herald a new wave of significant IPO activity. *See* Maureen Farrell & Corrie Driebusch, *IPO-Hungry Investors Look to Have Their Moment in 2019*, WALL ST. J. (Dec. 31, 2018), https://www.wsj.com/articles/ipo-hungry-investors-look-to-have-their-moment-in-2019-11546189200 [https://perma.cc/3FU2-V6TD].

[58] Joan MacLeod Heminway, *Personal Facts About Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior*, 42 WAKE FOREST L. REV. 749, 752 (2007).

[59] *See* LOSS ET AL., *supra* note 38, at 7–11 (describing "the recurrent theme" of federal securities legislation as "disclosure, again disclosure, and still more disclosure").

[60] Schwartz, *supra* note 1, at 1464.

[61] *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 473 (2017) ("For several decades now the majority view has been that, in theory, the cost-benefit analysis of mandatory disclosure in federal securities regulation is a favorable one . . . .") [hereinafter de Fontenay, *Deregulation of Private Capital*]; *see also* de Fontenay, *supra* note 40, at 759 (2014) (referring to "the orthodoxy of mandatory disclosure . . . "); Li-Wen Lin, *Corporate Social and Environmental Disclosure in Emerging Securities Markets*, 35 N.C. J. INT'L L. & COM. REG. 1, 2 (2009) (stating "disclosure is the orthodox focus of securities law"); Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1617–18 (2006) (stating "orthodox securities regulation rests [on the idea] that investors take advantage of the disclosures that SEC requirements generate"); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1400 (2002) (discussing "the developing consensus that American securities regulation is the optimal system for governing capital markets"); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999) (reporting on a "rough

"modern theory" of mandatory disclosure, the substance of which shall be examined in the next Section.

B. Debate over Disclosure and the Two Theoretical Bases for the Modern Theory

Scholars in the field widely agree that company disclosure provides numerous important benefits for investors, other companies, and the public at large,[62] but disagree whether this disclosure should be mandated, or whether it can be accomplished voluntarily. Though the modern theory of mandatory disclosure still prevails, several compelling arguments for voluntary disclosure have been made.

In the 1930s, when the federal securities laws were new, the driving rationale for mandatory disclosure was to treat "mom and pop" investors fairly by providing them with accurate and timely information about potential and actual investments.[63] But anyone who has actually looked at a securities filing in the primary market knows that these filings are so arcane and densely written as to be almost completely impenetrable to an ordinary retail investor. Rather, retail investors benefit from professional securities analysts who actually do read and trade based on such filings, and thereby drive market prices to incorporate the information contained in the

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consensus" in favor of mandatory disclosure and noting that "even most economics-oriented legal academics" agree); *id.* at 1340 (discussing the "prevailing consensus for retaining mandatory disclosure").

[62] *See* de Fontenay, *supra* note 40, at 733–34 (cataloging the "possible benefits" of securities regulation as "preventing unsophisticated investors from making risky investments, ensuring that investors are adequately informed before making risky investments, improving the allocational efficiency of capital markets, preventing fraud by issuers and intermediaries, correcting inefficiencies in the production of material investment information, standardizing disclosure practices among issuers, controlling specific managerial or promoter agency problems, and helping established firms create barriers to entry for new firms") (citations omitted); *see also* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 9 (1983) ("Historically, the proponents of the SEC's mandatory corporate disclosure system have advanced five principal arguments to justify the system. First, in the absence of a compulsory corporate disclosure system some issuers will conceal or misrepresent information material to investment decisions. Second, in the absence of a compulsory corporate disclosure system, underwriting costs and insiders' salaries and perquisites will be excessive. Third, in the absence of a mandatory corporate disclosure system, there will be less 'public confidence' in the markets. Fourth, in the absence of the laws creating a mandatory corporate disclosure system, neither state laws nor private associations such as the New York Stock Exchange can ensure the optimal level of corporate disclosure. Fifth, in the absence of a mandatory corporate disclosure system, civil or criminal actions will not ensure optimal levels of corporate disclosure.").

[63] de Fontenay, *Deregulation of Private Capital*, *supra* note 61, at 474 ("A moment's thought makes it clear that passive, dispersed investors require substantial amounts of information from issuers in order to have any hope of valuing their investment . . . .").

filing.[64] Hence, over time, the "fairness rationale" for mandatory disclosure has been "almost universally discarded" among scholars and policymakers.[65]

Similarly, no one seriously argues that large public companies would decline to provide information to the public absent legally mandated disclosure.[66] This lack of argument is generally based on the concept of "signaling," which suggests that companies have an incentive to disclose even bad news. This incentive exists because, if companies stay silent, investors will presume that things are even worse. Accordingly, a company seeking to raise money from the public has a clear economic incentive to disclose all information relevant to potential investors, regardless of whether such disclosure is mandated by law.[67] Potential investors will presume a company that discloses nothing has something to hide (such as poor business performance). Thus, a company that is doing well (or even just fine) has an incentive to voluntarily disclose relevant information to distinguish itself from those poor prospects that remain silent.[68]

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[64] EASTERBROOK & FISCHEL, *supra* note 4, at 293–94.

[65] Luca Enriques & Sergio Gilotta, *Disclosure and Financial Market Regulation*, in THE OXFORD HANDBOOK OF FINANCIAL REGULATION 514 (Niamh Moloney, et al., eds. 2015) ("The fairness rationale has been almost universally discarded. Today, nobody seriously argues that protecting investors via disclosure is a proper policy just because doing so is . . . just."); Easterbrook & Fischel, *Protection of Investors*, *supra* note 33, at 692–93 ("The justification most commonly offered for mandatory disclosure rules is that they are necessary to 'preserve confidence' in the capital markets. It is said that investors, especially small and unsophisticated ones, withdraw their capital to the detriment of the markets and the economy as a whole when they fear that they may be exploited by the firms or better-informed traders. Disclosure rules both deter fraud and equalize 'access' to information, restoring the necessary confidence. . . . [This argument is not persuasive;] after fifty years, the proponents of regulation have no scientifically-acceptable evidence of a favorable cost-benefit ratio for any disclosure rule that rests on the benefits of reducing fraud or increasing confidence.").

[66] EASTERBROOK & FISCHEL, *supra* note 4, at 288 ("Firms have been disclosing important facts about themselves . . . as long as there have been firms.").

[67] *See* Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 184–85 (Franklin R. Edwards ed., 1979) ("[I]n a competitive market (with no mandated disclosure) the managers of firms . . . will have a strong self-interest in disclosing relevant information.").

[68] EASTERBROOK & FISCHEL, *supra* note 4, at 288–89; Easterbrook & Fischel, *Protection of Investors*, *supra* note 33, at 683 ("[T]ake a simple example of a firm that wants to issue new securities. The firm has a project (say, the manufacture of a new computer) that it expects to be profitable. If the firm simply asked for money without disclosing the project and managers involved, however, it would get nothing. Investors would assume the worst, because, they would reason that if the firm had anything good to say for itself it would do so. Silence means bad news. A firm with a good project, seeking to distinguish itself from a firm with a mediocre project (or no project at all), would disclose the optimal amount of information. That is, it would disclose more and more so long as the cost of disclosure (both direct costs of dissemination and indirect costs of giving information to rivals) was

As Easterbrook and Fischel, among others, have explained, disclosure is so valuable to both the public and public companies that law need not command it.[69] Therefore, we should expect it to come voluntarily. The upshot of this "voluntary disclosure" theory is that any sort of mandated disclosure that goes beyond what companies would voluntarily provide would be superfluous and wasteful.[70]

Beyond the company itself, a private stock exchange likewise has powerful economic incentives to regulate its securities market in a way that will protect and benefit investors, a point championed by John Mahoney.[71] The way that an exchange makes money is by listing companies and having investors buy in or trade with one another, as each transaction generates a return for the exchange.[72] Since revenues rise as the volume of transaction rises, an exchange has a financial incentive to attract investors. As a result, exchanges have an interest in ensuring that investors feel well-protected and sufficiently informed when they trade on the exchange.[73] Under this theory, it would harm investors for the government to impose any additional disclosure obligations, because they cost more to produce and disseminate than they are worth to investors.[74]

Additionally, an exchange could impose strict listing standards to protect investors, rather than listing any company that asks. An exchange could also discipline brokers who take advantage of investors by expelling them from the exchange (and thus impacting their livelihood).[75] And even if individual companies

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worthwhile to investors as a whole."); Romano, *supra* note 3, at 2374 ("Because firms need capital and investors need information, firms have powerful incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities.").

[69] EASTERBROOK & FISCHEL, *supra* note 4, at 288–89 ("If disclosure is worthwhile to investors, the firm can profit by providing it. . . . [For this reason, [f]irms have been disclosing important facts about themselves . . . as long as there have been firms.").

[70] de Fontenay, *Deregulation of Private Capital*, *supra* note 61, at 476 ("In this view, mandating disclosure either leads to a surfeit of information that investors do not actually want—with heavy costs on the companies that generate it—or stifles innovation and improvements in disclosure."); Seligman, *supra* note 62, at 5 n.24 ("In theory, it can be argued that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to voluntarily disclose all or virtually all information material to investors.").

[71] Mahoney, *supra* note 3, at 1453.

[72] EASTERBROOK & FISCHEL, *supra* note 4, at 294–95 ("[T]he success of an exchange depends on the amount of trading.").

[73] *Id.* ("[E]xchanges have incentives to adopt rules governing trade that operate to the benefit of investors."); Mahoney, *supra* note 3, at 1459 ("Self-interested stock exchange members will produce rules that investors want for the same reasons that self-interested bakers produce the kind of bread that consumers want.").

[74] STRINGHAM, *supra* note 32, at 195–200; Mahoney, *supra* note 3, at 1500 ("Exchanges have strong incentives to provide rules of market structure that investors want and to compel adherence by their members to contractual and fiduciary obligations.").

[75] STRINGHAM, *supra* note 32, at 30–33.

face a collective action problem that would prevent them from providing efficient levels of disclosure, an exchange can solve that problem by requiring all listed companies to make certain specified disclosures.[76] Indeed, stock exchanges performed all of these functions from the 1600s to the present day.[77] Moreover, given their economic incentives and deep knowledge of market conditions, exchanges may do a better job regulating securities markets than government officials.[78] Similar arguments could apply to professional underwriters and investment banks, as well as any other intermediaries that bridge the divide between companies and the public.

Based on these theories, a few dissenters have challenged the modern theory in support of mandatory disclosure and spoken out in favor of voluntary disclosure. Among the most notable of these dissenters are Professors Roberta Romano, Paul Mahoney, Alan Palmiter, Stephen Choi, and Andrew Guzman. All of these professors have published articles questioning the soundness of the arguments in favor of mandatory disclosure and other aspects of modern securities regulation.[79]

Even so, the consensus in favor of mandatory disclosure remains as strong as ever. This strength is unrelated to any empirical findings in support of mandatory disclosure, as the empirical evidence, although voluminous, is ultimately inconclusive.[80] Rather, modern scholars' support for legally mandated disclosure

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[76] EASTERBROOK & FISCHEL, *supra* note 4, at 294–95 ("Organized exchanges offer the firms a way to cope with the collective action problem.").

[77] *See generally* STRINGHAM, *supra* note 32; *see also* Mahoney, *supra* note 3, at 1459–62; NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 2 (section on "Disclosure and Reporting Material Information").

[78] Mahoney, *supra* note 3, at 1462 ("[A] governmental regulator that sets out to determine optimal exchange rules starts from a substantial disadvantage in information, experience, and incentives compared to an exchange.").

[79] *See generally* Romano, *supra* note 3, at 2359; Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998).

[80] Fox, *supra* note 61, at 1394 (stating that "empirical studies have not resolved the issue one way or the other . . ."). Some empirical studies suggest that companies would voluntarily disclose all the information the market would want without legal compulsion. *See, e.g.*, de Fontenay, *supra* note 40, at 728–29 (detailing empirical study concluding that "the securities laws are not achieving their principal goal" of "remedying the underproduction of material investment information" in "today's debt markets" because, "[p]urely through private ordering, the loan market appears to be providing sufficient information for investors . . ."); Romano, *supra* note 3, at 2373; George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 144–45 (1973) (empirical analysis of stock prices before and after the passage of the 1930s federal securities laws finding no significant effect from the new mandated disclosure—suggesting that companies were already voluntarily providing all the information that the market desired). Other empirical studies lend support to the consensus view that mandatory disclosure is needed, beneficial and efficient. *See, e.g.*, REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL

rests primarily on theory. Specifically, this theory includes two ideas that sound in law-and-economics: (1) opportunism resulting in agency costs, and (2) inaccurate pricing caused by information underproduction.[81]

1. Agency Costs

First, the separation of ownership and control that is so essential to the corporate form[82] also creates agency costs and the risk of opportunistic behavior by corporate management.[83] The idea here, at its most basic, is that those who manage a

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APPROACH 279 (2d ed. 2009) [hereinafter KRAAKMAN (2009)] (acknowledging that "early" empirical studies found otherwise, but contending that recent empirical studies support the orthodox consensus in favor of mandatory disclosure); Prentice, *supra* note 61, at 1495–99 (presenting empirical findings to show that "American-style securities regulation [is] the optimal approach to producing efficient securities markets"); Fox, *supra* note 61, at 1393 ("There is affirmative evidence for the proposition that mandatory disclosure has increased the amount of meaningful information in the market and has improved price accuracy."). In the end, the empirical data is inconclusive. Fox, *supra* note 61, at 1394; REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 204 (1st ed. 2004) [hereinafter KRAAKMAN (2004)] ("[B]oth supporters and critics of the U.S. mandatory disclosure legislation . . . acknowledge that empirical studies can neither demonstrate that their benefits outweigh their costs, nor show the converse.").

[81] REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 246 (3d ed. 2017) [hereinafter KRAAKMAN (2017)] ("The case for mandatory disclosure [is premised on the concern] that firms will not disclose sufficient, or sufficiently comparable, information without it."); Enriques & Gilotta, *supra* note 65, at 514 ("Today, nobody seriously argues that protecting investors via disclosure is a proper policy just because doing so is . . . just. Many, instead, and especially policymakers, contend that protecting investors is instrumental to the well-functioning—if not to the very existence—of the market and has thus an efficiency justification."); Merritt B. Fox, *Rethinking Disclosure Liability in the Modern Era*, 75 WASH. U. L.Q. 903, 915 (1997) ("[T]he function of mandatory disclosure is efficiency—improved selection of the proposed new investment projects in the economy and improved operation of existing ones—not investor protection."). A third, weaker, theory for mandatory disclosure is based on "the value of standardization" which improves comparability between firms. But this can be achieved through private standard-setting bodies, like the NYSE. KRAAKMAN (2017), *supra* note 81, at 246 (making the modest claim that "mandatory disclosure may accelerate the standardization process"); EASTERBROOK & FISCHEL, *supra* note 4.

[82] *See, e.g.*, DEL. CODE ANN. tit. 8 § 141(a) (2019) (providing that the board of directors shall manage the corporation).

[83] EASTERBROOK & FISCHEL, *supra* note 4, at 217 ("Once they are ensconced, and have raised the capital the firm needs, managers may elect to behave opportunistically—to maintain themselves in office or raise their compensation at the expense of investors."); KRAAKMAN (2017), *supra* note 81, at 245–58; EASTERBROOK & FISCHEL, *supra* note 4, 9–10; Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 336–38 (1979); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 718 (2006).

corporation (CEO, etc.) have different incentives than the shareholders.[84] In particular, corporate management would surely be disinclined to share certain types of news with investors lest they get demoted or terminated, especially items that put them personally in a bad light.[85] Furthermore, shareholders might be glad to go along with minimal disclosure of bad news, since the value of their holdings would go down upon release.[86] This is an unfortunate reality, as this kind of information would be socially useful for the world to know so the market price for a stock can reflect its true value based on all accurate information.[87] Mandatory disclosure offers one solution to the fundamental agency problem of the corporate form by mandating that this information becomes publicly available.[88]

2. Information Underproduction

Second, there is the theoretical claim that "mandatory disclosure [helps] market participants to determine prices for securities that accurately reflect all available information," thereby enhancing social welfare.[89] Disclosure must be mandated because it might not be forthcoming voluntarily, such as when "the private benefits of disclosure to issuers may be less than its social benefits to market participants."[90] The idea is that left to their own devices, companies might not provide as much disclosure as diversified investors would like, due to collective-action problems.[91]

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[84] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 4, at 9–10; BERLE & MEANS, *supra* note 8, at 6; Jensen & Meckling, *supra* note 8, at 308; KRAAKMAN (2017), *supra* note 81, at 246.

[85] KRAAKMAN (2004), *supra* note 80, at 246; *cf., e.g.*, Thomas Gryta et al., *GE Board in Dark on CEO's Use of Extra Jet*, WALL ST. J., Oct. 30, 2017, at B1 ("General Electric Co. executives didn't notify the company's board until this month about its regular flying of a spare business jet for its chief executive . . . . While CEO, Mr. Immelt wanted a backup jet in case there was a mechanical issue that could lead to delays . . . . Flight crews were told to not openly refer to the backup planes, for fear of raising eyebrows . . . . One person said the flight manifest sometimes listed 'Robert Jeffries' or 'Jeffrey Roberts' as the passenger on the second plane, when in fact the seats were empty.").

[86] KRAAKMAN (2004), *supra* note 80, at 278.

[87] KRAAKMAN (2017), *supra* note 81, at 246–48.

[88] Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (contending that "the principal purpose of mandatory disclosure is to address certain agency problems . . .").

[89] *Id.* at 1048.

[90] KRAAKMAN (2017), *supra* note 81, at 246; *see also* EASTERBROOK & FISCHEL, *supra* note 4, 290–91; Easterbrook & Fischel, *Protection of Investors*, *supra* note 33, at 673–80.

[91] EASTERBROOK & FISCHEL, *supra* note 4, at 290–91 ("The information produced by one firm for its investors may be valuable to investors of other firms . . . . Yet firm *A* cannot charge the investors in these other firms for the benefits, although they would be willing to pay for them. Because they cannot be charged, the information will be underproduced.").

For example, a company might rationally decide not to disclose a certain piece of information, even if investors would want to know it because doing so would aid a competitor.[92]

These two justifications for mandatory disclosure—agency costs and underproduction of information—have sound theoretical bases and have proved persuasive to the current generation of securities law scholars and policymakers.[93] The overwhelming consensus in the field remains that mandatory disclosure is both beneficial and efficient, and should remain as the essential component of securities regulation both in the United States and abroad.[94] A substantial majority of securities law scholars—including Professors John Coffee, Merritt Fox, Alan Ferrell, Reiner Kraakman, Robert Prentice, and Michael Guttentag—practitioners, and regulators all support the modern theory in favor of mandatory disclosure.[95]

III. THE MODERN THEORY DOES NOT APPLY TO PRIMARY OFFERINGS

The previous Part described the powerful and popular modern theory in favor of mandatory disclosure in public stock markets. Yet, for all its strength and all its adherents, that consensus ultimately rests on just two theoretical justifications—(1) agency costs, and (2) information underproduction. And while these two theories apply quite obviously and directly to a secondary market (where investors trade securities with one another), they have only a limited relationship with the primary market (where companies issue securities to investors), as this Part establishes. The upshot is that the modern theory should be conceptually limited in application to

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[92] KRAAKMAN (2017), *supra* note 81, at 246–48.

[93] de Fontenay, *Deregulation of Private Capital*, *supra* note 61, at 477 ("[T]he contemporary case for imposing disclosure requirements on firms rests primarily on collective action problems and agency costs that disincentivize voluntary corporate disclosure.").

[94] KRAAKMAN (2004), *supra* note 80, at 204 ("Despite academic criticism, however, the majority view among both scholars and regulators is that public companies would underproduce information in the absence of mandatory disclosure."); Fox, *supra* note 61, at 1339–40, 1339 n.13 (identifying only a handful of "prominent dissenter[s]" from the consensus view). This is true not only in the United States but around the world. *See* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 125 (2007) ("[T]he case for mandatory disclosure is strong for virtually all countries around the world."); Prentice, *supra* note 61, at 1495 (discussing the "developing global consensus favoring American-style securities regulation as the optimal approach to producing efficient securities markets").

[95] KRAAKMAN (2009), *supra* note 80, at 279 (Although "legal scholars continue to debate how far issuers should be given discretion over disclosure in public markets[, i]n our view recent scholarship supports the conventional view that publicly-traded firms under-report information without legal compulsion."). Even the authors of an article called *The Failure of Mandated Disclosure* accept that mandatory disclosure is appropriate for the securities context. *See* Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 732 (2011).

secondary markets. A further lesson is that scholars ought to seriously entertain the possibility that mandatory disclosure may not be required, or even helpful, for primary offerings.

A. The Two Theoretical Bases of the Modern Theory Are Addressed to Secondary Markets, not Primary Offerings

Recall that there are powerful economic incentives for corporate insiders and promoters to voluntarily provide full and fair disclosure to potential investors in a primary offering.[96] This is a function both of the signaling theory discussed above[97] and the long-term interest of the exchange, which hopes to entice investors to return to buy into future offerings.[98] Nevertheless, as this Article showed in Part I, this theory of voluntary disclosure has largely been overcome by two powerful law-and-economics concepts that undermine it: (1) agency costs, and (2) information underproduction.[99]

These concepts, however, pertain almost entirely to the secondary market and are largely inapplicable in the context of primary offerings, as this Section will explain.[100] Agency costs are irrelevant to primary offerings, simply because there can be no agents until there are shareholders.[101] And while information underproduction is not totally irrelevant in the context of primary offerings, it holds little force as a practical matter.[102]

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[96] EASTERBROOK & FISCHEL, *supra* note 4, at 288–90; Seligman, *supra* note 62, at 61 ("In theory, it can be argued that a mandatory corporate disclosure system is unnecessary because corporate managers possess sufficient incentives to voluntarily disclose all or virtually all information material to investors. *These incentives are strongest with respect to new issues.*") (emphasis added).

[97] *See supra* Section II.B; *see, e.g.*, de Fontenay, *Deregulation of Private Capital*, *supra* note 61, at 475 (stating "issuers therefore face powerful market incentives to disclose precisely the amount and type of information that potential investors desire").

[98] Mahoney, *supra* note 3, at 1465–70.

[99] *Supra* Section I.B.1-2; de Fontenay, *Deregulation of Private Capital*, *supra* note 61, at 477–78.

[100] *Cf.* KRAAKMAN (2017), *supra* note 81, at 247–52 (explaining how the value of mandatory disclosure on the secondary market can have a knock-on benefit for the primary market).

[101] *Infra* Section II.A.1.

[102] *Id.*

1. Agency Costs

Agency costs refer to misbehavior by the board of directors, CEO, and other managers (agents) of a public company whose shares are already widely dispersed. Agency costs are purely a function of a secondary market where public investors have already paid over their capital and must hope that the management will work diligently for the corporate interest.[103]

As Easterbrook and Fischel explain, "[o]nce they are ensconced, and have raised the capital the firm needs," managers have the chance to behave opportunistically and take advantage of the investors.[104] But this can only happen once they are ensconced. In other words, it is only after a primary offering occurs that managers have the power to oppress the investors whose capital they (now) control. Before that moment, agency costs are physically impossible. Outsiders have not yet handed over their money. Therefore, there are no principals and no agents (yet).[105] In short, the concept of agency costs has no logical application in the context of primary markets.

2. Information Underproduction

Information underproduction is based on the idea that information is a valuable public good because it enhances the accuracy of the prices at which securities trade on the secondary market. Recall the example where McDonald's has access to information relevant to the valuation of Coca-Cola. The secondary market benefits from the disclosure of such information because this information would allow traders to better estimate the value of Coca-Cola. However, actually obtaining this information is costly and the actor holding the information (McDonald's) would not capture the full benefits of disclosure if they released the information, leading to the concern that it will not be disclosed. The issue, importantly, is much bigger than Coke and McDonald's. Many, perhaps all, companies have access to information that they do or could collect that would help traders value other companies. In the absence of compulsion, none of the companies would collect and disclose this information, leaving them all worse off than they could have been if they all cooperated. Mandatory disclosure can remedy this problem, and thereby benefit participants in the secondary markets.

Note that this issue of information underproduction is entirely about the secondary market. Mandatory disclosure can induce cooperation among issuers so

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[103] *Cf.* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1419 (1989) ("Managers and investors . . . assume their roles with knowledge of the consequences. Investors part with their money willingly, putting dollars in equities instead of bonds or banks or land or gold because they believe the returns of equities more attractive. Managers obtain their positions after much trouble and toil, competing against others who wanted them . . . . They must attract . . . investors by promising and delivering what those people value.").

[104] EASTERBROOK & FISCHEL, *supra* note 4, at 217.

[105] *Cf. id.* at 4 ("Investors part with their money willingly . . . .").

that they provide all the information that market participants want, thereby allowing traders to more accurately value the securities being traded in the secondary market. That concept is all well and good, but it does not directly relate to primary offerings.

Still, there is at least one sense in which information underproduction may be a concern in the context of primary offerings: a company making a primary offering may have information useful for the secondary market. A company that has not yet gone public itself may still possess information that affects the accurate valuation of publicly-traded companies. However, the knowledgeable company would still lack a full incentive to determine or disclose that information because it might not capture the full benefits of doing so.

For instance, when Tesla held its IPO in 2010, it probably held certain information about electric cars that was relevant to the stock price for Ford or General Motors. Information underproduction could possibly pose an issue in such circumstances. Absent mandatory disclosure, Tesla may have found it inefficient to disclose that information because it might have been helpful to traders of Ford or GM, as these companies are direct competitors. Additionally, investors would have sound theoretical reason to fear that Tesla might not offer certain disclosures that would benefit their business rivals unless compelled to do so. Thus, information underproduction may have some relevance to the primary market.

But this Article will not overstate the case. For one thing, the private incentives to offer precise "signals" of quality are at their strongest when dealing with primary offerings.[106] For another, sophisticated actors in the primary markets, such as exchanges and underwriters, are in a position to demand (and receive) all the information they desire about the issuer. Thus, the primary context provides scholars with less reason to worry about information underproduction than does the secondary market. In addition, primary offerings occur relatively infrequently, on a one-off basis. Conversely, the secondary market goes on every day. So, information underproduction is only a problem in the primary market as a one-time issue for each issuer, as opposed to an ongoing problem.

Furthermore, as a general rule, IPO companies are smaller and younger than those already public. As a result, IPO companies do not have much information that the market otherwise lacks. For example, the following companies conducted the largest IPOs on the New York Stock Exchange in November 2018: CNFinance Holdings, Eton Pharmaceuticals, Vapotherm, Weidai, Bain Capital Specialty Finance, and TuanChe.[107] None of these are household names, and none likely hold anywhere near the same amount of market-relevant information that already-public companies do. The information they provide (or not) in connection with their IPOs hold only slight relevance for the companies whose securities are already traded on the secondary market.

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[106] *See supra* Section II.B (explaining the concept of signaling).

[107] *IPO Data*, NYSE, www.nyse.com/ipo-center/recent-ipo [https://perma.cc/TF78-3LDQ] (last visited Feb. 4, 2019).

For all these reasons, the concept of information underproduction has only very limited relevance in the context of a primary market. Although there are exceptions, information underproduction is generally not an issue in the primary market.

B. Primary Offerings Do Not Necessarily Require Full Mandatory Disclosure

As this Article just demonstrated, the two theoretical bases underlying the modern theory of mandatory disclosure—agency costs and information underproduction—have little to no relevance to the primary market. It follows from this analysis that mandatory disclosure is not a necessary component of a well-functioning primary market. Furthermore, the theory of voluntary disclosure—that founders and companies have a private incentive to provide the optimal level of information that shareholders would desire—applies clearly and directly to primary markets.[108] Primary public stock markets thus appear to be free of the market failures that led to the modern theory in favor of mandatory disclosure.[109]

Nevertheless, the anticipated benefits of mandatory disclosure in a secondary market could indirectly impact the primary market.[110] For instance, if a primary investor expects that corporate management will be well-behaved thanks to mandatory disclosure imposed as part of the secondary market, she will pay a higher price to the company than she would otherwise.[111] But this argument is really just another in favor of mandatory disclosure in the secondary market. Therefore, this argument is not directly relevant to whether the law should mandate disclosure for primary offerings.

One final objection to the idea presented here is that an IPO lasts a millisecond, while the secondary trading of the shares sold to the public will go on every business day, potentially for decades. Even if a company were excused from mandatory disclosure in the IPO (primary market), this excuse would hardly make a difference because the company would be immediately subject to mandatory disclosure in the secondary market where its shares would later trade. This objection is true, as far as it goes, but it also shows how wedded scholars are to our traditional conceptions of a public stock market.

Yes, a company that does an IPO on the New York Stock Exchange (or similar) is immediately subject to mandatory disclosure under the Securities Exchange Act

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[108] Romano, *supra* note 3, at 2374 ("Because firms need capital and investors need information, firms have powerful incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities.").

[109] It is possible that other, unidentified market failures (other than agency costs or information underproduction) could support mandatory disclosure in the primary market, providing an objection to this Article's claim. Yet, as far as research reveals, the existing literature does not appear to introduce any additional theories that could apply to the primary market context.

[110] KRAAKMAN (2017), *supra* note 81, at 245 ("[T]he prospect of a liquid [secondary] market is relevant to primary markets.").

[111] *See id.*

of 1934 once it enters the secondary market.[112] But the New York Stock Exchange is not the only type of public stock market, theoretically. One could, for instance, conceive that a public stock market could operate solely in a primary capacity, with no secondary trading. Shareholders would buy shares straight from the company and then hold them, rather than trade them.[113] Such a primary-only market could truly be free of mandatory disclosure. The equity crowdfunding market in New Zealand is one real-world example of a primary-only market, as this Article explains in Part III.

Alternatively, the United States could have some sort of reduced disclosure rule for IPOs, and then ramp up the level of disclosure over time once the shares begin trading in the secondary market. Thus, the disclosure rule would be more like a gradual on-ramp than an immediate jump to full disclosure obligations. The "on ramp" provisions of the JOBS Act of 2012 provide an example of this idea in practice.[114] Essentially, these rules allow relatively small companies ("emerging growth companies") to launch an IPO without complying with the full level of mandatory disclosure and then to provide only limited disclosure for several years thereafter.[115] After a set number of years, these issuers become subject to the ordinary disclosure obligations of public companies. This model is consistent with the thesis herein.

To summarize, because the modern theory in favor of mandatory disclosure is built on concepts that relate almost exclusively to the secondary market, this theory has little persuasive force when it comes to the primary market. This concept leads directly to the seemingly radical suggestion that the United States can have a well-functioning public stock market without mandatory disclosure, as long as this market is limited to primary offerings.

C. A Resolution to the Persistent Disagreement Over the Modern Theory

The analysis presented here also may explain why scholars continue to dissent against the modern theory of mandatory disclosure, even after all these decades. Those in support of mandatory disclosure tend to focus on the secondary market, while those in dissent tend to focus on the primary market. If the thesis of the present work is accepted, then both camps may be correct.

Treatises and articles in support or defense of the modern theory are full of terms like "market price," "traders," and "liquidity." These ideas all relate to the secondary market, not the primary market.[116] For example, one key article by Merritt

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[112] *See* Benston, *supra* note 80, at 133.

[113] In lieu of an 'exit' through the secondary market, such shareholders could, say, have the right to sell their shares back to the company (maybe once a year) at an appraised value. Other alternatives are possible.

[114] Jumpstart Our Business Startups Act, Pub. L. No. 112–106, Tit. I, 126 Stat. 315 (2012) (codified at 15 U.S.C. §78a (2012)).

[115] *Id.*

[116] *E.g.*, KRAAKMAN (2017), *supra* note 81, at 244–55; Ronald J. Gilson & Reinier H.

Fox explains that shareholders benefit from mandatory "periodic disclosure" because it "increases the effectiveness of a number of devices—the shareholder vote, shareholder enforcement of management's fiduciary duties, and the hostile takeover threat—that work to limit the ability of managers to deviate from acting in the shareholders' best interests."[117] Each of the devices Professor Fox cites are features of the secondary market only; they have no relevance to a primary market.

Likewise, Professor Coffee's classic article in support of the modern theory is based primarily on the idea that information is a "public good" and mandatory disclosure is therefore needed to ensure accurate pricing of securities traded on the secondary market.[118] In a similar vein, one leading treatise describes the "principal purpose" of mandatory disclosure to be that it "enhance[s] price informativeness [among] traders" in the secondary market, who "impound new information into price extremely rapidly," which "enhances liquidity [and] allows companies to use market prices as benchmarks of performance."[119] Market prices, traders, research, and informative prices all refer to the secondary market of securities trading rather than the primary market of securities issuance.

In contrast, the few scholars who dissent from the modern theory often focus on the primary market. Judge Easterbrook and Professor Fischel, for instance, use the example of "a firm that wants to issue new securities" to explain their influential challenge to the modern theory.[120] Professor Roberta Romano similarly observes, "[b]ecause firms need capital and investors need information, firms have powerful

Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, *passim* (1984); Coffee, *supra* note 6, at 726–27.

[117] Fox, *supra* note 61, at 1355–56.

[118] Coffee, *supra* note 6, at 734–37 ("[Because] the securities market [is] the principal allocative mechanism for investment capital, the behavior of securities prices is important not so much because of their distributive consequences on investors but more because of their effect on allocative efficiency. In this light, it is important not only that the game be fair, but that it be accurate—that is, that capital be correctly priced. Depending on a firm's share price, its cost for obtaining capital will be either too high or low as compared to the cost that would prevail in a perfectly efficient market.").

[119] KRAAKMAN (2017), *supra* note 81, at 247; *see also, e.g.*, Gilson & Kraakman, *supra* note 116, at 638–39 (suggesting that the "market participants [who benefit] most from mandatory disclosure . . . [are] members of the professional trading community").

[120] EASTERBROOK & FISCHEL, *supra* note 4, at 288–89 ("These arguments [in support of the modern theory] share a problem, because they leap from the benefit of disclosure to the benefit of mandatory disclosure . . . . Take a firm that wants to issue new securities . . . ."). *But cf. id.* at 289 ("Self-induced disclosure occurs in the secondary market too."); Mahoney, *supra* note 3, at 1465 ("It is more analytically tidy to consider new-issue disclosure as a species of corporate law (albeit federal corporate law) than as a portion of the regulatory system for securities markets.").

incentives to disclose information if they are to compete successfully for funds against alternative investment opportunities."[121] She similarly observes that the prospect of future primary offerings can drive secondary-market disclosure itself.[122]

With an appreciation that the principles underlying the modern theory in favor of mandatory disclosure are largely inapplicable to the primary market, one can see that the supposed conflict between supporters and dissenters may be more apparent than real. In truth, they each may be correct in their domain. Supporters may well be right that mandatory disclosure is beneficial or necessary in secondary markets. And dissenters may likewise be correct that mandatory disclosure is useless or harmful in primary markets.

From time to time, scholars have recognized this possibility, although they have not dwelt on it. Professor Coffee, for instance, has acknowledged that the dissenters' argument "does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions."[123] Professor Palmiter has likewise suggested that the argument in favor of mandatory disclosure is "flawed" because it "assumes market failure without distinguishing between primary and secondary markets."[124] More recently, Professors Henderson and Haeberle have taken care to exclude the primary market from their ongoing discussion of federal securities regulation.[125]

More commonly, however, supporters and opponents of mandatory disclosure have failed to expressly delineate between the primary and secondary markets, leading them to speak past one another.[126] One contribution of the present work is to highlight the important distinction between primary and secondary markets and to show that these parties may both be right. In addition, there is an interesting interplay between the two, with companies voluntarily providing information for traders on the secondary market to facilitate future primary offerings. Even so, it behooves scholars to keep the two markets separate for purposes of mandatory disclosure.

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[121] Romano, *supra* note 3, at 2374.

[122] *Id.* ("[S]tudies have found that the quantity and quality of publicly traded firms' voluntary disclosures (such as earnings forecasts) are positively correlated with the issuance of securities.").

[123] Coffee, *supra* note 6, at 746 (saying that while "the theory of voluntary disclosure" was not persuasive with regard to "secondary market trading," it "does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions").

[124] Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 128–29 (1999).

[125] Haeberle & Henderson, *supra* note 30, at 385 n.3 ("We do not address the disclosures that must be made when firms first sell stock to the public in an IPO. Instead, we focus on only ongoing disclosure by public firms as well as disclosures associated with secondary offerings of securities by the same.").

[126] *See infra* Section II.A.2.C.

IV. REAL-WORLD EXAMPLE: EQUITY CROWDFUNDING IN NEW ZEALAND

The core claim of this Article—that the modern theory of mandatory disclosure is generally inapplicable to primary offerings—has thus far been premised entirely on theoretical arguments and ideas. To buttress the claim, this Part presents an empirical report on equity crowdfunding in New Zealand—a real-world public market for primary offerings that operates without mandatory disclosure. As this Part will show, New Zealand's equity crowdfunding market functions well in the absence of mandatory disclosure and, indeed, has outpaced the American system, which retained mandatory disclosure as part of its equity crowdfunding law.[127]

A. Background on Equity Crowdfunding

Equity crowdfunding is a novel way for a company to make a primary offering to the public through Internet-based platforms (or portals) and is based on the prior practice of "reward" crowdfunding, as on Kickstarter and similar websites.[128] Reward crowdfunding is an Internet-based marketplace for the financing of entrepreneurial projects whereby an artist or entrepreneur posts to a dedicated website a description of the project she wants to pursue, the amount of money she needs to fund it, and usually promises some sort of reward or benefit to those who provide funding. Members of the public—the crowd—peruse the various projects available on the website, decide which one(s) they want to support, and then pledge their money to the cause. If and when a given project reaches its target funding amount, the platform collects the money and transmits it to the entrepreneur. On some crowdfunding sites (including Kickstarter), if a project fails to reach the target, the platform nullifies the pledges, and no money changes hands. This is known as an "all-or-nothing" rule.

For example, a rock band that wants to record an album might post the idea along with a sample track and ask the crowd to contribute 20 dollars per person. In return, the band promises to send a copy of the CD once the band completes it. The band uses the money it collects upfront to rent a recording studio, hire a producer, et cetera. This simple idea has grown into a multi-billion-dollar market in less than a decade. Kickstarter alone reports that users have contributed more than 4 billion dollars on its website since its founding in 2009.[129]

Equity crowdfunding is based on reward crowdfunding and simply extends the concept to investments.[130] It works just like reward crowdfunding except that, instead of receiving a tangible reward like a CD from a band, the financial backers

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[127] Portions of this Part are adapted from Schwartz, *Equity Crowdfunding in New Zealand*, *supra* note 23, at 246–54, and Schwartz, *Gatekeepers, supra* note 18, at 930–37.

[128] Schwartz, *supra* note 1, at 1459–60.

[129] *Stats*, KICKSTARTER, https://www.kickstarter.com/help/stats?ref=global-footer [https://perma.cc/8SRB-G3VU] (last updated Sept. 12, 2019).

[130] Schwartz, *supra* note 1, at 1460.

get a share of stock or some other security, such as a share in the band's profits on the sale of the CD.

This novel method of online investing holds great promise, but it also violates the usual legal rules for making a public offer of securities in the United States. For, under the Securities Act of 1933, a company is legally required to "register" any shares of stock, bonds or other securities before offering them to the public.[131] As demonstrated in Part II.A, this registration process calls for copious mandatory disclosure about the company and the securities to be offered,[132] the costs of which can be millions of dollars. This cost presents an obvious hurdle for the startups and small businesses that might look to crowdfunding for financial capital.[133]

Thus over the past few years, the United States and other countries, including New Zealand, sought to legalize and encourage equity crowdfunding by amending their securities laws to expressly exempt small-scale equity crowdfunding from the usual registration requirement.[134] In the United States, the JOBS Act of 2012 exempted equity crowdfunding from the registration rules, including the normal rules of mandatory disclosure, but then added a different, more simplified set of mandatory disclosures for companies to make.[135] New Zealand went even further, exempting equity crowdfunding from mandatory disclosure entirely.[136]

B. New Zealand Equity Crowdfunding: No Mandatory Disclosure

New Zealand legalized equity crowdfunding in the Financial Markets Conduct Act of 2013. That statute was expressly modeled on the American JOBS Act of the prior year.[137] However, the New Zealand version is much more liberal (in the classic sense; New Zealanders would call it 'light-handed') in that it imposes very few rules and regulations on the practice.[138] Most importantly, issuing companies have no

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[131] 15 U.S.C. § 77e(a)(1) (2012).

[132] *See* 17 C.F.R. § 229 (2018) (instructions for filing registration statement).

[133] Schwartz, *supra* note 1, at 1468–70.

[134] The United States, New Zealand and other jurisdictions have all included an annual issuance cap of about $1 million in their equity crowdfunding laws, meaning that a company may only issue $1 million worth of securities per year through this exemption.

[135] Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 302, 126 Stat. 306 (2012) (codified 15 U.S.C. §§77a, 77b, 77d, 77g, 77r, 78c, 78a, 78c, 78*l*, and 78o).

[136] FINANCIAL MARKETS CONDUCT ACT 2013, Schedule 1, § 6(1)(a) ("An offer of financial products to a person (A) does not require disclosure under Part 3 of this Act if the offer is through a licensed intermediary in the course of supplying prescribed intermediary services to (A)."); FINANCIAL MARKETS CONDUCT REGULATIONS 2014 § 184(a) (defining equity crowdfunding as a "prescribed intermediary service").

[137] OFFICE OF THE MINISTER OF COMMERCE, FINANCIAL MARKETS CONDUCT REGULATIONS PAPER 4 — LICENSING REGIMES 136–43 (Cabinet Bus. Comm. PrintBusiness Committee June 2013).

[138] *See* Henry William Hillind, *Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding*, 21 N.Z. BUS. L.Q. 46, 52 (2015) (describing the New Zealand approach to crowdfunding as "more liberal compared to international jurisdictions").

mandatory disclosure obligations under the New Zealand crowdfunding law. This lack of obligations greatly simplifies the process and lowers the cost of selling shares to the public.[139] In the United States, although the JOBS Act simplified the disclosure process for crowdfunding issuers, issuers are still legally required to provide significant and specific financial and business disclosures.[140] In New Zealand, this is not the case.

New Zealand relies on private ordering rather than legal obligations to achieve effective disclosure.[141] Hence, New Zealand crowdfunding platforms are required to implement "disclosure arrangements" that are "adequate" to provide potential investors with information relevant to their decision to invest; but the content, manner, and style of disclosure is a business decision for the platform.[142] Furthermore, issuing companies need not file anything at all with the FMA (New Zealand's SEC-equivalent). This model is very different from the American model of equity crowdfunding with its requirement that issuers file a standardized government-drafted form (Form C) with 25 specific items of mandatory disclosure.[143]

C. Empirical Report on New Zealand Equity Crowdfunding

New Zealand's equity crowdfunding market presents a useful test-case for this Article's critique of the modern theory of mandatory disclosure. This Article argues that, because the underpinnings of the modern theory relate to the secondary market, a primary securities market should be able to function well without mandatory disclosure. By legalizing an equity crowdfunding market with no mandatory disclosure, New Zealand has put this claim to the test. What has this experiment shown?

New Zealand's liberal model, including its abandonment of mandatory disclosure, has generated a successful equity crowdfunding market that compares favorably with American venture capitalism (VC) and angel investment. Furthermore, from a financial perspective, New Zealand has greatly outpaced the United States (who, like most jurisdictions, retained mandatory disclosure for its crowdfunding market), and has suffered no fraud and very few business failures.

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139 FINANCIAL MARKETS CONDUCT ACT 2013, Schedule 1, § 6(1)(a) ("An offer of financial products to a person (A) does not require disclosure under Part 3 of this Act if the offer is through a licensed intermediary in the course of supplying prescribed intermediary services to (A)."); FINANCIAL MARKETS CONDUCT REGULATIONS 2014 § 184(a) (defining equity crowdfunding as a "prescribed intermediary service").

140 Jumpstart Our Business Startups Act §302, 126 Stat. at 315–321.

141 *See infra* Section III.D.

142 Financial Markets Conduct Regulations 2014, Reg. 186(1)(d).

143 17 C.F.R. §§ 227.201(a)–(y) (2018) ("An issuer offering or selling securities [via equity crowdfunding] . . . must file with the Commission and provide to investors and the relevant intermediary the following information . . . ."); 17 C.F.R. § 239.900 (2018) (Form C).

In the first year of equity crowdfunding in New Zealand,[144] 27 crowdfunding campaigns were launched, and 21 of those succeeded in reaching their financial target, indicating a 78% success rate.[145] The 21 successful campaigns collectively raised a total of $10 million.[146] The average amount raised was about $500,000, with two campaigns reaching the legal crowdfunding limit of NZ$2 million.[147] These numbers represent a significant contribution of capital to New Zealand entrepreneurs, as one can see when comparing them to the amounts invested by New Zealand VC and angel investors. In 2014, New Zealand angels invested $45 million in 118 deals,[148] and New Zealand VC funds likewise contributed $45 million in total, spread across 62 investments.[149] Equity crowdfunding's first-year total of $10 million and 21 deals, while lower than the totals of VCs or angels, is in the same ballpark.

New Zealand's numbers are even more impressive when compared to the American experience. In its first year of operation, from mid-2016 to mid-2017, the United States saw 211 crowdfunding campaigns in total, 112 of which were successful, thus representing a 53% success rate.[150] The total amount raised by all successful campaigns was about $35 million.[151] The average amount raised was about $300,000, with nine campaigns hitting the $1 million maximum.[152]

To properly compare New Zealand and the United States, one must account for the fact that the American economy is about 100 times as large as that of New Zealand.[153] If one were to scale New Zealand's figures up by a factor of 100, which

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[144] The analysis here compares the first year of crowdfunding in each jurisdiction. In the United States, this was 2016–17; in New Zealand, this was 2014–15.

[145] *New Zealand Equity Crowdfunding—1st Year in Review*, CROWDREADY (Aug. 18, 2015).

[146] *Id.* The currency conversions in this section are based on a 0.8 conversion rate between the New Zealand Dollar and the United States Dollar, which was the approximate rate at the time in question (2014–2015), and are rounded for the sake of simplicity.

[147] *Id.*

[148] NEW ZEALAND GOVERNMENT, TOWARDS 2025, BUSINESS GROWTH AGENDA PROGRESS REPORT (Sept. 8, 2015) https://www.beehive.govt.nz/sites/default/files/Business%20Growth%20Agenda%20-%20Towards%202025.pdf [https://perma.cc/R2J4-J33Y].

[149] NEW ZEALAND PRIVATE EQUITY & VENTURE CAPITAL CAP. ASS'N, NEW ZEALAND PRIVATE EQUITY AND VENTURE CAPITAL MONITOR: 2014 FULL YEAR REVIEW (2014) https://www.nzvca.co.nz/wp-content/uploads/2014/04/1527715_NZPEVC-Monitor_web.pdf [https://perma.cc/PYB9-YDEB].

[150] *CCA Regulation Crowdfunding Indices*, CROWDFUNDING CAP. ADVISORS (July 28, 2016), https://crowdfundcapitaladvisors.com/cca-reg-cf-index/ [https://perma.cc/9NT6-VE7F]; *see also The Current Status of Regulation Crowdfunding*, WEFUNDER, https://wefunder.com/stats [https://perma.cc/B3RP-Y3ZE] (last visited July 1, 2019).

[151] *The Current Status of Regulation Crowdfunding*, *supra* note 150.

[152] *Id.*

[153] The gross domestic product (GDP) of the United States is about $18 trillion and the GDP of New Zealand is about $175 billion (at the time of writing). *GDP (current US$)*, WORLD BANK, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD? [https://perma.cc

is only fair, New Zealand's equity crowdfunding market would be orders of magnitude larger than that of the United States. Based on such a calculation, New Zealand had *13 times as many campaigns* as the United States, those campaigns had a *success rate of nearly 80%*, compared to the American rate of about 50%, and New Zealand companies raised *30 times as much money* as did their American counterparts.

Moreover, looking at the history of New Zealand equity crowdfunding, with dozens of companies funded and tens of millions of dollars raised, not a single funded company has been revealed to be a fraud, and there has been just one liquidation.[154] Admittedly, the time period is short (just four years), and New Zealand's economy, in general, has done well over that time, meaning that fraud may yet be revealed in some future period when economic conditions are less forgiving. In addition, recent equity crowdfunding in the United States has grown significantly since its first year in operation.[155] Even taking this growth into account, New Zealand's market remains an order of magnitude larger than that of the United States, thus demonstrating the effectiveness of New Zealand's system.

D. Private Ordering in New Zealand Equity Crowdfunding

How did New Zealand generate such a successful equity crowdfunding market without mandatory disclosure? First, because New Zealand's legal regulations are simple and few, compliance costs appear to be much lower than in a traditional IPO or even in an American equity crowdfunding campaign.[156] Second, and more importantly for present purposes, New Zealand's crowdfunding system depends on private actors to organize the market, keep it honest, and make it work well, all without direct participation on the part of the government.[157] Pursuant to this design,

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/S2HA-VMSX] (last visited June 25, 2019).

[154] Interview with Hayley Buckley, Partner, Wynn Williams, in Auckland, N.Z. (May 18, 2017); Paul McBeth, *Balex Marine, Snowball Crowdfunder Participant, Sunk by High Costs, Slow Sales*, NAT'L BUS. REV. (May 17, 2017) (reporting on the first crowdfunding company to liquidate).

[155] Since Title III of the Jobs Act went into effect, the number of equity crowdfunding offerings has increased each year. In 2016, during the first seven months that Regulation Crowdfunding was in effect, American companies launched 188 equity crowdfunding campaigns. In 2017, the number of offerings rose to 514, and in 2018, this number rose again to 732 offerings, an increase of 42% from the prior year. Andrew A. Schwartz, *Crowdfunding Issuers in the United States*, 58 WASH. U. J.L. & POL'Y (forthcoming 2019). Similarly, the total amount raised in 2017 was $71 million; in 2018 that grew to $109 million. *The 2018 State of Regulation Crowdfunding*, CROWDFUND CAP. ADVISORS, (Jan. 24, 2019), https://cdn.crowdfundinsider.com/wp-content/uploads/2019/02/CCA-2018-State-of-Regulation-Crowdfunding-Summary-FINAL.pdf [https://perma.cc/8FYZ-DBG7].

[156] *See* Schwartz, *Equity Crowdfunding in New Zealand*, *supra* note 23, at 252–54 (discussing compliance costs under the U.S. crowdfunding policies).

[157] *See id.* at 272–73.

market participants have established numerous effective modes of private ordering or private governance, the most important of which are "gatekeepers" and "syndication."

First, New Zealand's law envisions that the licensed crowdfunding platforms would act as "gatekeepers" that only allow legitimate and promising companies to access the crowd.[158] Platforms have a direct economic interest in establishing and maintaining a reputation as a reliable place for investors to put their money.[159] If they allow fraudulent or low-quality companies onto their site, and investors lose money, those investors will not come back, and the platform will go out of business.[160] Knowing all this, platforms can be expected to only invite legitimate and sound companies to participate on their sites.[161] The platform's gatekeeping role thus protects investors and gives them the confidence to participate in the market.

In practice, New Zealand platforms take their gatekeeper role seriously and are very selective in deciding which companies to allow to list on their site.[162] They understand how vital it is to protect their reputation and accordingly exclude companies that are unlikely to succeed, or that have any chance of being fraudulent. Snowball Effect, for instance, lists only 2% of the hundreds of companies that want to crowdfund on their site, "mostly because they're not investment ready."[163] The platform is selective because, according to the company, "we've got our own reputation [to protect and because] we want investors to get what we think are interesting opportunities that are ready for public investment."[164] This focus on

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[158] *Crowdfunding Platforms*, FINANCIAL MARKETS AUTHORITY, https://www.fma.govt.nz/compliance/role/crowdfunding-platforms/your-on-going-obligations/ [https://perma.cc/NR47-VT6L] (last updated July 4, 2019).

[159] *See* Interview with Simeon Burnett, CEO, Snowball Effect, in Auckland, N.Z. (Feb. 27, 2017).

[160] *See* Mackenzie McCarty, *Cabinet Gives Green Light to Equity Crowdfunding*, N.Z. Lawyer (Feb. 28, 2014), https://www.nzlawyermagazine.co.nz/news/cabinet-gives-green-light-to-equity-crowdfunding-184672.aspx [https://perma.cc/3GQX-HMPT] ("It's . . . really going to be quite self-fulfilling, because the platform will be incentivized to have the best companies - they really don't want any failures on their platforms. And that's aligning them absolutely with the interests of investors.") (quoting Hayley Buckley, a law partner working alongside the crowdfunding platform, "Snowball Effect").

[161] *See id.* (discussing the strict licensing process).

[162] *See* Interview with Simeon Burnett, *supra* note 159 (discussing the rigorous listing requirements).

[163] *See* Schwartz, *Gatekeepers*, *supra* note 18, at 932 n.282 ("98% of companies we point in another direction.") (citation omitted); *see also* John Anthony, *New Zealand Crowdfunding Platforms Gearing Up for Big 2016*, STUFF (Jan. 21, 2016, 5:42 PM), http://www.stuff.co.nz/business/industries/75424341/new-zealand-crowdfunding-platforms-gearing-up-for-big-2016 [https://perma.cc/75KG-7SVK] ("Snowball Effect had been approached by hundreds of companies wanting to crowdfund but it was selective about which were chosen for the platform.").

[164] *See* Anthony, *supra* note 163 ("We need to make sure that companies are suitable for our offering and a lot of companies aren't.") (quoting Snowball Effect CEO Simeon

selectivity, rather than inclusivity, is not unique to Snowball Effect but is rather standard practice in the industry.[165]

Second, "syndication" is where the crowd invests alongside a large and sophisticated "lead" investor. This method comes directly from angel investors.[166] Under this model, one "active" or "lead" angel, presumably an expert in the relevant industry, researches a company and the proposed terms of investment and then reports back to the rest of the angels in the group.[167] The other angels in the group play a "passive" role; they trust in the expertise and diligence of the lead angel.[168]

The distinctive legal regime in New Zealand has allowed syndication to develop as a key method for privately regulating the country's equity crowdfunding market. Unlike the United States (as well as practically every other country), New Zealand's crowdfunding law imposes no cap on the amount an investor may contribute.[169] This decision was a conscious one on the part of the government. New Zealand specifically designed this system, at least in part, to facilitate large investments by lead investors and syndication by the rest of the crowd, just like in traditional angel investing.[170] Hence, under New Zealand law, an angel investor is legally permitted to invest hundreds of thousands of dollars through a crowdfunding campaign, making it cost-effective to undertake the burden of acting as a lead investor.[171] The lead investor often makes a very sizable investment herself, sometimes as much as $500,000 at a time.[172] Such an amount would be unlawful under American law but is perfectly legal in New Zealand.[173]

Burnett).

[165] *See* Nathan Rose, *Equity Crowdfunding Evolutions Expected to Take Place in New Zealand*, #NZENTREPRENEUR (Feb. 22, 2016), https://nzentrepreneur.co.nz/equity-crowdfunding-evolutions-expected-to-take-place-in-new-zealand/ [https://perma.cc/7SA8-UVJ8] ("Each equity crowdfunding marketplace [in New Zealand] is 'curated' or 'vetted' to some extent.").

[166] *See* Dale A. Oesterle, *Intermediaries in Internet Offerings: The Future Is Here*, 50 WAKE FOREST L. REV. 533, 542 (2015) ("The syndicates shadow trade, as coinvestors, on the trades of 'lead angels' or 'angel advisers.'").

[167] *See id.* at 542–43 ("[T]he angel takes the lead in identifying the investment opportunity and negotiating the terms on behalf of their syndicate.").

[168] *See id.* at 542 (noting that passive investors are given the option to observe and follow in the angels' lead).

[169] Nathan Rose, *How the World Regulates Equity Crowdfunding*, REG. REV. (June 26, 2019), https://www.theregreview.org/2019/06/26/rose-how-world-regulates-equity-crowd funding/ [https://perma.cc/X44B-5GEC].

[170] *See* Interview with James Hartley, Manager, Financial Markets Policy, N.Z. Ministry of Bus. Innovation & Emp't, in Auckland, N.Z. (Apr. 4, 2017) (noting the similarities to angel investing).

[171] *See* Oesterle, *supra* note 166, at 543 ("The lead angels' or angel advisers' economic incentive to participate is a form of carried interest, a slice of the profits of the syndicate returns.").

[172] *See* Interview with Simeon Burnett, *supra* note 159.

[173] 15 U.S.C. § 77d(a)(6)(B)(ii) (2012) (establishing $100,000 as the most that any

In practice, lead investors have become a very important component of New Zealand's equity crowdfunding marketplace.[174] Like in an angel group, the lead investor conducts research on the company, and the rest of the crowd comes along for the ride. Professional investors, including angels and VCs, sometimes play the role of cornerstone investor.[175] They serve to lend credibility to an offer; others take the fact that someone has bought a large block of shares as a signal that the company is sound and the valuation is fair.[176] Commonly, a lead investor will arrange to contribute a large sum to a crowdfunding campaign in advance, thus providing it with momentum from the first day. The experience in New Zealand shows that lead or cornerstone investors have become an important component of the crowdfunding marketplace.[177]

In conclusion, New Zealand's experience shows that private ordering can serve as an effective substitute for mandatory disclosure.

V. CONCLUSION

This Article challenges the idea that mandatory disclosure is truly necessary for primary offerings of securities, as scholars have largely presupposed until now. The conceptual underpinnings of the modern theory of mandatory disclosure—concern

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individual may annually invest in crowdfunding companies). In the United States, syndication is not a viable model for crowdfunding due to the structure of the securities crowdfunding law in place there. The JOBS Act places a low legal limit on the total amount that a person may invest in all crowdfunding companies each year. The upshot is that most Americans are limited to about $3,000–$5,000 per year or less—and this amount is not per investment, but rather per year—making it economically infeasible for any one person to take on the role of lead investor. *See* 15 U.S.C. § 77d(a)(6)(B)(i) (2012). The investor cap is simply too low to make it worthwhile for a lead angel to spend the time and effort it takes to find an appropriate investment and conduct adequate due diligence.

[174] *See* Interview with Simeon Burnett, *supra* note 159.

[175] *See* Calida Smylie, *Equity Crowdfunding Numbers Slump After First Year*, NAT'L BUS. REV. (Nov. 7, 2014) (describing "at least four campaigns [as] being partially led by a professional investor"); *see also* Brendan Manning, *Riding the New Wave of Equity-Raising*, N.Z. HERALD, (July 23, 2015, 5:00 AM), https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11485195 [https://perma.cc/HF9S-RLLU] ("We're seeing some angels and VCs integrating equity crowdfunding as a step in their investment strategy.") (quoting Armillary Private Captial director David Wallace).

[176] *See* Shaun Edlin, *Pre-arranged Capital and Momentum: Is Real Money Being Raised Through Online Marketplaces?*, SNOWBALL EFFECT (Aug. 24, 2016), https://www.snowballeffect.co.nz/blog/lessons-weve-learnt-about-momentum [https://perma.cc/WMJ9-UDKX] (noting that a lead investor helps validate the offer price); *see also* Interview with Simeon Burnett, *supra* note 159.

[177] *See* Edlin, *supra* note 176 ("We encourage companies raising through Snowball to seek a credible investor to lead their offer . . . . To date, only three offers through our marketplace have failed to reach their minimum investment target . . . the one thing all three offers had in common was that they lacked a credible lead investor for the round."); Interview with Hayley Buckley, Partner, Wynn Williams, in Auckland, N.Z. (May 18, 2017).

over agency costs and information underproduction—as persuasive as they may be in the context of secondary markets, hold very little relevance to primary offerings. This profound insight challenges the very foundations of modern securities law in the United States and around the world. Furthermore, as a matter of empirical reality, New Zealand's equity crowdfunding market represents an example of a successful public market for primary offerings that operates through private ordering, not mandatory disclosure.

In light of this argument and evidence, it is no longer tenable to simply say that public securities markets require mandatory disclosure because of agency costs and information underproduction. Rather, scholars of securities law should acknowledge that the modern theory may only apply to secondary markets, not primary ones, and adjust our conversations about mandatory disclosure accordingly. Going forward, scholars and policymakers should keep an open mind to the possibility that a primary securities market open to the public could potentially operate in a socially optimal way by abandoning mandatory disclosure. Equity crowdfunding in New Zealand is one example of a privately ordered primary securities market, and others may follow its lead.