BEHAVIORAL ECONOMICS AND THE REGULATION OF PUBLIC OFFERINGS

by
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The SEC adopted new rules in 2005 governing registered public offerings in the United States. Few, if any, of the rules make sense if we start from a presumption that investors are rational and are able to account properly for any information they receive during the public offering process. In this Article, I examine the new rules and assess the implicit behavioral assumptions about investors contained in the rules. I also provide an assessment of the behavioral biases that may affect regulators at the SEC. Regulator biases may lead the SEC to take an ad hoc evaluative process often ending with a reference to "investor confidence" in justifying new regulations. As a minimal solution, I propose that the SEC bear the burden of specifying its assumptions behind investor behavior explicitly together with how regulations will benefit investors suffering from such biases (as well as how other investors are affected by the regulations). Taking such an approach will lead to a more consistent approach in how the SEC deals with investor biases and reduce unnecessary regulation (as opposed to the SEC's present ad hoc approach as typified in the public offering rules). To the extent other more public choice factors motivate regulation and references to "investor confidence" are merely a pretext, my proposal would help bring transparency to these other factors by focusing attention on whether the "investor confidence" rationale, in fact, is justified.

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I. INTRODUCTION

Congress enacted the federal securities laws during the Great Depression. Many aspects of the securities regulatory regime reflect the means of communication available to investors in the 1930s. The securities laws governing public offerings as originally enacted, among other things, required that dealers, for a specified period of time, send out the statutory prospectus together with or preceding written confirmation of sales in a public offering.[1] While the statutory prospectus is of little use to investors who have already made their purchase decision, piggybacking the distribution of the statutory prospectus with the written confirmation of sales was one method of ensuring the physical distribution of the document generally throughout the securities market of the 1930s.[2]

Technology today enables methods of a communication far different from those in use in the 1930s. The rapid growth of the Internet in the 1990s has provided participants in the securities markets, including most individual retail investors, the ability to access information on publicly-traded companies both at low cost and without delay at the SEC's own web site, among other sources.[3] Technological advances combined with recently implemented regulatory changes to the periodic reporting requirements for public companies, enacted as part of the Sarbanes Oxley Act,[4] led the SEC to rethink the public offering

[1] *See infra* text accompanying notes 83–85 (discussing the prospectus delivery requirement).

[2] Jim Cox states the motivation behind the prospectus delivery requirement succinctly: "[T]he prospectus delivery requirements serve two highly complementary purposes in terms of investor protection: (1) at least among brokers and dealers, it sharpens section 12(a)(2)'s disciplinary effects, and (2) it disseminates information about the offering." James D. Cox, *The Fundamentals of an Electronic-Based Federal Securities Act*, 75 WASH. U. L.Q. 857, 866−67 (1997). Cox also notes that "[n]either of these objectives necessarily depends on the solicited investor actually reading the prospectus or understanding its contents." *Id*. at 867.

[3] *See* SEC, http://www.sec.gov (last visited on Nov. 15, 2005).

[4] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. Section 409 of the Sarbanes-Oxley Act provides "[e]ach issuer reporting under Section 13(a) or 15(d) . . . disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the Commission determines . . . is necessary or useful for the protection of investors and in the public interest." *See* Sarbanes-Oxley Act § 409. *See also* Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,594 (Mar. 25, 2004) and Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date; Correction, 69 Fed. Reg. 48,370 (Aug. 10, 2004). For a summary of the Sarbanes-Oxley Act see JAMES HAMILTON & TED TRAUTMANN, SARBANES-OXLEY ACT OF 2002: LAW AND EXPLANATION (2002).

The SEC also promulgated Regulation AC in the wake of scandals involving analysts at Merrill Lynch and other Wall Street brokerage firms in the early 2000s. Regulation AC, among other things, requires a broker-dealer to provide a certification from the research

process in the United States. The SEC's review resulted, in the summer of 2005, in a series of reforms that worked to alter radically the regulation of public offerings (termed the "2005 Reforms").[5]

The 2005 Reforms deal with a number of aspects in the regulation of the public offering process. The SEC provided certain reporting issuers the ability to incorporate-by-reference information contained in prior SEC filings into the Form S-1 version of the registration statement.[6] The SEC expanded the required disclosure in annual Form 10-K filings for Exchange Act reporting issuers to include a risk factors section.[7] The SEC also provided a number of clarifying provisions on when liability will apply for material misstatements and omissions in offering documents for various participants in the offering process.[8] This Article focuses on the reforms that affect communications during the various stages of the public offering process including: (1) prior to the filing of a public offering registration statement (the Pre-Filing Period); (2) during the period after the filing while the registration statement awaits becoming effective with the SEC (the Waiting Period); and (3) the period after the registration statement becomes effective and sales may commence (the Post-Effective Period).[9] The rules that govern the public offering process through these three periods are collectively referred to as the "public offering rules." The Article also examines the changes under the reforms to shelf registration offerings, particularly for well-known seasoned issuers (WKSIs), a new category of issuers created under the 2005 Reforms.

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analyst authoring an analyst report that the views in the report are in fact the analyst's truthful opinion. *See* Regulation Analyst Certification, 17 C.F.R. §§ 242.500–242.505 (2005).

[5] *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722 (final rule Dec. 1, 2005) [hereinafter "Promulgating Release"]. The 2005 Reforms reflect the culmination of a multi-decade review of the securities offering process, starting with Milton H. Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340, 1341–42 (1966) (advocating a move away from the transactional focus of the Securities Act and toward a company registration system of securities regulation). The SEC, as recently as 1998, put forward a release, known as the "Aircraft Carrier" release for its sheer size, recommending a move toward company registration. *See* The Regulation of Securities Offerings, Securities Act Release No. 33-7606A, 63 Fed. Reg. 67,174 (Nov. 13, 1998).

[6] *See* Form S-1, SEC Securities Act, Fed. Sec. L. Rep. (CCH) ¶ 7121, at 6235 (Aug. 24, 2005).

[7] *See* Form 10-K, SEC Exchange Act, Fed. Sec. L. Rep. (CCH) ¶ 31,101, at 22,061 (Oct. 10, 2005).

[8] For a summary of the 2005 Reforms change to the liability regime see SULLIVAN & CROMWELL, LLP, CLIENT MEMORANDUM, SEC ADOPTS LANDMARK REFORMS TO THE REGISTERED SECURITIES OFFERING PROCESS (2005), http://www.sullivancromwell.com/files/FileControl/17ba4162-af26-4e49-b1b1-7b40e3fe3ad2/7483b893-e478-44a4-8fed-f49aa917d8cf/Presentation/File/GPM5851.pdf).

[9] For a summary for the public offering rules see STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 423–63 (1st ed. 2005). The Article does not analyze the reforms made to Rules 137, 138, and 139 of the Securities Act governing research analyst reports relating to companies in the public offering process. *See* Securities Act Rules 137, 138, 139, 17 C.F.R. § 230.137-9 (1996).

The securities regime embodies at least three purposes in its regulation of the public offering process. First, the public offering rules require issuers to generate two mandatory disclosure documents: the registration statement and the statutory prospectus (consisting of Part I of the registration statement).[10] Second, the rules work to restrict the amount of other information an issuer and other offering participants may distribute to the investing public. Lastly, the public offering rules ensure the distribution of the statutory prospectus broadly to investors during the Post-Effective Period (both to enable the widespread dissemination of the information in the statutory prospectus and to bring dealers within the ambit of Section 12(a)(2) antifraud liability for communications made "by means of" a prospectus).[11]

What behavioral assumptions implicitly underlie the public offering rules? If we assume all investors are rational, then little justification exists for many of the public offering rules.[12] What purpose is served in restricting information disclosure if investors are rational? Rational investors will simply place the appropriate weight on any and all information the investors receive about an offering.[13] If the registration statement and statutory prospectus provide useful information and other information disclosure from the issuer do not, then investors will pay most attention to the mandatory disclosure documents while discounting the other information.[14] Similarly, why force the physical delivery of the statutory prospectus to investors? Rational investors may locate the statutory prospectus of a company easily at the SEC's own website or, alternatively, will heavily discount the price of companies where the mandatory

[10] The registration statement is contained in Forms S-1 and S-3 (depending on the type of issuer). *See* Form S-1, Fed. Sec. L. Rep. (CCH) ¶ 7121, at 6235, Form S-3, SEC Securities Act, Fed. Sec. L. Rep. (CCH) ¶ 7151, at 6247 (Aug. 31, 2005). Not all issuers must use Forms S-1 or S-3. The SEC, for example, allows small business issuers and foreign issuers to use alternative (and less demanding) registration statement forms. The Securities Act also provides heightened liability provisions for material misstatements and omissions (where a duty to disclose exists) in Sections 11 and 12(a)(2). *See* Securities Act of 1933 § 11, 15 U.S.C. § 77k (2000); Securities Act of 1933 § 12, 15 U.S.C. § 77l (2000).

[11] *See* Securities Act of 1933 § 12(a)(2). See also *supra* note 2.

[12] On a similar note, others have argued that accepting modern finance theory leads to the conclusion that the limitations in the public offering rules on the disclosure of additional information on top of the mandatory disclosure documents should be relaxed. *See, e.g.*, Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989) (arguing that "non-fraudulent extraneous offers that are disseminated to the public should, with minor exceptions, be permitted.").

[13] Extremes are, of course, possible. An investor buried under an avalanche of information may not have the ability to place the appropriate weight on all received information. Courts recognize a "buried facts" doctrine under which information buried together with other information is not considered disclosed to investors. *See, e.g.*, Kohn v. American Metal Climax Inc., 322 F. Supp. 1331, 1362 (E.D. Pa. 1970). I assume here that the amount of information disclosed voluntarily on the part of issuers in a public offering do not approach such an extreme as to bury investors in too great an amount of information.

[14] Issuers may, of course, lie. Antifraud liability, however, addresses the possibility of false information. In discussing the regulation of public offerings, I focus only on the rules that limit the ability of issuers to disclose information. I do not deal directly with the antifraud liability provisions.

disclosure documents are not readily available. Issuers, in turn, will have a voluntary incentive to ensure adequate distribution of the mandatory disclosure documents to reduce this discount.[15]

More plausible arguments exist for requiring the creation of the mandatory disclosure documents, even where investors are fully rational. Rational investors will discount companies that choose not to make mandatory disclosure, giving companies a voluntary incentive to disclose information.[16] Collective action problems may nonetheless prevent effective standardization.[17] Mandatory disclosure can provide a low cost means of achieving standardization. Mandatory disclosure may work to force the lowest-cost provider of corporate information, the issuer itself, to provide information to the market, thereby reducing the duplicative research costs that analysts and other securities participants might expend in researching the company.[18] Mandatory disclosure may also help impose greater accountability for managers, thereby reducing agency costs between managers and dispersed public shareholders.[19]

This Article examines the 2005 Reforms and the SEC's assumptions on investor behavior motivating the reforms. The reforms largely leave the present mandatory disclosure regime untouched.[20] The bulk of the reforms deal with the restrictions placed on issuers and other offering participants in making disclosures related to the issuer or the offering during the public offering process as well as the prospectus delivery requirements. For some issuers, specifically well-known seasoned issuers, the 2005 Reforms effectively remove most of the restrictions imposed by the public offering rules through changes made to the shelf registration process. For other issuers, the reforms retain many aspects of the public offering rules. In putting forward the reforms, the SEC implicitly held a vision of investors somewhat different from rational. The SEC, however, failed to specify its assumptions on how investors behave; nor

[15] What is "adequate" for distribution may depend on the particular type of issuer. For issuers that are well-followed by many analysts and whose securities trade in a liquid market, issuers may simply post the prospectus on a centralized website, such as the SEC's website, to ensure that the information is disseminated broadly into the marketplace and incorporated in the market price.

[16] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

[17] *See* James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1211–17 (1999) (discussing the importance of mandatory disclosure in standardizing accounting standards and allowing investors to compare different companies).

[18] *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 733 (1984) ("[A] major significance of a mandatory disclosure system is that it can reduce these [duplicated] costs. Rival firms do not need to incur expenses to produce essentially duplicative data banks when a central securities data bank is in effect created at the SEC.").

[19] *See* Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems,* 62 U. CHI. L. REV. 1047, 1051−52, 1080 (1995).

[20] *See supra* notes 6−7 and accompanying text (discussing briefly the impact of the 2005 Reforms on disclosure requirements of the securities laws).

did the SEC state how the reforms address behavioral deficiencies among investors.

The Article questions whether the SEC is correct in its implicit behavioral assumptions about investors. If investors do not always act rationally, how exactly do they act? The Article also addresses the more difficult task of determining what solutions may ameliorate investor behavioral biases even if identified. SEC regulators, who suffer from their own behavioral biases, may not arrive at the best regulatory approach. The lack of any explicit exposition in the 2005 Reforms of the SEC's underlying assumptions on the behavioral biases of investors leaves cause for concern. At the very least, a lack of any explicit attention to behavioral assumptions leads to inconsistencies within the reforms and the rest of the securities regulatory regime in how investors are treated. The SEC's approach to protecting investors is piecemeal and, as a result, non-uniform. Because of the lack of any explicit attention to how investors are viewed, the SEC as an entity may have no single view on investor behavior. Instead, policy over time consists of an amalgamation of the assumptions of disparate individual regulators at the SEC, heightening the risk of errors and inconsistencies when attempting to deal with investor biases.

One possible response is to force regulators to ignore investor biases and assume instead that investors are always rational. This presumption, while not accurate, may lead to fewer regulatory errors and allow the market the ability to come up with its own solutions to investor biases.[21] Short of adopting an investors-are-always-rational stance, how can we improve on SEC decisionmaking? This Article contends that if the SEC desires to treat investors as less than fully rational, the SEC should specify and disclose its assumptions explicitly. Setting forth an explicit set of assumptions together with supporting evidence will promote consistency across the securities laws in how investors are treated. Explicit assumptions will also allow outside observers to critique the SEC's assumptions, placing greater discipline in how these assumptions are developed and reducing the possibility of the SEC's own biases improperly affecting how it views investors. An explicit assumption requirement will lead the SEC to avoid simply adopting ad hoc assumptions about what regulations are needed to support "investor confidence." Examples of the SEC's invocation of the need to protect "investor confidence," without much additional analysis, are numerous.[22] The focus on determining how investors behave may help

[21] *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 42 (2003) (noting that "[o]ne response . . . would be to ignore investors' behavioral biases altogether and structure regulation on the basis of the rational actor model" but also noting that "[w]e think that is an unlikely outcome").

[22] *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722 (final rule Dec. 1, 2005) (justifying the 2005 Reforms as increasing both market efficiency and "investor confidence" leading to "more efficient capital formation"); Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, 70 Fed. Reg. 42,234 (final rule Aug. 22, 2005) (justifying amendments to Forms S-8, 8-K and 20-F as enhancing "investor confidence in the securities markets and promot[ing] efficiency and capital formation"); Regulation NMS, Exchange Act Release No. 34-51808, 70 Fed. Reg. 37,496 (effective Aug. 29, 2005) (justifying Regulation NMS as important in

disabuse individual SEC regulators of their own misconceptions on investor behavior at which they otherwise may arrive through error-prone, arm-chair speculation.

The SEC's reference to "investor confidence" may reflect something other than a desire to protect investors. The SEC may act on behalf of special interests in the securities industry, using the mantra of investor confidence as a pretext for its actions. Explicitly stating exactly how investors are protected and the underlying assumptions made on investors may work to expose this pretext. Where the explicit assumptions made on investors are flawed or outright incorrect or where the regulations adopted are inconsistent with the assumptions, one can question whether the SEC really is acting on behalf of investors. Less sinisterly, the SEC (or Congress) may trade off investor protection with other goals, such as allowing companies to raise capital in a quick and efficient manner and the desire to protect small business issuers. Even in such a case, disclosure on the part of the SEC of its explicit investor assumptions, instead of the less informative "investor confidence" boilerplate language, provides outside parties a greater ability to assess the validity of the tradeoffs the SEC makes, and indeed may lead the SEC and ultimately Congress to take a more critical view of such tradeoffs.

Part II discusses the implicit investor behavioral assumptions underlying the 2005 Reforms. Part III examines biases that may affect SEC regulators, calling into question the wisdom of the SEC's approach to dealing with investor biases. Part IV sets forth the proposal for the SEC to provide explicit assumptions on how it views investors.

II. ASSESSING THE 2005 SEC REFORMS

This Part first (A) canvasses the 2005 Reforms, focusing on the aspects of the reforms that implicitly assume that investors do not (always) act rationally. The Part then (B) assesses whether the reforms in fact will work as intended to protect investors that act under the influence of behavioral biases and how the protections afforded in the public offering rules after the reforms relate to the rest of the securities regulatory regime.

promoting "investor confidence in the markets"); Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, 65 Fed. Reg. 51,716 (final rule Oct. 23, 2000) (justifying the prohibition of selective disclosures under new Regulation FD as necessary to prevent the "loss of investor confidence in the integrity of our capital markets"); Mutual Fund Redemption Fees, Release No. IC-26782, 70 Fed. Reg. 13,328, 13,337 (final rule May 23, 2005) (justifying new Rule 22c-2 designed to deter short-term trading in mutual funds as follows: "Increased investor confidence may result because the rule enables funds to obtain from financial intermediaries information that will allow funds to identify investors who are market timing through omnibus accounts. Funds would benefit by an increase in investor confidence because long-term investors would be less likely to seek alternative financial products in which to invest.").

A. *Canvassing the Reforms*

The public offering rules that govern the public offering process derive from Section 5 of the Securities Act. This section discusses the impact of the 2005 Reforms on each of the time periods in the public offering process—the Pre-Filing Period, the Waiting Period, and the Post-Effective Period—and changes in the reforms to shelf registration offerings. This section examines the effect of the reforms on the information environment surrounding an issuer, including permissible information, mandatory disclosures, and the use of "cooling off" periods. This section also discusses distinctions made in the reforms among different types of issuers.

1. *Pre-Filing Period*

From the enactment of the securities laws in the 1930s until the SEC's Public Offering Reforms in 2005, the SEC took a negative view on communications that related to the offering in the Pre-Filing Period. Section 5(c) of the Securities Act blocks all offers of securities prior to the filing of a registration statement with the SEC.[23] The SEC's negative view on Pre-Filing Period communications led the SEC to take an expansive approach to the definition of an "offer" as provided in Section 2(a)(3) of the Securities Act.[24]

In a series of Securities Act Releases in the decades following the enactment of the Securities Act, the SEC made clear that the term "offer" includes not only explicit offers of securities for sale but also a broad range of communications that may raise the interest of investors in the offering or in the issuer. The SEC stated in *In re Matter of Carl M. Loeb, Rhoades & Co.* that:

> [W]e have made clear our position that the statute prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, condition the public mind or arouse public interest in the particular securities . . . .[25]

The introduction of a new series of press releases touting the business prospects of the company, for example, may constitute an offer if the company is in the public offering process (or "in registration").[26] Similarly, communications undertaken by an underwriter of the offering to tout the prospects of the issuer's industry, even if not specifically mentioning the issuer, may be considered an offer.[27] Switching the time, form, and manner of

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[23] Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000).

[24] Securities Act of 1933 § 2, 15 U.S.C. § 77b (2000).

[25] *In re* Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 850 (1959).

[26] The SEC has defined "in registration" as "the entire process of registration, at least from the time an issuer reaches an understanding with the broker-dealer, which is to act as managing underwriter until the completion of the offering and the period of 40 or 90 days during which dealers must deliver a prospectus." Publication of Information Prior to or After Filing and Effective Date of Registration Statement, Securities Act Release No. 33-5009, 34 Fed. Reg. 16,870, n.4 (Oct. 18, 1969).

[27] *See* Statement of Commission Relating to Publication of Information Prior to or After Effective Date of Registration, Securities Act Release No. 33-3844, 22 Fed. Reg. 8,359 (Oct. 24, 1957) (noting that the distribution of promotional material by an underwriter about

communication to investors may also lead the SEC (and courts) to characterize a communication as an offer.[28] Moving a CEO's speech to analysts up in time to coincide with marketing efforts for a company's public offering may cause the speech to be treated as an offer.[29]

Two types of communications raised particular concern for the SEC. First, the SEC viewed forward-looking projection information (or "soft" information) as posing a heightened risk to investors. The SEC discouraged the disclosure of projections relating to sales, earnings, and other financial components of an issuer's valuation.[30] The SEC feared that such projections are inherently unreliable and may mislead particularly unsophisticated investors who fail to appreciate this unreliability.[31] Second, the SEC struggled with how to treat more "factual" information about an issuer. On the one hand, factual information about an issuer, such as its historical earnings, could raise interest among investors for the issuer, if for example the historical earnings were high. Indeed, the SEC has stated that: "[T]he danger to investors from publicity amounting to a selling effort may be greater in cases where an issue has 'news value' since it may be easier to whip up a 'speculative frenzy' concerning the offering by incomplete or misleading publicity and thus facilitate the distribution of an unsound security at inflated prices."[32] On the other hand,

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the issuer's industry even where "no reference to any issuer or any security nor to any particular financing" is made would be a violation of Section 5).

[28] The SEC's concern is with the motivation behind disclosure. The SEC stated that an offer may include communications "calculated, by arousing and stimulating investor and dealer interest . . . to set in motion the processes of distribution." *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. at 851. The SEC has carried its focus on changes in time, manner, and form of communications to the application of the new Rule 168 and 169 safe harbors for certain factual and forward-looking information. *See infra* text accompanying notes 39-54 (describing Rules 168 and 169).

[29] *See* Statement of Commission Relating to Publication of Information Prior to or After Effective Date of Registration, Securities Act Release No. 33-3844, 22 Fed. Reg. 8,359, 8,360 (Oct. 24, 1957) (stressing the fact that "the scheduling of the speech [to analysts] had not been arranged in contemplation of a public offering" in stating that it would have no objections to the delivery of a speech at an analysts' meeting by a president of a company in registration).

[30] Guidelines for Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 33-5180, 36 Fed. Reg. 16,506, 16,507 (Aug. 21, 1971) ("[C]are should be exercised so that, for example, predictions, projections, forecasts, estimates and opinions concerning value are not given with respect to such things, among other, as sales and earnings and value of the issuer's securities.").

[31] *See, e.g.*, Union Pac. R.R. v. Chicago & N.W. Ry. Co., 226 F. Supp. 400, 408–09 (N.D. Ill. 1964) (noting that "[t]here is good reason for [the SEC's] emphasis on prediction. Bald statements contrary to concrete and historic fact run the risk of ready refutation and exposure, and to that degree are self-policing. Predictions, estimates, and opinions are more elusive and may present graver dangers of misleading the investing public."); Carl W. Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 258 (1972) ("[A]ccording to the traditional SEC view, the inclusion of soft information in filings would clothe such information with an unduly high aura of credibility. Investors assume, with a great deal of justification, that information appearing in SEC filings has been prepared with considerable care, tending to assure its accuracy.").

[32] *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. at 853.

certain companies, including publicly-traded companies, routinely make disclosure of factual information to the public capital markets.[33] For most public companies, the periodic disclosure is mandatory under the Securities and Exchange Act and an important source of information for investors contemplating purchasing the securities of a public company already trading in the secondary market.[34]

The SEC's 2005 Reforms radically expanded the ability of issuers to communicate during the Pre-Filing Period.[35] As an alternative to the reforms, the SEC could have provided a blanket safe harbor from the definition of an "offer" for all issuers and offering participants.[36] The SEC, however, did not go so far. Instead, the SEC's reforms took a variegated approach, sometimes eliminating the Section 5(c) prohibition and other times allowing certain types of information but not others.[37]

First, the SEC's reforms reduced the categories of information that constitute an "offer" and thus may run afoul of Section 5(c). Rule 168 of the Securities Act provides a safe harbor for most Exchange Act reporting issuers and those working on their behalf, other than an underwriter or dealer participating in the offering,[38] to continue the regular release of "factual business information."[39] If Rule 168 applies, then communication is excluded from the definition of an "offer" for purposes of Section 5(c).[40] Communication under Rule 168 may not make any explicit reference to the offering itself or otherwise constitute a part of the offering activities.[41] The exclusion of factual information recognizes the need of certain issuers, particularly Exchange Act reporting issuers, to disclose information regularly to the investing public. Rule 168 does not give issuers complete freedom to make factual disclosures. Only

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[33] Exchange Act reporting companies are required to file annual Form 10-Ks, quarterly Form 10-Qs and episodic Form 8-Ks with the SEC. *See* Form 10-K, SEC Exchange Act, Fed. Sec. L. Rep. (CCH) ¶ 31,031, at 22,062 (Oct. 10, 2005); Form 10-Q, SEC Exchange Act, Fed. Sec. L. Rep. (CCH) ¶ 31,031, at 22,021 (Oct. 10, 2005); Form 8-K, SEC Exchange Act, Fed. Sec. L. Rep. (CCH) ¶ 31,001, at 21,992 (July 27, 2005).

[34] *See* Securities Exchange Act of 1934 § 12, 15 U.S.C. § 781 (a), (g) (2000); Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a) (2000).

[35] Unless otherwise provided, all rules referenced in this Article are promulgated by the SEC under the Securities Act of 1933.

[36] Section 28 of the Securities Act provides the SEC with the regulatory authority to provide such an exemption. *See* Securities Act of 1933 § 28, 15 U.S.C. § 77z-3 (2000). The SEC does in fact provide such an exemption for well-known seasoned issuers in the Pre-Filing Period through Rule 163 of the Securities Act, providing an exemption for all offers from Section 5(c) so long as the conditions of Rule 163 are met. *See infra* text accompanying notes 61−63 (describing Rule 163).

[37] The reforms do not simplify the securities laws but instead add another layer of complexity on top of an already Byzantine area of securities regulation.

[38] *See* Securities Act Rule 168(b)(3), 17 C.F.R. § 230.168 (2005).

[39] *See id.* at Rule 168(b)(1).

[40] In excluding communications from the definition of an offer, the Rule also exempts communications from § 2(a)(10)'s definition of ''prospectus'' and thereby excludes the communications from the application of § 5(b)(1) in the Waiting and Post-Effective periods. *See id.* at Rule 168.

[41] *See id.* at Rule 168(c).

certain types of factual information are included in the safe harbor.[42] The issuer must have "previously released or disseminated information of the type described in this section in the ordinary course of its business."[43] The information disclosure must be of the same "timing, manner, and form" as similar past information disclosures.[44]

The SEC's reforms also reflect a changed attitude with respect to forward-looking information. The SEC's (and Congress's) softening stance to forward-looking information already was evident in prior reforms. Investors seeking to value a security may find forward-looking projections of revenues, costs, and earnings, among other financial information, particularly helpful.[45] In the 1980s, the SEC moved to require management to discuss known trends and uncertainties relating to liquidity, capital resources, and results of operations in the Management Analysis and Discussion disclosure section contained in the Form 10-K annual filing as well as in the registration statement.[46] When Congress enacted the Private Securities Litigation Reform Act of 1995, it provided a safe harbor for forward-looking information under certain conditions from private antifraud liability.[47] Rule 168 goes one step further by also allowing issuers to make disclosures of certain forward-looking information, including earnings projections, during the public offering process.[48]

Non-Exchange Act reporting issuers may make use of an analogous safe harbor in Rule 169 of the Securities Act. As with Rule 168, communication

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[42] *See id.* at Rule 168(b)(1) ("*Factual business information* means some or all of the following information that is released or disseminated under the conditions in paragraph (d) of this section, including, without limitation, such factual business information contained in reports or other materials filed with, furnished to, or submitted to the Commission pursuant to the Securities Exchange Act of 1934.").

[43] *Id.* at Rule 168(d)(1).

[44] *Id.* at Rule 168(d)(2). Investment companies and business development companies are excluded from using Rule 168's safe harbor. *See id.* at Rule 168(d)(3).

[45] For more on what information investors require to value companies *see* TIM KOLLER ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES (4th ed. 2005).

[46] *See* Form 10-K, Item 7, SEC Exchange Act, Fed. Sec. L. Rep. (CCH) ¶ 31,101, at 22,067 (Oct. 10, 2005); Regulation S-K, Item 303, SEC Securities Act, Fed. Sec. L. Rep. (CCH) ¶ 71,033, at 61,863 (June 2, 2004) (codified at 17 C.F.R. § 229.303). At least one study exists finding empirical support for the fact that the required Management Discussion & Analysis disclosure helped increase share price accuracy in the United States. *See* Merritt B. Fox et al., *Law, Share Price Accuracy and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 368−78 (2003).

[47] *See* Securities Exchange Act of 1934 § 21E, 15 U.S.C. § 78u-5 (2000); Securities Act of 1933 § 27A, 15 U.S.C. § 77z-2 (2000). The safe harbors do not cover forward-looking statements made during an initial public offering or contained in financial statements prepared according to generally accepted accounting principles, among other contexts. *Id.* Also, the safe harbors only exempt from antifraud liability and do not protect against the liability consequences under Section 12(a)(1) for violations of Section 5's public offering rules.

[48] Forward-looking information that is permitted includes financial projections, statements about the issuer management's plans and the issuer's future economic performance, and any underlying assumptions. *See* Securities Act Rule 168(b)(2), 17 C.F.R. § 230.168 (2005).

under Rule 169 may not make any explicit reference to the offering itself or otherwise constitute a part of the offering activities.[49] Rule 169 allows non-reporting issuers and those working on their behalf, other than an underwriter or dealer participating in the offering,[50] to continue disclosure of "factual business information."[51] Most IPO issuers fall under the scope of Rule 169. Similar to Rule 168, Rule 169 provides an exemption from Section 5(c)'s prohibition on offers in the Pre-Filing period.[52] Unlike Rule 168, however, Rule 169 does not exempt forward-looking information from the definition of an offer. Rule 169 tracks Rule 168's requirements for the regular release of information similar in type to previously released information in the ordinary course of business and release in the same "timing, manner, and form."[53] Rule 169 also requires that the factual information must have been disseminated previously to "persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the issuer's securities, by the issuer's employees or agents who historically have provided such information."[54]

Second, the SEC's reforms rely on a "cooling off" period for certain communications. Rule 163A exempts communications by or on behalf of an issuer that do not reference the public offering and that take place more than 30 days prior to the filing of the registration statement from the definition of an offer for purposes of Section 5(c) of the Securities Act.[55] Rule 163A requires that the issuer take "reasonable steps within its control to prevent further distribution or publication of such communication during the 30 days immediately preceding the date of filing the registration statement."[56] In justifying Rule 163A, the SEC stated that: "we believe that the 30-day

[49] *See id.* at Rule 169(c).

[50] *See id.* at Rule 169(b)(2). Investment companies and business development companies are excluded from using Rule 169's safe harbor. *See id.* at Rule 169(d)(4).

[51] Rule 169(b)(1) defines "factual business information" to include factual information "about the issuer, its business or financial developments, or other aspects of its business" and advertisements about the issuer or its products or services. *See id.* at Rule 169(b)(1).

[52] In excluding communications from the definition of an offer, the Rule also exempts communications from Section 2(a)(10)'s definition of ''prospectus'' for purposes of Section 5(b)(1) in the Waiting and Post-Effective periods.

[53] *See* Securities Act Rule 169(d)(1) & (2), 17 C.F.R. § 230.169 (2005).

[54] *Id.* at Rule 169(d)(3).

[55] *See* Securities Act Rule 163A, 17 C.F.R. § 230.163A (2005). Underwriters and dealers participating in the offering are excluded from using Rule 163A. *See id.* at Rule 163A(c). *See also supra* note 26, (detailing the SEC's pre-Rule 163A position on when an offering goes "in registration").

[56] *See id.* at Rule 163A(a). Certain types of offerings and issuers are excluded from using Rule 163A. Excluded transactions include business combination transactions. *Id*. at Rule 163A(b)(1). Excluded issuers include issuers that were at any time in the past three years blank check companies, shell companies, or issuers of a penny stock offering. *Id*. at Rule 163A(b)(3). Investment companies and business development companies are also excluded from using Rule 163A. *Id*. at Rule 163A(b)(4). Communications that fall under the Rule 163A safe harbor are not treated as in connection with a registered securities offering for purposes of Rule 100(b)(2)(iv) of Regulation FD, thus subjecting such communications to the strictures of Regulation FD. *See id*. at Rule 163A(d).

timeframe adequately assures that these communications will not condition the market for a securities offering by providing a sufficient time period to cool any interest in the offering that might arise from the communication."[57]

Third, the SEC introduced a new partitioning of issuers in the reforms. The type of issuer may proxy for the availability of market-based mechanisms that may protect even the most unsophisticated and behaviorally challenged investors. For issuers whose securities trade in liquid secondary markets, securities intermediaries, including analysts, brokers, and other professionals, may provide assistance for less informed investors.[58] Likewise, more unsophisticated investors, at least in theory, may look to the market price for the securities of such issuers to incorporate publicly-available information.[59] Reflecting these differences among issuers, the SEC divided issuers into four categories: non-reporting, unseasoned, seasoned, and well-known seasoned issuers. Non-reporting issuers are those issuers that are not required to file Exchange Act reports pursuant to Sections 13 or 15(d) of the Exchange Act. Unseasoned issuers are Exchange Act reporting issuers that do not meet the requirements of Form S-3. Seasoned issuers are Exchange Act reporting issuers that are eligible to use Form S-3 but that are not otherwise well-known seasoned issuers. Well-known seasoned issuers are defined to include, among other things, an issuer eligible to use Form S-3 with an equity market float in the hands of non-affiliates of at least $700 million.[60]

The 2005 Reforms provide well-known seasoned issuers greater ability to engage in Pre-Filing Period communications. Rule 163 allows WKSIs to

[57] *See id*. at Rule 163A(a).

[58] Indeed, most individual investors may never bother looking at the prospectus, looking instead to intermediaries such as brokers to filter the information for them. *See* Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1164−70 (1970); HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 96−116 (1979).

[59] Under the semi-strong form of the efficient capital markets hypothesis (ECMH), the secondary market stock price will incorporate all publicly-available information relevant to the valuation of the stock. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (providing a survey of theoretical implications of efficient markets and empirical testing of the efficient markets hypothesis); *see also* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907, 911 (1989) ("The empirical evidence to date (with some exceptions) appears to establish the validity of the weak and semi-strong versions but not the strong form of the efficient capital markets hypothesis.").

[60] *See* Securities Act Rule 405, 17 C.F.R. § 230.405 (2005). Among other things, an issuer seeking to obtain WKSI status must be current in its Exchange Act filings and have timely filed its Exchange Act filings for the past 12 months. An investment company or business development company is excluded from WKSI status. Also excluded are ineligible issuers including those issuers that within the past three years were a blank check or shell company or issued a registered penny stock offering. Issuers that violated the antifraud provisions of the federal securities laws as well as issuers that filed a bankruptcy petition—unless the issuer filed an annual report containing audited financial statements subsequent to its emergence from bankruptcy—are also ineligible. *Id*. The SEC reported that: "In 2004, those issuers, which represented approximately 30% of listed issuers, accounted for about 95% of U.S. equity market capitalization." Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,727 (final rule Dec. 1, 2005).

engage in written and oral offers of the securities during the Pre-Filing Period. Rule 163 imposes minimal requirements on WKSIs. Well-known seasoned issuers must include a mandatory legend with any written offer pursuant to Rule 163 (deemed a "free writing prospectus").[61] The legend states that the issuer may file a registration statement with the SEC and directs potential investors to read the statutory prospectus. The legend also informs investors of the availability of filed documents on the EDGAR system located at the SEC's website.[62] As well, the WKSI must file any free writing prospectuses under Rule 163 with the SEC promptly upon the filing of the registration statement.[63]

2. Waiting Period

In the Waiting Period, Section 5(c) no longer applies and oral offers are allowable.[64] Written offers, however, continue to be prohibited due to the operation of Section 5(b)(1).[65] Under Section 5(b)(1), prospectuses are prohibited unless the prospectuses meet the requirements of a Section 10 statutory prospectus.[66] Section 2(a)(10) defines prospectuses to include written communications as well as broadcast communications, such as TV and radio transmissions that offer securities for sale.[67] The broad definition of a prospectus limits the ability of the issuer or other offering participants from disseminating written or broadcast offers other than the preliminary prospectus in the Waiting Period. Under the assumption that the attention of investors will stray to other, more "flashy" documents if given the opportunity, the limitation on other written and broadcast materials works, at least in theory, to focus the attention of potential investors on the preliminary prospectus.[68]

The 2005 Reforms retain the basic structure of the prohibition on prospectuses in the Waiting Period while adding significant exceptions. First, the reforms expand on the ability of issuers and other offering participants to make offers through written and broadcast communications. The safe harbors for factual and forward-looking information that do not reference the offering

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[61] *See* Securities Act Rule 163(b)(1), 17 C.F.R. § 230.163 (2005). Rule 163 provides a cure provision for certain "immaterial or unintentional" failures to include the legend. *Id*. at Rule 163(b)(1)(iii).

[62] http://www.sec.gov.

[63] *See* Securities Act Rule 163(b)(2), 17 C.F.R. § 230.163 (2005). Rule 163 provides a cure provision for certain "immaterial or unintentional" failures to file. *Id*. at Rule 163(b)(2)(iii). Communications that fall under the Rule 163 safe harbor are not treated as in connection with a registered securities offering for purposes of Rule 100(b)(2)(iv) of Regulation FD, thus subjecting such communications to the strictures of Regulation FD. *See id.* at Rule 163(e). Among others, investment companies and business development companies may not use Rule 163's safe harbor. *See id.* at Rule 163(b)(3).

[64] *See* Securities Act of 1933 § 5(c), 15 U.S.C. § 77e (2000).

[65] *See* Securities Act of 1933 § 5(b)(1), 15 U.S.C. § 77e (2000).

[66] *See* Securities Act of 1933 § 10, 15 U.S.C. § 77j (2000).

[67] *See* Securities Act of 1933 § 2(a)(10), 15 U.S.C. § 77b (2000).

[68] *See, e.g.*, John C. Coffee Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration,* 52 WASH. & LEE L. REV. 1143, 1151 (1995) (noting that the prohibition on traditional free writing in the Waiting Period works to restrict "any written communications during the waiting period that could compete with the SEC-filed preliminary prospectus for the investor's attention").

and are not part of the offering activities contained in Rules 168 and 169, discussed above, continue to apply in the Waiting Period.[69] In the Waiting Period itself, the SEC expanded the safe harbor for communications under Rule 134, allowing issuers and those working on the issuers' behalf to disclose, among other things, information on marketing events, including roadshow presentations, and a description of the procedures that the underwriters will use to conduct the offering.[70]

The SEC also moved to expand the ability of issuers and offering participants (including, unlike in the Pre-Filing Period, underwriters) to transmit written offers of securities in the Waiting Period (and beyond) through the creation of a new class of written communications: free writing prospectuses. In the Pre-Filing Period, as discussed above, well-known seasoned issuers may already send free writing prospectuses subject to certain conditions under Rule 163. After the filing of the registration statement, issuers generally are allowed to make use of free writing prospectuses pursuant to Rules 164 and 433.

Rules 164 and 433 allow issuers and other offering participants to transmit a wide variety of "written" information relating to an offering as free writing prospectuses.[71] Rule 433(c)(1) prohibits the inclusion of information that is

[69] If either Rule 168 or 169 apply, the communication is deemed not an offer not only for purposes of Section 5(c) but also for Section 2(a)(10) (and thereby for Section 5(b)(1)). *See* Securities Act Rule 168, 17 C.F.R. § 230.168 (2005); Rule 169, 17 C.F.R. § 230.169 (2005).

[70] *See* Securities Act Rule 134, 17 C.F.R. § 230.134 (1996). Compliance with Rule 134 provides an exemption from, among others, the definition of a "prospectus" under Section 2(a)(10) of the Securities Act. Once out of the definition of a prospectus, communications will no longer run afoul of the prohibition under Section 5(b)(1). While Section 12(a)(2) liability does not apply to Rule 134, Rule 10b-5 antifraud liability does apply to material misstatements and certain material omissions in a Rule 134 communication. *See* Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1996).

[71] Securities Act Rule 405 defines "written communication" to include "graphic communication." Securities Act Rule 405, 17 C.F.R. § 230.405 (2005). Rule 405 then goes on to define "graphic communication" as "all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet Web sites" and other similar information. *Id*. Rule 405 importantly provides that: "Graphic communication shall not include a communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means." *Id*. Thus, electronic road shows that are live qualify as "oral" communication and do not require free writing prospectus status under Rule 433 in order to be used freely in the Waiting Period. Pre-recorded electronic road shows may potentially receive free writing prospectus status under Rule 433. Non-reporting issuers that use a pre-recorded electronic road show must file the road show with the SEC "unless the issuer of the securities makes at least one version of a *bona fide* electronic road show available without restriction by means of graphic communication to any person . . . ." Securities Act Rule 433(d)(8)(ii), 17 C.F.R. § 230.433 (2005). The SEC treats information contained on a third-party website that is hyperlinked from the issuer's website as potentially a written offer of the issuer's securities. *Id*. at Rule 433(e)(1). On the other hand, the SEC treats "historical issuer information that is identified as such and located in a separate section of the issuer's Web site containing historical issuer information" as not a written offer so long as certain other conditions are met. *Id*. at Rule 433(e)(2).

inconsistent with information contained in the filed registration statement or periodic and current Exchange Act filings.[72] Rule 433 requires that certain free writing prospectuses are filed with the SEC.[73] Issuers and offering participants must also retain free writing prospectuses they have used for a period of three years after the initial bona fide offering of the securities that have not already been filed with the SEC under Rule 433.[74]

Second, unlike in the Pre-Filing Period, differences among issuers are less important. All types of issuers may take advantage of free writing prospectuses under Rules 164 and 433, excluding certain ineligible issuers.[75] Additional conditions are, nonetheless, placed on non-reporting and unseasoned issuers. Rule 433 requires that non-reporting and unseasoned issuers must ensure that recipients of a free writing prospectus receive a formal statutory prospectus (a preliminary prospectus in the Waiting Period) either prior to or together with the free writing prospectus.[76] In the case of an IPO issuer, the preliminary prospectus must include a price range.[77] For issuers transmitting an electronic free writing prospectus, the additional statutory prospectus delivery burden is not large. The non-reporting or seasoned issuer only needs to include a hyperlink to the statutory prospectus to meet the prospectus delivery requirement of Rule 433.[78]

Third, despite the expansion in the ability of issuers to disclose information in the Waiting Period, the SEC did not provide for a cooling off period before sales may commence. While the SEC provided for a cooling off

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[72] *See id*. at Rule 433(c)(1). As discussed later, Rule 433 also requires that a free writing prospectus includes a mandatory legend. *See infra* text accompanying note 79.

[73] *See id*. at Rule 433(d)(1). Issuers must file free writing prospectuses in two instances. First, "issuer free writing prospectuses" used by any person must be filed. *Id*. Issuer free writing prospectuses include all information distributed by the issuer, on behalf of the issuer, or used or referred to by the issuer. *Id*. Second, "issuer information" contained in free writing prospectuses prepared by any other person must be filed (but not information prepared based on the issuer information by someone other than the issuer). *Id*. Rule 433(h)(2) defines issuer information as "material information about the issuer or its securities that has been provided by or on behalf of the issuer." *Id*. at Rule 433(h)(2). Special rules apply for free writing prospectuses from media sources containing information provided by the issuer or other offering participant. *Id*. at Rule 433(f). Rule 433 requires other persons to file free writing prospectuses in certain circumstances. Underwriters, among others, must file free writing prospectuses that are distributed in "a manner reasonably designed to lead to its broad unrestricted dissemination" unless previously filed with the SEC. *Id*. at Rule 433(d)(1)(ii). Exceptions exist to the filing requirement. For example, filing is not required where "substantive changes from or additions to a free writing prospectus previously filed with the Commission." *Id*. at Rule 433(d)(3). The SEC also provided a cure provision for certain "immaterial or unintentional" failures to file. *See* Securities Act Rule 164(b), 17 C.F.R. § 230.164 (2005).

[74] *See* Securities Act Rule 433(g), 17 C.F.R. § 230.433 (2005). Rule 164 provides a cure provision for certain "immaterial or unintentional" failures to retain records. *See* Securities Act Rule 164(d), 17 C.F.R. § 230.164 (2005).

[75] *See id.* at Rule 164(e)–(g).

[76] *See* Securities Act Rule 433(b)(2), 17 C.F.R. § 230. 433 (2005).

[77] *Id*. The price range requirement results in a delay in the use of free writing prospectuses in the Waiting Period until the issuer has set the price range for the offering.

[78] *See* Notes to Securities Act Rule 433(b)(2)(i), 17 C.F.R. § 230.433 (2005).

period for information distributed more than 30 days prior to the filing of the registration statement pursuant to Rule 163A, the SEC chose not to provide a similar cooling off period in the Waiting Period. Rules 164 and 433, for example, allow for the continued use of free writing prospectuses right up to and continuing past the effective date of the registration statement when sales may commence.

Lastly, as with WKSIs using Rule 163 in the Pre-Filing Period, the SEC provides for additional mandatory disclosure in the form of a legend for those sending a free writing prospectus under Rules 164 and 433. Issuers using a free writing prospectus under Rules 164 and 433 must include a mandatory legend indicating that a registration statement has been filed with the SEC, recommending that investors read the statutory prospectus, and providing information on where the investor may obtain the statutory prospectus.[79]

3. Post-Effective Period

In the Post-Effective Period, Section 5(a) no longer applies and sales of securities may commence. The public offering rules provide for a lessened degree of information restrictions in the Post-Effective period. Section 5(b) continues to apply after a registration statement goes effective, with no fixed ending date. The securities laws nonetheless indirectly provide an end to the Post-Effective Period through a series of exemptions.

Most participants in the securities markets are exempted from Section 5, and thus the Post-Effective Period requirements, through Section 4(1) of the Securities Act, including the majority of secondary market investors.[80] For those investors selling in transactions not involving an issuer, underwriter, or dealer, there are no Post-Effective Period requirements, aside from antifraud rules, due to the operation of Section 4(1). For those not eligible to use Section 4(1), such as underwriters and dealers, Section 5(b)'s restrictions apply in the Post-Effective Period. The public offering rules, nonetheless, provide for the possibility of "traditional" free writing.[81] Under Section 2(a)(10)(a) of the Securities Act, communications that otherwise would fit the broad definition of a prospectus are deemed excluded from the definition so long as a Section

[79] *See id.* at Rule 433(c)(2). The SEC provided a cure provision for certain "immaterial or unintentional" failures to include the legend. *See* Securities Act Rule 164(c), 17 C.F.R. § 230.164 (2005).

[80] *See* Securities Act of 1933 § 4(1), 15 U.S.C. § 77d (2000). Technically, Section 4(1) excludes transaction involving a securities dealer. However, courts routinely gloss over this exclusion from the use of Section 4(1). *See e.g.*, Ackerberg v. Johnson, Jr., 892 F.2d 1328, 1334 n.4 (8th Cir. 1989) ("While it is true that § 4(1) exempts transactions and not individuals, . . . the mere involvement of a broker, *qua* broker, in a secondary transaction by persons other than an issuer, underwriter or dealer, is insufficient to vitiate the exemption"). Note that Rule 164 limits certain ineligible issuers from using free writing prospectuses. *See* Securities Act Rule 164(e), 17 C.F.R. § 230.164 (2005).

[81] This Article uses the term "traditional" free writing to refer to free writing pursuant to Section 2(a)(10)(a) of the Securities Act as distinguished from free writing prospectuses under Rules 164 and 433.

10(a) statutory prospectus is sent either before or together with the communication.[82]

An important consequence of the traditional free writing exemption is the prospectus delivery requirement. Section 2(a)(10) defines a written confirmation of sales as a prospectus.[83] To the extent no exemption from Section 5 applies, Section 5(b)(1) prohibits the transmission of a written confirmation of sales unless accompanied or preceded by a statutory prospectus. Dealers that transmit a written confirmation of sales may do so only if they, following the traditional free writing requirements, also transmit a statutory prospectus either before or together with the written confirmation of sales.

The prospectus delivery requirement is only limited in duration. Dealers, no longer acting as an underwriter in the offering, may avail themselves of an exemption from Section 5 under Section 4(3) of the Securities Act.[84] Section 4(3)'s exemption applies after a specified time period following the commencement of the public offering, dependent on the type of issuer. In the case of a non-reporting issuer whose securities will be listed on a national securities exchange or NASDAQ, the time period is 25 days.[85] After the 25-day period, dealers may send out a written confirmation of sales and other written documents (including analyst reports on the issuer) without having to also send the final statutory prospectus.

The 2005 Reforms retain the structure of the Post-Effective Period public offering rules. The reforms work through the addition of exemptions from the operation of the rules. First, the reforms expand upon the information issuers and other participants may voluntarily transmit in the Post-Effective Period. In addition to traditional free writing under Section 2(a)(10)(a) of the Securities Act, issuers and other offering participants may communicate through the use of free writing prospectuses pursuant to Rules 164 and 433 in the Post-Effective Period, as in the Waiting Period. Unlike for traditional free writing, WKSIs and seasoned issuers making use of a free writing prospectus do not need to deliver a statutory prospectus together with the communication.[86] Issuers may also continue to engage in factual and forward-looking information disclosure, depending on the type of issuer, under Rules 168 and 169.

Second, the reforms radically alter the prospectus delivery requirement. The prospectus delivery requirement, prior to the reforms, posed a dilemma for issuers, underwriters, and dealers. Issuers and underwriters generally wait until the last possible moment before setting the price for a public offering. But

[82] *See* Securities Act of 1933 § 2, 15 U.S.C. § 77b (2000).

[83] *See id*. at § 2(a)(10).

[84] *See* Securities Act of 1933 § 4(3), 15 U.S.C. § 77d (2000).

[85] *See* Securities Act Rule 174(d)(1) & (2), 17 C.F.R. § 230.174 (2005).

[86] On the other hand, a filing requirement exists for free writing prospectuses. *See* Securities Act Rule 433, 17 C.F.R. § 230.433 (2005). Where filing is not required, Rule 433 imposes a record retention requirement. *See id.* at Rule 433(g). Rule 433 also imposes a legend requirement. *See id.* at Rule 433(c)(2). Traditional free writing under Section 2(a)(10)(a) of the Securities Act does not have filing, record retention, or legend requirements.

printing a complete and new final prospectus takes time. The logistics of sending the printed final prospectus to all the underwriters and dealers across the country are also daunting. For many years, the clearance and settlement period was five days after the trade date. This five-day period gave the issuer and underwriters time to print and distribute the final statutory prospectus to accompany the confirmation sent to purchasers in the offering. In 1993, the SEC promulgated Exchange Act Rule 15c6-1, reducing the standard clearance and settlement time from five to three business days after the trade (referred to as ''T+3'').[87] To address the conflict between printing delays and the T+3 standard, the SEC adopted Rule 434, which allows the use of the preliminary prospectus, combined with supplementing documents (typically a ''term sheet'') as a substitute for the final prospectus. The ability of the issuer and the underwriters to satisfy the prospectus delivery requirements with the preliminary prospectus (already printed for use in the Waiting Period), combined with a term sheet (shorter and quicker to draft and print), allowed issuers and underwriters greater flexibility in meeting the T+3 requirement. Printing the term sheet is substantially easier than printing an entirely new final prospectus.

In the 2005 Reforms, the SEC moved in a dramatic new direction with prospectus delivery. The SEC eliminated Rule 434, doing away with the concept of a disaggregated final statutory prospectus. Instead, the SEC adopted an access-as-delivery approach to the prospectus delivery requirement under Rule 172. If the registration statement has gone effective and a final prospectus is filed with the SEC, among other requirements, Rule 172(a) exempts written confirmations of sales from the reach of Section 5(b)(1).[88] Broker-dealers, as a consequence, no longer need to mail out a final prospectus together with the confirmation of sales.[89] Brokers, nonetheless, must still send the preliminary prospectus at least forty-eight hours prior to the delivery of securities for sale or the transmission of the confirmation of sales for non-reporting issuers.[90]

[87] *See* Exchange Act Rule 15c6-1, 17 C.F.R. § 240.15c6-1 (1996).

[88] Securities Act Rule 172 is fairly lenient on how issuers may meet this filing requirement. Securities Act Rule 172(c) requires that an issuer only make a "a good faith and reasonable effort to file such a prospectus within the time required under Rule 424 . . . and, in the event that the issuer fails to file timely such a prospectus, the issuer files the prospectus as soon as practicable thereafter." Securities Act Rule 172(c), 17 C.F.R. § 230.172 (2005). Various exclusions exist to Securities Act Rule 172. Investment companies and business development companies may not use Securities Act Rule 172. *See id.* at Rule 172(d). The registration statement must not be subject to any pending proceeding or examination under Section 8(d) or 8(e) of the Securities Act. *See id*. at Rule 172(c)(1). The issuer or participating underwriter or dealer may not be subject to a section 8A proceeding. *See id*. at Rule 172(c)(2).

[89] Even if the issuer fails to file the final prospectus, dealers may nonetheless use Securities Act Rule 172's safe harbor. *See id*. at Rule 172(c)(4).

[90] Similarly, if a final prospectus is filed with the SEC, Rule 172(b) deems that the final prospectus delivery requirement for securities transmitted for sale under Section 5(b)(2) are met. *See id*. at Rule 172(b). *See* Exchange Act Rule 15c2-8, Exchange Act, 17 C.F.R. § 240.15c2-8 (1996).

Instead of a statutory prospectus delivery requirement, the SEC created a new notice delivery requirement. Rule 173 requires that for transactions in which the final prospectus delivery requirement applies under Rule 174 and Section 4(3), participating underwriters, brokers, and dealers (or issuer if sold directly by the issuer) must send to each purchasing investor, who purchased directly from the respective underwriter, broker, dealer, or issuer, notice that the sale took place under an effective registration statement or a final prospectus pursuant to an effective registration statement.[91]

The access-as-delivery regime is not universal. Traditional free writing other than the written confirmation of sales is not covered under Rule 172, and still falls under the prospectus delivery requirement (although a seasoned issuer or WKSI may avoid prospectus delivery if it instead complies with the free writing prospectus requirements under Rules 164 and 433). The access-as-delivery regime also applies only in the Post-Effective Period. For situations requiring the transmission of a statutory preliminary prospectus in the Waiting Period (such as non-reporting and unseasoned issuers using a free writing prospectus), no safe harbor from delivery similar to Rule 172 exists.

Third, the SEC did not make distinctions among issuers for the reforms specific to the Post-Effective Period. Outside of the safe harbors in Rules 168 and 169 for factual and forward-looking information that apply throughout the public offering process, and the free writing prospectus provisions under Rules 164 and 433 that extend from the Waiting Period and into the Post-Effective periods, the reforms provide for the same exemptions generally for issuers once in the Post-Effective Period. All issuers, except for certain ineligible issuers,[92] may take advantage of the access-as-delivery regime under Rule 172. Similarly, issuers must comply with the notice requirement under Rule 173.[93]

[91] The notice must be provided not later than two business days following the completion of the sale. *See* Securities Act Rule 173(a), 17 C.F.R. § 230.173 (2005). Purchasers may request a copy of the final prospectus from the person sending out the notice. *See id.* at Rule 173(d). After the effective date of the registration statement, notices mailed under Securities Act Rule 173 are exempt from section 5(b)(1) of the Securities Act (and thus avoid the prospectus delivery requirement). Compliance with Securities Act Rule 173's notice requirement is not a prerequisite for the application of the Securities Act Rule 172 access-as-delivery safe harbor from the prospectus delivery requirement. *See id.* at Rule 173(c).

[92] Offerings by investment companies and business development companies, as well as offerings relating to a business combination transaction or that are registered on Form S-8, are excluded from the Securities Act Rule 172 access-as-delivery system. *See* Securities Act Rule 172(d), 17 C.F.R. § 230.172 (2005). Securities Act Rule 172(c) also delineates certain disqualifying conditions, including where the registration statement is subject to a pending proceeding or examination under Section 8(d) or (e) of the Securities Act. *See id.* at Rule 172(c).

[93] Securities Act Rule 173(f) excludes certain issuers from the notice requirement, including investment companies and business development companies. *See* Securities Act Rule 173(f), 17 C.F.R. § 230.173 (2005).

4. Shelf Registration

In 1983, the SEC adopted Rule 415 providing for shelf registration offerings.[94] Traditionally, the SEC frowned upon public offerings that extended past thirty days from the effective date.[95] Through a shelf registration, issuers could sell securities beyond the thirty-day limit. Shelf registration allows issuers, particularly larger Exchange Act reporting issuers, to avoid the public offering process and the associated costs and delays.

In the 2005 Reforms, the SEC made a number of changes to the shelf registration process. Consider shelf registration offerings of common stock sold in open market transactions. Before the 2005 Reforms, Form S-3 issuers could register such offerings on the shelf pursuant to "Old Rule 415(a)(1)(x)," so long as they had a reasonable belief that the securities would be sold on a continuous or delayed basis within a two-year time period.[96] As well, the issuer needed to make an Item 512(a) undertaking, agreeing to update the registration statement under certain circumstances.[97] Lastly, for "at the market" equity offerings, "Old Rule 415" required that an underwriter handle the offering.[98] For "at the market" equity offerings of voting stocks, "Old Rule 415" imposed maximum offering amount limits.[99]

The 2005 Reforms add the ability for WKSIs and seasoned issuers in a Rule 415(a)(1)(x) offering to commence with immediate shelf takedowns of registered securities, while removing the two-year limitation for such offerings.[100] The 2005 Reforms remove the requirement that "at the market" equity offerings must have an underwriter associated with the offering, as well as the offering amount limitations on at-the-market offerings of voting equity stock. Instead, "at the market" equity offerings simply must take place according to Rule 415(a)(1)(x), requiring, among other things, that the issuer qualify for WKSI or seasoned issuer status.[101] Issuers must still comply with the Item 512(a) undertaking.[102] The 2005 Reforms impose a three year re-

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[94] *See* Shelf Registration, Securities Act Release No. 33-6499, 48 Fed. Reg. 52,889 (final rule Dec. 31, 1983).

[95] *See In re* Shawnee Chiles Syndicate, 10 S.E.C. 109 (1941).

[96] *See* Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 47 Fed. Reg. 11,380 (Mar. 3, 1982) (explaining the provisions of "Old Rule 415").

[97] Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 33-6423, 47 Fed. Reg. 39,799 (Sept. 2, 1982).

[98] *Id*. An "at the market" offerings is defined as "an offering of securities into an existing trading market for outstanding shares of the same class at other than a fixed price on or through the facilities of a national securities exchange or to or through a market maker otherwise than on an exchange." *Id*.

[99] *Id*. (stating that "where voting stock is registered, the amount of securities registered for such purposes must not exceed 10% of the aggregate market value of the registrant's outstanding voting stock held by non-affiliates of the registrant. . . .").

[100] *See* Securities Act Rule 415(a)(1)(x), 17 C.F.R. § 230.415 (2005).

[101] *See id.* Securities Act Rule 415(a)(1)(x) in turn requires that the securities are registered on Form S-3 or F-3 and are to be sold on an "immediate, continuous, or delayed basis." *Id.*

[102] *See id*.

registration requirement on Rule 415(a)(1)(x) offerings.[103] The SEC permits the issuer to transfer any unsold securities and filing fees paid in connection with the unsold securities to the new shelf registration statement filed pursuant to the three-year re-registration requirement.[104]

While the reforms to shelf registration offerings did not change the scope of voluntary disclosure issuers may make, or implement cooling off periods, the reforms altered in several ways the mandatory disclosure regime for issuers and differentiated further among different types of issuers. First, the 2005 Reforms gave issuers more flexibility in how mandatory disclosure items are reported. The shelf registration reforms implemented new guidance on what information issuers may omit from the registration statement under Rule 430B and how updating of the registration statement to include this information and the updating requirements in Item 512(a) affects Section 11 liability.[105] Shelf registration issuers may choose to file a complete prospectus at the time of the original effective date for the offering. However, doing so generally is not in the best interests of issuers. At the very least, price-related information may change over time, including the price of the offering and the discount given to underwriters, among other things. Rule 430B gives issuers the ability to omit certain information from the initial "base" prospectus.[106] A shelf offering under Rule 415(a)(1)(x) may omit "information that is unknown or not reasonably available to the issuer pursuant to Rule 409."[107] Such information may include the price-related information and the specific identities of underwriters in future shelf takedowns.

Second, the 2005 Reforms make distinctions based on the type of issuer in the shelf registration. As discussed above, only WKSIs and seasoned issuers may make use of a Rule 415(a)(1)(x) shelf registration. Under the reforms, the SEC implemented the concept of an "automatic shelf registration statement" for well-known seasoned issuers. An automatic shelf registration statement becomes effective immediately upon filing under Rule 462(e) of the Securities Act. Rule 430B allows a WKSI to omit additional information from the base prospectus, including the amount of securities it intends to offer of a particular class.[108] Moreover, a WKSI may add on additional classes of securities at any time through an amendment to the registration statement that is treated as immediately effective,[109] allowing the WKSI to take advantage of market opportunities to sell particular types of securities immediately.[110] While Rule 415(a)(1)(x) does impose a three-year re-registration requirement, this is

[103] *See id.*
[104] *See id.*
[105] *See* Item 512(a), Prospectus in a Registration Statement after Effective Date, Securities Act Rule 430B, 17 C.F.R. § 230.430B (2005). *See also supra* note 8 (citing summary of the liability changes contained in the 2005 Reforms).
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] *See* Securities Act Rule 462(e), 17 C.F.R. § 230.462 (2005).
[110] *See* Securities Act Rule 413(b), 17 C.F.R. § 230.413 (2005).

primarily for housekeeping purposes (aggregating all prior registration statement amendments into one single document). Pursuant to Rule 462(e), any subsequent automatic registration statement is effective immediately upon filing. WKSIs have the option of paying filing fees on a "pay-as-you-go" basis at the time of each specific takedown of securities for sale from the shelf registration.[111] The SEC's 2005 Reforms allow WKSIs in practice to sell any amount of securities off the shelf without delay after filing the initial shelf registration statement.

In effect, the 2005 Reforms implement a company registration model for WKSIs.[112] With automatic shelf registration, there no longer is any need for WKSIs to deal with restrictions on communications during the public offering process. Because an automatic shelf registration statement is effective immediately upon filing, there is no longer a waiting period. Issuers still face the restrictions of the Pre-Filing Period. However, these restrictions apply in effect only for the initial automatic shelf registration statement.

B. A Behavioral Analysis of the Reforms

The post-reform public offering rules work along a number of dimensions to (1) restrict the disclosure of certain information, (2) impose cooling off periods, (3) require additional mandatory information disclosure, and (4) segment among different issuers. The reforms to the public offering rules are summarized in the following table:

[111] *See* Securities Act Rule 456(b), 17 C.F.R. § 230.456 (2005).

[112] For more on company registration, see sources cited *supra* in note 5.

	(Loosening) Restrictions on Information	**Cooling Off Period**	**Required Information Disclosure and Delivery**	**Segmenting Issuers**
Pre-Filing Period	•*Rules 168, 169* factual and forward-looking information •*Rule 163* WKSI Pre-Filing offers	•*Rule 163A* thirty-day period	•*Rule 163* legend	•*Rules 168 v. 169* factual v. forward-looking information •*Rule 163* WKSI Pre-Filing offers
Waiting Period	•*Rules 168, 169* factual and forward-looking information •*Rule 134* •*Rule 164/433* free writing prospectus	None	•*Rule 433* legend •*Rule 433(b)(2)* prospectus delivery	•*Rules 168 v. 169* factual v. forward-looking information •*Rule 433(b)(1) & (2)*
Post-Effective Period	•*Rules 168, 169* factual and forward-looking information •*Rule 134* •*Rule 164/433* free writing prospectus	None	•*Rule 433* legend •*Rule 433(b)(2)* prospectus delivery •*Rule 172* access equals delivery •*Rule 173* notice	•*Rules 168 v. 169* factual v. forward-looking information •*Rule 433(b)(1) & (2)*
Shelf Registration	None	None	•*Rule 430B* base prospectus	•Automatic shelf registration for WKSIs •*Rule 415(a)(1)(x)* shelf offerings only for seasoned issuers and WKSIs

If we start with an assumption that investors are completely rational, the necessity for the public offering rules becomes unclear. This section explores

the underlying assumptions implicit in the 2005 Reforms on how investors react to information provided during the public offering process.

1. Restrictions on Information

The public offering rules traditionally protected investors through the restriction of information disclosure. The broad definition of an offer under Section 2(a)(3) of the Securities Act, combined with the prohibition on offers in the Pre-Filing Period pursuant to Section 5(c), places a wide range of communications that may raise the interest of investors in an offering under the prohibition of the public offering rules. Similarly, the ban on prospectuses under Section 5(b)(1) that do not meet the requirements of a statutory prospectus given in Section 10 limits that ability of offering participants to make written or broadcast offers in the Waiting Period (and to a lesser extent in the Post-Effective Period).[113]

The SEC's 2005 Reforms retain the general structure of the public offering rules. Rather than do away with the public offering prohibitions, the SEC introduced a number of safe harbors that allow issuers and other offering participants to disseminate a greater variety of information to investors. Rules 168 and 169 allow issuers to disseminate both factual and, in the case of Exchange Act reporting issuers, forward-looking information.[114] While issuers even prior to the reforms could make the argument that factual information did not constitute an "offer,"[115] the reforms provide greater certainty, thereby expanding the ability of risk-adverse issuers (with respect to legal liability) to make factual disclosures. Rules 164 and 433 allow issuers and other offering participants to make use of free writing prospectuses to disseminate offer-related information in the Waiting Period.[116] Well-known seasoned issuers may use Rule 163 to distribute free writing prospectuses and make oral offers in the Pre-Filing Period.[117]

The SEC in the decades leading up to the 2005 Reforms concerned itself with investors that may go into a "speculative" frenzy if presented with information that may highlight the issuer, even if no mention is made of the

[113] Section 2(a)(10)(a)'s traditional free writing safe harbor allows offering participants to disclose a greater range of written information in the Post-Effective Period. *See* Securities Act § 2(a)(10)(a), 15 U.S.C. § 77b(10) (2000).

[114] *See supra* text accompanying notes 39–54 (discussing Securities Act Rule 168 and Securities Act Rule 169).

[115] *See* Guidelines for the Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 33-5180, 36 Fed. Reg. 16,506 (Aug. 21, 1971); Publication of Information Prior to or After Filing and Effective Date of Registration Statement, Securities Act Release No. 33-5009, 34 Fed. Reg. 16,870 (Oct. 7, 1969); Offers and Sales of Securities by Underwriters and Dealers, Securities Act Release No. 33-4697, 29 Fed. Reg. 7317 (June 5, 1964); Publication of Information Prior to or After the Effective Date of a Registration Statement, Release No. 33-3844, 22 Fed. Reg. 8359 (Oct. 8, 1957).

[116] *See* Securities Act Rule 164(a), 17 C.F.R. § 230.164 (2005); Securities Act Rule 433(b)(1), 17 C.F.R. § 230.433 (2005).

[117] *See supra* text accompanying notes 61–63 (discussing Securities Act Rule 163).

offering.[118] The public offering rules "protect" investors from becoming exposed to the wrong types of information before they have the benefit of receiving the formal statutory prospectus. What assumption justifies this approach to investor protection? Investors may make decisions with overconfidence or overoptimism.[119] Male investors in particular may trade excessively in securities.[120] Investors may also engage in framing, determining the worth of investments based on their current holdings (or lack of holdings) of the investments (exhibiting the "endowment effect").[121] Investors may treat recently gained money in the stock market as "house money" and take excessive risks with this newly obtained wealth.[122] In contrast, loss aversion may lead investors to hold on to losing stocks longer than optimal from a tax planning perspective.[123] Investors also suffer from a lack of ability to process large amounts of information. As a result, investors may turn to heuristic rules of thumb.[124] Such rules of thumb may lead investors to make errors. Under the availability heuristic, investors place too much weight on more recent and salient information.[125] The hindsight bias leads investors to place too great ex

[118] *See In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843, 853 (1959) (expressing the SEC's concern with a "speculative frenzy" surrounding a public offering).

[119] *See* Simon Gervais & Terrance Odean, *Learning To Become Overconfident*, 14 REV. FIN. STUD. 1, 2 (2001) ("Overconfidence does not make traders wealthy, but the process of becoming wealthy can make traders overconfident."); MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 37–39 (3d ed. 1994); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806 (1980). *See also* Lynn Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407, 415–18 (2002) (discussing how investors engage in adaptive expectations).

[120] *See* Brad M. Barber & Terrance Odean, *Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment*, 116 Q.J. ECON. 261 (2001).

[121] *See* Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980) (discussing the endowment effect theory); Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990) (providing empirical evidence that the endowment effect is persistent even for people who have the ability to learn). *See also* Jennifer Arlen et al., *Endowment Effects Within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1, 31 (2002) (noting that their results "are largely consistent with the hypothesis that situating subjects in an agency context mutes the endowment effect because the subjects focus on the exchange value of the entitlements for trade").

[122] *See, e.g.*, Jonathan Clements, *The Stock Market Isn't as Bad as You Think: The Right Moves for Tough Times,* WALL ST. J., Sept. 11, 2002, at D1 (noting that "[t]his increased appetite for risk was further bolstered by the 'house money' effect. Like casino gamblers who get lucky early in the evening, investors made so much money that they felt they could take a few extra chances. After all, even if they lost a little, they would still have handsome profits.").

[123] *See* Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. FIN. 1775 (1998) (reporting that despite tax advantages investors were more willing to sell winning positions than losing ones).

[124] Not all heuristics are incorrect. Heuristics may develop and survive over time due to their general tendency to get correct results on average. In specific circumstances, nonetheless, a heuristic may lead people astray.

[125] *See* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1127–28 (1974) (describing the availability heuristic).

ante probabilistic weight on events that actually occur.[126] Investors may also suffer from a confirmation bias, rationalizing prior poor investment decisions as justified, confirming the wisdom of these decisions.[127]

Unfortunately, no unified theory exists for why investors engage in biased behavior.[128] Nor does a precise theory exist for how to address individual behavioral biases. The SEC has not attempted to put forward its own theory. Instead, the regulators at the SEC rely on ad hoc assumptions on what investors require for protection. The restriction of information during the public offering process reflects an implicit assumption that investors, if conditioned by other types of information, may pay too little attention to the formal statutory prospectus and thereby make poor investment decisions. Such other information may lead investors to go into an irrational, speculative frenzy, driving up the price of even poor investment choices.

The 2005 Reforms reflect a change in the SEC's attitude with respect to how investors deal with factual information. The reforms implicitly assume that investors, either directly or indirectly through the operation of the market and securities intermediaries, are able to handle factual and forward-looking information in the case of WKSIs and seasoned issuers. However, the SEC still deems investors in offerings by unseasoned and non-reporting issuers as unable to discount properly forward-looking information and prone to misjudging information to their own detriment (at least in the Pre-Filing Period). The SEC explained simply that:

> [W]e are not proposing a safe harbor for forward-looking information for non-reporting issuers because of the lack of such information or history for these issuers in the marketplace. In those circumstances, we believe that the potential for abuse in permitting a safe harbor for the continued release of forward-looking information as a way to condition the market for the issuer's securities outweighs the legitimate utility to the issuer of

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[126] *See* Baruch Fischhoff, *Hindsight Is Not Equal to Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty,* 1 J. EXPERIMENTAL PSYCHOL: HUM. PERCEPTION & PERFORMANCE 288, 288 (1975) (discussing the hindsight bias and evidence demonstrating the existence of this bias).

[127] *See* Robert Forsythe et al., *Anatomy of an Experimental Political Stock Market*, 82 AM. ECON. REV. 1142 (1992); Charles G. Lord et al., *Biased Assimilation and Attitude Polarization: The Effects of Prior Theories on Subsequently Considered Evidence*, 37 J. PERSONALITY & SOC. PSYCHOL. 2098 (1979). See also Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) ("Once a person voluntarily commits to an idea or course of action, there is a strong motivation to resist evidence that it was ill-chosen.").

[128] *See* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CINN. L. REV. 1023, 1035 (2000) ("To date, behavioral economics has not (and may not ever) develop a single theory that explains or predicts the full range of human behavior, as rational choice theory claims to do. Instead, it offers a pragmatic collection of 'situation-specific mini-theories useful in the analysis of discrete legal problems.'"); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1560−61 (1998) (arguing that supporters of behavioral economics "have no theory, but merely a set of challenges to the theory-builders, who in the relevant instances are rational-choice economists and, I am about to suggest, evolutionary biologists").

the safe harbor.[129]

Nowhere did the SEC, however, detail how it determined the "potential for abuse" and weighed the risks of such abuse against the loss to investors from the lack of forward-looking information disclosures in the case of non-reporting issuers. Particularly for companies without a large (or indeed any) analyst following, such as unseasoned and non-reporting issuers, investors may value forward-looking projections and other disclosures from the issuer. Absent information provided through the issuer, investors may lack other sources of information for smaller issuers. Even worse, investors may turn to chat rooms and Internet message boards to fill the information void for forward-looking information.[130]

In promulgating the 2005 Reforms, the SEC made little mention of the types of investors that invest in initial public offerings or offerings on the part of unseasoned issuers. The types of investors in such markets and how such investors behave are, however, crucial to justifying the SEC's reforms. Suppose most investors of IPOs are sophisticated institutional investors, not an implausible assumption prior to the Internet-driven IPO market at the end of the 1990s. In this case, one could argue that such investors are less likely to go into a speculative frenzy compared with the general pool of investors investing in more seasoned issuers.[131] At the very least, one could make the case that IPO issuers should have the ability to make factual and forward-looking projection disclosures to the more sophisticated investors. Alternatively, suppose a significant fraction of IPO investors are relatively uninformed and unsophisticated, as was arguably the case in the late 1990s. Even here, if such investors are rational, they will realize their lack of ability to assess little known companies and will correspondingly either avoid such offerings or invest through a mutual fund intermediary. No reason exists, under such an assumption, to prohibit disclosure of forward-looking or factual information directed at investors.

Suppose that investors are, in fact, not always rational and instead suffer from some degree of behavioral biases. Investors of such offerings are simply unable to handle factual and forward-looking information. Overconfidence and the availability bias may lead such investors to overweigh the importance of such information. Bounded rationality may limit the ability of investors to look closely at all the mandatory disclosure items once given other factual and

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[129] Securities Offering Reform, Securities Act Release No. 33-8501, 69 Fed. Reg. 67,392, 67,404 (proposed rule Nov. 17, 2004).

[130] See Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV 57 (2006) (noting that investor willingness to look to web sites, chat rooms, and other Internet sources has led to "a dramatic growth in Internet securities fraud.").

[131] *But see* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 641–48 (1996); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L.J. 1397, 1432 (2001) (arguing that "[a]s with most other behavioral foibles, the availability heuristic affects professional investors as well as amateurs, perhaps even more.").

forward-looking information. At least three puzzles arise.[132] First, if investors of unseasoned or non-reporting issuers are unable to handle information, why does the SEC allow such issuers and other offering participants to make disclosures that condition the market broadly through free writing prospectuses in the Waiting Period (a practice forbidden in the Pre-Filing Period)? Disclosing forward-looking information in the Waiting Period is closer in time to the actual purchase decision, leaving little or no period for investors to "cool off." Free writing prospectuses containing forward-looking information pose, arguably, a greater problem to investors that suffer from behavioral biases than forward-looking disclosures in the Pre-Filing Period. Perhaps the SEC assumes that investors are more swayed by information received in the Pre-Filing Period and not in the Waiting Period. Perhaps the SEC believes that the less salient and further back in time information, in fact, is more important for investor decisionmaking. It is unclear, however, what justifies this view of investors.

Second, if investors are unable to handle information disclosure, why would these investors have the ability to comprehend and benefit from mandatory disclosures contained in the registration statement and prospectus? Investors unable to discount properly other information are equally unlikely to place the appropriate weight on the registration statement or prospectus. Investors that suffer from overconfidence or optimism are just as likely, for example, to ignore the mandatory disclosures and legends.

Third, irrational investors may face cognitive problems when dealing with information other than forward-looking disclosures. Irrational investors, for example, may place too great a weight on even historic trends in revenues and costs, believing, for example, that a positive trend in past revenues necessarily means that revenues will continue to rise in the future. But perhaps the SEC assumes that investors are irrational in how they react to other information but react with rational logic when faced with a mandatory disclosure document and historic information. The SEC may have another view of investors. It is hard to know given the lack of any explicit exposition on how the SEC assumes investors behave and how the public offering rules and the 2005 Reforms to the public offering process benefit investors. Indeed, it is possible that the SEC has no one view; instead individual regulators may hold disparate views that aggregate in different ways across newly promulgated regulations over time, leading to inconsistencies in how investors are treated.[133]

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[132] One can also wonder what makes such behaviorally challenged investors in an offering involving a WKSI or seasoned issuer immune from speculative frenzies? One response is that the stock of such companies trade in liquid secondary markets and the unsophisticated investors may look to the market price. An efficient market, however, may not necessarily protect all unsophisticated investors in the market. *See infra* text accompanying notes 156−166 (citing the example of mini-tender offers as an illustration of where unsophisticated investors may not look to the secondary market price in making investment decisions).

[133] The phenomenon of groupthink, see *infra* text accompanying notes 181−182, may temper how disparate the views held by individual regulators become.

2. Cooling Off Period

A cooling off period may help reduce the influence of behavioral biases.[134] Investors arguably suffer from an availability bias, placing too much weight on recently obtained and more salient information.[135] Placing a delay before such investors purchase securities may reduce the influence of the availability bias, leading investors to place a more appropriate weight on public offering materials. Investors that otherwise may act with overconfidence or over-optimism may rethink their decisions during a cooling off period, leading to better investment decisionmaking. As fewer investors are under the influence of the availability bias or act with overconfidence or over-optimism, the market as a whole may benefit. Other investors that rely on the market's sense of the latest "hot issue" as a (flawed) heuristic to determine what issues to purchase are therefore less likely to purchase into the offering solely due to speculation in the market.

But exactly what cooling off period is required? The SEC in the 2005 Reforms makes the assumption that communications prior to a certain time period (the 30-day period prior to the filing of the registration statement) pose insufficient risk of driving investors into a speculative frenzy or otherwise conditioning the market to warrant regulation.[136] Presumably, the SEC assumes that a 30-day cooling off period allows individual investors time to rethink the value of disclosed information and to open themselves up to the possibility of more negative information contained in the statutory prospectus. To the extent a feedback dynamic exists in the market, where investors become interested in a company because other investors are already interested, a 30-day period helps to break the feedback loop before sales may commence.

Puzzles exist with how the reforms implement the cooling off period in Rule 163A during the Pre-Filing Period. First, if 30 days really is enough time for the market to cool down after the dissemination of information, then why are issuers restricted under Rule 163A from engaging in disclosures that explicitly reference the offering? Investors would have the same 30-day cooling off period for such offering-related disclosures. The SEC implicitly assumes that information that explicitly references the offer has a longer lasting impact on the capital markets. The assumption, however, is not supported with any evidence.

The SEC also provides no support for the contention that 30 days is the proper period of time to allow for cooling off. Perhaps 60 or 100 days is the proper time period. Moreover, the 30-day period is not measured from the time that sales may commence to investors. Instead, the 30-day cooling off period under Rule 163A is measured backward in time from the *filing* of the

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[134] The entire Waiting Period was originally viewed as a cooling down period of sorts. *See, e.g.*, Clark Byse & Raymond J. Bradley, *Proposals to Amend the Registration and Prospectus Delivery Requirements of the Securities Act of 1933*, 96 U. PA. L. REV. 609, 614 (1947) ("As understood by the draftsmen of the Act, the purpose of the twenty-day 'waiting' or 'cooling' period was to arrest the high pressure distribution practices then in vogue.").

[135] *See supra* note 124 and accompanying text.

[136] *See supra* note 57.

registration statement, leaving a period potentially much greater than 30 days before sales start in the public offering once the Waiting Period is also taken into account. The period is also variable, depending on the length of the waiting period. No matter what assumptions one has of the inability of investors to handle information, why should the cooling off period be variable in length before sales may commence? If one were to vary the length of the cooling off period, why not vary it based on the type of company? In other parts of the 2005 Reforms, the SEC chose to distinguish among issuers. Only WKSIs enjoy the ability to utilize an automatic shelf registration statement.[137] Rule 163A, however, makes no distinctions among companies (aside from certain ineligible issuers) in applying the 30-day cooling off period.

The cooling off period in Rule 163A is also not consistent with other cooling off periods found in the securities laws. The SEC provides a 20-day cooling off period for non-Exchange Act reporting issuers in a Regulation A mini-public offering (limited to $5 million or less in offering amount among other restrictions).[138] Regulation A allow issuers to use a wide variety of written offering materials to "test the waters" during the period prior to the filing of an offering statement (the rough corollary to the registration statement in a registered public offering).[139] However, the issuer must cease all "test the waters" activities 20 days prior to when sales commence (not, as in the registered public offering process under Rule 163A, from when the registration statement is filed with the SEC).

Perhaps investors who purchase Regulation A securities are different from those that purchase in a public offering and require a fixed 20-day cooling off period compared with the variable, at-least 30-day cooling off period under Rule 163A for disclosures in the Pre-Filing Period of a public offering. Perhaps the larger size of a public offering justifies a longer and more variable cooling off period. And perhaps not. The SEC provides no rationale and no assumptions about investor behavior in simply putting in place a new cooling off period under Rule 163A. We are left only with the implicit and vague notion that investors would benefit from a 30-day cooling off period prior to the filing of the registration statement.

Even if we accept this notion, why then is there no cooling off period during the Waiting Period after the use of free writing prospectuses? If cooling off periods work to protect investors for information disclosed under Rule 163A in the Pre-Filing Period, then investors presumably would also benefit from a cooling off period after the use of free writing prospectuses in the Waiting Period. Perhaps the SEC assumes that investors do not need a cooling

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[137] *See supra* text accompanying notes 109–11.

[138] Regulation A provides an exemption from Section 5 of the Securities Act. Issuers qualifying for a Regulation A offering may sell securities that are freely transferable immediately after the offering. For a description of Regulation A, see Choi & Pritchard, *supra* note 9, at 586–99.

[139] *See* Securities Act Rule 254, 17 C.F.R. § 230.254 (2005). The SEC in the past proposed (but ultimately did not act) to extend test the waters to registered public offerings. *See* Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 33-7188, 60 Fed. Reg. 35,648, (July 10, 1995) (proposing Rule 135d).

off period once in the Waiting Period and only act irrationally in the Pre-Filing Period.

3. Mandatory Information Disclosure and Delivery

One possible method of correcting for behavioral biases is to provide corrective or cautionary information to investors. If investors view sales materials too optimistically, then providing the investors more sober materials on the issuer's business, properties, and financial health may, in theory, help overcome their overoptimism. Additional information may serve to educate investors about the potential pitfalls they face in investing in public offerings or, alternatively, caution the investors to take extra care in their investment decisions.[140] If investors are capable of learning, then mandatory disclosure and legends may work to educate investors, reducing their behavioral biases.

The 2005 Reforms retain the focus of the public offering rules on the creation of the registration statement and statutory prospectus.[141] The reforms, nonetheless, dramatically alter the distribution of the statutory prospectus. In the Waiting Period, issuers that enjoy the ability to transmit free writing prospectuses have less incentive to distribute the preliminary prospectus. Rather than use a preliminary prospectus to raise awareness among a broad range of investors about an offering, issuers may simply mail out their own customized free writing prospectus.[142] While Rule 433 imposes a prospectus delivery requirement, the requirement does not apply to seasoned and well-known seasoned issuers.[143] Moreover, unseasoned and non-reporting issuers may satisfy the prospectus delivery requirement for electronic free writing prospectuses with the inclusion of an electronic hyperlink to the statutory prospectus.

During the Post-Effective Period, the 2005 Reforms largely do away with the prospectus delivery requirement associated with the transmission of the confirmation of sales for all types of issuers pursuant to Rule 172.[144] Brokers selling the offered securities of a non-reporting issuer (e.g., an IPO issuer) must

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[140] On the other hand, it is unclear whether the SEC would in fact implement an effective educational system. *See, e.g.*, Choi & Pritchard, *supra* note 21, at 66 ("We have little confidence that the SEC will soon see the light and begin to discourage small investors from picking their own stocks, thereby incurring the wrath (and lobbying clout) of the investment industry. A more likely scenario is educational interventions to promote 'more rational' active investing.").

[141] The reforms do implement some informational changes, including incorporation-by-reference for certain Form S-1 issuers and the inclusion of a risk factors section in the annual Form 10-K filing. *See supra* notes 6–7.

[142] Issuers, of course, may still mail out the preliminary prospectus as a voluntary matter to satisfy the demand of investors for such information. *Cf.* Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 BUS. LAW. 653, 685−86 (2001) (reporting that the quality of disclosures are generally higher than legally required in European private placements due to market requirements for this higher level of disclosure). If issuers voluntarily disclose a high level of disclosure, however, then it is unclear what is the need for mandatory disclosure.

[143] *See* Securities Act Rule 433, 17 C.F.R. § 230.433 (2005).

[144] *See supra* text accompanying notes 88–89 (discussing Rule 172).

still ensure delivery of the preliminary prospectus at least 48 hours prior to the delivery of the confirmation of sales.[145] For other forms of traditional free writing under Section 2(a)(10)(a), the reforms left the prospectus delivery requirement intact, although WKSIs and seasoned issuers and other offering participants may simply utilize the free writing prospectus provisions of Rules 164 and 433 to avoid the prospectus delivery requirement.

For investors that are completely rational and are aware of the presence of a mandatory disclosure document, it is unclear what benefit exists with delivering the statutory prospectus. Such investors presumably will make the low-cost expenditure of downloading the prospectus directly from the SEC's website. Even if obtaining the statutory prospectus is not low cost, rational investors will discount their willingness to pay for the security given the heightened risk associated with investing without the benefit of the statutory prospectus. Issuers may then respond with the voluntary distribution of the prospectus to avoid this discount.

The SEC, however, did not completely do away with the prospectus delivery requirement in the 2005 reforms. Prospectus delivery is still required in the Waiting Period for unseasoned and non-reporting issuers making use of free-writing prospectuses.[146] In addition, traditional free writing in the Post-Effective Period still requires the delivery of a final statutory prospectus.[147] What justifies retaining a prospectus delivery requirement in such circumstances?

To assess the justification for retaining some prospectus delivery requirement, it is important to assess who are the investors participating in the offerings by unseasoned and non-reporting issuers. If investors purchasing securities in offerings by unseasoned and non-reporting issuers are (a) unable to make an informed investment decision without the information contained in a statutory prospectus, (b) will read the statutory prospectus if given to them, *and* (c) will not otherwise penalize issuers that fail to ensure adequate dissemination of the information in the statutory prospectus, then imposing a prospectus delivery requirement is justified. What investors fit these criteria?

Consider institutional investors. Institutional investors should have no difficulty in locating SEC filing documents on the Internet and assessing the information contained in such documents. While some have made the argument that even institutional investors suffer from behavioral biases,[148] the market treats those institutions that do not achieve superior returns harshly. This market discipline is likely to set an upper bound on the amount of biases among

[145] *See* Securities Act Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (2005).

[146] *Id*. In addition, Rule 15c2-8(d) requires brokers to provide a final statutory prospectus to all those who make a written request. *See id.*

[147] Securities Act of 1933 § 2(a)(10)(a), 15 U.S.C. 77b (2000).

[148] *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

institutions.[149] On the other hand, consider individual investors without significant investing experience (or indeed, with some degree of experience that may lead to overconfidence). The danger of these individual investors being led astray during an offering is quite significant. Even for such investors, it is unclear what benefit providing a mandatory disclosure document such as the statutory prospectus will provide. The lack of expertise on the part of such investors is likely to reduce the benefit from receiving the prospectus; indeed, most individual investors are likely not to read the prospectus even if delivered to them. For investors that never read the prospectus, the presence of institutional investors that do read the prospectus may provide some degree of protection. Where a company's securities trade in a liquid capital market, the information contained in a publicly-available prospectus will become incorporated in the secondary market price.[150] WKSIs and seasoned issuers must take into account this price when setting the offering price. Even if no liquid market exists, the issuers and underwriters must set the offering price to attract sufficient numbers of institutional investors to sell out the offering.

Regardless of what types of investors would benefit from a mandatory delivery requirement, why is this requirement imposed only in certain areas and not others? The SEC implicitly assumes that investors in the Post-Effective Period will benefit from the delivery of the formal prospectus together with traditional free writing and that investors in unseasoned and non-reporting issuers will benefit from the delivery for the statutory prospectus together with free writing prospectuses (both in the Waiting Period and Post-Effective Period). The SEC, however, provides no justification for why investors benefit from the delivery of the statutory prospectus *only* in these circumstances.[151]

The second form of additional information investors receive consists of a boilerplate legend, required as part of specified communications. The legends generally work to caution investors not to place too great weight on the information and to look for the mandatory information documents. Rational investors, however, should already understand the risks involved in investing and discount the stocks they purchase accordingly. Extra cautionary statements that provide no new information (other than the caution) will not improve the ability of rational investors to make decisions. But perhaps the SEC has in mind more irrational investors. However, it is uncertain whether an irrational

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[149] On the other hand, Langevoort makes that argument that certain biases—including overoptimism for example—may help bolster organizational morale and thus survive even in the face of competitive pressures. *See id.* at 155. *But see* Choi and Pritchard, *supra* note 21, at 20 ("[W]hile some amount of biases may be beneficial for institutions and therefore resistant to competitive pressures (such as overoptimism), such biases will have limited impact on investor welfare. Institutional-based biases that have large negative impacts on investors will impair profitability, making those institutions vulnerable to competition from other institutions.").

[150] *See supra* note 58 (citing sources on the efficient capital markets hypothesis).

[151] One could perhaps argue that the real goal is the distribution—even if somewhat random—of the statutory prospectus broadly to the market. However, the availability of the statutory prospectus at the SEC's website undermines this distribution argument. In adopting Rule 172, doing away with much of the prior physical delivery of the prospectus, the SEC also seems to reject general distribution as a goal of the prospectus delivery requirement.

investor, plagued with overconfidence and overoptimism and focusing on the more salient information that others are making large profits in the latest hot IPO market, really will pause to consider the cautionary language contained in a legend. Indeed, it is unclear if any investor ever pauses to read a boilerplate legend. The assertion in the prior sentence is of course ad hoc.[152] What is troublesome, however, is that the SEC likely bases its decisionmaking on whether to employ mandatory legends on a similar ad hoc analysis. Regulation A, for example, requires issuers to provide a boilerplate on the cover page of the offering circular indicating the exempt status of the offering from Section 5 in "capital letters printed in boldfaced type."[153] How does the SEC know that placing a boilerplate in all capital letters and in boldface will appreciably increase the readership of boilerplate legends?

4. Type of Issuer

The 2005 Reforms make extensive distinctions based on the type of issuer engaged in a public offering, particularly in the Pre-Filing Period. Well-known seasoned issuers enjoy great freedom to disclose information during the public offering process. WKSIs may also register for an essentially indefinite shelf registration period for all practical purposes.[154] IPO issuers, on the other hand, do not enjoy the same leeway to utilize the shelf registration process. Within the public offering rules, IPO issuers face a number of additional restrictions, including a prohibition on forward-looking disclosures during the Pre-Filing Period.[155] Even in the Waiting and Post-Effective Periods, IPO issuers must couple disclosures on free writing prospectuses with the delivery of a statutory prospectus.[156]

The type of issuer serves as only an imperfect proxy for the needs of investors that invest in particular issuers. Larger, well-known issuers are followed by a number of analysts and the securities of such issuers trade in liquid secondary markets. Even unsophisticated investors in well-known seasoned issuers may, at least in theory, look to the market price to incorporate publicly available information.[157] The presence of a market price limits the ability of issuers and others to take advantage of the more unsophisticated investors.

The market price, however, is not perfect protection for unsophisticated investors purchasing the securities of even well-known seasoned issuers. First, the market price may not accurately reflect all publicly available information. Noise traders, for example, may cause the market price to deviate from the

[152] The observation is based on a sample size of one: the author's own experience with his own investment decisions.

[153] *See* Securities Act Rule 253(d), 17 C.F.R § 230.253 (2005).

[154] *See supra* text accompanying notes 108–12 (discussing the new shelf registration regime for WKSIs).

[155] *See supra* Part II.A.1 (discussing the Pre-Filing Period regime).

[156] The availability of electronic delivery under Rule 433(b)(2) for electronic free writing prospectuses reduces the burden of the delivery requirement. *See* Securities Act Rule 433, 17 C.F.R § 230.433 (2005).

[157] *See supra* note 59 (discussing the efficient capital markets hypothesis).

fundamental value of a company.[158] Instead of arbitraging away such pricing anomalies, more sophisticated investors may choose to ride along with "bubble" type movements away from fundamentals in the hopes of cashing out at a profit before the market corrects itself.[159] Evidence exists that during the late 1990s, the secondary market price for many publicly traded companies displayed large pricing anomalies. Companies, for example, that added a "dot com" to the end of their name without any change in the business plan or financials suddenly experienced significant upswings in their market price.[160]

Second, behaviorally challenged investors may not refer to the secondary market price in making decisions about an offering. In a mini-tender offer, the bidder offers to purchase less than 5% of an issuer's outstanding common stock. Section 14(d) of the Exchange Act does not apply to bidders for less than 5% of a company's outstanding equity securities.[161] As a result, bidders in a mini-tender offer face the far less burdensome rules under Section 14(e) of the Exchange Act.[162] In the 1990s, many mini-tender offers took place at *less* than the secondary market price. Successful bidders in such an offering profited by reselling the shares into the secondary market at the prevailing price. Investors in a mini-tender offer sell at a loss despite the ready presence of information on the secondary market price.[163]

Unseasoned and non-reporting issuers (e.g., an IPO issuer) do not offer the same level of market protection for investors. This does not, however, lead to the conclusion that the investors of such issuers are in need of greater securities market protections. Institutional investors of unseasoned and non-reporting issuers are likely able to fend for themselves.[164] And even individual investors

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[158] *See* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853−54 (1992) (noting that some economists, concerned with an apparent inability to validate the efficiency model, have responded with alternative hypotheses such as "noise" pricing influences); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 648−50 (1995) (reporting skepticism on the part of financial economists on the validity of the efficient market hypothesis); J. Bradford De Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703, 713, 717 (1990).

[159] *See* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 154, 155-6 (2000).

[160] *See* Michael J. Cooper et al., *A Rose.com by Any Other Name*, 56 J. FIN. 2371 (2001).

[161] *See* Securities Exchange Act of 1934 § 14, 14(d), 15 U.S.C. § 78n (2000).

[162] *See id*. at § 14(e).

[163] *See* Commission Guidance on Mini–Tender Offers and Limited Partnership Tender Offers, Exchange Release No. 34–43069, 65 Fed. Reg. 46,581 (effective July 31, 2000) ("The offering documents in mini-tender offers frequently are very brief and contain very little information. Often, these mini-tender offers are made at a price below the current market price. However, frequently there is no disclosure of this fact in the offering documents or in any disclosure that the security holders ultimately receive. This lack of disclosure can mislead security holders because most tender offers, especially third-party offers, historically have been made at prices that are at a premium to the current market price.").

[164] *But see* Langevoort, *supra* note 148 (discussing the biases that may plague organizations).

that act rationally—and have access to the advice of securities market professionals—may not need greater protections when investing in the securities of an unseasoned or non-reporting issuer. Of course, maybe most investors of unseasoned and non-reporting issuers are, in fact, extremely behaviorally challenged and refuse to listen to the advice of securities professionals. Without any explicit attention to developing such information, how does the SEC know?

The SEC, moreover, has not treated small, less well-followed issuers consistently in the securities laws. Small business issuers obtain special advantages in selling securities to the public in other areas. In the context of public offerings, small business issuers may make use of Forms SB-1 and SB-2 to sell securities with reduced disclosure compared with Form S-1.[165] A small business issuer making use of Form SB-2, for example, needs only to provide two fiscal years' worth of audited income statements and an audited balance sheet for the past year. In contrast, Form S-1 requires three fiscal years of audited financial statements.[166] A non-Exchange Act reporting issuer may also take advantage of Regulation A to engage in a mini-public offering. While the total amount of the offering is limited to $5 million or less, issuers in a Regulation A offering may engage in "test the waters."[167] Under "test the waters," an issuer may send out offering related materials during the Pre-Filing Period of a Regulation A offering so long as a 20-day cool down period before sales commence is observed.[168]

One can wonder why the SEC focuses so much attention on issuers if issuers serve as only an imperfect proxy for the types of investors. While tracking secondary market sales in a public market would be difficult if not impossible, determining the mix of initial purchasers is far less burdensome. The SEC should provide a detailed accounting of how the types of investors correlate with the types of issuers in their categorization scheme. In the promulgating release for the 2005 Reforms, the SEC gives some information on the breakdown of investors in well-known seasoned issuers as developed within the SEC's Office of Economic Analysis. The SEC relates that: "Issuers with market capitalization in excess of $700 million that conducted offerings from 1997 to 2004 typically had an average of 12 analysts."[169] Moreover, the SEC reported that: "Institutional investors accounted for an average of 52% of

[165] *See* Form SB-1, SEC Securities Act, Fed. Sec. L. Rep. (CCH) ¶ 7312, at 6501 (Nov. 2, 2001); Form SB-2, SEC Securities Act, Fed. Sec. L. Rep. (CCH) ¶ 7313, at 6507 (Nov. 2, 2001).

[166] *See id*.

[167] *See* Securities Act Rule 254, 17 C.F.R. § 230.254 (2005).

[168] In contrast, the safe harbor under Rule 163A, providing for a 30-day cooling off period prior to the filing of the registration statement, does not apply for any disclosure that refers to the offering. *See* Securities Act Rule 164, 17 C.F.R. § 230.164 (2005).

[169] *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722 (Aug. 3, 2005). The SEC also reported that: "Issuers with a market capitalization of between $75 million and $200 million, in most cases, have between zero to five analysts following them, with approximately 50% having zero to two analysts following them." *Id*. at 44,728.

equity ownership prior to offerings by issuers with market capitalization above $700 million."[170] However, what is not discussed are the identities and, most importantly, assumed capabilities and rationality of investors in unseasoned and non-reporting issuers.

III. THE CHOI-PRITCHARD CRITIQUE

What should the SEC do about behavioral biases among investors? The SEC's 2005 Reforms directly implicate many of the protections in the securities laws for investors that may suffer from a number of biases contained in the public offering rules. The reforms, on the one hand, take into account the ability of investors to handle certain types of information and with sufficient delay before an investment decision and the presence of analysts and other securities market intermediaries that work to protect investors for issuers that trade in liquid secondary markets. The SEC, however, may not have accurately assessed how investors will behave under the reforms.[171] Unsophisticated investors may need more time to "cool off" after receiving selling materials before making a purchase. Investors of even seasoned or well-known seasoned issuers may, in fact, lack the ability to handle forward-looking information. While more disclosure into the market may help some investors, the increased information may simply cause others to fall further into the traps of overconfidence and overoptimism.

While the SEC has not made any systematic assertions about its assumption on investor behavior, the SEC implicitly makes assumptions about how investors behave, as demonstrated in the development of the public offering rules and most recently in the 2005 Reforms. An important question to ask before the SEC starts to take into account the various investor behavioral pitfalls that may affect investors is whether the SEC is in a good position to address these problems. The SEC faces its own set of deficiencies in developing regulatory policy.[172] Consider the following non-exhaustive list of behavioral biases that may affect SEC regulators:

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[170] *See id.*

[171] Commentators have made the argument that taking into account behavioral biases among investors will lead to a better understanding of the financial markets. *See* Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 153 (2003) ("Behavioral finance can be invoked as a counterweight, to demonstrate the costs and risks of [deregulatory] proposals under an arguably more realistic view of how markets behave."). The real question, though, is whether the SEC itself can effectively undertake such an analysis.

[172] *See* Jennifer Arlen, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1769 (1998) ("Proposals designed to address biases generally entail the intervention of judges, legislators, or bureaucrats who are also subject to various biases. The very power of the behavioralist critique—that even educated people exhibit certain biases—thus undercuts efforts to redress such biases."); Bainbridge, *supra* note 128, at 1057−58 ("[L]egislators and regulators are no less subject to bounded rationality and other cognitive biases than any other decisionmakers."); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1519 (1998) ("Less attention has been devoted to whether courts or regulators

Bounded Search and Bounded Rationality. The SEC's typical response to any new regulatory crisis is predictable: more mandatory disclosure. One reason for this response is the difficulty and cost involved in searching out new alternatives. Regulators, like other people, become accustomed to certain frameworks in dealing with problems. The phenomenon of bounded search may therefore lead the SEC to ignore potential fruitful methods of regulation. Disclosure may not, however, serve the best interests of behaviorally challenged investors. Consider investors that suffer from bounded rationality. Added disclosure may exacerbate the decisionmaking problems such investors face.[173]

Faced with myriad sources of information on the financial markets, the SEC has difficulty in processing all the information, displaying bounded rationality. Most regulatory actions by the SEC, with the notable exception of the 2005 Reforms, are reactive. Only after a scandal arises does the SEC (Congress) typically move forward with new, comprehensive sets of regulations.[174]

Availability and Hindsight Biases. To manage the tremendous amount of information the SEC receives on the financial markets, regulators make use of rules-of-thumb.[175] These rules-of-thumb display at least two types of behavioral biases. First, regulators suffer from the availability bias, placing too much weight on more recent and salient information.[176] While everyone knew of the possibility of corporate fraud, the occurrence of Enron (together with WorldCom, Tyco, Adelphia, and others) put the possibility starkly in front of regulators. The potential for overreaction is greater given the availability bias.

The closely related hindsight bias posits that regulators (and others) may place too much weight on events that actually happen.[177] Thus, for any one company the probability of fraud may in fact be only 0.01%. After observing fraud, regulators affected by the hindsight bias may come to believe that the chance for fraud in fact was significantly higher than 0.01%, again leading to an overreaction in the regulatory response.

are likely to be biased along the lines suggested in the behavioral literature, perhaps because bureaucratic activity seems more organizational than individual.").

[173] *See* Choi & Pritchard, *supra* note 21, at 47. As well, overconfident investors may simply ignore increased disclosure.

[174] *See* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 850 (1997) (contending that the major legislative moves to enact new securities regulation over the past 300 years followed large and sustained price collapses in the stock market).

[175] Choi and Pritchard provide the example of accounting fraud. They note that while accounting fraud has increased, the SEC pays too much attention to this salient fact and fails to focus on the fact that accounting fraud as a percentage of all accounting filings remains miniscule. *See* Choi & Pritchard, *supra* note 21, at 25 n.122.

[176] *See* Tversky & Kahneman, *supra* note 125 and accompanying text.

[177] *See* Fischhoff *supra* note 126 and accompanying text.

Overconfidence. Experts in many areas suffer from potential overoptimism and overconfidence in their own abilities.[178] Regulators at the SEC may suffer from the same overconfidence. The turf wars the SEC has fought with the Commodity Futures Trading Commission (CFTC) over the years were driven in part by the SEC's belief that they were the better regulating entity.[179] Overconfidence may also explain the SEC's know-it-when-I-see-it reliance on "investor confidence" in justifying its regulatory changes.[180]

Confirmation Bias. Under the confirmation bias, people tend to invent ex post justifications for actions they have taken in the past, even if they would not justify the actions if starting from a clean slate.[181] The confirmation bias leads to a bias for remaining with the status quo. Even where regulatory changes do occur, they may occur more gradually or incrementally than warranted due to the confirmation bias.

Groupthink. The SEC as a regulatory agency is comprised of a number of individuals. Each individual, nonetheless, rather than operating independently, cooperates with one another to accomplish the SEC's mission of investor protection. When individuals in a group work toward a particular goal, they may come under the influence of groupthink. Under groupthink, individuals may think less about the actions of the group, instead adopting the goals and methods of the group uncritically.[182]

These deficiencies within the SEC may lead to regulatory error. The SEC (and Congress), for example, may overreact when faced with a prominent and public financial scandal.[183] In another article, Adam Pritchard and I start with the array of behavioral biases that may affect the SEC and make the recommendation that the SEC should act cautiously before promulgating new regulatory measures aimed at correcting behavioral biases among investors.[184] One difficulty in assessing how the various behavioral biases interact with one another is a lack of any underlying theory for why such biases exist among people, including regulators.[185] Without such an overarching theory, predictions become difficult.

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[178] *See* Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411, 412 (1992) (noting that experts are "often wrong but rarely in doubt.").

[179] *See* Choi & Pritchard, *supra* note 21, at 29.

[180] *See supra* note 22 (citing examples of the SEC's invocation of "investor confidence" to support its regulatory changes).

[181] *See supra* note 127 and accompanying text.

[182] *See* IRVING L. JANIS, VICTIMS OF GROUPTHINK (1972); *see also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 99–108 (applying analysis to decisions by corporate boards); Robert J. Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1, 37–49 (1981).

[183] *See, e.g.*, A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1078–83 (2005) (noting that the availability heuristic may lead regulators to overreact when faced with a scandal).

[184] *See* Choi & Pritchard, *supra* note 21.

[185] *See supra* note 128 (citing sources on the point that a unifying theory of behavioral economics is lacking).

The impact of the behavioral biases affecting the SEC may be particularly acute when the SEC attempts to correct behavioral biases of investors. Precisely because so little is known about why investors have particular biases (that may lead to overtrading, holding on to loss stock longer than optimal, etc.), the chance of individual regulators at the SEC falling into a behavioral trap in designing solutions for investor biases is high. In comparison, when the SEC designs regulations aimed at a non-behavioral problem in the market, the impact (and thus desirability) of such regulations are both easier to predict beforehand and to observe after implementation.

Consider, for example, the SEC's move to address the problem of high bid-ask spreads in the over-the-counter market in the early 2000s.[186] One could predict, ex ante, with some degree of confidence that converting to decimal pricing would result in greater competitive pressure reducing the bid-ask spread for stocks.[187] While not without controversy, economic theory allows such a prediction. A greater ability to cut price will lead market actors in competition to engage in such price-cutting; conversely, a reduced ability to cut prices will lead to artificially elevated prices even in a competitive environment. After implementation of decimal pricing, one could reject this theory if prices did not drop. Post reform, observers reported that prices did in fact drop significantly.[188] Economic theory, of course, is not infallible. Such theory is, however, better developed and more subject to verifiability than the panoply of behavioral biases that may affect investors.

Compare the example of decimal pricing with the decision in the 2005 Reforms not to include forward-looking projections in the Rule 169 safe harbor as applied to IPO issuers. It is hard to know exactly how such a prohibition will benefit investors due to the lack of a general theory of what causes behavioral biases and the reluctance of the SEC to specify the assumptions it makes on investor behavior. The lack of a theory makes it impossible to test whether in fact a rule change to accommodate behavioral biases in fact is effective. Suppose, for example, that individual investors continue to invest in underperforming IPOs after the implementation of Rule 169. Is this because investors are in fact rational and make poor decisions due to the lack of forward-looking information, so that we can reject the initial behavioral

[186] *See* Order Directing the Exchanges and the National Association of Securities Dealers, Inc. to Submit a Phase-in Plan to Implement Decimal Pricing in Equity Securities and Options, Exchange Act Release No. 34-42914, 65 Fed. Reg. 38,010 (June 19, 2000) (ordering the move to decimal pricing).

[187] *See, e.g.*, John C. Coffee Jr., *Brokers and Bribery*, N.Y.L.J., Sept. 27, 1990, at 31 ("Such a system fosters open and visible competition and, coupled with the duty of best execution, would predictably narrow the bid and asked price spread"); John F. Olsen & Daniel W. Nelson, *Factors a Company Should Consider in Selecting a Market in Which to Trade its Publicly Held Securities*, SG022 ALI-ABA 251, 256 (2001) ("The change from fractions to decimals was intended to benefit investors by making prices easier to understand, reducing bid-ask prices.").

[188] See Scott Gibson, et al., *The Effect of Decimalization on the Components of the Bid-Ask Spread*, 12 J. FIN. INTERMED. 121 (2003) (providing evidence that greater minimum tick sizes in pricing allowed market makers to obtain excess rents in the form of greater bid-ask spreads).

assumptions made about investors? Or is it because investors are even more behaviorally challenged than first thought and will invest unwisely in IPOs due to the greater factual disclosures allowable under Rule 169? The amorphous nature of behavioral biases and the lack of any specification of initial assumptions on the part of the SEC makes it possible to explain almost any outcome as supporting the view that investors are behaviorally challenged.

The lack of objective measures to determine the presence and extent of behavioral biases in investors as well as the effectiveness of regulations in addressing these biases gives SEC regulators great leeway to generate ad hoc justifications for their regulations. Regulators at the SEC may simply claim that "investor confidence" requires their regulations without much analysis.[189] Without an objective yardstick, the SEC will face little criticism for its assertions. As well, SEC regulators faced with little feedback on the correctness of their views may reinforce cognitive illusions under which the regulators themselves may labor. Groupthink may flourish in the absence of objective feedback on the usefulness of regulations designed to address behavioral biases.

IV. CLARITY IN BEHAVIORAL ASSUMPTIONS

The SEC rarely investigates the empirical assumptions made in its regulations of investor behavior.[190] In justifying special treatment for well-known seasoned issuers, the SEC provided some market statistics on what percentage of issuers that would qualify as well-known seasoned issuers are followed by analysts.[191] However, simply listing membership in a particular category falls short of assessing the impact of regulation on investors who buy and sell securities of such issuers. Indeed, in most other areas of regulation, the SEC adopts and modifies regulations under the mantra that "investor confidence" requires such changes.[192] But how exactly does the SEC know exactly what determines investor confidence? Simple assertions aside, where is the evidence?

One way to deal with the possibility of regulatory error when it comes to protecting investors and ensuring investor confidence is simply to revisit any regulatory change after a certain period of time. The SEC may simply make incremental changes and hope for the best, correcting mistakes after the fact,

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[189] *See supra* note 22.

[190] In justifying the 2005 Reforms, the SEC puts forward a regulatory cost-benefit analysis section in its promulgating release. *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,790 (Aug. 3, 2005). The cost-benefit analysis undertaken by the SEC, however, makes no mention of the assumptions the SEC employs about how investors behave. Rather, the analysis simply lists the SEC's "belief" that the reforms will, among other things, "[m]ake the capital formation process more efficient" and "[e]liminate barriers to open communications that have been made increasingly outmoded by technological advances." *Id.* at 44,797.

[191] *See supra* text accompanying note 169.

[192] *See supra* note 22 (citing instances where the SEC invoked "investor confidence" as its rationale for regulatory change).

and using the benefit of historical experience as a guide. For example, the SEC announced its reliance on the ability to revisit regulatory changes in justifying the dollar thresholds it adopted as part of the definition of a well-known seasoned issuer.[193] Experimentation may help the SEC develop its understanding of investors and correct for behavioral anomalies.

While experimentation may provide valuable information to the SEC, costs exist with taking too haphazard an approach to implementing regulations designed to address investor biases. In particular, undoing the status quo is often difficult. Interest groups may arise that prefer the status quo. WKSIs that just meet the current criteria will resist any changes that cause them to fall out of the WKSI category. SEC regulators may also fall under the influence of a confirmation bias, justifying regulatory changes after the fact that, from an objective standpoint, may not represent the best regulatory course of action.[194]

The 2005 Reforms are an example of the relatively slow pace at which the SEC engages in reform. On the one hand, not until the National Securities Markets Improvement Act of 1996 did Congress fully authorize the SEC to alter the public offering process and implement the wide-ranging reforms that the SEC eventually took in 2005.[195] Measured from 1996, the 2005 Reforms took almost a decade to promulgate. Even before obtaining general exemptive authority in 1996, however, the SEC enjoyed broad interpretive authority to determine the contours of terms such as "offer." When Congress established that offers are prohibited through Section 5(c) of the Securities Act, it defined offers in Section 2(a)(3) only as "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[196] Using its interpretive authority, the SEC was responsible for much of the expansive scope the gun-jumping rules took during much of its history. The SEC, in *In re Carl M. Loeb, Rhoades & Co.* and a series of Securities Act releases, provided an expansive view of an offer.[197] Through this broad definition of an offer, the SEC affected a broad definition of a prospectus that includes all written offers. Similarly, it was the SEC's longstanding efforts that resulted in issuers eschewing forward-looking information disclosure in the

[193] *See* Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44,730 (Aug. 3, 2005) ("We . . . are directing the staff of the Division of Corporation Finance and OEA to undertake a study in three years after full implementation of the rules to evaluate the operation of the definition we adopt today and any material changes in the data upon which the thresholds are based and report back to us and recommend any potential changes to the thresholds based on such new data.").

[194] *See supra* note 127 (discussing the confirmation bias).

[195] *See* National Securities Markets Improvement Act, Pub. L. 104-290, 110 Stat. 3416 (Oct. 11, 1996). Section 28 of the Securities Act provides: "The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Securities Act of 1933 § 28.

[196] Securities Act of 1933 § 2(a)(3), 15 U.S.C. § 77b (2000).

[197] *See supra* notes 25−29 and accompanying text.

public offering process.[198] Measured from the initial broad definitional approach the SEC took to the term "offer," it took decades before the SEC finally engaged in efforts, as part of the 2005 Reforms, to allow more communication during the public offering process, which is exempt from consideration as an offer.[199]

One solution to the SEC's lack of any clear foundation on how investors behave is for the SEC to adopt a presumption that reduces potential regulatory error costs. A possible irrebuttable presumption would be to assume that all investors act rationally.[200] An assumption of rationality, although not always accurate, will likely approximate how the more sophisticated, institutional investors behave in the market. To the extent such investors set the market price, other investors are also protected somewhat through the price mechanism. A rationality assumption also provides regulators less leeway to engage in regulatory actions that may suffer from behavioral biases. Because investor behavioral biases are hard to verify objectively, regulators suffering from overconfidence, groupthink, and other biases are more likely to make errors in identifying investor biases. Removing investor biases as a justification will therefore reduce the impact of regulator biases.

Assuming that all investors are rational is not without its costs. Not all investors are rational and some of the less rational investors may suffer from participating in the markets. Even institutional investors may suffer to some extent from their own biases. If both investors and regulators suffer from biases, how should we deal with behavioral biases?

This Article recommends a different approach to the problem of SEC regulatory error. Even if the SEC eschews adopting an irrebuttable presumption that all investors are rational, the SEC should clarify the assumptions on which it relies upon in putting forward regulations. In promulgating new regulations, the SEC should specify:

(a) the specific types of investors the SEC seeks to protect,

(b) how such investors engage in flawed decisionmaking,

(c) how the SEC predicts the regulations will protect such investors, and

(d) the cost of the regulations to other investors that do not suffer from the same behavioral biases.

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[198] *See supra* note 30 and accompanying text.

[199] Similarly, while shelf registration was first introduced in 1983 through SEC rulemaking, the SEC did not make appreciable changes to the shelf registration process until the 2005 Reforms. *See* Choi and Pritchard, *supra* note 21, at 45 ("The combination of behavioral biases and public choice motivations of SEC regulators may also generate a one-way ratchet effect: Regulations are easy to promulgate but difficult to remove. Overconfidence may fuel self-interest to push the SEC to implement new regulations. Once new regulations are in place, the confirmation bias may lead SEC regulators to then further 'buy in' to the usefulness of such regulations. Why question the status quo, which has proven so effective in the past? Feedback tending to show that regulations are imposing costs in excess of benefits will be downplayed because of the SEC's confidence in its regulatory abilities.").

[200] *See id.* at 42.

Given the difficulties in reforming existing regulations, providing a detailed set of behavioral assumptions that it makes about investors will force the SEC to consider exactly how its regulations are designed to protect investors, improving on the effectiveness of the regulations and lowering the need for later regulatory revisions. Detailed assumptions will also assist the SEC and outside observers in determining when regulatory changes are necessary and exactly what changes need to be made, shortening the time needed for later change (and resistance by interest groups in favor of the status quo).

Consider Rule 169, which provides a safe harbor for factual but not forward-looking information for non-reporting issuers.[201] The restriction on the ability of non-reporting issuers to distribute forward-looking information limits such issuers from publishing projections of the issuers' earnings during the public offering process. The SEC may, if required to do so, attempt to justify this restriction by contending that most investors in an IPO are individual investors. Furthermore, the SEC could contend that individual investors are easily led into speculative frenzies due to the projections. Restricting disclosure of forward-looking projections of earnings would therefore help minimize such frenzies. Other investors may suffer a cost due to the loss of forward-looking projections from inside the issuer, particularly to the extent that the issuer is not well-known and alternative sources of information are absent as a result.

Making the SEC's assumptions about investor behavior explicit would lead to a number of benefits. Providing a set of assumptions allows, at least in certain instances, for a test to see whether imposing regulatory protections in fact makes investors better off. If investors are not made better off, one may have the ability to reject the underlying assumptions. Explicit assumptions also open the SEC up to more outside criticism. If the SEC's assumptions are incorrect, outside observers will have an opportunity to demonstrate this incorrectness through empirical and other studies. The SEC, in turn, will face greater pressure to perform its own studies to support its assumptions, leading to more accurate assumptions compared to simple invocations of the needs of "investor confidence." Outsiders, for example, may challenge the assumption that most investors of an IPO are individual investors. Even among those who are individual investors, it is unclear how many are not capable of appropriately discounting the risks inherent in relying on forward-looking projections. The SEC's regulatory choice of simply denying the market such forward-looking information may also come under scrutiny. Removing forward-looking projections arguably may fail to protect unsophisticated investors suffering from overconfidence and overoptimism, among other behavioral flaws, from investing in the latest "hot" IPO. An overconfident investor may invest regardless of the disclosure of forward-looking information. Moreover, the protection may prove not worthwhile given the reduction of information given to more sophisticated investors (as well as brokers and other intermediaries who act to "filter" the information to less sophisticated investors).[202] Without

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[201] *See supra* text accompanying notes 51–54 (describing Rule 169).

[202] *See supra* note 58 (citing Homer Kripke's work first making this point).

internal projections of growth, revenues, and profits, sophisticated investors and market intermediaries are less able to predict accurately the value of an IPO. To the extent unsophisticated investors look to these sophisticated investors and brokers and other sources of analysis for guidance, the SEC's reforms may actually work to harm the more unsophisticated.[203]

Of course, even with explicitly stated assumptions it may not be possible to verify whether regulations put in place to address these defects in fact work as intended. Given the multitude of reasons why investors may continue to underperform when investing in IPOs, attributing poor performance to the existence of any particular bias is difficult. Likewise, attributing better performance solely to the correction of a particular bias may also prove problematic. Explicitly stating assumptions about investors, even where it is not possible to test the accuracy of an underlying behavioral assumption, still would prove beneficial for at least a couple of reasons. First, some assumptions may prove facially implausible. Why is it that investors who are unable to handle forward-looking information disclosures in the Pre-Filing Period under Rule 169 suddenly are able to handle forward-looking disclosures made through free writing prospectuses in the Waiting Period under Rules 164 and 433? Such investors surely do not become more rational during the course of the public offering process for any particular issuer.

Second, providing one explicit set of assumptions will shed light on where the SEC is presently inconsistent in its treatment of investors. Suppose the SEC states that individual investors are capable of handling offer-related information so long as they receive a suitable cooling off period, such as in Regulation A offerings. One might wonder why the same individual investors cannot handle forward-looking projections under Rule 169 in the case of an IPO if provided a similar cooling off period. Likewise, one might also ask why, if investors are capable of accessing the information contained in a final statutory prospectus through the SEC's website, justifying Rule 172's access-as-delivery regime, the same investors lack the capability to access the preliminary prospectus from the SEC's website in the Waiting Period for purposes of meeting the prospectus delivery requirement imposed on unseasoned and non-reporting issuers utilizing free writing prospectuses.[204] Inconsistencies may also become apparent with positions other governmental bodies have taken with respect to investors. The U.S. Supreme Court in *Basic, Inc. v. Levinson*, for example, rejected the Third Circuit's "agreement-in-principle" definition of materiality for merger negotiations because "[i]t assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing."[205] The Court's vision of investors in *Basic* stands in contrast with the

[203] *See id.*

[204] *See* Securities Act Rule 433, 17 C.F.R. § 230.433 (2005).

[205] Basic, Inc. v. Levinson, 485 U.S. 224, 234 (1988) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)). The *Basic* Court went on to state that the materiality requirement is not meant to "attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations." *See id*. at 234.

SEC's implicit assumptions of investor behavior as embodied in the public offering rules even after the 2005 reforms.

Third, requiring that the SEC provide a detailed explanation of its assumptions about investor behavior will help the SEC focus on its regulatory task and minimize the influence of behavioral biases on SEC decisionmaking. Behavioral biases have the greatest influence on SEC decisionmaking when the SEC is able simply to declare in an ad hoc fashion that "investor confidence" is in peril.[206] Because no standard exists for determining when investor confidence is at issue, groupthink may lead individual regulators simply to go along with the general "investor confidence" pronouncement, particularly where no objective standard is available to refute this underlying assumption. Overconfidence in one's expertise may also lead to greater regulatory errors where no objective check exists on how a regulator determines when investors need protection. Forcing a detailed exposition of assumptions will focus the attention of regulators on their underlying assumptions and, hopefully, lead to a more critical assessment of the process by which they generate these assumptions. The assumptions also provide a benchmark against which investor behavior, and thereby regulations based on the assumptions, may be assessed.

Fourth, focusing the SEC on its assumptions about investor behavior may help break the SEC out of its tunnel vision approach to regulation. Much of securities regulation is focused on the protection of investors, particularly the more unsophisticated investors in the market. Rather than start from how investors behave and what regulations will best protect such investors, securities regulators typically start from regulatory solution first. Disclosure is often brought forward as a solution to many problems without much consideration of how investors are affected.[207] Similarly, the SEC often will focus its attention on the types of regulated companies before, if at all, analyzing the types of investors in such companies. Requiring that the SEC

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[206] *See supra* note 22 (citing examples of the SEC's reference to "investor confidence" in justifying regulatory changes).

[207] As Adam Pritchard and I wrote in a recent Article:

> We doubt that disclosure is the optimal regulatory strategy if most investors suffer from cognitive biases. Disclosure may be ineffective in educating investors who suffer from biases in decisionmaking. Investors suffering from an overconfidence bias, for example, may ignore the warning signs from disclosure. Similarly, it is unclear how disclosure can overcome the cognitive dissonance of people who have made a poor investment choice in the past. Investors with intractable loss aversion will continue holding a losing position in hopes of reversing their losses without regard to disclosure. And what disclosure will help them avoid ratifying their poor investment choices as "good" decisions? Finally, investment decisions may be driven in substantial part by the conversations that investors have had most recently. Disclosure may do little to influence investment decisions based on "tips" or fads.

See Choi & Pritchard, *supra* note 21, at 22. *See also* Pritchard, *supra* note 183, at 1088 ("[D]isclosure is far from a panacea. Bounded search at the SEC may blind regulators to possible alternatives to disclosure regulation.").

explicitly delineate its assumptions about investors may open the SEC up to different possibilities of regulatory protections other than disclosure.[208]

The SEC's invocation of the phrase "investor confidence" may reflect something other than implicit assumptions about how investors behave. An alternative view is that the SEC's actions merely reflect the preferences of interest groups with influence over the SEC. The 2005 Reforms could simply represent the desires of underwriters and certain law firms on Wall Street. Under this alternative story, the SEC did not retain the myriad complex rules and exceptions within the public offering rules to protect investors, but rather the SEC sought simply to protect the flow of fees to attorneys while giving greater latitude to underwriters to engage in selling efforts. Words such as "investor confidence," under this view, represent rhetoric designed to mask the true intentions of a captured regulatory agency.

Rhetoric, nonetheless, has importance. If the investing public and Congress believe the rhetoric, the SEC and influential interest groups will have greater leeway to implement regulations that further the interest groups' own narrow interests. Requiring the SEC to specify its assumptions about investors (and meet a burden of proof in justifying its beliefs about how investors behave), rather than relying on uninformative pronouncements based on investor confidence, makes it harder for the SEC to use its role as the "investors' advocate"[209] as a pretext to create rules that cater to special interests. Once the SEC specifies its assumptions, implausible assumptions and regulations that are inconsistent with the stated assumptions may lead outside observers to question the SEC's true motives. If investors are able to handle non-offer-related communications under Rule 163A due to the beneficial effects of a cooling off period, why not also allow offer-related communications in the Pre-Filing Period with a similar cooling off period? Why is it assumed that investors will cool off for some information but not others? Once this question is asked, it may become easier to ask what really is going on. Perhaps it is simply that the complex residual legal question of what constitutes an offer in the Pre-Filing Period generates large enough fees for attorneys to justify the retention of the prohibition of offers in the Pre-Filing Period.

As well, even if external groups seek ardently to push SEC regulators to promulgate rules designed to further the welfare of these interest groups, not all SEC (if any) regulators view themselves as beholden to special interests. Many highly qualified individuals go to the SEC truly to act as the "investors' advocate." Convincing themselves that the regulations they promulgate do, in fact, work to protect investors is important to the self-image of such regulators. Groupthink within the SEC may lead many public-minded individuals to come

[208] For a discussion of the range of ways the SEC may intervene in the market and the risks of regulatory behavioral biases affecting these forms of intervention, *see* Choi & Pritchard, *supra* note 21, at 56−71.

[209] The SEC refers to its role as the "Investors' Advocate" on its own web site. *See* SEC, *The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity*, http://www.sec.gov/about/whatwedo.shtml (last visited on Nov. 15, 2005).

to certain beliefs about what investors need for protection uncritically. Explicitly stating their assumptions about investors, thereby uncovering any inconsistencies, flaws, and outright errors in the assumptions, may lead such SEC bureaucrats to engage in more searching investigation and analysis about how investors behave.

The phrase "investor confidence" may also mask more legitimate regulatory tradeoffs. The SEC may genuinely believe that while investors remain prone to forward-looking information disclosures in the case of unseasoned and non-reporting issuers even in the Waiting Period, the need for issuers to sell their offering and raise capital overrides the potential problems facing behaviorally challenged investors. The SEC may also believe that investors more generally focusing on unseasoned and non-reporting issuers are relatively deficient in their decisionmaking compared to investors in WKSIs and seasoned issuers. Nonetheless, the SEC may make a tradeoff in allowing small business issuers to use less demanding disclosure forms, such as Forms SB-1 and SB-2, because it believes that the needs of small businesses to raise capital outweighs the risks to investors. Even in more legitimate cases, explicitly stating assumptions about investors helps clarify the exact magnitude of such tradeoffs. If investors are truly unable to handle forward-looking informational disclosures, then it may in fact not be worthwhile to allow small business to make reduced disclosures in Forms SB-1 and SB-2. Conversely, if investors do in fact act more rationally, then perhaps we should give small business issuers (and other issuers) greater choice in what they may disclose. Without an explicit vetting of the assumptions about how investors behave, such an assessment is not possible. Instead, we are left with the SEC's own ad hoc and non-transparent assumptions about investor behavior.

One fear of having regulators explicitly focus on investor biases is that the very exercise may lead regulators to uncover more biases among investors and promulgate a greater level of regulatory intrusion to correct such biases than warranted (due, for example, to regulator biases that may lead the SEC to overreact to the presence of new investor biases).[210] To the extent SEC regulators are so prone, one modification to the Article's proposal would be to adopt a rebuttable presumption of rationality coupled with a burden of proof on regulators to provide evidence demonstrating the presence of a systematic behavioral bias among investors, the likelihood that new regulations will protect such investors, and the costs of the regulations to investors that do not suffer from the bias. Setting a relatively high burden of proof, for example, will lead only to regulations aimed at behavioral biases that are demonstrably beneficial for investors as a whole (if any such regulations exist).[211]

[210] Thanks to Troy Paredes for pointing out this possibility.

[211] Exactly how high a burden of proof the SEC should face turns on an assessment of the risk that regulatory behavioral biases may lead the SEC to overregulate when faced with a possible investor bias.

V. CONCLUSION

The SEC's 2005 Reforms present a number of puzzles if we start from an assumption that investors are rational. The 2005 Reforms retain limitations on the types of information issuers may disseminate in the market, particularly in the Pre-Filing Period. The reforms also require the delivery of a preliminary prospectus together with or before the distribution of a free writing prospectus on behalf of a non-reporting or unseasoned issuer. The reforms similarly continue to require the delivery of a final prospectus together with any traditional free writing in the Post-Effective Period. Where investors are rational, however, the value of the remaining limitations and requirements placed on issuers during the public offering process is questionable.

Even if we start from the assumption that investors are not rational, the 2005 Reforms present puzzles. Why, for example, are cooling off periods used in some areas of the securities laws but not others? If investors really lack the ability to handle information, will providing a legend as part of free writing prospectuses inoculate the investors from the adverse effects of behavioral biases?

Perhaps the SEC has a well thought-out vision of investors that justifies those aspects of the 2005 Reforms that cater to investors who are not fully rational. Restricting issuers from disclosing forward-looking information in the Pre-Filing Period may paternalistically serve to protect certain irrational investors from their own poor judgment. The SEC's promulgating release behind the 2005 Reforms, however, does not mention these assumptions and we are left simply guessing. The guesswork is particularly difficult where the SEC's efforts do not completely address the needs of unsophisticated investors suffering from overconfidence, overoptimism, and a host of other behavioral biases. If investors are truly unsophisticated, why then allow even non-reporting issuers to disclose information, including forward-looking information, freely using free writing prospectuses during the Waiting Period? Exactly what kind of irrationality does the SEC have in mind?

The lack of attention on the specific assumptions behind how investors behave is particularly troublesome given the host of behavioral biases that may affect regulators. Regulators, just as investors, may act with overconfidence and overoptimism. Regulators may place too great weight on more recent and salient information. Reliance on heuristics may lead regulators to suffer from hindsight biases. Individual regulators may also buy too deeply into the regulatory mission, engage in groupthink, and develop tunnel vision in how they approach new problems in the capital markets. Even more problematic, the SEC may simply invoke "investor confidence" without really meaning it, instead catering to the needs of powerful interest groups in the securities industry. Detailing the assumptions the SEC makes with respect to investors may help expose flaws and inconsistencies in the assumptions and regulatory regime, thereby focusing attention on the possibility of other, more public choice motives behind the SEC's actions.

Given behavioral biases within the SEC, this Article makes a minimal suggestion for improving how the SEC deals with investor biases. While the

SEC discusses the general costs and benefits of its public offering reforms in its promulgating release,[212] it does so without any detailed discussion of the investors whom the public offering rules are designed to protect. The Article contends that the SEC should make explicit its assumptions about the types of investors it seeks to protect, how such investors behave, and how regulatory protections benefit such investors (and harm other investors, if any). The very act of specifying such information will help reduce biases among regulators and introduce the SEC to possible new types of regulatory protections. Where an over-regulatory response to investor biases is a fear, the Article proposes imposing a rebuttable presumption of investor rationality, imposing the burden of proof on the SEC to provide evidence that investors are in fact behaviorally biased and that regulation is a beneficial response. Delineating the SEC's assumption behind investors also opens the SEC up to greater outside review, limiting the ability of the SEC to promulgate unwarranted regulatory protections.

[212] *See* 70 Fed. Reg. 44,722, 44,790.