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Article

Temporal Perspectives: Resolving the Conflict Between Current and Future Investors

Steven L. Schwarcz†

The fundamental goal of securities law is to make markets more efficient by providing transparency to investors, thereby reducing asymmetric information.1 The fundamental goal of corporation law is to cause managers to govern for the benefit of the firm and its investors.2 The fundamental goal of credit

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2. John H. Matheson & Brent A. Olson, Corporate Law and the Longterm Shareholder Model of Corporate Governance, 76 MINN. L. REV. 1313, 1326
rating agencies is to provide ratings that accurately inform investors of the likelihood of timely payment on a firm's bonds. This Article argues that these goals are, at best, imperfectly achieved because of the conflict between current and future investors (hereinafter, the "temporal conflict"), and the different perspectives that conflict creates—not only confusing the investor audience within each of these areas of law, but also creating inconsistent obligations to investors across these areas. An understanding of the temporal conflict also reveals that widespread perceptions of corporate wrongdoing can be misleading where corporate actions taken ex ante to benefit one investor group inadvertently harm another investor group ex post.

This Article’s purpose is both positive and normative: to explain the temporal conflict and its attendant problems, and to help resolve the conflict by analyzing, in each case, who should be included in the relevant audience. Because my analysis focuses on the inherently clashing perspectives of current and future investors, it is fundamentally different from the fo-

(1992) (observing that “the fundamental goal of corporate law is so theoretically and historically obvious that it need not be explicated: the goal is to maximize corporate—and thus shareholder—welfare”).

3. “Current investors” of a firm at any given time are those who, at such time, hold securities of the firm. “Future investors” of a firm at any given time are those who do not, at such time—but who do at a later time—hold securities of the firm. For example, if at a given time Investor X holds securities of Firm Y, Investor X would be a current investor at that time in Firm Y. Similarly, if at a given time Investor W holds no securities of Firm Y but later holds securities of Firm Y, Investor W would be a future investor at that time in Firm Y. The term “future investors” thus includes only those who in fact later invest in securities of the firm at issue, and does not include those who may later invest but do not in fact do so, no matter how likely that later investment was.

The temporal conflict is not between types of investors per se, but between current and future investors of any given type. Examples include the conflict between current and future shareholders, or between current and future bondholders.

4. Although this Article uses the term “temporal conflict,” the conflict also could be described as “inter-temporal” or “inter-temporal.” Cf. Henry T.C. Hu, New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare, 69 TEX. L. REV. 1273, 1287 (1991) (characterizing this conflict as one of “pronounced intertemporal dimensions”).

5. See infra notes 32–34 and accompanying text.

6. The actual identity of the current and future investors is irrelevant to my analysis of the temporal conflict so long as—as would be expected—there are at least some current investors and future investors who are different at any given point in time. The fact that future investors eventually become current investors is thus not determinative. See infra note 59. Similarly, the type of investors to whom directors are obligated (e.g., shareholders, creditors) is
cus of existing scholarship, which examines second-order distinctions resulting from the conflicting goals of current long- and short-term investors. That is a more tractable conflict because the investor audience is known. In contrast, few courts or commentators have ever grappled with the temporal conflict, making it virtually an issue of first impression.

This Article ultimately argues for a second-best solution to the temporal conflict: proposing that firms should err against disclosure in cases of ambiguity. This solution, I show, would be less costly to investors, issuers, and markets than existing disclosure strategies. This solution also could help resolve the broader debate over how to minimize the ambiguity of disclosure in securities law.

INTRODUCTION

To understand the temporal conflict, consider the dilemma of disclosure. By disclosing risks, a firm’s management reduces, and ideally eliminates, the information asymmetry between the firm and investors in the firm’s securities. There is little question that a clear and credible risk must be disclosed. Disclosure, however, involves probabilities and difficult judgment choices, and often is ambiguous (hereinafter “disclosure ambiguity”):

irrelevant to my analysis, which focuses on the temporal conflict between current and future investors of any given type. See supra note 3.

7. For a detailed discussion of how these conflicts differ, see infra notes 55–58 and accompanying text.

8. See infra Part I (Relevant Legal Precedents). I have discussed the temporal conflict with several top securities law professors and regulators, and—even though they agree this is an interesting and important issue—they are not aware of any other precedent. See, e.g., Letter from Eric T. Spink, Canadian Barrister and Solicitor and former Vice-Chair, Alberta [Canada] Securities Commission, to the author 3 (June 28, 2004) (on file with the Minnesota Law Review) (observing that “I am not aware of any scholarly review of the ‘conflict’ between current and future investors but I can attest to the fact that it was already a long-standing issue in Canada in 1988 (when I first encountered it”). I will pay a $100 reward to anyone finding a significant precedent that might have been missed in this research! For conjecture on why there are so few precedents, see infra notes 89–91 and accompanying text (explaining that low historical turnover levels in holdings of securities reduced the temporal conflict’s significance, whereas recent financial innovation has dramatically increased turnover levels and thus the conflict’s significance).

9. See infra notes 195–96 and accompanying text.

10. I later discuss when the duty to disclose arises, and conclude that the timing of disclosure is neutral to this Article’s analysis. See infra note 16.
Many pages of judicial and scholarly ink have been spent assessing the conceptual or contextual importance or significance of a wide variety of facts and events, the nature of a "reasonable shareholder" or "reasonable investor," and the composition of a "total mix" of information, among other things, in order to determine whether a particular fact is or was required to be disclosed. Unfortunately, however, applicable decisional law and scholarship often do not permit a definitive determination as to the materiality of facts or events, even if recurring.\(^\text{11}\)

If a risk is possible though unlikely, should management disclose it?\(^\text{12}\) If the risk should be disclosed, how prominently...
should it be disclosed? These questions raise an inherent dilemma: disclosure of a possible risk harms a firm's current investors, and the more prominent the disclosure, the greater their harm. On the other hand, failure to disclose the risk, or to give sufficient prominence to the disclosure, may harm the firm's future investors. On which audience should disclosure be focused?


For example, for disclosure on the firm's financial statements, should the risk be disclosed as a liability or merely in the footnotes to the financial statements as a contingency? Cf. infra notes 32-34 and accompanying text (discussing that question in connection with the adequacy of Enron's disclosure).

Although disclosure alerts current investors to the possibility of opting out of their investment based on the risk disclosed, a decision to opt out is as likely to be wrong as right where there is disclosure ambiguity. Moreover, even where opting out is the right decision, those investors still would be harmed to the extent the disclosure reduces the sales price of their securities before they have the chance to sell. Although some investors, such as day traders, might be able to sell before the price drops, most of a firm's current investors will not. See, e.g., Baruch Lev & Meiring de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis, 47 STAN. L. REV. 7, 21 (1994) (stating that prices of "widely held and heavily traded securities" appear to "promptly incorporate relevant public information"). One reviewer of this Article nonetheless argues that "that price reduction will be moderated by the possibility that the risk will ultimately pass without negatively affecting the issuer [whereas] [i]f the ambiguous risk is not disclosed until it becomes more obviously material, the price reduction or 'harm' will be greater and more surprising." Letter from Eric T. Spink to author, supra note 8, at 1. Ultimate passing of the risk will not, however, lessen the harm to those current investors who sell their securities after the price drops but before the risk passes. Furthermore, in cases where the ambiguous risk later becomes "more obviously material," there is no basis to believe, as former Vice-Chairman Spink contends, that the price reduction absent earlier ambiguous disclosure will be greater than the price reduction with such disclosure: the latter necessarily must take into account both the price reduction caused by the ambiguous disclosure and the additional price reduction caused by later disclosure that the once-ambiguous risk is now more obviously material.

And the less prominent the disclosure, the greater the potential harm to those investors.

This Article previously indicated, supra note 3, that current investors of a firm are those who, at any given time, hold securities of the firm, while future investors of a firm are those who do not, at such time—but who do at a later time—hold securities of the firm. Because, as discussed in the text above, the consequences of the temporal conflict are most pronounced in the disclosure context, the relevant time is likely to be a time that disclosure is legally
Corporation law suggests the audience should be current investors. Directors and management, at least in the United States, have a fiduciary duty only to investors holding an existing property right or equitable interest to support such a duty—i.e., current investors.\textsuperscript{17} Presumably, then, in case of doubt, management should err on the side of less prominent disclosure of risk because that helps current investors preserve the value of their investments.\textsuperscript{18}

Management, however, also must comply with securities law. In theory, securities law appears less explicitly cognizant of temporal distinctions and mostly concerned with disclosure for the sake of market efficiency, to be achieved through full disclosure of material information which, in turn, would allow...
investors to make informed decisions. In practice, though, securities law in the United States requires disclosure in two contexts, each of which raises the temporal conflict. The first context is the disclosure required in connection with the issuance of securities, usually in the form of a prospectus and associated registration statement. The second context is periodic reporting.

Disclosure required in connection with the issuance of securities is intended to inform investors considering buying those securities. Therefore, the primary investor audience would appear to be future investors. This disclosure focuses on warning those investors of all possible material risks associated with the securities. The temporal conflict arises because such disclosure could hurt current investors.

The temporal conflict also arises in the context of periodic reporting. Although the disclosure here appears to be intended for the benefit of all investors, current and future, disclosure


22. This appears to be the theory of the SEC's exchange decisions, discussed infra notes 70-74 and accompanying text.

23. See, e.g., Grossman v. Novell, Inc., 909 F. Supp. 845, 850 (D. Utah 1995) (“The purpose of Rule 10b-5’s ‘omission of a material fact’ language is to allow plaintiffs to sue companies that fail to disclose risks to potential investors.”), aff'd, 120 F.3d 1112 (10th Cir. 1997).

24. Periodic reporting has three statutorily stated goals: protection of investors, protection of the public interest, and ensuring fair dealing in securities. See, e.g., 15 U.S.C. § 78m(a) (2000) (requiring “[e]very issuer of a security registered pursuant to section 78l to file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security”) (emphasis added); 15 U.S.C.A § 78m(l) (West Supp.
law, at least in the United States, implicitly allows firms to favor the interests of one such group of investors over another. Firms are afforded leeway with the timing of the required periodic reporting, for example, and have the option to disclose "soft information" that is not required. Thus, any such disclosure (or lack of disclosure) can be phrased or timed in a manner that benefits one audience over the other. As a result, agency costs may bias this disclosure because the independent attorneys and underwriters who help prepare disclosure in the securities "issuance" context are usually not involved; instead, periodic reports are generally prepared by management and

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2004) (requiring "[e]ach issuer reporting under subsection (a) of this section or section 78o(d) [to] disclose to the public ... such additional information ... as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest") (emphasis added); see also Linda Yi, Road Shows on the Internet: Taking Individual Investors for a Ride on the Information Highway, 52 DUKE L.J. 243, 243 (2002) (noting that the SEC has adopted similar goals of protecting investors and promoting market efficiency).

25. See Grossman v. Novell, Inc., 120 F.3d 1112, 1119 (10th Cir. 1997) ("A statement or omission is only material if a reasonable investor would consider it important in determining whether to buy or sell stock.") (emphasis added).

26. See D. Casey Kobi, Wall Street v. Main Street: The SEC's New Regulation FD and its Impact on Market Participants, 77 IND. L.J. 551, 552-53 (2002) (arguing that the '34 Act does not require a firm to disclose all material events as soon as they occur, therefore allowing firms some control over the precise timing of important corporate disclosures); see also Timely Disclosure of Material Corporate Developments, Exchange Act Releases Nos. 33-5092, 34-8995, IC-6209, 35 FED. REG. 16,733 (Oct. 29, 1970); Harvey L. Pitt, Speech by SEC Chairman: Fall Meeting of the ABA's Committee on Federal Regulation of Securities (Nov. 16, 2001) (transcript available at http://www.sec.gov/news/speech/spch524.htm) (discussing the SEC's intention in periodic reporting to "permit an appropriate amount of flexibility in deciding what to disclose immediately, and what can be deferred").

27. "Soft" information includes predictions and matters of opinion, as opposed to "hard" information which "is typically historical information or other factual information that is objectively verifiable." Garcia v. Cordova, 930 F.2d 826, 830 (10th Cir. 1991); see In re Sofamor Danek Group, Inc., 123 F.3d 394, 402 (6th Cir. 1997) (holding that there is no duty to disclose soft information unless such information is virtually as certain as hard information). Differentiating hard from soft information may not, however, always be a straightforward task. See Mark Klock, Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?, 28 J. CORP. L. 69, 92 (2002) (noting that "[t]he distinction between hard and soft information is itself soft and opaque").

the firm's internal counsel, who may well be current investors in the firm and certainly will be sensitive to the impact of disclosure on firm stock value. 29

Securities law is thus inconsistent—internally and with corporation law 30—as regards the temporal conflict. Moreover, it does not provide a principled basis to judge, from a temporal standpoint, who the appropriate investor audience should be.

Consequences of the temporal conflict: The temporal conflict is of real and not merely theoretical concern. 31 For example, be-

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29. See Charles M. Yablon & Jennifer Hill, Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?, 35 WAKE FOREST L. REV. 83, 86-88, 97-103 (2000) (discussing recent studies suggesting that even carefully structured pay packages inadvertently give CEOs incentives to manipulate the timing of disclosure for their own benefit, such as increasing the value of their stock options at the expense of shareholders).

30. In the United States, at least, securities law's inconsistency with corporation law is not problematic as a matter of positive law because securities law is primarily federal, whereas corporation law is state, and federal law preempts conflicting state law. See, e.g., Conkling v. Moseley, Hallgarten, Estabrook, & Weeden, Inc., 575 F. Supp. 760, 761 (D. Mass. 1983) (noting that federal law has largely superseded state regulation of securities transactions). Nonetheless, this Article seeks a normative resolution of the temporal conflict, and in many nations securities and corporation law constitute a single body of law. See, e.g., David M. Cielusniak, Note, You Cannot Fight What You Cannot See: Securities Regulation on the Internet, 22 FORDHAM INT'L L.J. 612, 624-25 (1998) (observing that Australian corporate law functions in this way). Moreover, scholars argue that securities and corporation law should constitute a single integrated body of law in the United States. See, e.g., Ralph C. Ferrara & Marc I. Steinberg, The Interplay Between State Corporation and Federal Securities Law—Santa Fe, Singer, Burks, Maldonado, Their Progeny, & Beyond, 7 DEL. J. CORP. L. 1, 3-4 (1982) (discussing the need to develop a federal corporation law to fill the gap between state corporation and federal securities law).

31. This Article focuses on the temporal conflict resulting from disclosing risk. If firms had the same reluctance to disclose positive information as they have to disclose risk, a temporal conflict resulting from that reluctance might mitigate some of the consequences discussed below on the supposition that benefit to future investors from failure to disclose positive information might offset harm to future investors from failure to disclose risk. In reality, though, firms rarely withhold positive information. See Langevoort, supra note 12, at 760 (contrasting the reluctance of firms to disclose negative information with their willingness to disclose positive information); Marc I. Steinberg, Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis, 22 U. PA. J. INT'L ECON. L. 635, 658 (2001) ("[a]bsent sound business reasons, companies normally are pleased to promptly disclose positive information"). For an interesting analysis of a type of temporal conflict regarding disclosure of positive information, see Ian Ayres, Back to Basics: Regulating How Corporations Speak to the Market, 77 VA. L. REV. 945, 987-91 (1991) (arguing that current shareholders would want disclosure of positive information, whereas future shareholders would not want disclosure of positive information until
cause the audience for disclosure is unclear, corporate actions viewed ex ante as proper are sometimes judged ex post as wrongful. Thus, Enron's special-purpose entity (SPE) transactions were disclosed in the notes to its financial statements. Although that disclosure arguably satisfied securities law standards, and any more prominent disclosure could have harmed Enron's current investors, many allege in retrospect that Enron's failure to give greater prominence to the disclosure misled future investors in Enron stock.

The temporal conflict creates other troublesome consequences. Consider, for example, a financial institution with a portfolio of bad loans that is expected, once the economy improves, to increase in value. Until then, however, generally accepted accounting principles (GAAP) would require the financial institution, if the loans deteriorate further, to periodically mark-to-market the loan value shown on its balance sheet by the loans' declining market value. If, however, the financial institution sells those loans to an independent special-purpose vehicle and takes back securities in exchange, GAAP might permit the institution to hold those securities without marking them to market. A financial institution may well decide to en-


36. See, e.g., id. at FAS115 [hereinafter FASB Statement No. 115]. FASB Statement No. 115 classifies most equity securities and all debt securities, other than loans, id. at FAS115-4 ¶ 4, held for investment into three categories based on the intent of the investor: held-to-maturity securities, trading securities, and available-for-sale securities. Id. at FAS115-5 ¶ 12. Unlike loan accounting, unrealized gains and losses on available-for-sale securities are ex-
gage in such a sale on the basis that it owes a duty to its current investors, whose investments would be impaired if the loans are prematurely marked down. Government regulators, however, might argue that the financial institution, by engaging in such a sale, has acted wrongfully and potentially harmed future investors.37

Confusion over the audience similarly raises problems in the context of credit rating agencies,38 and indeed accounts for an intensely-debated conundrum of ratings reliability. Rating agencies are presently conservative in downgrades to avoid the risk of a false negative, in which downgrading the rating of bonds of an otherwise healthy firm can become a self-fulfilling prophecy, hurting current investors.39 However, a rating agency's failure to timely downgrade, like the failure to do so in Enron, can significantly injure future investors and impair its credibility.40 For this reason, some argue that ratings should be based on (or perhaps even replaced by) market-based tests such as credit spreads which are more sensitive to the advent of bond risk, even though their hair-trigger sensitivity raises the risk of false negatives.41

cluded from earnings. Id. at FAS115-5 ¶ 13. If, therefore, the financial institution in the accompanying text intends to hold the securities it receives in exchange for its sale of loans as available-for-sale securities, it would not have to mark those securities to market.


38. Rating agencies are private companies that, by reason of their reputation, are able to issue (for a fee) credit ratings of a firm’s debt securities informing investors of the likelihood of timely payment thereon. For a comprehensive discussion of rating agencies, see Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1.


40. Id.

41. See, e.g., Frank Partnoy, The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies, 77 WASH. U. L.Q. 619, 657–59 (1999). There are, of course, many other areas where the temporal conflict can cause problems. One example is automobile recalls and safety alerts. Car manufacturers are often faced with the question of how and when to disclose information concerning potentially unsafe conditions in cars. Releasing more information (e.g., issuing recalls sooner and for “smaller” problems) would benefit car buyers (i.e., future owners) but could hurt current car owners by
This debate cannot be resolved in isolation. Current investors may prefer ratings to be conservative to protect the investment value of their securities. Future investors may prefer market-based tests to better anticipate the possibility of risk when investing in securities. Which approach is better therefore depends, in the first instance, on which audience is viewing the rating. Unfortunately, as with the other issues of disclosure discussed above, there is no clear understanding which audience that should be.

Insight into the temporal conflict also provides considerable explanatory power for corporate governance. Consider, for example, the controversy over contrasting definitions of "independence" based on share ownership, as applied to outside directors. Although this controversy goes beyond disclosure ambiguity and thus does not present the classic temporal conflict on which this Article focuses, the temporal conflict informs the dispute. The standard view on outside director independence is that of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation System (NASDAQ), both of which "affirmatively characterize shareownership [sic] as a relationship that does not preclude a determination that a director is independent." Their rationale is that because "the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding." A more controversial and indeed unorthodox position on independence, however, is taken by the Sarbanes-

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42. For an excellent review of this debate, see Deborah A. DeMott, Independent Directors: Beyond Disinterest (unpublished manuscript, on file with the Minnesota Law Review).

43. See supra notes 8–15 and accompanying text.

44. DeMott, supra note 42, at 10.

Oxley Act,\textsuperscript{46} which provides that a shareholder holding as little as ten percent of any class of a firm's voting securities may not be treated as "independent" for purposes of service on an audit committee.\textsuperscript{47}

The temporal conflict helps to reveal the merit of Sarbanes-Oxley's position on independence. An audit committee is required, under Sarbanes-Oxley, to be directly responsible for the appointment and compensation of the accountants who prepare the firm's audit reports and perform other audit services.\textsuperscript{48} The audit committee also has oversight responsibility for the external auditor's work.\textsuperscript{49} These new responsibilities "arguably shift [the] focus [of audit committees] away from an orientation defined in the first instance by the interests of the company's shareholders and toward the public-regarding orientation of external auditors, whose professional norms and legal duties are centered on assuring integrity in financial reporting."\textsuperscript{50} The temporal conflict provides insight into why a firm's substantial shareholders should not serve on the audit committee: being current investors,\textsuperscript{51} they will not have the same incentive as future shareholders to ensure that the firm's financial results are fairly presented.\textsuperscript{52}

\textit{Nature and scope of the inquiry:} This Article focuses primarily on the temporal conflict that arises in corporate disclosure.\textsuperscript{53} My inquiry begins by exploring the problems caused by

\begin{itemize}
\item \textsuperscript{47} DeMott, supra note 42, at 7–8.
\item \textsuperscript{49} Id.
\item \textsuperscript{50} DeMott, supra note 42, at 13.
\item \textsuperscript{51} See supra note 3 (defining current investors).
\item \textsuperscript{52} Cf. DeMott, supra note 42, at 13.
\item \textsuperscript{53} Temporal conflicts also can arise in nondisclosure corporate contexts, see supra notes 17–18 and accompanying text, as well as in completely noncorporate contexts. See infra note 114; cf. E-mail from Jill Fisch, Alpin J. Cameron Professor of Law, Fordham Law School, to the author (Aug. 2, 2004) (on file with the Minnesota Law Review) (arguing that the temporal conflict in a nondisclosure corporate context may be even more acute than in a disclosure context, but observing that any normative resolution of the former temporal
\end{itemize}
that temporal conflict. I then examine relevant legal precedents for resolving the conflict. There are few such precedents under U.S. law. Because of this paucity, and also to engage the conflict from an international perspective, I also examine analogous and foreign legal precedents. Thereafter, I analyze how the law should treat temporal conflicts from a more normative perspective.

One must distinguish the scope of my inquiry from the seemingly related, though fundamentally different, conflict between the goals of long- and short-term investors. That conflict focuses on whether directors should manage "for a long future, for expected [as opposed to present] competition, for a continuing as well as an immediately profitable venture." Short-term investors may prefer immediate profits, while long-term investors will prefer continuing profits. That conflict, however, addresses only current long- and short-term investors. Thus, it is more susceptible to resolution because the audience is known.

In contrast, the temporal conflict is more abstract: between current and future investors, irrespective of their long- or short-term investment intentions. This distinction is fundamental. For example, both long- and short-term current investors will disfavor the downgrading of a firm’s bond rating. However, both long- and short-term future investors will favor it. Also, long- and short-term current investors will, other

conflict would face questions about the extent to which there should be meaningful regulatory limits on management discretion other than prohibitions on self-dealing).

54. This fundamentally different conflict is discussed as a possible analogy to the temporal conflict. See infra notes 92–104 and accompanying text. The scope of my inquiry is also much broader than the narrow observation that, without securities regulation, "current shareholders [would] bear the costs of disclosure, yet prospective shareholders [would] share in the benefits of disclosure (i.e., they are free riders).” STAFF OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC, 95TH CONG., REPORT: THE NATURE OF MANDATED DISCLOSURE 618–56 (House Comm. Print 1977) (primarily the work of William H. Beaver), reprinted in RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 317, 321 (1980).


56. For example, the literature on resolving contention between acquiring-firm and target-firm shareholders in mergers describes this type of conflict because it is essentially between current shareholders of both firms. See, e.g., E.C. Lashbrooke, Jr., Asymmetric Information in Mergers and the Profits of Deceit, 28 LOY. L.A. L. REV. 507 (1995).

57. Similarly, both long- and short-term current investors will disfavor
things being equal, disfavor disclosure of a risk; whereas both
long- and short-term future investors will favor such disclosure.
To distinguish these conflicts, I will refer, as needed, to the con-
flict between current long- and short-term investors as a
"static-investor conflict," since (in contrast to the temporal con-
FIG. 1.1 that would arise because the disclosure
would impair their investment value in the firm's securities;
whereas both long- and short-term future investors will favor disclosure, which would lower the price of those securities.

58. In this sense, one might think of the temporal conflict as a "dynamic-
investor conflict" in the sense that it is a conflict between current and future
(i.e., changing) investors.

59. Such agreement on a disclosure regime is not an impossibility. Al-
though the respective interests of current and future investors regarding a
 discrete disclosure decision are necessarily antithetical, to the extent today's
"future" investors eventually purchase securities they then would become cur-
rent investors in those securities. However, agreement on a disclosure regime
is unlikely since current investors do not necessarily become future investors,
and at any finite future date there also necessarily will be future investors
who have not yet become current investors. In a different context, one com-
mentator has attempted to solve an intergenerational problem using hypo-
thetical bargain theory. See Thomas A. Smith, The Efficient Norm for Corpo-
rate Law: A Neotraditional Interpretation of Fiduciary Duty, 98 MICH. L. REV.
214, 266–67 (1999). Thomas Smith articulates the problem as a paradox:

If markets cannot perfectly anticipate the timing of cash flows, and
managers have information about the timing of flows superior to the
market, then they will face decisions that in effect force them to
choose among "generations" of shareholders. . . . One investment
might yield immediate benefits, while another might pay off only
years hence—a payoff that, if we assume imperfect markets, might
not reflect in the current price.

Id. at 266. Smith's methodology for solving this problem, however, appears
somewhat disingenuous. After assuming that investors are all rational—itself
a dubious assumption—he argues that "[r]ational investors are widely diversi-
fied," and because they are widely diversified, they will be "diversified across
all firms," and because they are diversified across all firms:

[I]t seems likely they will be holding securities of firms whose projects
are at all stages of their life cycles [and thus] will own some stock in
firms investing in projects that will not be correctly valued currently
and some stock in firms whose stock is rising only now to correct pre-
viously mistaken valuations.

See id. at 267. These assumptions, however, assume away the underlying
problem.
solely by current and future investors; there also are costs to firms issuing securities and to the securities markets. My focus is on minimizing all of those costs.

I. RELEVANT LEGAL PRECEDENTS

U.S. legal precedents: There are few judicial precedents in the United States, and little scholarship, addressing the temporal conflict. In general, courts have ignored the distinction between current and future investors, or have been sloppy when alluding to it. For example, the court in In re Craftmatic Securities Litigation cites TSC Industries, Inc. v. Northway, Inc. for the proposition that the disclosure standard should be judged from the standpoint of "a reasonable investor contemplating the purchase of securities," whereas the court in Grossman v. Novell, Inc. cites to the same Supreme Court case for the proposition that the disclosure standard should be judged from the standpoint of "a reasonable investor... considering... whether to buy or sell stock." Technically, however, the Supreme Court case stands for neither such proposition. It only holds that disclosure should be judged from the standpoint of what "a reasonable shareholder would consider... important in deciding how to vote"—which, if anything, is a current-investor standard since only current shareholders can vote shares.

60. See infra note 165 and accompanying text (discussing all of the interests affected by disclosure).

61. I therefore do not delve, for example, into a Rawlsian-style examination of how a hypothetical rational investor unaware of his temporal status would—if given the chance—choose to order a disclosure regime to minimize the temporal conflict.

62. See E-mail from Thomas Lee Hazen to the author, supra note 11, at 1 (observing that, to his knowledge, "there has never been an attempt in the materiality cases to address [the temporal] distinction" between current and future investors).

63. 890 F.2d 628 (3d Cir. 1990).

64. 426 U.S. 438 (1976).

65. In re Craftmatic Sec. Litig., 890 F.2d at 639 (emphasis added).

66. 120 F.3d 1112 (10th Cir. 1997).

67. Id. at 1119 (emphasis added).

68. TSC Indus., 426 U.S. at 449.

69. I do not claim that the Craftmatic and Grossman courts were fundamentally wrong, merely that they were sloppy. Cf. Basic Inc. v. Levinson, 485 U.S. 224, 231–33 (1988) (assuming that a reasonable investor could be either a current investor looking to sell or a future investor looking to buy, though failing to recognize that this distinction might have consequences for SEC-mandated disclosure).
The only context in which U.S. authorities have focused with any degree of precision on the distinction between current and future investors is that of delisting securities from a securities exchange. In *In re Midland Resources, Inc.*, for example, the SEC issued an order granting an application of the American Stock Exchange to delist stock and subordinated debentures from that exchange. The SEC rejected Midland's argument that delisting would hurt current investors, reasoning that "the primary concern in situations of this sort is the protection of future investors who rely on listing as an indication that the securities meet the qualifications which such listing suggests. The adverse effect on present [securities] holders must yield to that." On this same rationale, the SEC reached similar conclusions in later delisting cases.

The SEC's rationale in these delisting cases appears to be sound, based on their facts. The delisting event in all these cases clearly heralded the listed firm's imminent demise, and was not a technicality. Current investors at that time therefore already would have lost most of the value of their securities, with little if anything left to lose by the actual delisting. On the other hand, continued listing on the exchange would signal that the firm remained sound, thereby misleading future investors who could lose their entire new investment. The failure to delist thus would create troublesome distributional inequities.

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70. 46 S.E.C. 861 (1977).
71. *Id.* at 864.
72. See *In re Tassaway, Inc.*, 45 S.E.C. 706, 709 (1975) (stating that "[t]hough exclusion from the [NASDAQ quotation] system may hurt existing investors, primary emphasis must be placed on the interests of prospective future investors"); *In re Acme Missiles & Constr. Corp.*, 43 S.E.C. 485, 489 (1967) (stating that "while delisting may have adverse effects on present investors, such effects are outweighed by the protection afforded future purchasers by removing from Exchange trading securities not possessing the applicable qualifications"); *In re Fifth Ave. Indus. Corp.*, 43 S.E.C. 146, 150 (1966) (stating the same proposition as *Acme Missiles*).
73. In *Midland*, the firm had suffered continuous losses totalling more than $42 million over a four-year period and showed no indication of a return to profitability. 46 S.E.C. at 863–64. In *Tassaway*, the firm not only failed NASDAQ's nominal $250,000 capital-plus-surplus requirement but also had a capital deficit of over $3.4 million. 45 S.E.C. at 708. In *Acme Missiles*, the firm's operating activities had effectively ceased operation. 43 S.E.C. at 486. And in *Fifth Avenue Industries*, a substantial portion of the firm's operating properties was condemned, with a similar impact on the firm's operations. 43 S.E.C. at 147.
that, if left unchecked, could impair the reputation, and therefore value, of exchanges in securities markets.74

Distinguished by the narrow factual context, the delisting cases do not provide a useful framework for analyzing the temporal conflict. The balance between the interests of current and future investors usually is much more equal than in those cases. Those cases also can be distinguished in that they do not involve disclosure ambiguity.

Scholarship on the temporal conflict is likewise minimal. Professor Daniel Fischel tacitly recognized the conflict's existence as the source of confusion in Dirks v. SEC,75 a Supreme Court case examining, among other things, whether officers of Equity Funding of America breached their corporate fiduciary duty by disclosing information about the firm's fraud to an investment analyst.76 The Court had held that those officers did not breach their fiduciary duty because their motivation was public spirited—to disclose the fraud—and exposure of fraud is a public good.77 Fischel disagreed with the Court's reasoning, arguing it "ignores the effects of tipping on the wealth of the firm's investors,"78 and that the Court should have focused on "the effect of [the officers'] conduct on investors' wealth [to] determine whether a breach of fiduciary duty has occurred."79 Taking that focus, Fischel observed that "it could be argued that the actions by Equity Funding's [officers] were causally related to the company's eventual bankruptcy, to the obvious detriment of its current investors."80 Notwithstanding that detriment, however, Fischel ultimately concluded that the officers did not violate their fiduciary duty because "a rule that restricts the firm's ability to defraud future investors" would be—and therefore the officers "were probably" acting—"consistent with the organizing principles of the firm."81

The only scholarship that directly addresses at least one aspect of the temporal conflict is a 1991 symposium article by

74. See, e.g., Steven L. Schwarcz, Collapsing Corporate Structures: Resolving the Tension Between Form and Substance, 60 BUS. LAW. 109, 124 (2004) (observing that "even the perception of distributional inequities can discourage market participants by undermining expectations").
76. Fischel, supra note 34.
77. Id. at 138.
78. Id.
79. Id.
80. Id.
81. Id. at 139.
Professor Henry T.C. Hu. Investigating the process of financial innovation and the basic pecuniary goals of publicly held firms, Hu argued that such innovation has rendered "intolerably ambiguous" the principle that corporations are to be run primarily for the benefit of their shareholders.\(^3\) In part, he claimed, this ambiguity results from increasing stock turnover, creating an "especially serious" timing problem where, for example, "the person who happens to hold shares at [the time of] disclosure of [a worthwhile long-term] investment does not continue to hold them through the payoff period for the investment."\(^4\) If, because of information asymmetry, this disclosure "has the effect of depressing the trading price[,] the investment would hurt contemporaneous shareholders and help those who hold shares in the future as the benefits of the investment[ ] become evident."\(^5\) Existing conceptions of the pecuniary goals of corporations "do not," Hu observed, address such "problems of conflicts of interest among different generations of shareholders."\(^6\) Accordingly, "[t]o the extent that securities laws allow some discretion in the timing of disclosures, managers have a basic fiduciary problem in terms of which 'generation' of shareholders to favor."\(^7\)

Hu therefore recognized the temporal conflict resulting from discretion in the timing of disclosure, an aspect of the conflict that this Article discusses in the context of periodic reporting.\(^8\) He did not, however, discuss the temporal conflict in a wider disclosure context,\(^9\) nor did he attempt to engage the conflict other than identifying its existence as creating "serious problems because of the increasing proportion of short-term shareholders."\(^10\) Nonetheless, Hu's tying of the temporal conflict's significance to the increasing proportion of short-term investors, and thus an increasingly higher turnover of investors

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82. Hu, supra note 4, at 1286.
83. Id. at 1287.
84. Id.
85. Id. at 1287–88.
86. Id. at 1300 (emphasis added).
87. See supra notes 24–29 and accompanying text.
88. Although Hu agrees with me that the temporal conflict "is clearest in the disclosure context," he focuses in that context only on timing of disclosure. Hu, supra note 4, at 1300. Hu does note, however, that a temporal conflict also could arise in nondisclosure contexts, such as a firm's decisions about dividends, stock buy-backs, issuance of shares, and mergers and acquisitions. Id. at 1300–01.
89. Id. at 1303.
in securities, may help to explain why there are so few precedents. When, as in the past,

turnover levels are low, the problem in fiduciary doctrine is less material. Low turnover levels, in effect, provide a practical, partial solution to a fundamental problem in legal theory. . . .

Unfortunately, the modern financial market is inhospitable to such a makeshift solution. With financial innovation playing a leading role, stock turnover has increased dramatically in the past two generations. 90

The increase in the turnover rate of securities held by investors therefore makes the temporal conflict an urgent problem in today's financial environment. 91 Given the paucity of precedents, I next examine potentially analogous legal precedents.

Analogous legal precedents: The most analogous precedents under U.S. law are those governing the resolution of the static-investor conflict, since that conflict, like the temporal conflict, involves time-related considerations. The static-investor conflict pits investors who generally hold securities (usually shares of stock) for long-term capital appreciation and income against other investors (especially traders) who purchase shares to profit short term, such as on daily market movements. 92 Short-term investors will prefer to reap the immediate profits from investment, while long-term investors may prefer that firms forego immediate gains in favor of outlays or plans that "optimize long-run firm value." 93 Management therefore must decide whether their duty is to maximize short-term shareholder value or long-term firm value. 94

Corporation law provides limited guidance for making this decision. A firm's directors only need "chart a course for [the]
corporation which is in its best interests without regard to a fixed investment [time] horizon.” That course is left to the directors’ business judgment, and there is no general duty to sacrifice long-term corporate interests for the sake of maximizing share value in the short term. A firm’s directors thus often will side with long-term shareholders in a hostile takeover context—even where doing so is not necessarily for wholly disinterested reasons—by arguing that the takeover would not be in the best long-term interests of the firm.

This limited guidance does not provide insight for resolving the temporal conflict. The static-investor conflict, and thus any insight into its resolution, concerns the tension between the interests of long- and short-term current investors. In contrast, the temporal conflict concerns the tension between current and future investors, irrespective of whether they have long- or

97. Time Inc., 571 A.2d at 1150; cf. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994) (holding that a sale of control obligates directors to “focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders”); Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding, in the limited circumstance where a firm is for sale, that management has a duty to maximize short-term shareholder value). Commentators Martin Lipton and Paul K. Rowe summarize the interplay between Time Inc. and Revlon nicely:

In Revlon, Delaware required directors to maximize short-term value once they decided to sell a company for cash. Conversely, Delaware decided that it would not require directors to maximize short-term value outside this particularly narrow situation. Delaware companies are not required to be for sale twenty-four hours a day and seven days a week. Directors could agree to friendly stock mergers without putting the firm “in play” or having to “auction” the company.

Martin Lipton & Paul K. Rowe, Pills, Polls and Professors: A Reply to Professor Gilson, 27 DEL. J. CORP. L. 1, 11 (2002).
98. For example, Thomas Hazen has observed that:

Corporate managers may believe that a hostile takeover attempt would sacrifice the long-term future of the company in favor of short-term profit maximization. . . . Permitting managers to defend against takeovers allows them to preserve the status quo in hopes that the company can continue to pursue its long-term objectives. It also permits managers to keep their own jobs.

Hazen, supra note 93, at 195.
99. See id. at 142 (stating that “[t]arget management typically responds [to a hostile takeover] by resisting, claiming that it is looking out for the long-term interests of shareholders”).
short-term interests. The dynamic of these two conflicts is therefore fundamentally different, as illustrated by a real-world example. Assume that a proposed merger would create long-term value for a firm. Current investors in the firm with a long-term focus would likely favor the proposed merger. In contrast, current investors with a short-term focus may not recognize the merger’s long-term value. Undervaluing the merger, these current investors might favor, say, a competing takeover offer that maximizes short-term share price. Under the law governing this static-investor conflict, the firm’s directors have discretion either to choose the merger and fight the takeover (as desired by the current investors with a long-term focus), or oppose the merger and acquiesce to the takeover (as desired by the current investors with a short-term focus).

100. See supra notes 57–58 and accompanying text.

101. The hypothetical above also assumes that the proposed merger would not trigger duties under Revlon or otherwise constitute a sale of control. See supra note 97.

102. See Time Inc., 571 A.2d at 1148. On the question of whether current investors with a short-term focus should recognize long-term value, see Bernard Black & Reinier Kraakman, Delaware’s Takeover Law: The Uncertain Search for Hidden Value, 96 Nw. U. L. Rev. 521, 532–33 (2002) (noting that “under elementary principles of finance, even short-term investors have an incentive to maximize the firm’s long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell”); Hazen, supra note 93, at 143 (stating that “if the current price adequately takes account of a company’s long-term prospects, then it would make little sense to talk of long-term shareholders’ interest as distinct from their short-term interest”); id. at 200 (asking why the “efficient market [does] not fairly value” the shares in question by factoring in expected long-term prospects in addition to short-term performance); Henry T.C. Hu, Risk, Time, and Fiduciary Principles in Corporate Investment, 38 UCLA L. Rev. 277, 336–42 (1990) (discussing how stock market myopia is inconsistent with the efficient market hypothesis); Mark A. Sargent, Lawyers in the Perfect Storm, 43 Washburn L.J. 1, 13 (2003) (suggesting that in a market unhampered by inefficiencies, “if the firm really was sacrificing the long-term interests of the corporation for short-term benefits in an unjustifiable way, the market would recognize that fact and discount the price of the firm’s securities appropriately”).

103. See Time Inc., 571 A.2d at 1148.

104. As David Silk and David Katz have observed: [E]ven if a hostile bid provides greater current and other short-term value than a merger, and even if that hostile bid provides for an admittedly fair price, the target’s board may attempt to preserve or achieve for its stockholders the business benefits of the original merger transaction so long as the original merger does not itself constitute a change of control.

The temporal conflict, however, pits the firm's current investors, irrespective of their long- or short-term focus, against the firm's future investors, again irrespective of their focus. The entire dynamic has changed: future investors are indifferent to the merger-versus-takeover decision because, at the time of that decision, they do not hold the firm's securities. Moreover, at any future date on which they purchase securities, such investors can choose freely to purchase the firm's shares, if fairly valued, or instead to purchase other securities. In short, the merger-versus-takeover decision neutrally affects future investors. Likewise, the idea of giving directors discretion to decide how to resolve the static-investor conflict does not inform the temporal conflict—it is precisely that discretion under existing law that gives rise to the temporal conflict. Furthermore, such discretion would be subject to agency-cost bias because directors, who often own securities of the firm, are by definition current investors and thus have a conflict of interest. Accordingly, the static-investor conflict does not provide useful precedents for resolving the temporal conflict.

Precedents from foreign legal systems: The temporal conflict can arise in virtually any legal system. Thus it is useful to examine whether foreign authorities have recognized and grappled with this conflict.

A line of British Commonwealth cases involving contested corporate takeovers has been suggested to this author by several foreign colleagues as illustrative of the temporal conflict. The question in these cases was whether directors of the target firm breached their duty by allotting shares in the firm to third parties, thereby thwarting a takeover by certain current shareholders perceived as damaging to the firm's future. Although it might appear that the rights of current shareholders were thus pitted against those of future shareholders (i.e., the firm's future owners), these cases are better viewed as static-investor conflicts between competing groups of current investors, with directors attempting to favor the bloc of current investors that better serves the firm's long-term interests. Moreover, these

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105. Investors would not be expected to purchase the firm's shares, for example, unless they believe the stock price, as adjusted by the market to reflect the acquisition, is competitive.

106. To this extent, these English common law cases are similar to the takeover cases discussed in connection with the static-investor conflict, supra notes 95–104 and accompanying text. Furthermore, these cases do not appear to involve any disclosure ambiguity, and, absent asymmetric information,
cases all were decided on narrow, technical grounds—in each case, whether the firm’s directors could use their share allotment power to dictate who would control the firm. The cases therefore do not provide a reliable, much less a principled, basis for balancing the interests of current and future shareholders.

Indeed, few relevant authorities have been found concerning the temporal conflict. For example, a Company Law Review Steering Group assigned the task of examining U.K. company law to suggest reforms recently proposed a concept known as “enlightened shareholder value,” intended to encompass future as well as present shareholders. The group’s recommendations, however, are presently in limbo. Also, a leading English-law commentator, J.D. Heydon, has asserted that the standard for determining directors’ duties, “best interests of the company,” means the best interests of “present and future members” of the company. He then supports that assertion, however, by arguing that “a long-term view should be balanced against the short-term interests of present [company] members”—suggesting he may be conflating the temporal conflict and the static-investor conflict.

future investors would not even be harmed by the unfavored bloc winning because the firm’s share prices, and thus the cost of shares purchased by future investors, would fall to reflect the lowered market value.


109. E-mail from Brian R. Cheffins to the author, supra note 108.

110. J.D. Heydon, Directors’ Duties and the Company’s Interests, in EQUITY AND COMMERCIAL RELATIONSHIPS 120, 123 (P.D. Finn ed., 1987). This same viewpoint, that the best interests of the firm are those of both its present and future members, is taken in E. MILNER HOLLAND, Q.C., BD. OF TRADE, THE SAVOY HOTEL LIMITED AND THE BERKELEY HOTEL COMPANY LIMITED: INVESTIGATION UNDER SECTION 165(b) OF THE COMPANIES ACT, 1948: REPORT OF MR. E. MILNER HOLLAND, Q.C. 16 (1954).

111. Heydon, supra note 110, at 123. Again, this same viewpoint is seen in E. MILNER HOLLAND, Q.C., supra note 110, at 16 (a firm’s board of directors should “balance a long-term view against short-term interests of present members”). To confuse matters further, another leading English-law scholar, commenting specifically on Heydon’s assertion, observes that although “there
None of these authorities provides a meaningful framework for analysis. I therefore begin the analysis from first principles.

II. ANALYSIS

How should the temporal conflict be resolved? This is a normative question and requires a normative answer. The temporal conflict reflects, at its core, an information asymmetry problem—the degree to which information about a firm’s risks should be disclosed, directly or through ratings, where there is disclosure ambiguity. My analysis therefore begins by focusing on the information asymmetry problem, and then considers the consequences of disclosure for current and future investors.

Eliminating information asymmetry: The most obvious way to solve this information asymmetry problem is for the firm issuing securities (issuer) to provide investors—both current and future—with all possible information, thereby reducing the information asymmetry. This suggests that the temporal conflict could be resolved by providing maximum disclosure. In a perfect universe where disclosure eliminates all information asymmetry, there should be little difference between the audience of current investors and future investors because prices have already adjusted to reflect all information.

is some authority for extending [the duty of a firm’s directors] to future shareholders as well as present ones[,] I do not find that expression of directors’ duties particularly helpful.” I.A. Renard, Commentary, in EQUITY AND COMMERCIAL RELATIONSHIPS, supra note 110, at 137, 138.

Indeed, any positive law resolution of the temporal conflict would be misleading to the extent it is country-specific and constrained by idiosyncrasies in the country’s laws.

Recall that the temporal conflict effectively arises only where there is disclosure ambiguity since a clear and credible risk must be disclosed irrespective of the impact on current and future investors. See supra notes 8–11 and accompanying text.

One could apply this same approach to more generic temporal conflicts, such as automobile recalls, safety alerts, and college rankings. See supra note 41. The temporal conflict reflects, at its core, an information asymmetry problem—the degree to which information about risks associated with an entity should be disclosed, directly or indirectly, where there is disclosure ambiguity. Only after that problem is analyzed can one take into account the consequences of disclosure to current and future concerned third parties. The analysis therefore should begin by focusing on the information asymmetry problem, and then take those consequences into account.

Or, in other words, markets are semi-strong efficient, reacting instantly and correctly to all information as it is disclosed to the public. See, e.g.,
That solution, however, is flawed in the imperfect universe in which we live. Experience shows that no disclosure regime can completely eliminate information asymmetry.\footnote{Cf. infra note 158 and accompanying text (observing that disclosure regimes have failed to eliminate ambiguities). Moreover, future risks cannot be precisely assessed, and often are unknown.} Furthermore, contrary to intuition, at some point maximizing disclosure does not reduce, but actually \textit{increases}, asymmetric information. This occurs for two reasons. First, disclosure of a profusion of details can simply obfuscate and confuse investors, and some investors may not even have the time to review much less fully evaluate the disclosure.\footnote{Steven E. Bocher \& Samir Bukari, \textit{The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives}, in \textit{SECURITIES LAW \& THE INTERNET 2002: DISCLOSURE PRACTICES IN LIGHT OF ENRON \& CURRENT SEC DISCLOSURE INITIATIVES} 397, 416 (2002) (observing that \textit{"opt[ing] on the margin to disclose rather than not... would result in the dissemination of information that could work to crowd out information of genuine interest to investors"); Paredes, supra note 12 (arguing that the existing disclosure system may subject investors, analysts, and other securities market participants to information overload); cf. Schwarcz, supra note 34 (arguing that as transaction structures become more complex, the disclosure becomes so complex that investors may be unable to understand it).} Even the most sophisticated investors can suffer information overload.\footnote{Paredes, supra note 12, at 454-55 (observing that \textit{"[s]everal studies and experiments show that experts can become overloaded, even if they can effectively use more information than non-experts... [t]his should not be surprising given that everybody—experts and non-experts alike—has limited cognitive abilities").} This concern is well illustrated by a leading decision of the full court of the Federal Court of Australia, involving the adequacy of disclosure in a prospectus describing a proposed acquisition of a mutual insurance company and plans to demutualize it.\footnote{Fraser v. NRMA Holdings Ltd. (1995) 55 F.C.R. 452.} Even under a materiality standard,\footnote{Id. at 467-68.} the court rejected allegations that the disclosure was inadequate because it did not set forth every possible formulation of the commercial objective of the proposal, and arguments for and against those possibilities. It reasoned that such comprehensive disclosure would be likely to confuse rather than to illuminate the issue for decision, even for people having a familiarity with corporate law and commerce. The need to make full and fair disclosure must be tempered by the need to present a document that is intelligible to reason-

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able members of the class to whom it is directed, and is likely to assist rather than to confuse.\textsuperscript{121}

The court stressed that disclosure must be both practical and realistically useful:

In complex cases it may be necessary to be selective in the information provided, confining it to that which is realistically useful.\ldots It is important that the adequacy of the information provided by the prospectus and supporting documents be assessed in a practical, realistic way having regard to the complexity of the proposal.\textsuperscript{122}

The second reason that maximizing disclosure does not necessarily reduce and actually can increase asymmetric information is that—even absent a profusion of details—behavioral psychology shows that people, and therefore investors, are not rational assessors of information. They overestimate the chances that something they recently became aware of, like airplane crashes or illnesses, will happen.\textsuperscript{123} Likewise, investors may well overestimate the likelihood and impact of

\footnotetext{121}{Id. at 468.}
\footnotetext{122}{Id. Similar arguments have been made in the United States:
Reasonable investors do not want to know everything that could go wrong, without regard to probabilities; that would clutter registration statements and obscure important information. Issuers must winnow things to produce manageable, informative filings.\ldots Their approach is \textit{ex ante}. Issuers and underwriters must decide what information will be useful without burying investors under a blizzard of paper.


123. Stephen J. Choi & A.C. Pritchard, \textit{Behavioral Economics and the SEC}, 56 STAN. L. REV. 1, 16 (2003) (observing that people have a tendency to overestimate the probability that salient risks will occur, such as overestimating the risks of flying due to the newsworthiness of plane crashes even though car crashes are much more common); Christine Jolls, \textit{Behavioral Economic Analysis of Redistributive Legal Rules}, 51 VAND. L. REV. 1653, 1662–63 (1998) (observing that probability exaggeration may occur when an event is “available,” or comes readily to a person’s mind, with the most available events being those that have received a large amount of media attention); Larry E. Ribstein, \textit{Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002}, 28 J. CORP. L. 1, 46 (2002) (discussing the “availability heuristic,” such as the exaggerated perception of a wide range of risks, from corporate fraud to nuclear power accidents, given prominence in the media).}
disclosed potential risks. This overestimation itself creates a form of information asymmetry.

For these reasons, maximizing disclosure harms existing investors but does not necessarily benefit future investors. Since maximizing disclosure is not the answer, I next examine more nuanced solutions, including economic theory on solving the information asymmetry problem, which economists often refer to as the "Lemons" problem.

Economic theory on solving the asymmetric information problem: Economists ask how transactions ever occur if the seller has more information than the buyer and the information disparity cannot be cured (at least at reasonable cost). The problem was first systematically studied by George Akerlof, using the crude but intuitive example of the used-car market:

From time to time one hears either mention of or surprise at the large price difference between new cars and those which have just left the showroom. . . . The individuals in this market buy a new automobile without knowing whether the car they buy will be good or a lemon. But [overall market statistics enable them to] know that with [a high] probability it is a good car and with [a lower] probability . . . it is a lemon . . . . After owning a specific car, however, for a length of time, the car owner can form a good idea of the quality of this machine; i.e., the owner assigns a new probability to the event that his car is a lemon. This estimate is more accurate than the original estimate. An asymmetry in available information has developed: for the sellers now have more knowledge about the quality of a car than the buyers. But [absent a solution,] good . . . and bad [used] cars must still sell at the same price—since it is impossible for a buyer to tell the difference between a good [used] car and a bad [used] car.

124. See, e.g., Paredes, supra note 12, at 455 (citing a "vast behavioral finance literature suggest[ing] that securities market professionals, like lay investors, are subject to all sorts of cognitive biases that affect investment decisions"); Peter H. Huang, Regulating Anxiety and Excitement: Affective Investing and Effective Securities Regulation 54 (2002), at http://www.law.upenn.edu/fac/pwagner/adhoc/summer2002/huang.pdf (observing that the regulatory policy of mandatory disclosure can have "unintended and undesired consequences," such as investors overreacting to a material event that has a small probability of occurring).

125. But cf. Letter from Eric T. Spink to author, supra note 8 (suggesting "that, by exposing investors to disclosure of potential risks, investors (more likely, their professional advisors) will become more capable of rationally assessing those risks and the risk of over-reaction should be reduced").

126. To this extent, the optimal degree of disclosure is not predetermined by the relevant investor audience.


128. George A. Akerlof, The Market for "Lemons": Quality Uncertainty and
Akerlof argues that it is up to the seller to achieve a solution to this problem of quality uncertainty: "those [merchants] who can identify used cars in our example and can guarantee the quality may profit."129

One obvious solution is guaranties,130 such as warranties on the sale of goods,131 to shift the risk from the buyer to the seller. Other institutions that have arisen to counteract this problem are brand-name goods,132 chains (such as hotel and restaurant chains),133 and governmental and private-sector certification through, for example, licensing.134 Brand-name goods and chains, however, appear to be indirect guaranties made by placing the reputation of the goods or the chain as a hostage. If the goods are defective, or the chain provides inferior quality, the reputation suffers. Therefore, one can view the possible solutions as being in two categories: protect the buyer of (in our context) securities either by (1) direct or indirect guaranties of their value or (2) governmental and/or private-sector certification of their quality. I examine these protections in turn.

Direct guaranties would not work to the extent that issuers of securities, by the very nature of securities, already make themselves liable to investors for repayment.135 There nonetheless may be ways to create indirect guaranties, such as bonds or hostages to be sacrificed in the event of management exploitation of the information asymmetry. An obvious approach is to provide for case-by-case ex post review of, and some form of punishment for, management exploitation of the information asymmetrically.

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129. Id. at 496 (emphasizing that "these skills are equally necessary—both to be able to identify the quality of inputs and to certify the quality of outputs").

130. Id. at 499.


133. Id. at 500.

134. Id.

135. In the case of debt securities, the issuer is liable as a recourse obligation; and even equity securities give investors residual claims against the issuer. See, e.g., Steven L. Schwarcz, Rethinking A Corporation’s Obligations to Creditors, 17 CARDozo L. REV. 647, 667 (1996). Moreover, any scheme to increase the priority of equity investors’ residual claims would be problematic: making those claims pari passu with the issuer’s debt claims would dilute recovery on the latter, merely shifting some of the losses from the issuer’s equity investors to the issuer’s debt investors; whereas keeping the residual claims subordinate to debt claims would not improve the position of equity investors.
asymmetry (or otherwise to use ex post review as a sort of bond that substitutes for ex ante screening of the transaction). To some extent, this review is already performed by administrative agencies such as the SEC (in the United States) and through litigation in courts. In those cases, the punishment includes civil liability and possible criminal prosecution of management.

An ex post approach, however, is a blunt instrument. It poorly filters bad actions because they will be discovered only after they occur. Furthermore, it creates uncertainty for, and imposes a chilling effect on, good actions because unlikely events sometimes do occur. Where such events cause investors to lose money, management must argue ex post, possibly in the face of adverse publicity and zealous government officials, that its failure to disclose that event was justifiable. Nor has

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136. See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 781, 787 (2001) (describing how the United States has partially solved the "information asymmetry problem through a complex set of laws and private and public institutions that give investors reasonable assurance that the issuer is being (mostly) truthful"). Rule 10b-5 under the '34 Act, for example, makes it unlawful for any person in connection with the purchase or sale of any security:
   (a) To employ any device, scheme, or artifice to defraud; (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


138. Cf. Mitu Gulati et al., Fraud by Hindsight, 98 NW. U. L. REV. 773, 774, 778 (2004) (observing that people tend to view past events as having been inevitable, and also tend in hindsight to mistake innocent or even good actions as misconduct); Jeffrey J. Rachlinski, A Positive Psychological Theory of Judging in Hindsight, 65 U. CHI. L. REV. 571, 572 (1998) (arguing that "the defendant's level of care will seem less reasonable in hindsight than it did in foresight").

139. It is human nature to infer the obvious, though incorrect, cause from a
the existing system of ex post review and punishment yet resolved the temporal conflict.

The second approach to protecting investors is to certify the quality of their securities, either through government or reputable private-sector entities. Governmental certification is a form of merit regulation, and can be expensive. In the context of the original enactment of the federal securities laws in the United States, government certification was explicitly rejected as unworkable for that reason. At that time, there was significant controversy whether a securities law should focus on requiring full disclosure or on imposing governmental merit analysis. State “blue sky” laws provided for both. Nonetheless, Congress, after “considerable debate . . . decided not to follow the pattern of the state acts and eschewed the idea of a [merit regulation] approach, opting instead for a system of full disclosure.” Governmental merit regulation simply does not appear to be cost effective.

dramatic event. Cf. DON HERALD, THE HAPPY HYPOCHONDRIAC 64 (1962) (a humorous book in which, after surviving numerous imagined scares, a hypochondriac ultimately dies of old age; but on his gravestone is written the words, “I told you I was no hypochondriac”); Steven L. Schwarcz, Rethinking Freedom of Contract: A Bankruptcy Paradigm, 77 TEX. L. REV. 515, 592 (1999) (arguing that ex post judicial reassessment of a troubled debtor’s determination whether offered liquidity is likely to help the debtor rehabilitate may cause the “liquidity [to] dry up because few liquidity providers would be willing to be second guessed”); supra notes 123–24 and accompanying text (explaining why people do not rationally assess cause and effect).

140. Indeed, at a fundamental level, government regulation and government certification are related concepts; the government effectively certifies as “legal” only those transactions that comply with the regulation.

141. See Robert L. Knauss, A Reappraisal of the Role of Disclosure, 62 MICH. L. REV. 607, 615 (1964) (arguing that the “main argument for disclosure was that a regulatory approach was not administratively practical”).


143. Id. at 20 (observing that “the state blue sky laws not only focused on providing investors with full disclosure of relevant facts, but also required that all securities registered thereunder ‘qualify’ on a merit basis, evaluating the substantive terms of the securities to be offered”).

144. Id. at 21–22. Part of Congress’s rationale was that a disclosure approach would avoid any implication that, by approving issuance of a security, the government was guaranteeing its soundness. James M. Landis, The Legislative History of the Securities Act of 1933, 28 GEO. WASH. L. REV. 29, 30, 34 (1959).

145. There is little current literature on government certification of securities quality because, until recently, disclosure was seen as the complete answer. It is not, however, entirely clear whether Congress’s decision to favor disclosure over merit regulation reflected a fair test of the latter. The “blue sky
Certification of the quality of securities by private-sector entities likewise does not appear to be feasible. In fact, although a form of private-sector certification of quality already exists—the ratings system provided by nongovernmental rating agencies on the safety of debt securities\(^\text{146}\)—it has proven ineffective for solving the problems caused by the temporal conflict. While valuable, ratings are limited. They are presently only given on debt, not equity, securities.\(^\text{147}\) Ratings also do not purport to certify against fraud,\(^\text{148}\) nor would it appear to be cost effective for rating agencies to do so.\(^\text{149}\) Possibly for this reason, the rating agencies failed to predict Enron's demise, and Enron's debt was not downgraded below investment grade until days before its bankruptcy.\(^\text{150}\) Moreover, ratings themselves are subject to a significant temporal conflict.\(^\text{151}\)

An indirect form of private-sector certification of quality is also performed by outside professionals involved in the issuance of securities. Traditionally, a professional gatekeeper—such as an independent auditor, securities analyst, investment banker, or, at times, a lawyer—"represents to the market . . .

\(^\text{laws proved to be relatively ineffective in stamping out securities frauds, especially on a national level.}^\text{HAZEN, supra note 142, at 20. However, at least one commentator argues that such ineffectiveness "should not condemn this type of [substantive] control. The States had effective power only within their boundaries. And the amazing interstate complexity of the security business made action by the separate States conspicuously ineffective." William O. Douglas, Protecting the Investor, 23 YALE REV. 521, 531 (1934).}

\(^\text{146.}^\text{Partnoy, supra note 41; Schwarez, supra note 38, at 3.}

\(^\text{147.}^\text{Schwarez, supra note 38, at 6. Although stock analysts "certify" equity securities in the very limited sense of providing buy or sell recommendations, these are not certifications of quality per se but a balancing of quality and price, and often are notoriously unreliable. See, e.g., Paul M. Healy & Krishna G. Palepu, The Fall of Enron, J. ECON. PERSP., Spring 2003, at 3, 16–21.}

\(^\text{148.}^\text{Schwarez, supra note 38, at 6.}

\(^\text{149.}^\text{Rating agencies do not presently have the resources, such as investigative staff, to investigate possible fraud of the companies whose securities they are rating. Interview with John Rutherford, Jr., President and Chief Executive Officer, Moody's Corporation, and Raymond W. McDaniel, President, Moody's Investors Service, Inc., Durham, N.C. (Duke Law School) (Sept. 24, 2002) (on file with the University of Illinois Law Review). If a rating agency were to obtain such resources, there is concern that the greatly increased staffing and size would bureaucratize the ratings process (making individual staff members feel less personally responsible), with unintended consequences. \textit{Id.} Moreover, this increased staffing, along with the premium required to offset litigation and settlement costs resulting from failures to discover fraud, would significantly increase the cost of ratings, potentially undermining their economic vitality.}

\(^\text{150.}^\text{Testimony of Frank Partnoy, supra note 33.}

\(^\text{151.}^\text{See supra notes 38–41 and accompanying text.}
that it has evaluated the issuer's product ... [in] good faith and that it is prepared to stake its reputation on the value of the innovation."\textsuperscript{152} Post-Enron, however, the public has lost confidence, at least temporarily, in traditional gatekeeper mechanisms.\textsuperscript{153} Moreover, gatekeepers may well be subject to the same information asymmetry to which investors are subject.

Another indirect form of private-sector certification of quality is management's signaling, to investors, that management believes in the issuer. Traditionally, management does this by investing in the issuer's stock and by accepting stock options as compensation.\textsuperscript{154} This certification did not prove reliable, however, in Enron.

Traditional economic solutions to the asymmetric information problem thus do not resolve the temporal conflict. Accordingly, this Article next seeks a second-best solution.

Second-best solutions: Given the continued existence of an information asymmetry problem, I now examine whether the resulting temporal conflict can be minimized.\textsuperscript{155} Because the temporal conflict only arises where there is disclosure ambiguity,\textsuperscript{156} one possibility is to design a disclosure system that minimizes the degree of ambiguity inherent in a disclosure decision.

Existing disclosure regimes all have that goal, yet they have failed to eliminate such ambiguities. The SEC believes that ambiguities necessarily result from any articulated disclosure standard.\textsuperscript{157} Moreover, although some regimes even provide lists of information or events likely requiring disclosure in an attempt to reduce disclosure ambiguity, regulators themselves admit that lists cannot anticipate all possible future cir-

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{152}] Gilson & Kraakman, supra note 19, at 620.
\item[\textsuperscript{153}] John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 BUS. LAW. 1403, 1416–17, 1420 (2002).
\item[\textsuperscript{154}] A HANDBOOK OF BUSINESS LAW TERMS 570–71 (Bryan A. Garner ed. 1999).
\item[\textsuperscript{155}] One reviewer of this Article asked if the consequences to investors of the temporal conflict somehow could be mitigated by diversifying investment portfolios as a function of time. I do not see how that could be done. Even if it could, the transaction costs of actively achieving, monitoring, and maintaining such a perfectly timed investment portfolio would be high, if not prohibitive.
\item[\textsuperscript{156}] The temporal conflict is the conflict over which audience to favor when there is a disclosure ambiguity. See supra notes 8–11 and accompanying text; see also supra note 113.
\item[\textsuperscript{157}] Heminway, Materiality Guidance in the Context of Insider Trading: A Call for Action, supra note 11, at 1155–56.
\end{enumerate}
\end{footnotesize}
cumstances in which disclosure should occur, and do not remove all discretion on the final disclosure decision. As a practical matter, therefore, some degree of ambiguity appears to be inherent in any disclosure system.

The existing disclosure strategies employed in the United States and other nations with large securities markets do not directly confront that inherent ambiguity. Rather, these strategies assume there usually is a "correct" binary disclosure decision—disclose or do not disclose—that, with enough care, is ascertainable ex ante. That assumption, though, has given

158. See, e.g., Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43, 154, and Investment Company Act Release No. 24,599, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, 83,684 (Aug. 15, 2000) [hereinafter Selective Disclosure and Insider Trading] (listing seven "types of information or events that should be reviewed carefully to determine whether they are material" in a selective disclosure context but cautioning that, by listing such items, the SEC "do[es] not mean to imply that each of these items is per se material" and that "[t]he information and events on this list still require determinations as to their materiality" and further cautioning that the SEC "do[es] not and cannot create an exclusive list of events and information that have a higher probability of being considered material"); H.K. EXCHS. & CLEARING LTD., GUIDE ON DISCLOSURE OF PRICE-SENSITIVE INFORMATION (2002), at 3–4, http://www.hkgem.com/listingrules/e_price-guide.pdf (listing sixteen events that likely require disclosure, but asserting that although certain items may be listed as common examples of price-sensitive [i.e. material] information, "no definitive list" of such items can be given; ultimately "[d]eciding on what information is price-sensitive is a matter of judgement [sic]" for company directors); U.K. LISTING AUTH., THE UKLA'S GUIDANCE ON THE DISSEMINATION OF PRICE SENSITIVE INFORMATION 6 (2001), http://www.fsa.gov.uk/ukla/2001instruments/guidance_manual_nov/guidance2_nov.pdf [hereinafter THE PSI GUIDE] (noting that "[p]recisely what will constitute price sensitive [i.e. material] information will vary widely from company to company, depending on a variety of factors," and that consequently "[i]t is therefore not possible to set out a formula for identifying price sensitive information that will cover all possible permutations and situations").

159. The United Kingdom and Hong Kong, however, indirectly confront the inherent ambiguity of disclosure decisions by encouraging firms that are in doubt about disclosure to contact the applicable securities regulator for guidance. See H.K. EXCHS. & CLEARING LTD., supra note 158, at 1 (encouraging issuers that are in doubt about disclosure to contact the exchange); THE PSI GUIDE, supra note 158, at 8 (stating that "[i]f a company is uncertain whether a matter should be announced the UKLA provides a Helpline which provides advice on such matters"). Even assuming this approach reduces uncertainty, it appears to be expensive and cumbersome.

160. For example, some reason:

Where there is a duty to disclose a material fact, whether in accordance with mandatory disclosure rules or anti-fraud rules, the materiality of that particular fact determines whether an individual or entity is obligated to disclose that fact. Either the fact is material and must be disclosed, or it is not material and need not be disclosed.
rise to the temporal conflict and resulting costs discussed in the introduction of this Article.\textsuperscript{161}

Focusing on the inherent ambiguity of disclosure decisions, however, reveals a way to procedurally mitigate the temporal conflict. That inherent ambiguity means that, contrary to accepted doctrine, a disclosure decision is sometimes not truly binary—disclose or do not disclose—because there is no "correct" answer. If the decision-making process somehow could be transformed into a binary process, however, the temporal conflict over which audience to favor when there is a disclosure ambiguity would be minimized.

There is, I believe, an effective way to transform the existing decision-making process into more of a binary process: incorporate into the existing process a rule dictating in advance which way a disclosure decision should be made when facing disclosure ambiguity.\textsuperscript{162} Although this procedural bright-line rule cannot entirely eliminate uncertainty—there still will be cases at the margin in which the existence of disclosure ambiguity itself will be uncertain, thereby creating uncertainty whether to apply the bright-line rule\textsuperscript{163}—it could dramatically reduce the uncertainty by rendering certain a significant portion of otherwise ambiguous disclosure decisions. This rule also should be easy to apply since it does not purport to change the

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Heminway, \textit{supra} note 11, at 1148. In the exclusive context of selective disclosure under Regulation FD, the SEC has stated it will not "second-guess[ ]... close materiality judgments" or "bring enforcement actions under Regulation FD for mistaken materiality determinations that were not reckless." Selective Disclosure and Insider Trading, \textit{supra} note 158. However, some commentators have suggested that recent Regulation FD enforcement actions show that, in practice, the SEC is, in fact, second-guessing managements' materiality judgments. \textit{See} John J. Huber & Thomas J. Kim, \textit{The SEC's Regulation FD—Fair Disclosure} 4–5, 62 (2003), at http://www.lw.com/resource/publications/_pdf/pub619.pdf. There may be more flexibility, however, when disclosing "soft" information. \textit{See supra} note 27 and accompanying text.

\textsuperscript{161} \textit{See supra} notes 32–41 and accompanying text.

\textsuperscript{162} I later argue that of the two ways such a rule could dictate in advance which way an ambiguous disclosure decision should be made—requiring management either to: (1) disclose when in doubt, or (2) not disclose when in doubt—the preferred rule is the latter. \textit{See infra} notes 165–96 and accompanying text.

\textsuperscript{163} In this context, I considered whether it might be appropriate to try to define what constitutes a disclosure ambiguity. I concluded it was inappropriate since any such definition would effectively shift the disclosure standard from the existing materiality standard to a new standard with its own inherent ambiguities. \textit{Cf. infra} note 164 and accompanying text (clarifying my intent not to change existing disclosure standards).
current materiality standard for disclosure or otherwise affect substantive law; the rule merely sets a disclosure procedure where the current materiality standard results in ambiguity. The rule would not apply, for example, to a decision whether to disclose a sizable lawsuit against a firm for dumping toxic chemicals into a river (unambiguously material), nor would it apply to a decision whether to disclose a frivolous lawsuit such as one alleging the firm planted microchips in the plaintiff's brain (unambiguously nonmaterial). Thus, the rule is fundamentally different from proposals to adopt a bright-line rule for disclosure to replace or define the standard of materiality.\textsuperscript{164}

My proposed rule would only be justified, however, if the net cost of disclosure with that rule is lower than the net cost of disclosure without that rule, taking into account any increased costs imposed by the rule and any cost reductions from the rule's reduced uncertainty. In each case costs to current investors, to future investors, to firms issuing securities, and, to the extent not already taken into account, to securities markets should be included.\textsuperscript{165} Because the net cost of disclosure without that rule is merely the net cost of the existing disclosure regime, this inquiry can be restated more succinctly: a bright-line rule dictating in advance which way an ambiguous disclosure decision should be made would be justified if the cost reductions from the rule's greater certainty exceed the rule's increased costs.

\textsuperscript{164} For discussion regarding proposals to adopt a bright-line rule for disclosure to replace or define the standard of materiality, see Basic Inc. v. Levinson, 485 U.S. 224, 233–36 (1988) (concluding that although a "bright-line rule indeed is easier to follow than a standard [like materiality] that requires the exercise of judgment in light of all the circumstances . . . [a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive"); Heminway, supra note 11, at 1155–56 (commenting on the SEC's recent conclusion that "any bright-line rule" for disclosure that replaces a materiality standard unavoidably results in over- or under-inclusion); Herbert S. Wander, Securities Law Disclosure After Sarbanes-Oxley, June 2003, in ADVANCED SECURITIES LAW WORKSHOP 218 (2003) (arguing that "[t]he quest for specific bright lines to define materiality is doomed to failure").

\textsuperscript{165} These categories comprise all the interests affected by disclosure. See, e.g., Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 CONN. L. REV. 1125, 1141 (2003) (discussing how immediate disclosure could imprecisely reduce the value of a firm); Arthur R. Pinto, Corporate Governance: Monitoring the Board of Directors in American Corporations, 46 AM. J. COMP. L. 317, 333–35 (1998) (observing that disclosure informs both current and future investors about their investment, and that markets are affected by disclosure).
To compare those costs, one needs to articulate the actual bright-line rule. There are two ways a bright-line rule could dictate in advance which way an ambiguous disclosure decision should be made: management could be required either to disclose when in doubt (i.e., err on the side of disclosing) or not to disclose when in doubt (i.e., err on the side of not disclosing). I next examine which bright-line rule—erring on the side of disclosing or of not disclosing—has lower costs in cases of disclosure ambiguity. I then analyze whether that lower-cost rule is justified by comparing the cost reductions from its greater certainty to the rule's increased costs.

A bright-line rule requiring management to disclose when in doubt would trigger a one-time transitional market-price adjustment to the additional disclosed risk, hurting then-existing current investors. Although this rule theoretically would protect future investors by disclosing all ambiguously material risks, that protection would have to be balanced against the rule's recurring costs. For example, erring in favor of disclosure can lead to a profusion of detail that obfuscates and confuses future investors, making it more difficult for them to review and evaluate the prospectus. Moreover, behavioral psychology predicts that investors may well overreact to some undisclosed risks, making future investors less likely to invest in the securities than if the risks were not disclosed. Erring on the side of disclosure thus would harm those future investors who suffer an opportunity cost by not investing in the securities. Furthermore, in a world of evolving international capi-

166. Future investors who subsequently become current investors should not be hurt since the additional disclosure made pursuant to this rule would have reduced the market price of the securities prior to their purchase. One commentator has suggested that to the extent current investors control the firm, perhaps they should bear this cost. In reality, however, even equity investors have only indirect control (through electing management), and investors are equally, if not more, likely to be debt investors.

167. See supra note 117 and accompanying text.

168. See supra note 123 and accompanying text (discussing that people overestimate the chances that something they recently become aware of will happen). This cost, based on irrational overreaction, is different from the more rational one-time transitional market-price adjustment to additional disclosed risk discussed supra note 166 and accompanying text.

169. Also, because future investors recognize that they will become current investors once they purchase securities, some future investors may choose not to invest out of concern that disclosure made during the period they would be current investors will depress the price of their securities.

170. In a thick market for investment securities, this opportunity cost would be reduced to the extent future investors can find equivalent substitute
tal markets, erring on the side of disclosure may impose competitive costs on the markets themselves, driving some future investors to invest in other, perhaps foreign, reputable markets with lower perceived risks.\footnote{171} Thus, erring on the side of disclosure where there is disclosure ambiguity does not necessarily increase, but may well decrease, transparency and drive investors to other markets.\footnote{172}

This conclusion is supported by finance theory. Erring on the side of disclosing ambiguously material risks would inject what Professor Fischer Black refers to as "noise" into the market alongside information.\footnote{173} In Black's conceptualization, "information" is any item of data that correctly reflects a stock's fundamental value,\footnote{174} while "[n]oise is any [item of] data that is not information."\footnote{175} Accordingly, information is useful to market participants for trading purposes, whereas noise is not useful, or worse, detrimental to profitable trading.\footnote{176}

Telling the difference between noise and information can sometimes be difficult, especially if noise abounds.\footnote{177} Investors then can confuse noise with information and mistakenly "trade on the noise as if it were information."\footnote{178} This not only causes

\textit{investments.}

\footnote{171} Erring on the side of disclosure appears more likely to drive future investors to other markets with lower perceived risks than to cause them to demand a discount; this reflects that overreaction itself is irrational, and thus future investors may find it difficult to price a discount. See\textit{ supra} note 168 and accompanying text.

\footnote{172} Whether or not those markets presently exist, they may well exist in the future, especially if there is investor demand for alternative securities. Some investors might also invest in domestic nonsecurities investments, thereby weakening securities market demand.


\footnote{174} \textit{Id.} at 532–33. A stock's true value is an elusive thing, however. See\textit{ id.} ("All estimates of value are noisy, so we can never know how far away price is from value.").


\footnote{176} Black, \textit{supra} note 173, at 529.

\footnote{177} \textit{Id.} at 534.

\footnote{178} \textit{Id.} at 529, 531, 534. In a sense, noise mimics information and competes antagonistically with it for investor attention. Additionally, some investors may trade on noise for the simple reason that "they like to do it." \textit{Id.} at 534. Some noise theorists "postulate that a substantial portion of traders in the market are irrational, in the sense that they suffer testable cognitive biases that impede their collective ability to coldly calculate the intrinsic value of securities." Lynn A. Stout, \textit{How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement}, 19 CARDOZO
markets to become less efficient, but creates a risk that market-pricing errors "will be cumulative, in the same sense that a drunk tends to wander farther and farther from his starting point." 

Applying Black's formulation to the temporal conflict, risks that are ambiguously material include both noise and information. Disclosing those ambiguously material risks, therefore, would introduce into the market both noise that looks like information and information that looks like noise. Investors then would have difficulty distinguishing noise from information, and could mistakenly trade on the noise in the incorrect belief it is information. The result would be that securities markets become less efficient and subject to cumulative pricing errors.

Even worse, disclosing ambiguously material risks may actually exacerbate the temporal conflict. This results because noise trading can increase investors' focus on the short term, and thus bring about more volatile markets: "noise traders may overreact to information, thus forcing inordinate attention on short-term performance and increasing volatility." Short-term investment focus and market volatility increase the securities turnover rate, which in turn increases the impact of

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L. REV. 475, 478 (1997). As noise increases, these traders have more chances to focus on extraneous data that has emotional appeal but little actual utility from a valuation standpoint and commit valuation errors that, when aggregated, cause inefficient pricing of shares. Id. ("Because noise traders act on psychological impulse ('noise') rather than true information, their trading tends to drive stock prices away from best estimates of fundamental values.").

179. Black, supra note 173, at 532.
180. Id.
181. Even those in the best position to know the difference—a firm's officers and professional advisors—will have difficulty separating the informational wheat from the noisy chaff when risks are ambiguously material; if it were otherwise, the materiality of such risks would not be ambiguous. It also has been suggested that mandatory disclosure in general has the effect of generating vast amounts of noise but very little information. See Mahoney, supra note 175, at 742 ("Although the mandatory disclosure system may produce little or no information, it produces noise in mind-boggling quantities.").
183. See Summers & Summers, supra note 182, at 269 (noting that "frequent trading is the essence of" short-term speculative trading strategies that
the temporal conflict. Moreover, short-term investment focus may cause other undesirable consequences.

For these reasons, a bright-line rule erring on the side of disclosure where there is disclosure ambiguity would be costly, could lead to market inefficiency, and may even exacerbate the temporal conflict.

In contrast, a bright-line rule requiring management not to disclose when in doubt would neutrally affect the value of current investors' securities other than triggering a one-time transitional price adjustment. Although this rule marginally might increase risk for future investors due to the possibility that an undisclosed risk later turns out to be material, those investors presumably would discount for this increased risk.

increase volatility and that depend upon excess liquidity for their viability).

184. See supra notes 89–91 and accompanying text (discussing the temporal conflict as an even more urgent problem because of the increase in the turnover rate of securities held by investors).

185. Short-term investment focus may negatively affect the economy itself:

Short-termism as the driving force of investing is, however, highly destructive. Short-term investing pressures managers to engage in short-term management, damaging the future prospects of the corporation with promiscuous layoffs, inadequate funding for research and development, environmental pollution and substandard production quality. Short-term investing drives managers to manage earnings, not business. Only by managing earnings can most corporations consistently satisfy a short-term market's demand for constantly increasing stock prices. Also, managing earnings instead of businesses in response to the short-term pressures of the market leads managers to mislead investors, sometimes, as we have recently seen, crossing over the line into gross illegality.


Other commentators have expressed similar concerns. See Hazen, supra note 93, at 179 (noting that many commentators “have suggested that corporate managers’ obsession with short-term shareholder wealth maximization has, in many cases, diverted their attention away from the efficient operation of their companies”); Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. CHI. L. REV. 187, 210 (1991) (arguing that “[t]he focus on the short term has come at the expense of the long-term planning, investment and business development of the corporation,” and that “corporations have sacrificed research and development expenses, capital expenditures, market development, and new business ventures, simply because they promise to pay off only in the long term”).

186. See supra note 14 (observing that although disclosure of an ambiguous risk could alert current investors to the possibility of opting out of their investment based on the risk disclosed, most of those investors would not benefit since the disclosure would reduce the sales price (i.e., value) of their securities). Erring against disclosure, however, may trigger a one-time transitional market adjustment in prices reflecting the discount next discussed.

187. This so-called “lemons” discount arises wherever a purchaser (in our
Any such discount should be minimal, since it reflects only marginally increased risk, and also would result in only a one-time transitional market-price adjustment since, after initial price adjustment, the discount would be embedded in both the purchase and sale price of the securities. Future investors also would benefit from this rule as to risks first arising after they become current investors. Additionally, the rule would reduce at least the perception, if not the reality, of agency costs for those members of management tempted to err against disclosure absent the rule. 188 Although some agency cost would remain to the extent managers may be tempted, at the margin, to decide that a given disclosure decision is ambiguous to avoid disclosing, 189 ex post review and punishment could limit most abuse. 190 How the rule would affect the market for securities ultimately is an empirical question. Some investors, for example, might try to find alternative markets that offer more information about ambiguous risks. However, even those investors may be deterred by the cost of assessing those risks. Furthermore, as described in the prior paragraph, investors may well prefer to invest in markets with lower perceived risks.

case, investor) has less information about what is being purchased than the seller (in our case, issuer). See Akerlof, supra note 128, at 488–89.

188. See supra text accompanying note 29 (arguing that agency costs may bias disclosure prepared by a firm's management and internal counsel, without independent professional gatekeepers).

189. Cf. supra note 163 and accompanying text (observing that a brightline rule cannot eliminate uncertainty). This temptation might arise, for example, where disclosure of a risk would negatively impact management's compensation, such as where compensation is strongly tied to share price.

190. The existence of a disclosure ambiguity is objectively determinable and should be subject to ex post review by a regulator or a court. If that review treats management's finding of a disclosure ambiguity as a presumptively conflicted decision, to which no deference is due—as opposed to treating it as business judgment, to which considerable deference is due—agency costs would be greatly mitigated. See, e.g., Henry N. Butler & Fred S. McChesney, Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation, 84 CORNELL L. REV. 1195, 1199 (1999) (linking managerial discretion with agency costs); Robert Dean Ellis, Equity Derivatives, Executive Compensation, and Agency Costs, 35 HOUS. L. REV. 399, 402 (1998) (linking the “problem[ ] of managerial discretion” with agency costs); Ronald J. Gilson, Lipton and Rowe's Apologia for Delaware: A Short Reply, 27 DEL. J. CORP. L. 37, 42 (2002) (referring to “the potential for agency costs” in a takeover context as “the reason for restraining [management’s] discretion”); Larry Lang et al., Asset Sales, Firm Performance, and the Agency Costs of Managerial Discretion 30 (Nat'l Bureau of Econ. Research, Working Paper No. 4654, 1994) (linking agency costs with managerial discretion in use of funds from asset sales).
A bright-line rule requiring management not to disclose when in doubt therefore appears to be the lower-cost, and thus preferred, strategy. Accordingly, I next compare that rule to the existing disclosure regime, by examining whether cost reductions generated from that rule's reduction of uncertainty exceed any increased costs imposed by the rule itself.

This bright-line rule—errng against disclosure in cases of disclosure ambiguity—should generate significant cost reductions. Because existing disclosure strategies assume the disclosure decision is ascertainable ex ante with enough care, management must make exquisite and nuanced decisions, often requiring the help of highly paid professionals. If management decides incorrectly, there can be significant liability. That potential liability, and the need to insure against it, imposes further costs. A bright-line rule erring against disclosure in cases of disclosure ambiguity would greatly reduce these costs because it would make disclosure decisions simpler and more straightforward while simultaneously reducing the chance of liability.

191. See supra note 160 and accompanying text.

192. HAZEN, supra note 142, § 3.2 at 127 (observing that firms often retain special outside securities counsel to supervise the preparation of their SEC prospectuses). Since the implementation of the Sarbanes-Oxley Act of 2002 (part of which requires executive certification of each annual and quarterly report), the hiring of outside securities counsel has increased because firm executives are fearful of personal liability. See SWIDLER BERLIN SHEREFF FRIEDMAN LLP, CORPORATE UPDATE: CEO AND CFO CERTIFICATIONS AND CORPORATE DISCLOSURE CONTROLS (2002) (on file with the Minnesota Law Review) (discussing recommendations for firms attempting to comply with Sarbanes-Oxley). For some firms, the annual cost of outside securities counsel exceeds $1 million. Michael Murray, CFOs Say Sarbanes-Oxley Compliance Presents Challenges, MBA NEWSLINK, Sept. 18, 2003, at http://www.mortgagebankers.org/cmnewslink/issues/2003/09/18.asp (last visited Jan. 12, 2005).

193. In the United States, for example, the firm itself, as issuer of the securities, is strictly liable for a wrong disclosure decision. HAZEN, supra note 142, § 7.4 at 357. Members of management will also be liable unless they can establish an appropriate due diligence defense. Id. § 7.4[2] at 359. Although that defense theoretically requires "the highest standard of care," id. § 7.4[2][A][1] at 359, "the courts have not been able to articulate . . . the requisite standard of care." Id. § 7.4[3] at 366. That inability creates uncertainty and potential liability. Indeed, one commentator argues that "[t]o a large extent, BarChris [, the seminal case on this due diligence defense,] may be viewed as treating 'inside' signatories [to a registration statement, required for publicly-issued equity securities,] in effect as guarantors of the accuracy of the registration statement." STEINBERG, supra note 16, § 6.04 at 162. Underwriters who help to sell the securities, and to some extent even professionals involved in the preparation of the prospectus and other sales materials, also can be liable. HAZEN, supra note 142, § 7.3[3] at 350.
This bright-line rule would reduce costs even further by minimizing the amount of detail in the prospectus, thereby making it easier to review the prospectus and minimizing investor confusion. The rule also would minimize opportunity costs where risks never materialize but their disclosure causes investors to overreact and not invest. And, of course, the rule would minimize the temporal conflict and its resulting devaluation of current investors' securities.

Although this bright-line rule would impose costs, they appear to be modest compared to the rule's cost reductions. One such cost is that risks as to which there is disclosure ambiguity will not be disclosed to future investors, thereby exposing those investors to marginal undisclosed losses. As discussed, however, future investors should not be harmed because they can compensate by discounting for this risk. The rule also should have relatively little impact on the integrity of securities markets: neither existing disclosure strategies nor the bright-line rule assures future investors that all risks will be disclosed, and the difference in disclosure is limited to those risks as to which there is disclosure ambiguity.

194. See supra notes 171–88 and accompanying text.

195. Because my proposed bright-line rule pertains to disclosure ambiguity, it would not have materially affected investor losses in Enron. Fraud and/or investor failure to read footnotes—not disclosure ambiguity—was the underlying problem in Enron:

[Investors] could have had a heads-up that all was not quite right at [Enron] long before the bad news broke in October. The source of this information? The footnotes companies are required to publish with their financial statements.... Footnotes do not make for easy reading, however, and the numbers are often difficult to decipher.

Anne Tergesen, The Fine Print: How to Read Those Key Footnotes, BUS. WK., Feb. 4, 2002, at 94, 94–95; see also Testimony of Frank Partnoy, supra note 33 (observing that an argument can be made “that Enron satisfied its disclosure obligations” even though “the result of Enron's method of disclosure was that investors did not get a clear picture of the firm's finances”). This neutral effect does not undermine this Article's argument, which is comparative—namely, that the bright-line rule is not costless, merely less costly than the existing disclosure regime. The occasional “Enron” may well be a cost of any system. Nonetheless, the bright-line rule might have mitigated losses by making potential Enron investors, knowing they are not receiving all information, more skeptical. And, to the extent Enron resulted from investor failure to read footnotes, it is less likely to be repeated. See, e.g., Steven L. Schwarcz, Securitization Post-Enron, 25 CARDOZO L. REV. 1539, 1556 n.87 (2004) (“Post-Enron, no reasonable investor can claim ignorance of financial statement footnotes; investors have been widely educated to carefully review those footnotes as part of their investment or credit decisions.”).
On balance, therefore, a bright-line rule erring on the side of not disclosing appears to manage disclosure ambiguity at lowest overall cost to current and future investors, issuers, and markets, and thus best resolves the temporal conflict.

This rule, moreover, may have significance beyond the temporal conflict. A bright-line rule erring against disclosure in cases of ambiguity can help to resolve the ongoing broader debate over how to minimize the ambiguity of disclosure in securities law generally. Such ambiguity is regarded as a major flaw in the existing securities disclosure regime. Although a

196. Several commentators have offered recommendations for minimizing disclosure ambiguity. See Heminway, supra note 11, at 1191–1211 (proposing materiality guidance designed to reduce disclosure ambiguity in insider trading context); see also id. at 1155 n.83 (citing COMM. ON FED. REGULATION OF SEC., AM. BAR ASSOC. SECTION OF BUS. LAW, REPORT ON REGULATION FD (2002), at 4–5, http://www.abanet.org/buslaw/committees/CL410000/reports/20020206000000.pdf (suggesting approaches intended to reduce disclosure ambiguity in Regulation FD context)); Wally Suphap, Getting it Right Versus Getting it Quick: The Quality-Timeliness Tradeoff in Corporate Disclosure, 2003 COLUM. BUS. L. REV. 661, 710 (suggesting that “[i]n order to alleviate the ambiguities inherent in materiality judgments, the SEC could consider adopting bright line standards with well-defined and objective triggering events”) (footnote omitted); Shannon M. Mudd, Note, The Missing Piece of the Mosaic: Improving Regulation FD, 80 WASH. U. L.Q. 971, 992–95 (2002) (proposing replacement of current materiality standard in Regulation FD context). Heminway notes, however, that “[a]ttempts to more clearly define materiality for various federal securities law purposes . . . have failed.” Heminway, supra note 11, at 1153; see also Wander, supra note 164, at 218 (stating that in a Regulation FD context, “[i]f the SEC did provide more guidance on materiality, I fear it would only enlarge materiality and cause more confusion and uncertainty”).

197. See Heminway, supra note 11, at 1139–40 (arguing that “the current legal standard [governing materiality] is inadequate for transaction planning and judicial decision-making,” and suggesting that it facilitates “allegations that there has been a failure of adequate disclosure, even with thoughtful advance planning”). Heminway further argues that “[t]he high degree of imprecision inherent in this [materiality] standard not only creates legal uncertainty and headaches (sometimes nightmares) for transaction planners, litigants, enforcement agencies, and courts, but also is inessential to (and potentially distracts from) achievement of the basic policy goals underlying” various aspects of securities regulation. Id. at 1140. Regulation FD in particular has brought urgency to the problem of ambiguous materiality, though in this context materiality determines not what must be disclosed but rather what must not be selectively disclosed. See id. at 1139 n.28 (quoting Jason Michael Craft, What’s All the Commotion?: An Examination of the Securities and Exchange Commission’s Regulation FD, 14 DePAUL BUS. L.J. 119, 156 (2001) (stating that “[o]ne of the largest failures of Regulation FD is the SEC’s lack of any meaningful guidance or direction as to what information will . . . be considered material”)); see also Mudd, supra note 196, at 986 (observing that “[s]ince the adoption of Regulation FD, commentators most frequently criticize the vague materiality
complete discussion of that debate is beyond this Article's scope, nothing in this Article would prevent the proposed bright-line rule from being applied to all disclosure ambiguities to reduce uncertainty. Indeed, that broad application is implicitly assumed since the temporal conflict can arise in the context of any disclosure ambiguity.

CONCLUSION

Described as a "fundamental problem in legal theory," the temporal conflict—the anomaly that disclosure of ambiguous risks harms a firm's current investors, whereas failure to disclose these risks may harm the firm's future investors—can arise wherever there is disclosure ambiguity. This conflict causes corporate actions that are viewed ex ante as proper sometimes to be judged ex post as wrongful, exposes financial institutions to possible liability, undermines the credibility of credit rating agencies, and misleads investors. As the world shrinks through global investment and information exchange, markets that have managed the temporal conflict will become increasingly competitive and valued by investors.

There are, however, few relevant legal precedents or authorities discussing the temporal conflict, and none that provides a conceptual basis for analysis. This Article therefore engages in a fundamental inquiry, examining the temporal conflict as a problem of asymmetric information but finding that traditional law and economic solutions are inadequate. The Article then seeks second-best solutions, concluding that a procedural bright-line rule—err ing against disclosure in cases of standard").

198. Hu, supra note 4, at 1302.

199. See supra note 41 (discussing how temporal conflicts could arise in the contexts of automobile recalls, safety alerts, and college rankings).

200. The apparent mystery of why there are so few precedents may be explained by the fact that historically low turnover levels in holdings of securities muted the conflict's significance; only in recent years, with financial innovation dramatically increasing turnover levels, has the temporal conflict become an urgent and important problem. See supra notes 89–91 and accompanying text.

201. These solutions are inadequate because maximizing disclosure of risks does not always reduce, but sometimes actually increases, asymmetric information. This is because investors are not always rational assessors of information; they may well overestimate the likelihood and impact of disclosed potential risks, just like people generally overestimate their susceptibility to recently-heard risks like airplane crashes and illnesses. This overestimation itself creates an information asymmetry.
ambiguity—would help resolve the temporal conflict and also would be less costly to investors, issuers, and markets than existing disclosure strategies. Because this rule derives from a normative analysis, and nothing in that analysis turns on U.S. law, the rule should have applicability not only in the United States but also in foreign legal systems.

In deriving this rule, I recognize that a procedural bright-line rule erring against disclosure in cases of ambiguity would reduce uncertainty, whether or not there is a temporal conflict. Application of the rule to all disclosure ambiguities, which is implicitly assumed in this Article, therefore could help resolve the broader debate over how to minimize the ambiguity of disclosure in securities law.

One nonetheless might question the political viability of a procedural bright-line rule erring against disclosure. After all, such a rule runs counter to the momentum of securities law development worldwide, which has moved towards increasing disclosure. The response, of course, is that this bright-line rule

202. Although I assume a “materiality” standard for disclosure, as under U.S. law, most foreign legal systems follow the same or a similar disclosure standard. See, e.g., INT’L ORG. OF SEC. COMM’NS (IOSCO) TECHNICAL COMM., PRINCIPLES FOR ONGOING DISCLOSURE AND MATERIAL DEVELOPMENT REPORTING BY LISTED ENTITIES 3 (Oct. 2002), http://www.iosco.org/pubdocs/pdf/IOSCOPD132.pdf (reporting that “[i]n spite of the different [disclosure] approaches used, most jurisdictions agree that listed entities should have an ongoing obligation to disclose information that would be material to an investor’s investment decision and that is necessary for full and fair disclosure”); IOSCO, INTERNATIONAL DISCLOSURE STANDARDS FOR CROSS-BORDER OFFERINGS AND INITIAL LISTINGS BY FOREIGN ISSUERS II–2–II–9 (Sept. 1998), http://www.iosco.org/pubdocs/pdf/IOSCOPD81.pdf (showing materiality standards used in 1998 by Australia, the European Union, Hong Kong, Japan, Mexico, Ontario, Quebec, Switzerland, and the United States); Simon Wong, Materiality and Timeliness, Address Before the Second Meeting of the Eurasian Corporate Governance Roundtable 2 (June 7, 2001), http://www.oecd.org/dataoecd/60/14/2353282.pdf (observing that “many countries utilize the concept of materiality to determine the minimum amount of information that must be disclosed by a company”). Different nations, however, may judge “materiality” in slightly different ways. See, e.g., Marc I. Steinberg, Insider Trading Regulation—A Comparative Analysis, 37 INT’L LAW. 153, 163 (2003) (observing that, at least in the insider-trading context, “the U.S. standard [of materiality], analyzing whether the affected information would assume significance to the mythical ‘reasonable’ person in making her investment decision, has not been accepted with frequency elsewhere,” and noting that the predominant alternative considers “the information’s impact on the market price of the affected security”).

only would apply in cases of disclosure ambiguity,\(^{204}\) where additional disclosure does not necessarily increase but, as explained, may well decrease transparency.\(^{205}\) At the same time, the rule would make local securities markets more competitive with reputable foreign markets that have lower perceived risks.\(^{206}\) As a practical matter, moreover, the rule should be easy to implement because it "preserves the existing legal analysis [for disclosure, i.e., materiality,] but at the same time presents better guidelines for transactional lawyers."\(^{207}\)
firmative Disclosure Obligations—An Analytical Framework for Merger Negotiations, Soft Information, and Bad News, 46 Md. L. Rev. 923, 929 (1987) (observing that the existing legal analysis for disclosure "creates difficult counseling situations and liability concerns, particularly given that any adjudication will be determined with hindsight").