

Lecture 6: The enforcement of mandatory disclosure.

The enforcement is absolutely crucial for the effectiveness of mandatory disclosure, in other words mandatory disclosure will be ineffective without a specific enforcement system aimed at assuring truth and completeness.

The importance of enforcement

In order to understand how the enforcement in general, and enforcement of mandatory disclosure in particular work, we need some background notions.

Enforcement strategies may be classified as follows:

1) private vs public enforcement.

Public enforcement uses public agents (as for example, agencies, police, prosecutors) to detect and sanction violators of legal rules. Private enforcement, instead, is a strategy where private parties are entrusted to disrupt misconduct and to enforce substantive provisions of law. On the one hand, private remedies provide the relief to those harmed by a securities law violation, on the other, they are also a powerful incentive for individuals and firms to comply with the law.

2) ex-ante vs ex-post enforcement.

Ex-ante measures basically prescribe specific behaviours aimed at avoiding a violation to occur. Ex-post measures react to violations which have occurred by recurring to an adjudicators (courts, agencies, government). While ex-ante measures occur before the effect of the violation, ex-post measures are instead a form of reaction which occur after the effect.

Enforcement strategies, according to these four features, can be organized in a specific matrix (known as enforcement matrix) with two rows and two columns. In this way, we may have private ex-ante and private ex-post enforcement strategies or public ex-ante and public ex-post enforcement strategies.

Enforcement strategies in securities regulation

Considering securities regulation and in particular mandatory disclosure, enforcement strategies can be organized as follows:

	Private	Public
Ex-ante	Gatekeepers	Administrative approval
Ex-post	Civil liability	Criminal sanctions – Administrative fines

We can distinguish four different strategies, each one for a specific context. Some of these strategies are intuitive, for example a public ex-post strategy like a criminal sanction or an administrative fine: someone violates something within mandatory disclosure provisions gets criminal sanctions or administrative fines. Other strategies are easy to understand, for example

administrative approval. It is a public ex-ante strategy because it occurs before the violation, is aimed at preventing the violation to occur, and at the same time it is decided by a public agent.

Gatekeeping strategies

Generally, gatekeepers are professionals whose product is necessary for clients wishing to enter a particular market or engage in certain activities (as doctors, lawyers). Doctors for example are professionals whose product (the prescription) is necessary for clients wishing to enter in a particular market (drug market). Thus, gatekeepers are positioned so as to be able to prevent wrongdoing by withholding necessary cooperation or consent. Imagine a patient wants to buy a drug not because he needs it but because he wants to resell it to make a profit; because the patient without the cooperation of the doctor (gatekeeper) cannot buy the drug, the doctor, who understand that there is no need to buy the drug, by withholding his cooperation (by not prescribe) can prevent wrongdoing. So, this is an ex-ante private enforcement strategy. Ex-ante because it is aimed at avoiding wrongdoing before it occurs. Private because the party entrusted to disrupt wrongdoing is a private person and not a public agent.

Within the financial markets context, gatekeepers are repeat players (typically firms) who provide certification or verification services to investors, vouching for someone else who has a greater incentive than they to deceive. They are for examples auditors, underwriters, financial analysts, rating agencies. Imagine a rating agency, it is a firm that provides certifications to investors, which rate the credit worthiness of an issuer. Basically, by rating an issuer, the rating agency vouchers for the issuer who has a greater incentive to cheat the public because by rating they verify that the issue is a good product.

Gatekeepers act as a reputational intermediary to assure investors as to the quality of the signal sent by the issuer. They do so by lending or pledging their reputational capital to the issuer, enabling investors or the market to rely on the issuer's own disclosure where they otherwise might not. Gatekeepers are trusted to the extent that they are a repeated player who possess a significant reputational capital that would be lost or depreciated if they were found to have condoned wrongdoing. Because gatekeepers put their reputational capital at risk (for example when they rate an issuer), as long as whose value exceeds the expected profit that they will receive from the client, they should be faithful to investors certifying only good issuers and not providing false of certification. Because the cost of the reputational capital is generally very high vis a vi the benefit of getting something from the client, typically it would be irrational for gatekeepers to allow fraud.

Private gatekeeping strategies are generally considered more efficient than public gatekeeping strategies, because market gatekeepers face powerful private incentives which public gatekeepers do not, and for this reason they have more incentives not to be bribed. Public gatekeepers are monopolist in their activity, and therefore they could be bribed more easily because even though their reputation is disrupted, they still work, and do not risk lose their market. Rather, market gatekeepers work in the market environment and therefore they face this very powerful incentive to behave in a way which preserve their reputational capital. For this reason, they are much less prone to fraud than public gatekeepers are.

This gatekeeper model, which is commonly used in securities regulation, failed in the 2002 and 2007 crises, where a bunch of gatekeepers, auditors in the crises of 2002 and rating agencies in the crisis of 2007, didn't do their work as they were expected allowing number of fraud that have a relevant impact on their reputational capital. The two most important examples are the Enron's bankruptcy which causes the 2002 crisis and the sale of the so-called toxic products, which have been rated by rating agencies with the high possible rate (AAA), all over the world that cause the 2007 crisis.

This failure can be explained:

- 1) by the presence of agency problems within the auditing network.

Because auditors are not a single firm but a network of different firms all over the world (such a kind of franchising), there can exist problems of network externalities or agency problems between the members of an auditing network and network itself. As a consequence, the reputation of the all auditing firm can be affected by the bad behaviour of a single branch of the auditing network which cares only about its business without considering the network itself.

It was the case of Enron in 2002. Enron was based in Houston, Texas, and was the 7th company for market capitalization in the US. It went dramatically bankrupt from one day to the other because of a number of tricks in its balance sheets. The auditor firm, Arthur Anderson Houston, which was supposed to certify its balance sheet, was completely bribe by Enron and not only allowed the fraud but even advised about how to do the fraud. Arthur Anderson Houston was a specific firm belonging to Arthur Anderson Network, which had Enron as the main client. Arthur Anderson Houston basically wanted to keep the client without caring about the reputation of Arthur Anderson's brand. Arthur Anderson Houston had no incentives to preserve the reputation of the brand because the incentive to do big business with its main client was much higher than the possible cost to the brand which is a cost of someone else. This is a typical agency problem characterized by the presence of network externalities, where Arthur Anderson Network is the principal and Arthur Anderson Houston the agent: the fact that Arthur Anderson Houston wanted to pursue its own business had a very bad impact on Arthur Anderson network.

- 2) by the oligopolistic feature of gatekeepers' market.

Reputation is very costly to build, therefore the market for gatekeepers has very high barriers to entry and is naturally oligopolistic. As a consequence, the market mechanism could not act as it should, and the market incentives may not be as expected.

- 3) by the perverse effect of market competition.

Under the normal natural effect of competition, we would expect that raters look for greater reputation and therefore they tend to be true in evaluating the rating of issuers. Instead, when the competitive pressure is pretty high and raters want to gain market share they may tent to be more generous. As a consequence, the model fails.

The reasons that determine the failure of gatekeeping strategies are possible defects which have been considered in order to correct the model. After the crisis, the gatekeeper was kept with a number of legal codifications to manage and mitigate these risks maintaining at the same time the model as it was.

Administrative approval

In order to understand the administrative approval strategy, which is an ex-ante public enforcement strategy, we could examine the regulation of the prospectus, meaning the mandatory disclosure to the primary market in an IPO. Under the Prospectus Regulation, a prospectus shall not be published unless the relevant competent authority has approved it. Approval means that the competent public

authority of the home Member State should scrutinize whether the prospectus is complete (meaning it has all the items required to be in the prospectus), is consistent (meaning there is no contradiction between the different items in the prospectus), and whether the information provided are comprehensible. According to this mainstream approach, the approval does not involve any control on the merit of offered securities, and because the control is formal and does not involve the quality of the offered security it limits the risk of civil liability for the competent authority. Because it is very difficult that a competent authority misses something in verifying whether a prospectus is consistent, complete, and comprehensible the possibility of a civil liability becomes very little.

The fact that an administrative approval is needed after the control by the private gatekeeper implies that the control by the administrative authority can be considered a sort of double check fixing the possible problems or failures with the private gatekeeping strategy. The fact that the control exercised by the competent authority is very powerful but at the same time it is entrusted with a task which is so little as checking the completeness, the consistency, and the comprehensibility of the prospectus, may result in some abuses by the authority in order to obtain some more additional information which may not be needed. In order to mitigate this risk, the competent authority should behave according to the rule of law. So, in the case that the public authority abuses of its power, the issuer can react.

Under European Union law, when a prospectus is approved by the relevant competent authority of a single Member State, this approval enjoys the benefit of the mutual recognition. Therefore, once that the prospectus is approved by a home Member State, it shall be valid for the offer to the public in any number of host Member States. Competent authorities of host Member States shall not undertake any approval or administrative procedures relative to prospectuses approved by the competent authorities of other Member States (European Passport).

Some precautionary measures are, nevertheless, provided: if the competent authority of the host Member State has clear and demonstrable grounds for believing that irregularities have been committed by the issuer, it shall refer those findings to the competent authority of the home Member State and to ESMA. Moreover, if the issuer persists in the infringement despite the measures taken by the competent authority of the home Member State, the competent authority of the host Member State after informing the home Member State and ESMA shall take all appropriate measures in order to protect investors.

Criminal sanctions and Administrative fines

In order to understand the public ex-post enforcement strategy, we need to look at the economic theory of the sanction. According to this theory, legal rules create an implicit price. In other words, sanctions may be considered as a way to create an artificial cost which may outweigh the benefit for the wrongdoer. Therefore, by applying sanctions wrongdoings can be deterred because the cost of the sanction is higher than the relevant benefit of the wrongdoing.

When the agent (wrongdoer) commits after rational computation of the potential gain and the risk of getting caught and punished, wrongdoing will occur only if the expected gain to the wrongdoer exceeds the expected cost. The expected cost of the wrongdoing depends upon two factors: (1) the magnitude of the sanction, and (2) the probability of being caught and convicted. Therefore, the expected cost of wrongdoing is the product of the probability and the magnitude of the sanction. For the wrongdoers the expected cost of wrongdoing remains exactly the same either when the probability increases and the magnitude of the sanction decreases or when the probability decreases and the magnitude of the sanction increases. For the justice system instead the cost of wrongdoing may change. The probability of being caught and convicted under criminal law is very costly and depends in large parts on the resources devoted to enforcement: these resources are very costly. By

contrast, administrative fines are relatively cheap because the cost to catch violators may be lower and on the other hand the procedure which leads to a fine has much less guarantees than the criminal procedure and therefore the cost to comply with it is much lower.

As a consequence, for a government administrative fines may be much more efficient than criminal sanction. Indeed, imagining wrongdoing by rational agent, as capital markets players are supposed to be, efficiency may prescribe to invest little in apprehending and prosecuting offenders but at the same time fine very severely those who are apprehended. In this way, the product of these two factors will be an unexpected cost for the wrongdoers enough high to deter their bad behaviour and enough efficient for the state to reach its goal.

This model is applied to securities regulation. The Prospectus Regulation, while allowing Member States to impose criminal sanctions, provides that Member States shall, in accordance with national law, provide for competent authorities to have the power to impose administrative sanctions and take appropriate other administrative measures. The Prospectus Regulation provides also that Member States shall ensure that these measures are effective, proportionate and dissuasive. This provision and the implementing measures are aimed at increasing the deterrence effect of sanctions. For example, violations of rules about mandatory disclosure to the primary market is sanctioned with the maximum administrative pecuniary sanction which can be twice the amount of the profits gained or losses avoided because of the infringement where those can be determined.

Civil liability

In order to understand the ex-post private enforcement strategy, we focus on the idea that violating mandatory disclosure may result in a monetary loss for investors. Under private law, the harm (the loss) suffered by investors may be compensated by providing the victims with damages (a monetary compensation) through a liability rule whose legal basis is either a misbehaviour (tort) or a violation of a contract.

From a functional point of view, damages are characterized by a double effect: they compensate the victim of the wrongdoing and at the same time they deter future wrongdoers from wrongdoing. From the perspective of the law, the fact that legal systems give priority to compensation or to deterrence, it may determine a very significant difference in the legal regime of civil liability. If the legal system gives priority to compensation rather than deterrence, the legal regime is known as strict liability. According to this approach, a liability is imposed by the simple fact that a certain behaviour determines a loss, regardless whether that behaviour can be considered negligent or not. On the other hand, if the legal system gives priority to deterrence rather than compensation, the legal regime is known as punitive damages. According to this approach, the wrongdoer will be sanctioned with very high damages, higher than the money needed to compensate the loss suffered by the investors. Increasing the amount of damages is a way to create a significant cost not to compensate the victim (which is over compensated) but to deter future wrongdoers. Even though this decision between compensation and deterrence, and therefore between strict liability and punitive damages, implies a decision about allocation of resources, such a difference may not be explained purely in terms of efficiency. For example, strict liability can be considered a way to underline the moral character of the wrongdoing and emphasize that also in private moral consideration are important. Or to the opposite, punitive damages can be considered a very strong form of punishing in order to shame people who behave badly.

The deterrent function of civil liability depends on its enforcement. Punitive damages, contingent fees agreements, class actions and other procedural rules (as common law discovery rules) are tools which are typically used to increase enforcement. Punitive damages are a way to increase the

amount to be repaid to investors; contingent fees are agreements under which lawyers are paid with a percentage of the recovery from the loss in order to manage transaction costs; class actions are tools which allow very easily to manage collective action problems; common law discovery rules are very technical and procedural rules according to which when the claim is approved by the Court, the defendant is supposed to discover all the evidence about the case.

The actual capacity of these tools to promote deterrence may be very debated. More particularly, empirical research shows that compensation and deterrence provided by class action may be largely a myth. Class actions are typically lawyer driven, which means they are promoted by lawyers who are basically interested to get the share of the recovery to the contingent fees agreement rather than to actually protect investors. And therefore, this mechanism which is supposed to be very efficient in deterrence and in compensate investors solving a collective action problem, may not be so because the compensation actually received by investors is very very little.