THE LOGIC OF SECURITIES LAW

The book opens with a simple introduction to financial markets; it understands the action and the players of Wall Street by comparing them to the action and the players of Main Street. First, the book explores the definition of a security by its function, the departure from the “buyer beware” environment of corporate law, and the entrance into the “seller disclose” environment of securities law. Second, it shows that the cost of disclosure rules is justified by their capacity to combat irrationalities, fads, and panics. The third part explains how the structure of class actions is designed to improve deterrence. Next it explores the economic harm from insider trading and how the law fights it. In sum, see how all these parts of securities law serve the virtuous cycle from liquidity to accurate prices and more trading and how the Great Recession showed that our securities regulation reacted mostly adequately to the crisis.

Professor Georgakopoulos is the H.R. Woodard Professor of Law at the Robert H. McKinney School of Law, Indiana University. He has researched and published extensively on securities law and related fields. His previous publications include *Principles and Methods of Law and Economics* and a coauthored five-volume treatise *Blumberg on Corporate Groups*.

The Logic of Securities Law

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To Lee and Dimitri.

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Foreword

Nicholas L. Georgakopoulos is much more than just a professor of law at Indiana University. He is an economist and an expert on finance and the financial markets, and he has written extensively on the application of economics to a variety of fields of law not limited to the laws regulating the financial markets. But this has been the primary focus of his current research and has resulted in this important, as well as thoroughly up-to-date, book on the regulation of securities trading.

Naturally, there is much discussion in this book of the crash of 2008 and its aftermath – the aftershocks continue to be felt. But the focus is broader. Indeed, Professor Georgakopoulos's focus is on the perennial controversies in the securities field, such as insider trading; the breadth of the book's scope makes the book a treatise on the law and economics of securities markets.

Insider trading had long been deplored and even punished when the pioneer "law and economics" law professor Henry Manne began to defend it in the 1960s. His defense did not result in a change in the law, but it started a lively debate to which Professor Georgakopoulos in this book (and in a precursor article that the Securities and Exchange Commission used to persuade the Supreme Court to maintain the prohibition) makes the important contribution of demonstrating that insider trading is indeed a harmful practice. "Insider trading" means trading on information concealed from the public and therefore unavailable to securities traders who are among (or are fed confidential information from) the insiders of firms. Knowing that trading on inside information is going on discourages securities trading by investors lacking such information by subjecting them to competition from traders who have superior knowledge of forthcoming changes in the values of securities. But this is a crude summary of the nuanced analysis in this book; Professor Georgakopoulos shows that not all insider trading harms the securities markets.

Interestingly, this book does not treat insider trading as a practice remote from other practices that are harmful to efficient markets, such as concealment of information from prospective traders; the book endorses rules requiring disclosure by participants in the securities market of information necessary for efficient trading and likewise rules punishing fraud, which is widespread in investment markets, as it is elsewhere. Professor Georgakopoulos rejects what he calls the "free-market objection to regulation. In the eyes of the inflexible free-market proponent, private parties would perfectly foresee the ills that regulation seeks to prevent and would make the least costly arrangements to avoid those ills. The inflexibility and the distorted incentives that regulation creates would never arise." As he shows, this is not true.

What really unifies this book is that, as Professor Georgakopoulos shows, ultimately securities regulation is all and only about information – about allaying, notably, "traders' fear of manipulated prices." Many securities investors, left to their own devices, as it were, would make investment decisions without obtaining readily available information to guide those decisions; many would seek no information at all, but trade on pure hunch or even pure gamble. Others would yield to irrational instinct to buy when securities prices are rising and sell when they are falling, even though prices often rise bubble-like before a crash (making it risky to buy when prices are rising, especially when they are rising fast and steep) and fall to bargain levels (making purchases likely to produce significant gains). Whether the issue is disclosure rules, fraud, insider trading, or "irrational exuberance" (buying in an expanding bubble), the focus of regulation remains, as it should, on maximizing the amount of truthful information in securities trading. As Professor Georgakopoulos points out, "Misrepresentations about financial goods tend to influence price more, last longer, attract wider (potentially global) attention, be more frequent, and be more costly to uncover than misrepresentations about real goods" (with, I would add, some notable exceptions, such as drugs).

The financial crisis centrally involved securities, such as the mortgage-backed securities that, when the real estate market plummeted, wreaked such havoc. And so the final section of this book "looks for anticrisis features in the law of securities regulation." Professor Georgakopoulos does not find many and is not at all enamored of Dodd-Frank and other measures to prevent a similar financial collapse in the future. He sees the crisis of 2008 as primarily a psychological phenomenon, what I would call an example of the tendency to keep buying as prices rise, and he sees the government as complicit in the crisis largely because of its sharing the market's sentiments and engaging in procyclic regulation that is too lax during the bubble (the euphoria period) and too strict after the crisis. He perhaps might have said more about what appears to have been the exceedingly lax regulation of the Wall Street securities firms (and not only Lehman Brothers) by the Securities and Exchange Commission, but he makes an intriguing proposal for moving toward countercyclic regulation. Throughout the book, his discussion of the crisis is lucid, interesting, and informative.

Richard A. Posner

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