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Voluntary Disclosure for Primary Securities Offerings

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Mandatory disclosure is a foundation of modern securities law, both in the United States and around the world. But is it really necessary? After all, corporate promoters wishing to sell securities for their full value already have an economic incentive to voluntarily provide information to potential investors; otherwise they would receive only a pittance per share. Furthermore, mandatory disclosure is so expensive that it now costs millions of dollars to file for an IPO, with the result that startups and small businesses may not be able to afford to go public. Even many billion-dollar private companies ("unicorns") have declined to go public, in part due to the high cost of mandatory disclosure. The time is thus ripe to question the consensus in favor of mandatory disclosure, as I do in a recently published article**.

The original rationale of mandatory disclosure, dating back to the federal Securities Act of 1933, was to treat retail investors fairly by providing them with accurate and timely information about potential and actual investments. But anyone who has actually looked at a securities filing knows that they are so arcane and densely written as to be almost impenetrable to an ordinary retail investor. Similarly, no one seriously argues that our large public companies would not provide any information to the public absent legally mandated disclosure. This is due to the economic concept of signaling, which suggests, at its most basic, that companies have an incentive to disclose even bad news because, if they stay silent, investors will presume that things are even worse. Hence, over time, both the fairness rationale and fear of no disclosure have fallen out of favor among scholars and policymakers.

In its place, modern scholars, led by Professor John Coffee, have set forth a pair of sophisticated law-and-economics defenses of mandatory disclosure: (1) agency costs and (2) information underproduction.[1]

Agency costs occur when corporate managers pay themselves extravagantly, work as little as possible, or even steal from the company, all to the detriment of investors. Under a regime of voluntary disclosure, where managers of a corporation are given free rein to decide what the company will and

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won't 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 investors. 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 discourages bad behavior, as managers police their own actions to avoid having to provide embarrassing disclosure later on.

As for information underproduction, the idea is that companies will rationally decline to expend resources to voluntarily collect and disclose information that could be relevant to the value of other firms – even if investors would prefer disclosure. McDonald's, which sells lots of soft drinks, presumably has information relevant to the accurate pricing of Coca-Cola stock, but it has no interest in tallying and reporting Coke sales because McDonald's would suffer all the costs, while Coca-Cola's investors would receive all the benefit (in the form of more accurate pricing). Mandatory disclosure can remedy this problem by forcing all public companies to share certain types of inform ation, thereby enhancing the accuracy of all securities.

The modern theory of mandatory disclosure, premised on these two concepts, has achieved hegemony in the field. Nearly all scholars support the idea, both in the United States and around the world, and only a very few academic skeptics – including Roberta Romano and Paul Mahoney – continue to hold out in favor of voluntary disclosure.

Almost entirely overlooked in the discussion, however, and a potential ground for reconciliation among these competing camps, is the simple distinction between *primary* markets (where companies offer securities directly to investors) and *secondary* markets (where investors trade securities with one another). The two key economic concepts that undergird the modern theory of mandatory disclosure – agency costs and information underproduction – make good sense in the context of secondary markets. But if we shift our gaze to the primary context, these two ideas become largely irrelevant.

First, agency costs arise only after the securities have been sold and the investors worry that management will run the company in its own interest, rather than for the benefit of shareholders. The concept is irrelevant to the primary market, where promoters are trying to get investors to buy the securities at the outset. In the primary market, there are no agents and hence no agency costs; they are a feature of the secondary market alone.

Second, information underproduction is largely a function of the secondary market only. The idea here is that 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 a one-time event. Furthermore, promoters have powerful economic interests to divulge all the information that investors want, and thus there is likely little relevant company information missing from public view.

This analysis poses a direct theoretical challenge to the dominant view that mandatory disclosure – and its costs – are justified in the context of primary offerings. The surprising result is that primary

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offerings may not actually require mandatory disclosure at all.[2] This novel distinction between primary and secondary markets, if accepted, could usher in a new era of simplified, low-cost primary offerings to the public.

Endnotes

1 *See* John C. Coffee, Jr., *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 Va. L. Rev. 717 (1984) (canonical exposition of the modern theory of mandatory disclosure).

2 *Accord* Coffee, 70 Va. L. Rev. at 746 (acknowledging that "the theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary distributions"); *see also* Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 Colum. Bus. L. Rev. 1, 128–29 (1999) (suggesting that the modern theory in favor of mandatory disclosure is "flawed" because it "assumes market failure without distinguishing between primary and secondary markets").

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