THE LIMITS OF DISCLOSURE*

By

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Overview

In deciding whether or not to impose a fiduciary duty upon broker-dealers comparable to that traditionally visited upon investment advisors, the SEC must consider whether lesser steps might be sufficient to the task. For example, would simply requiring disclosure by broker-dealers suffice? After all, as Brandeis so famously pointed out, sunlight is the best of disinfectants.[1] There is, in fact, empirical evidence that mandated disclosure--at least as part of a wider array of rigorous securities regulation that includes antifraud laws and vigorous enforcement--provides a variety of benefits including more robust stock markets, wider investor participation, cheaper costs of capital, and greater economic growth.[2]

The key questions for current purposes are whether mandated disclosures can be (a) sufficient to encourage broker-dealers to treat clients properly, and (b) adequate to enable clients to protect themselves? The sole purpose of this brief paper is to cast some doubt that either of these questions can be answered affirmatively.[3]

A Brief Introduction

Antibiotics are wonderful things, but as evolving staph infections have recently demonstrated, their efficacy has limits.[4] The same is true of mandatory disclosure, long a staple of securities and financial regulation. There can be no question that disclosure has its place as one of a brace of regulatory tools and that disclosure is frequently beneficial. Unfortunately, disclosure can be and has been overused.

In the financial and securities worlds, disclosure became the default remedy along with the rise of the efficient markets hypothesis and the rational man dogma of modern financial economics.[5] If, as economists have tended to assume, the markets are made up of fully rational investors who make optimal resource allocation and wealth maximization decisions, then disclosure is the appropriate remedy for all that ails the markets.[6] Indeed, it would be the only remedy that is needed.

Unfortunately, research in the fields of behavioral decision theory, cognitive psychology, behavioral economics, behavioral finance, brain science and elsewhere have largely decimated any notion that people, particularly when they act as investors, are the embodiment of the "Chicago Man" model of rationality.[7] Although there is still some essential truth in the notion that man is a rational animal and still some usefulness to the Chicago Man model, the evidence regarding the limitations of human decisionmaking, some of which will be summarized later in this article, is overwhelming,[8] meaning that the pins have been knocked out from under the rationale for using disclosure as the main tool of financial and securities regulation.

Unfortunately, for a variety of reasons, lawmakers and regulators seem to default to disclosure as the key remedy for even the most dramatic ills of the financial and securities systems. This is a natural thing for them to do because disclosure appears on its face to be cheap, easy, and effective.[9] "In short, when law-makers are pressed to act, mandated disclosure is appealing. Its critics are few. The law-makers can be seen to have acted. The fisc is unmolested."[10]

Unfortunately, disclosure mandated by government often does not do the job with which it is charged. There are now many, many studies which tend to indicate that mandated disclosure as a remedy—whether one addresses physicians' disclosures to patients, lenders' disclosures to borrowers, broker-dealers' disclosure to investors, or cops' disclosures to criminals (the Miranda warnings)—is often spectacularly ineffective. Ben-Shahar and Schneider survey scores of empirical studies and reach the discouraging conclusion that:

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> …although mandated disclosure addresses a real problem and rests on a plausible assumption, it chronically fails to accomplish its purpose…. Even where mandated disclosure seems to succeed, its costs in money, effort, and time generally swamp its benefits. And mandated disclosure has unintended and undesirable consequences, including driving out better regulation and hurting the people it is supposed to help.[11]

This conclusion derives additional support from the recent global financial crisis which has highlighted the limits of a disclosure regime in that in many areas where tragedy struck proper information was available for all to see, yet the disclosure did not prevent disaster.[12]

The Disclosers

Mandated disclosure often fails because of problems on the discloser's side of the equation. Individuals or firms required to disclose financial or other data often have difficulty interpreting the legislative or regulatory mandate, assembling the data, and effectively implementing the mandate (even if they desire to do so).[13] Commonly, they will resist good faith compliance with the disclosure mandate and thereby defeat its best intentions.[14]

Worse still is the potential psychological impact of the mandated disclosure. Cain and his colleagues have demonstrated that when individuals are asked to disclose conflicts of interest, this psychologically frees them up to act in an even more self-interested way than they would have had they not disclosed the conflicts in the first place.[15] Thus, required disclosure can enable a stockbroker, for example, to rationalize selling a product to clients that is not the best available because, after all, he or she has warned the clients of their vulnerable situation.

This result is completely consistent with the concept of moral self-regulation. People constantly evaluate their own moral character and compare it to the actions they have taken. If they take an action that they view as inconsistent with their self-perceived high moral character, they often then try to "rebalance" their moral scales by subsequently acting more ethically (moral compensation). On the other hand, if they take an ethical action that validates their self-image as a good person, they may give themselves permission to play fast and loose with the rules for a while (ethical licensing). Thus, studies show that people who committed to help a foreign student and were then given the opportunity to donate to a charity donated much less than people who had not committed to help the foreign student.[16] People who were asked to write about their positive features and were then given the chance to donate to a charity donated much less than people who were first asked to write about their negative features.[17] Thus, a stockbroker who has just done something upfront and honest (disclosed her conflicts of interest) will naturally give herself moral license to take a little advantage of a customer. This is not a conscious decision; most people are unaware of how their ethical decisionmaking can be influenced by a previous decision they have made.[18]

The Disclosees

The bigger problem with disclosure as the foundational remedy for the bad acts of securities professionals and others is the simple fact that investors, clients, and consumers, like everyone else, tend to only vaguely resemble rational actors in how they make decisions based on the information that they have been given. Several years ago, Professor Choi recommended that Wall Street be completely deregulated, sophisticated investors be left to fend for themselves, and unsophisticated investors be relegated to investing in passive mutual funds where others could look out for their interests.[19] His notion was that "[r]egulation of any sort may be unnecessary for rational investors with good information on the risks and returns offered through particular issuers."[20]

Choi's proposal initially assumed that market forces would cause stockbrokers, for example, to voluntarily disclose the information investors needed to know. That assumption was ill-founded.[21] More importantly for current purposes, the evidence is fairly strong that even if disclosure were mandated by the government, stockbrokers' customers would not as a general rule be able to protect themselves from fraud and other wrongdoing because they are not the rational actors that economists have often modeled them to be. The literature of behavioral psychology and related fields explains why investors typically do not seek out, do not effectively process, and do not even well remember the most important information that is disclosed to them in a variety of settings.

Investors rationally minimize the information that they take in before making a decision. After all, they have lives to live and cannot spend all of their time gathering information about just one of hundreds of decisions they must make during a day's time. In all contexts, including investment contexts, decision makers tend to "satisfice" rather than to optimize their decision making.[22] Studies show that "operating under conditions that have both financial and ego consequences and where information acquisition costs are virtually zero, even professional security analysts deciding on which securities to select do not acquire most (or even much) of the information available."[23] Naturally, lay investors gather even less information that is available to them. Ben-Shahar and Schneider observe that people don't like making financial decisions and avoid gathering information that is necessary to make those decisions;[24] for example, only 42% of workers have even *attempted* to calculate how much money they will need to save for their retirement.[25]

Financial information that is disclosed to investors is often beyond their ken. Even when regulators require disclosure to be *simplified*, it is very often beyond the ability of most investors to meaningfully comprehend.[26] Even if they understand it in the first place, they are unlikely to remember it correctly. Studies of informed consent find that people correctly remember only about a third of basic information that is conveyed to them.[27]

One key reason that investors do not invest more time and effort into reading and attempting to comprehend the information that is disclosed to them is that they tend to be overconfident in their decision making prowess[28] and overly optimistic that the bad things that happen to other investors (being defrauded, for example) will not happen to them.[29] Investors are generally poor at calculating probabilities,[30] and generally underestimate the likelihood of relatively low probability events like being defrauded.[31] Because of the attribution bias, investors are slow to learn their lessons because they tend to view their investment successes as the result of their own ability and their failures as being due to simple misfortune.[32] These phenomena—overconfidence, overoptimism, the attribution bias--affect professional investors as much as lay investors.[33]

The false consensus effect causes people to tend to believe that others view the world as they do,[34] meaning that people who are honest and would never think of defrauding or mistreating others often falsely ascribe that same attitude to intermediaries with whom they deal, such as stockbrokers.[35]

People also have difficulty properly calibrating the honesty and reliability of the source of their information.[36] Even when people can see the self-serving motives of the source of their information, they have great difficulty properly discounting the reliability of that information.[37] Therefore, even when they have objective evidence that their stockbrokers can profit by taking advantage of them, many people will make decisions as if that fact were utterly irrelevant. After all, they chose the stockbroker and they have (too much) confidence in their own judgment regarding the broker's character. Having chosen the broker because they believe in her integrity, that perception tends to dominate inconsistent facts as investors look for evidence that supports their original decision to repose confidence in the broker.[38]

Many people think that most politicians are crooks, but that their own representative is a good guy and that most lawyers are snakes in the grass, but that their brother-in-law who is a lawyer is a fine fellow. This effect, known as the personal positivity bias,[39] means that once people choose their stockbrokers, even sophisticated investors will strongly wish to trust them regardless of formal warnings and objective evidence that they are not trustworthy.[40]

This is but a tip of the iceberg regarding the vast array of data indicating that the manner in which people gather and process information, even when it is put right in front of them in readily-digestible form, remains quite vulnerable to fraud and other forms of mistreatment. One who studies the various heuristics and biases to which humans are subject can quickly become overwhelmed by the vast number of them. Even a partially comprehensive article on the topic quickly produces a lengthy laundry list of limitations upon rationality. It has been suggested that such a list may go too far,[41] but each year more evidence undermining the rational man model of decision making piles up, and the numerous studies recently surveyed by Ben-Shahar and Schneider regarding the failures of mandated disclosure[42] provide persuasive support for the point of view advanced in this article. As they conclude, "mandated disclosure is fundamentally misconceived because its solution to the problem of choice is information alone, but people's problems with their choices go well beyond informational insufficiency."[43] And these problems include vulnerability to fraud and other mistreatment that affects both sophisticated and lay investors.

Conclusion

People pay stockbrokers for investment advice because they do not want to gather the information and undergo the training necessary to make expert decisions themselves. They wish to rely upon the expert judgment of the securities professional. Unfortunately, if the professional's only responsibility is to disclose: "I may have a conflict of interest," the effects may be unfortunate. First, brokers will likely mistakenly believe that their customers will make meaningful use of the disclosure and will have a tendency to give themselves license to act more selfishly in giving investment advice. Second, the customers will likely not, in fact, make meaningful use of the disclosure. The customers won't read the disclosure. Or if they do, they will not understand its key points. Or if they do understand them, they will not long remember them. And if they do read, understand, and remember, they still will not likely adjust their decisionmaking sufficiently to account for the disclosed conflicts of interest.

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[1] LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 62 (1914).

[2] FRANK B. CROSS & ROBERT A. PRENTICE, LAW AND CORPORATE FINANCE 152-189 (2007) (summarizing existing empirical literature and adding modestly to it.

[3] This articles takes no position on the broader issue of whether a fiduciary obligation should be imposed upon broker-dealers.

[4] *See* BRAD SPELLBERG, RISING PLAGUE: THE GLOBAL THREAT FROM DEADLY BACTERIA AND OUR DWINDLING ARSENAL TO FIGHT THEM (2009).

[5] Emilios Avgouleas, "What Future for Disclosure as a Regulatory Technique? Lessons from the Global Financial Crisis and Beyond," 2 (March, 2009), *available at* http://ssrn.com/abstract=1369004.

[6] *Id.*

[7] *See generally* Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 VAN. L. REV. 1663 (2003) (contrasting the evidence supporting the competing behavioral and economic models of human behavior).

[8] *See, e.g.,* MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING (5th ed. 2002); REID HASTIE & ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD (2001); SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING (1993).

[9] Omri Ben-Shahar & Carl E. Schneider,"The Failure of Mandated Disclosure," 24-25 (March 2010), *available at* http://ssrn.com/abstract=1567284.

[10] *Id.* at 25.

[11] *Id.* at 4.

[12] Avgouleas, *supra* note __, at 14-22. Avgouleas makes a strong case for an explanation for the global financial crisis that is unrelated to disclosure deficiencies, noting that

> …investors had in many cases sufficient information about the risks of their investment strategies and of the financial products used to implement them. Yet market actors could not properly process available information in those cases and adjust their position to the riskiness of structured credit securities for a variety of reasons. First, due to product complexity, boundedly rational investors failed to understand the mechanics and risks of shadow banking and structured credit securities. Second, because of market players' tendency to herd, responding strategically to other market actors' behavior, these did not have the capacity or the desire to use in a rational way the disclosed information and take contrarian positions. Third, the influence of other behavioural factors such as the use of heuristics, and investor overconfidence in times of market euphoria, because of abundance of easy credit and rising market prices, meant that investors chose to ignore the warning signals in the disclosed data in favour of over-reliance on credit ratings.

Id. at 4.

[13] Ben-Shahar & Schneider, *supra* note __, at 29-32.

[14] *Id.* at 36.

[15] Daylian M. Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEG. STUD. 1, 6-7 (2005).

[16] Uzma Khan & Ravi Dhar, *Licensing Effect in Consumer Choice*, 43 JOURNAL OF MARKETING RESEARCH 259 (2006).

[17] Sonya Schdeva, Rumen Iliev & Douglas L. Medin, *Sinning Saints and Saintly Sinners: The Paradox of Moral Self-Regulation*, 20 PSYCHOLOGICAL SCIENCE 523 (2009)

[18] Chen-Bo Zhong et al., *Moral Self-Regulation: Licensing and Compensation*, *in* PSYCHOLOGICAL PERSPECTIVES ON UNETHICAL BEHAVIOR AND DECISION MAKING (David DeCremer, ed., 2009).

[19] Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000).

[20] *Id.* at 282-83.

[21] This assumption was dubious and inconsistent with stockbrokers' track record. *See* Robert A. Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L. J. 1397, 1426-34 (2002) [hereinafter "Prentice, *Whither Securities Regulation?"*].

[22] Herbert A. Simon, *Rational Choice and the Structure of the Environment*, 63 PSYCHOL. REV. 129, 129 (1956).

[23] JACOB JACOBY, IS IT RATIONAL TO ASSUME CONSUMER RATIONALITY? SOME CONSUMER PSYCHOLOGICAL PERSPECTIVES ON RATIONAL CHOICE THEORY 2-3 (N.Y. Univ. Ctr. For Law & Bus., Working Paper #CLB-00-009) (2000).

[24] Ben-Shahar & Schneider, *supra* note __, at 53.

[25] Ruth Helman et al., *Encouraging Workers to Save: The 2005 Retirement Confidence Survey*, 280 EBRI Issue Brief 1, 6 (2005).

[26] John Beshears et al., "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?" (April 2009), *available at* http://ssrn.com/abstract=1400943 (giving mutual fund disclosures as an example).

[27] Ben-Shahar & Schneider, *supra* note -_, at 47.

[28] Studies indicate that investors tend to be overconfident notwithstanding substantial evidence showing that lay investors are poor traders. Marcia Vickers & Gary Weiss, *Wall Street's Hype Machine,* BUS. WK., Apr. 3, 2000, at 112 (citing academic studies).

[29] *See, e.g.,* Werner F.M. De Bondt, *A Portrait of the Individual Investor,* 42 EUR. ECON. REV. 831, 839 (1998).

[30] Paul Slovic & Sarah Lichtenstein, *Comparison of Bayesian and Regression Approaches to the Study of Information Processing in Judgment,* 6 ORG. BEHAV. & HUM. PERFORMANCE 649, 724 (1971).

[31] *See* Robert A. Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis,* 2003 UNIV. OF ILL. L. REV. 337, 364 (hereinafter "Prentice, *Contract-Based Defenses"*)..

[32] *See* Tom Pyszczynski & Jeff Greenberg, *Toward an Integration of Cognitive and Motivational Perspectives on Social Inference: A Biased Hypothesis-Testing Model,* 20 ADVANCES EXPERIMENTAL SOC. PSYCHOL. 297, 298 (1987) (describing the attribution bias and its effects).

[33] *See* Prentice, *Whither Securities Regulation, supra* note __, at 1460-61 (citing numerous sources).

[34] *See* Colin F. Camerer, *Individual Decision Making, in* THE HANDBOOK OF EXPERIMENTAL ECONOMICS 587, 612-13 (John H. Kagel & Alvin E. Roth eds., 1995).

[35] Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud,* 46 VAND. L. REV. 75, 107 (1993).

[36] Amos Tverksy & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases, in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 7-11 (Daniel Kahneman et al. eds., 1982).

[37] Nicholas DiFonzo & Prashant Bordia, *Rumor and Prediction: Making Sense (but Losing Dollars) in the Stock Market*, 71 ORG. BEHAV. & HUM. DECISION PROCESSES 329, 346 (1997).

[38] *See* Prentice, *Contract-Based Defenses, supra* note __ at 367-69 (citing numerous sources).

[39] *See* PLOUS, *supra* note __, at 186.

[40] *See* Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 879 (1995).

[41] *See, e.g.,* Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 WM. & MARY L. REV. 1907 (2002) (suggesting that proponents of behavioral law and economics overpromise); Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should not Be Traded for Behavioral Law and Economics' Equal Incompetence,* 91 GEO. L. J. 67 (2002) (same).

[42] Ben-Shahar & Schneider, *supra* note ___, at 15-21.

[43] *Id.* at 48.