INCOMPLETE LAW

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I. INTRODUCTION

This Article develops a framework for analyzing the relation between basic features of statutory and case law and the design and functioning of institutions that enforce this law. The basic premise is that law is inherently incomplete and that this has important implications for law enforcement. In particular, when law is incomplete, special emphasis needs to be placed on the allocation of lawmaking and law enforcement powers (LMLEP) to different institutions such as legislatures, courts, or regulators, in order to attain optimal levels of law enforcement.¹ Using the development of the legal framework

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1. By "optimal" levels we do not mean "perfect" law enforcement. Every legal system will need to strike a balance between the danger of over-deterrence on the one hand and the danger of under-deterrence on the other. Law enforcement reaches optimal levels when the balance is struck in a way that ensures that actions that create great harm will be prevented or deterred, while actions that create more benefits than harm will be allowed to take place.
governing financial markets as an example to illustrate the conceptual framework, this Article examines how different legal systems have responded to the problem of incomplete law by reallocating lawmakers and law enforcement powers from courts to regulators. Most examples are drawn from the U.K., which has spearheaded financial market development since the mid-19th century. A comparative analysis of the U.S. and German experiences is also presented.

This Article regards a law as complete if a law enacted today unambiguously stipulates for all future contingencies; otherwise a law is incomplete. A law may be incomplete if it attempts to specify comprehensively actions that shall be covered but fails to include some which could result in similar harmful outcome. Alternatively, law may be incomplete because it uses open-ended, vague wording, as a result of which the boundaries of the law are not clearly delineated.

Incomplete law may be a function of bad drafting, but it is not limited to that. While failure to include all relevant issues that are known at the time a law is drafted or a court verdict is rendered may be the result of oversight, there are a number of other causes for incomplete law, including environmental factors and deliberate design.

Some areas of the law may be more incomplete than others. Environmental factors influence the relative incompleteness of law. Areas that are affected by a high pace of so-

2. The "incomplete law" problem has frequently been mentioned in academia without, however, developing a broader framework to explain the processes and institutions of lawmakers and law enforcement. Close to this Article's use of the term "incomplete law" is William M. Landes & Richard A. Posner, The Independent Judiciary in an Interest-Group Perspective, 18 J.L. & Econ. 875, 879 (1975). In this Article, which addresses the puzzle of judicial independence, the authors note that "... the limits of human foresight, the ambiguities of language, and the high cost of legislative deliberation combine to assure that most legislation will be enacted in a seriously incomplete form, with many areas of uncertainty left to be resolved by the courts." Id. at 879 (emphasis added). The theory presented in this Article goes a step further in developing a general analytical framework of the inherently incomplete nature of the law. In particular, this theory suggests that not only courts, but also other agents, such as regulators, may be charged with lawmakers and law enforcement and attempts to identify the optimal allocation of lawmakers and law enforcement rights.

3. For a differentiation of these types of incomplete law from the more common categorization used in the legal literature of "rules" and "standards," see infra discussion in note 27.
cioeconomic and/or technological change, for example, tend to be more incomplete than areas unaffected by exogenous change. The reason is that such change constantly challenges legal solutions designed to solve "old" problems and thus requires frequent adaptations of the law if it is to remain effective. Law may also be incomplete by design. Lawmakers may decide to design laws to be more or less complete. They may do so by enumerating only a few actions that the law will cover, or by drafting highly ambiguous, open-ended provisions.

Lawmakers choose the level and type of incompleteness for various reasons. The choice may be determined by perceptions of existing law enforcement institutions and their effectiveness. Knowing that courts will step in and fill the gaps left by laws may also lead lawmakers to draft broad, open-ended provisions rather than detailed ones. Conversely, if lawmaking powers are withheld from courts, or if courts are perceived to be incapable of exercising these powers in a meaningful fashion, lawmakers may want to record their intentions in a more precise manner in order to minimize courts' discretion. In addition, lawmakers may prefer incomplete over relatively complete law as a means to avoid difficult policy choices and shift responsibility for possible backlashes to the law enforcers.4 Finally, lawmakers may be ill-equipped or lack the necessary resources to write comparatively complete law. This Article does not address the reasons why lawmakers choose to make more or less complete law but makes the factual assumption that law is incomplete as a given.

When law is incomplete it cannot be applied to cases without clarifying the meaning of the law. This power to interpret existing law, to adapt it to changing circumstances, and to extend its application to new cases is herein referred to as the "residual lawmaking power."5 Residual lawmaking powers may

4. For a similar argument, see Eli M. Salzberger, A Positive Analysis of the Doctrine of Separation of Powers, or: Why Do We Have an Independent Judiciary?, 13 INT'L REV. L. & ECON. 349, 350 (1993). See also Joseph A. Grundfest & A.C. Pritchard, Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation, 54 STAN. L. REV. 627, 628-29 (2002), which suggests that lawmakers may decide to leave a law highly ambiguous, or incomplete, because that is the only compromise they can reach.

5. As discussed below, these terms are borrowed from the literature on incompleteness of contracts, which has inspired this Article. See discussion infra Part III.A.
be reserved by the legislature. They may also be vested with courts or with regulators (including self- and state regulators). This Article explores the conditions under which allocating residual lawmaking powers to legislatures, courts, or regulators is optimal.

In addition to lawmaking powers, law enforcement powers must be allocated. Even the best-designed law is useless without compliance, whether voluntary or coercive. A substantial literature has developed that explores the conditions for efficient law enforcement. At the core of this literature is the deterrence function of punishment as argued by Bentham, modeled by Becker, and further developed by Stigler. Polinsky and Shavell refined the model and gave a recent survey of the literature; their analysis is taken as a benchmark. This literature explores the optimal design of laws and punishment to achieve efficient deterrence. This literature, however, assumes implicitly that law is complete, i.e., that law is unambiguously stated for all individuals and law enforcers in an economy and that it covers all potential harmful actions.

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6. In the third chapter of his *The Rationale of Punishment*, entitled “Of the Ends of Punishment,” Jeremy Bentham writes about the deterrence effect of punishment:

Pain and pleasure are the great springs of human action. When a man perceives or supposes pain to be the consequence of an act, he is acted upon in such a manner as tends, with a certain force, to withdraw him, as it were, from the commission of that act. If the apparent magnitude, or rather value of that pain be greater than the apparent magnitude or value of the pleasure or good he expects to be the consequence of the act, he will be absolutely prevented from performing it. The mischief which would have ensued from the act, if performed, will also by that means be prevented.


10. Note, however, that some authors have addressed the fact that law is often vague. See, e.g., Robert Cooter & Thomas Ulen, *Law and Economics* 319-20 (3d ed. 2000). Their major interest is “how people adjust their precaution in response to legal uncertainty.” *Id.* at 319. By contrast, this Article focuses on how lawmakers and law enforcers can reduce the scope of uncertainty that results from incomplete law in order to optimize law enforcement from a social welfare perspective.
Under this assumption, it is possible to design law in such a way that optimal deterrence will achieve the most desirable outcome. Consistent with this assumption, enforcement by courts is at the center of the analysis.

If, however, law is incomplete as this Article argues, the challenge for law enforcement is more complex than the design of optimal punishment. It requires the design of appropriate institutional mechanisms to address the problem of suboptimal enforcement from a social welfare perspective. In particular, when the expected damages from harmful actions may be large, courts alone may not be sufficient to ensure optimal law enforcement. This follows from the nature of law enforcement by courts. Courts are designed to be reactive law enforcers. They become active only when another party—be it state or private—initiates legal proceedings. The reason that courts do not initiate investigations themselves is that this would undermine their neutrality and impartiality. At least in countries that are committed to the rule of law, these are core values that have shaped the design and the success of courts as reactive law enforcers. 11 By contrast, regulators enforce law—not exclusively, but primarily—proactively. They monitor behavior, launch investigations, and enjoin or punish actions on their own initiative. This Article suggests that proactive law enforcement by regulators has emerged largely in response to the problem of incomplete law in areas where substantial negative externalities rendered reactive law enforcement inefficient.

To highlight the central issues associated with incomplete law, this Article downplays incentive problems different lawmakers and law enforcers may face, including problems of regulatory capture or corruption. While recognizing that these issues are of great importance, this Article nonetheless

11. As Paul R. Milgrom, Douglass C. North, and Barry R. Weingast show, the emergence of neutral dispute resolvers has played a crucial role in the economic development of Europe since the late Middle Ages. See Paul R. Milgrom et al., The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs, 2 Econ. & Pol. 1, 19-20 (1990). Using a game theory model, they show the positive impact of courts acting as neutral arbiters. See id. at 6-9. Relaxing this assumption and assuming that courts violate their impartiality, there are negative implications for solving the information problem that traders face when they transact with parties with whom they do not maintain a long-term relationship.
suggests that analytically they are of secondary importance to the problem of incomplete law. Solving the problem of regulatory capture by, for example, abolishing regulators will not address the problems which gave rise to the establishment of regulators in the first place. Conversely, arguing that the existence of regulators can be attributed to their greater efficacy in collecting evidence when compared to courts does not explain the absence of regulators in many areas of law where the collection of information is very costly, or the presence of regulators in areas of the law where collecting information may not be particularly costly.

This Article does not suggest that regulators are desirable for all areas of the law even when law is highly incomplete. In a companion paper, the optimal allocation of lawmaking and law enforcement rights with regards to fiduciary duties directors owe to shareholders is analyzed, and the argument is made that although fiduciary duty is an example of a highly incomplete law, allocating LMLEP to courts is optimal. The reason why is that the expected harm is typically limited to the shareholders of a particular company. Moreover, it would be extremely difficult to standardize the type of actions that might result in harm in light of the diverse actions that directors may take and that may or may not result in harmful outcomes. Imposing a regulator not only would be costly but also would likely result in excessive oversight of decision-making processes in private sector companies.

This theory is not limited to corporate law or financial market regulations. To the contrary, its basic principles—the need to consider the allocation of lawmaking and law enforcement powers to different agents that perform different func-

12. We propose that problems such as corruption and regulatory capture arise at least in part because law is incomplete, as incompleteness by definition enhances the discretion of law enforcers and reduces the possibility of effectively monitoring their law abidance. Further analysis of the relationship between incomplete law and corruption will be left to future research.


tions—equally apply to environmental, safety, food and drug regulation, and the like. For illustrative purposes, however, analysis in this Article is limited to financial markets.

The incomplete law framework is inspired by the incomplete contract theory, which was spearheaded by Oliver Hart and others in the literature of economics. A reception of this theory into legal analysis is only beginning, but as suggested by others, it bears much promise. The starting point of this theory is that not only contracts but law is inherently incomplete—indeed that the incompleteness problem is more profound for law than for contracts.

A companion theoretical Article develops a model to explore the impact of incomplete law on different law enforcement mechanisms. The model demonstrates that under incomplete law the law enforcement by courts (along the lines of the Becker-Stigler model) may result in deterrence failure. The Article then suggests that introducing a different type of law enforcement mechanism, namely proactive law enforcement by a regulator, may mitigate the deterrence failure prob-

15. For references, see infra notes 82-90 and accompanying text.
16. See Karen Eggelson et al., Simplicity and Complexity in Contracts (John M. Olin Law & Economics (2d Series), Working Paper No. 93, 2000), available at http://www.law.uchicago.edu/Lawecon/index.html, for an excellent introduction to this newly developing field. The terminology of “incomplete contracts” has been used in the legal literature for quite a while. See Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 92 n.30 (1989). Scholars treat incompleteness of contract problems primarily as a design issue. Contracts are incomplete because it is too costly to write complete contracts, id. at 92-93, or because there are strategic reasons for drafters to believe that they might benefit from relatively incomplete contracts, id. at 94. By contrast, the incomplete contract literature in economics (to be discussed in greater detail in Part III.A, infra), argues that non-verifiability is at the heart of the incompleteness problem, and therefore it is impossible to design a complete contract. See Oliver Hart & John Moore, Foundations of Incomplete Contracts, 66 Rev. Econ. Stud. 115, 134-35 (1999).
17. We would even suggest that the fact that law is incomplete influences the strategies that are available for dealing with the problem of incomplete contracts.
lem. This Article, by contrast, addresses the broader conceptual issue of incomplete law and presents more detailed empirical evidence on the evolution of different types of law enforcement mechanisms in financial market development.

The Article is organized as follows. Part II develops the analytical framework of incomplete law and the proper allocation of lawmaking and law enforcement powers that is implied by incomplete law. Part III places this theory within existing literatures in law and economics, including the literature on the indeterminacy of law, the incompleteness of contracts literature, and the literatures on law enforcement and regulation. Part IV applies this framework to the development of financial market regulation in England since the mid-19th century. Part V extends this analysis to other countries and summarizes major developments in the regulation of financial markets in the U.S. (including the recent introduction of the Sarbanes-Oxley Act) and Germany. Part VI draws conclusions about the need for and the optimal level of regulation and proposes areas for future research.

II. INCOMPLETE LAW: A CONCEPTUAL FRAMEWORK

This section develops the incomplete law concept, explains why law is inherently incomplete, and argues that given incomplete law, the allocation of residual lawmaking and law enforcement powers (LMLEP) to different agents affects law enforcement. It then compares the tradeoffs of allocating LMLEP to legislatures, courts, and regulators.

A. Why Law is Incomplete

As suggested above, this Article considers a law as complete if all relevant applications of the law are unambiguously stipulated in the law and the law can be enforced literally provided that evidence is established. This requires that the law is self-explanatory, i.e., that every addressee agrees to the meaning of the law and, by implication, that there is no need for interpreting the law. Otherwise, a law is incomplete, that is, some of the relevant issues are not stipulated in the law or they remain ambiguous. An incomplete law cannot be enforced literally even when evidence is established.

The basic premise is that law is intrinsically incomplete. In a state governed by the rule of law, law is designed to serve a
large number of addressees for long periods of time and to cover a great variance of cases. Generality of law means that law is designed to last, to apply to large numbers of addressees for long periods of time. The concept is closely linked to the notion that everyone is equal before the law. A general law is designed to apply equally all conditions described in the law, irrespective of the class, social status, or other attributes of individuals subject to the law. As such, general law cannot be easily used as a tool for oppressing individual opponents or inflicting arbitrary punishments. The flip side of the generality of law is that it makes it impossible to design complete law, which could affect the outcome for a variety of cases that may arise in the future.

Absent the limitations of the generality of law constraint, law could be designed to be more complete. A law could be designed to apply to a specific case and to last only for a short period of time. Such a law would closely resemble a specific contract between the state and a private lawparty rather than a social contract with multiple addressees. This Article therefore terms it a “single-case-law.” Each single-case-law can be more complete for the particular issue it addresses and for the limited time period it covers. Still, this approach has significant limitations. Only the parties to this particular law benefit from it, and only for the time period for which the single-case-law was designed. Those not a party to the single-case-law might bargain for similar arrangements, but without certainty as to the outcome of their negotiations. Similarly, even the parties to the original law need to renegotiate its terms after it expires. Put differently, single-case-laws regulate specific affairs, but do not establish positive externalities in the form of general rules that might help others to structure their relations or serve as guidance for future disputes. They create private, but not social, benefits.19 They are also more susceptible to interest group pressure. Finally, because a special law must be passed for each particular case and for every future change, single-case-law suffers from high transaction costs.

Examples of single-case-law in recent Western legal history include the incorporation of companies in the 19th cen-

19. Steven Shavell, The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System, 26 J. LEGAL STUD. 575 (1997), developed this argument for the case of litigation.
tury by special approval (concession) granted by state bureaucracy\textsuperscript{20} or by special bill passed by the legislature.\textsuperscript{21} The increasing number of incorporation bills that legislatures in the U.S. had to enact during the period of industrialization, as well as mounting corruption allegations surrounding the adoption of these bills, resulted in the adoption of general incorporation acts in many states since the 1830s\textsuperscript{22} and in Delaware in 1871.\textsuperscript{23} As the number of single-case-laws did not subside, precisely because they gave companies advantages they could not obtain under general law, Delaware amended its constitution in 1897 to prohibit incorporation other than under the general law.\textsuperscript{24} Since then, changes in the law affect all companies incorporated in Delaware, and it is not in the discretion of the legislature to alter the law only for a specific company.\textsuperscript{25}

The generality of law may be disputed with regard to case law. In common law countries where courts have extensive original and residual lawmakership authority, the law is developed on the basis of specific cases brought before the courts. Only those parts of the decision that are supported by the facts are binding on other courts, as "holding" or \textit{ratio decidendi}. Other parts of the decision are considered \textit{dicta} and non-binding.\textsuperscript{26} Still, the holdings have legal force beyond the case at hand and, until overruled, are binding on all cases in lower courts that are alike. Thus, case law also exhibits the key features of generality and equality before the law.

\begin{itemize}
\item \textsuperscript{20} \textit{James Willard Hurst}, \textit{The Legitimacy of the Business Corporation in the Law of the United States} 17 (1970).
\item \textsuperscript{21} \textit{See Russell Carpenter Larcom}, \textit{The Delaware Corporation} 1 (1937).
\item \textsuperscript{22} \textit{Id.} at 2-4.
\item \textsuperscript{23} \textit{See Act of Mar. 21, 1871, ch. 152, 1871 Del. Laws 229} (allowing incorporation for "drying, canning, manufacturing and preparing of fruits and other products of the State for sale;" Susan Pace Hamill, \textit{From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations}, 49 \textit{Am. U. L. Rev.} 81, 105 & n.95 (1999)) (listing first general incorporation statutes of Delaware and other states). In 1875, Delaware amended its Constitution to broaden the legislature's authority to enact general incorporation statutes and passed a general incorporation statute under this amendment. \textit{See Larcom}, \textit{supra} note 21, at 4.
\item \textsuperscript{24} \textit{See Larcom}, \textit{supra} note 21, at 7.
\item \textsuperscript{25} \textit{Id.}
\item \textsuperscript{26} \textit{Jane C. Ginsburg}, \textit{Legal Methods: Cases and Materials} 80 (1996).
\end{itemize}
Law can be incomplete for different reasons. It may be incomplete because it broadly circumscribes outcomes without identifying particular actions, or enumerates only a few actions (Type I incomplete law). Alternatively, law may be incomplete because it specifies the actions that shall be prevented but fails to capture all relevant actions (Type II incomplete law).

An example of Type I incomplete law is tort law. General tort principles typically stipulate that damage to property, life, and liberty gives rise to a liability claim against the person responsible. Note that no single action is defined, only the broad outcome of damages to life, liberty, and property. Requiring intent or negligence or imposing strict liability can further circumscribe the scope of liability, but this still leaves open the question of what form actions might take that will trigger liability under the law.

A good example of Type II incomplete law is criminal statutes. They usually contain a number of provisions aimed at protecting property rights, but each designed to cover a particular action, such as theft, embezzlement, damage to property, and the like. Closer inspection of these provisions reveals that the law has not captured all possible actions that could violate property rights. Rather, a conscious choice was made

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27. In legal literature, some properties of incomplete laws of the first type are discussed as “norms,” and some properties of incomplete laws of the second type as “rules.” See generally Louis Kaplow, General Characteristics of Rules, in The Economics of Crime and Litigation 502, 508-14 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) (discussing “rules” and “standards”). For an analysis of the tradeoffs of norms and rules, see Louis Kaplow, Rules versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1993). Building on this literature, some authors have proposed to use primarily “bright-line rules” when legislating in emerging markets and developing countries. See, e.g., Jonathan R. Hay et al., Toward a Theory of Legal Reform, 40 Eur. Econ. Rev. 559, 566 (1996) (arguing that because courts in these countries tend to be weak, there should be fairly little discretion left for law enforcers). The underlying assumption is that the lawmaker has a choice to write more or less complete law. Id. While this is true to some extent, our point is that no law can be written so as to eliminate discretion completely, because law is inherently incomplete. The novelty of our theory is its suggestion that the incompleteness of law necessitates an allocation of residual lawmaking and law enforcement powers to different agents. Our theory also proposes tradeoffs to determine the optimal allocation of lawmaking and law enforcement powers.


29. See, e.g., infra note 31.
to write highly specific law even if this inevitably meant that actions resulting in similar harm would not be covered. This choice results from the commitment to the *nulla poena sine lege* (no punishment without law) principle, which follows directly from the rule of law principle.30

To illustrate the distinction between Type I and Type II incomplete law and its impact on law enforcement, consider the following case. Most legal systems prohibit theft. Theft is frequently defined as the appropriation of an asset owned by another person by breaching his or her possession.31 When electricity was invented and some people simply hooked their households to electricity lines themselves instead of connecting officially and paying their bills, the question arose whether this constituted a theft. For the German Supreme Court (*Reichsgericht*), which had to decide this issue in the late 19th century, the key question was whether electricity was an “asset” (*eine Sache*) as defined by law.32 It acquitted, because it denied the asset quality of electricity and argued that the extension of the existing theft provision would amount to lawmaking by analogy, which would be in violation of the *nulla poena sine lege* principle.33 The legislative response was to insert a new provision in the code that dealt specifically with appropriating energy.34

When confronted with similar cases, U.S. courts argued that the key issue was not the asset quality, but whether a thing can be appropriated. This allowed them to apply existing theft provisions even in cases where the asset quality of the item that


31. See, for example, the Penal Code of New York State, which defines larceny or theft as follows: “A person steals property and commits larceny when, with intent to deprive another of property or to appropriate the same to himself or to a third person, he wrongfully takes, obtains or withholds such property from an owner thereof.” N.Y. Penal Law § 155.05 (Consol. 2000). Similarly, see § 242 of the German Penal Code, which states that “whoever deprives another person of an asset with the intent of appropriating that asset either to himself or to a third person” commits a theft. § 242 Nr. 1 Strafgesetzbuch [StGB].

32. See RGStr 29, 111 (111); RGStr 32, 165 (166).

33. See RGStr 29, 111 (111); RGStr 32, 165 (166).

34. See § 248c StGB, first enacted in April 1900; see also Adolf Schönke & Horst Schröder, Strafgesetzbuch Kommentar [Penal Code Annotated] 910 (9th ed. 1959) (noting the law’s introduction in 1900).
was the object of the alleged theft was disputed.\textsuperscript{35} In other words, they interpreted the law to be broader and more ambiguous at the borders than their German counterparts had. Nevertheless, the matter remained sufficiently unsettled to bring a case to the New York Supreme Court as late as 1978.\textsuperscript{36} Meanwhile, New York has expanded the definition of property in its Penal Code to include "any article, substance or thing of value, including any gas, steam, water or electricity."\textsuperscript{37} While this broad definition facilitates law enforcement, courts will still need to develop criteria to exclude from this provision cases which do not meet the threshold implied in a theft accusation. More recently, English courts were confronted with the question of whether the case law on abstracting electricity could be expanded to convict persons who had fraudulently used telephone lines without paying. This was denied on the grounds that the use of analogy was inappropriate.\textsuperscript{38} Obviously, if England had followed the New York example, the courts could have convicted the accused. Absent such a broad definition, however, the court felt restrained by the \textit{nulla poena sine lege} principle.

The theft problem demonstrates that technological change may render previously fairly complete law incomplete. Prior to the invention of electricity or telecommunications, the concept of theft had been well defined and was fairly complete. But electricity and telephone lines were not assets or property in the traditional sense. Lawmakers and law enforcers had to decide whether the unauthorized use of electricity or telephone lines deserved the same level of punishment. The cases also reveal that courts exercise only limited residual lawmaking powers in the area of criminal law. The result has frequently been acquittal, even though the identified actions

\textsuperscript{35} \textit{See}, e.g., People v. Menagas, 11 N.E.2d 403, 407 (Ill. 1937).

\textsuperscript{36} \textit{See} People v. McLaughlin, 402 N.Y.S.2d 137 (N.Y. 1978). For a summary of U.S. and English case law in this matter, see \textit{id.} at 139-40. In the words of the Supreme Court of Illinois when dealing with this matter in 1937, "[t]he true tests of what is a proper subject of larceny seems to be not whether the subject is corporeal or incorporeal, but whether it is capable of appropriation by another than the owner." \textit{Menagas}, 11 N.E.2d at 407.

\textsuperscript{37} \textit{See} N.Y. Penal Law \textsection{} 155(1) (Consol. 2000).

\textsuperscript{38} \textit{See} Reg. v. Nadig, 14 Crim. App. R. (S.) 49-50 (1993). The appellate court held that "it was inappropriate to rely on the analogy of cases of fraudulently abstracting electricity" in this particular case. \textit{Id.} at 49-50, 52.
were widely regarded as wrongful.\textsuperscript{39} This is a clear example of deliberate under-enforcement of the law. It is the price legal systems pay for adhering to principles, such as \textit{nulla poena sine lege}, that limit the state’s power to punish unless the action has been clearly stipulated as a crime before it occurred. More generally, any attempt to write a highly complete law that specifies the type of action to be sanctioned is bound to result in under-enforcement, because actions the lawmaker did not foresee ex ante, but which may result in similar harmful outcomes, are bound to occur.

B. \textit{Incompleteness of Law Versus Imperfectness of Evidence}

The above example of electricity theft also demonstrates that it is important to distinguish the difficulty of establishing evidence from incomplete law. In the above cases, the fact that the accused had appropriated energy by hooking their households to existing electricity lines without a contract and without paying bills was undisputed. The only question was whether these actions constituted a theft.\textsuperscript{40}

The type of evidence needed to convict a person or to hold her liable under the law is determined by the law that shall be applied.\textsuperscript{41} Before collecting evidence it is therefore important to establish whether the action—assuming all relevant evidence can be established—falls within the scope of the law. If that is clearly not the case, there is no need to tackle the evidence question. Only if the law can be interpreted to cover the relevant actions does the question of evidence arise.\textsuperscript{42}

To give an example, suppose an anti-corruption law states that extending gifts to government officials is considered a bribe if the amount exceeds U.S. $500 per annum. There are allegations that A has presented a gift of U.S. $50 to the official in charge of building permits. Since the law clearly estab-

\textsuperscript{39} See, e.g., \textit{supra} notes 32-33, 38, and accompanying text.
\textsuperscript{40} See \textit{supra} notes 31-38 and accompanying text.
\textsuperscript{42} An effort to collect evidence will be wasted if the action does not fall within the scope of the law because the action will not survive the pleading stage of litigation. See Fed. R. Civ. P. 12(b)(6); 71 C.J.S. \textit{Pleading} § 118 (1996).
lishes a higher threshold than the alleged conduct meets, the action does not fall within the scope of the law. Thus there is no need to establish evidence. Note, however, that when the law is rather vague, i.e., when dealing with Type I incomplete law, it may be necessary to collect evidence in order to determine whether or not the law is applicable to a particular case. If, for example, the anti-corruption law states that a gift of “substantial” value may be considered a bribe, it may be relevant to collect evidence to show why a particular gift would be considered “substantial.” Still, even this question is different from the question of whether A has actually given the official a gift of U.S. $50.

C. Incompleteness of Law Versus Uncertainties of Punishment

The concept of incomplete law is related to the concept of vagueness or indeterminacy of the law. In their economic analysis of “vague standards” as opposed to “bright line rules,” Cooter and Ulen suggest that “in reality . . . legal commands are often vague and unpredictable.”43 They suggest that if law is vague, courts may err in setting the correct standard for an individual injurer, just as individual injurers may err in predicting the standard that courts will apply to them.44 As a result, injurers will take additional precaution to avoid punishment, because the potential damage from excessive punishment harms them more than the cost of over-precaution to avoid punishment.45

The incomplete law analysis differs from this framework in two important respects. First, the incomplete law analysis suggests that law may just as well result in under-enforcement as in over-enforcement. Ex ante it is difficult to predict which outcome is more likely. This follows from the notion that incomplete law covers both Type I and Type II incomplete law, whereas the vagueness theory covers only Type II. Second, and more importantly, the focus is less on the responsiveness of the potential injurer to legal uncertainty and more on the design of lawmaking and law enforcement institutions in areas where errors in law enforcement, including under- and over-enforcement, are associated with great harm. Whereas

43. Cooter & Ulen, supra note 10, at 319.
44. Id. at 319-20.
45. Id.
Cooter and Ulen suggest that courts may reduce the error problem on a case-by-case basis.\(^4\)\(^6\) This Article proposes that, under certain circumstances, it may be more efficient to reallocate lawmaking and law enforcement powers away from courts and to a different agent.

D. Allocating LMLE Powers

Every legal system allocates the power to make and enforce laws to different agents. The most common lawmaking agents in democratic systems are legislatures and, at least in common law countries, courts; the most important law enforcement agents are courts. These agents may be said to exercise original lawmaking and law enforcement powers. When law is incomplete, allocating original LMLEP alone is insufficient for achieving efficient levels of deterrence. Because a given law cannot resolve all future cases, the power to interpret and develop existing law and to decide how to deal with new cases needs to be allocated. We call these powers the residual LMLEP. These powers may be allocated to courts or to other agents, such as regulators.\(^4\)\(^7\) Different institutional constraints allow regulators to make and enforce laws in ways legislatures or courts cannot.

Each legal system faces the challenge of optimizing the relative completeness for different areas of the law and of allocating residual lawmaking powers to different agents. This Article does not suggest that there is a “best practice” for allocating LMLEP. However, the analytical framework allows identification of complementarities between types and degrees of incomplete law on the one hand, and the efficacy and costs of different law enforcement agents on the other. It may therefore also serve to assess the choices made by different legal systems.

The two major legal systems in the world, the common law and the civil law system, allocate residual lawmaking powers quite differently.\(^4\)\(^8\) In the common law system, judges not

\(^{46}\) Id. at 322.

\(^{47}\) As stated in the introduction, we limit our analysis in this Article to regulators generically defined. Future research shall address tradeoffs between state and self-regulators.

\(^{48}\) Scholars of comparative law typically distinguish several subfamilies within the civil law family, namely the French, German, and Scandinavian.
only hold extensive residual lawmaking powers; they are also vested with original lawmaking powers, i.e., with the power to develop new principles of law.\textsuperscript{49} In civil law systems judges are said to interpret, not make, law. The theft cases discussed above evidence differences in the approach civil and common law judges might take in handling similar cases. While the German Supreme Court felt compelled to acquit, the English and American courts developed new law addressing the cases before them.\textsuperscript{50}

The line between lawmaking and law interpretation, however, is often difficult to draw. Interpretation, even if narrowly construed, involves an element of residual lawmaking. It implies that the application of a law to a particular set of facts does not follow immediately from the wording of the statute or case law. In one sense, civil law judges may even be said to be less constrained than common law judges. They are not subject to the rule of precedent; that is, they are not legally obliged to follow the rulings of superior courts. In practice, however, lower courts will usually do so, as they risk being overruled otherwise. Yet the absence of a formal precedent rule still may give judges more leeway in interpreting the law. Thus, this Article suggests that, even in civil law countries, judges exercise residual lawmaking powers. It does, however, concede that judges in civil law jurisdictions are more constrained in exercising these rights than judges in common law jurisdictions, in part because of legal doctrine, and in part due to other institutional constraints on judges.\textsuperscript{51}

\textit{See, e.g., Konrad Zweigert \& Hein Kötz, Introduction to Comparative Law (Tony Wier trans., 3d rev. ed. 1998); Rene David \& John E. Brierly, Major Legal Systems in the World Today (1985); Mary Ann Glendon et al., Comparative Legal Traditions (1994).}

\textsuperscript{49} There is a substantial debate whether common law judges actually "make" law or whether they "find" the law based on legal principles. \textit{See, e.g.,} Jack G. Day, Why Judges Must Make Law, 26 Case W. Res. L. Rev. 563, 563-65 (1994) (rejecting the view that judges "find" law). For our purposes this distinction is not crucial. The key point is that in common law countries it is widely recognized that judges exercise substantial powers to make legally binding precedents, which fill some gaps in the law. This lawmaking power is one of their major functions.

\textsuperscript{50} \textit{See supra} text accompanying notes 32-33, 35.

\textsuperscript{51} For an empirical analysis of the "daringness" of judges in different legal systems, see Robert D. Cooter \& Tom Ginsburg, \textit{Comparative Judicial
The two major law enforcement agents, courts and regulators, differ in the process and timing of how they exercise their residual LMLEP. Courts are designed to function as neutral arbiters, another essential feature of a legal system based on the rule of law.\textsuperscript{52} They are therefore designed to be passive and to exercise their LMLEP only after a motion has been brought. They do not have the power to take action \textit{sua sponte} even when such an intervention might be desirable.

By contrast, regulators are designed to enforce law proactively. Proactive law enforcement includes various functions, such as controlling entry, monitoring activities, initiating investigations, enjoining actions, and initiating the administration of sanctions against violators. Courts can carry out none of these functions, because courts are designed to be impartial and therefore have to remain passive until others bring actions.\textsuperscript{53}

A simple example of a proactive law enforcer is the police. The police monitor behavior and seek to prevent damages by enjoining actions that are likely to cause harm. The police can stop a car even when the driver is not speeding or violating other rules, just because, for example, the manner of driving suggests that there could be something wrong (sometimes even exact observance of the rules can raise suspicions). Unlike courts, the police cannot convict the driver under criminal law. This remains the task of the courts. But they can stop him, administer an alcohol test, prevent him from continuing on his way if the test is positive, and even impose a fine. To this end the police are vested with the power to investigate, collect information, and enjoin actions.

This Article argues that the need for proactive law enforcers such as police or regulators arises only when law is incom-


\textsuperscript{52} Other features described above were the generality of law and equality before the law. \textit{See supra Part II.A.}

\textsuperscript{53} Our theory of regulation is consistent with Jeremy Bentham's argument made in the 19th century that there was a need for "devising a course of legislative acts adapted to prevent offenses," even though he did not refer explicitly to the issue of incomplete law. \textit{See Jeremy Bentham, Theory of Legislation 358 (Richard Hildreth trans., 2d ed. 1871).}
complete. When law is complete, legal systems do not have to concern themselves with seeking alternatives to courts as the major law enforcement institutions. All they need to do is ensure that the level of punishment and the probability of getting caught are sufficiently high. If law is incomplete, however, law enforcement agents and the optimal allocation of LMIEP become crucial. This is because when law is incomplete, it cannot effectively deter. In combination with the design of courts as reactive law enforcers and predominantly ex post lawmakers, the most likely outcome is under-enforcement of the law. As explained above, even when evidence has been established that the alleged actions have taken place and resulted in harmful outcomes, there may be doubts as to whether these actions fall within the scope of the relevant law. Individuals contemplating actions may respond to the incomplete law problem in two ways. They may proceed on the assumption that the law will not apply to them. Alternatively, they may be overly cautious because their actions may fall within the scope of a particular law and result in punishment. In either case, the deterrence effect of the law is not optimal. In the first case, the law under-deters; in the second, it over-deters.

Courts and regulators also typically differ as to when they exercise their LMIEP. Courts for the most part make and enforce law ex post, that is, after harm has occurred. Ex post law enforcement is closely related to the function of courts as reactive law enforcers. Because courts have to wait for others to bring a motion, they are typically called upon only at times when the incentives for bringing an action are sufficiently high. However, courts can also be asked to prevent harmful actions from taking place. The procedural means is to file a motion for a preliminary injunction.

By contrast, regulators make and enforce law both ex post and ex ante. Because regulators enforce law proactively, they can initiate enforcement proceedings when they find that the level of expected harm is sufficiently high. Moreover, they can

54. Here, we assume there are no incentive issues in collecting evidence. In focusing on incentive issues, Glaeser et al. show that regulators may be more effective law enforcers because they can be better incentivized. Glaeser et al., supra note 13, at 854. For further details, see discussion of their approach in Part III.C infra.
use their residual lawmaker powers to adapt and change rules in response to socioeconomic or technological change they observe and thereby enhance their ability to enforce the law at optimal levels.\textsuperscript{55} Regulators can exercise their lawmaker rights more flexibly than legislatures can. They need not go through a lengthy lawmaker process, but may, within the scope of their lawmaker rights, adapt and change the law in a simplified procedure. As long as their jurisdiction is sufficiently well-defined by law, which is democratically legitimized, this does not infringe on the powers of legislatures.

The lawmaker function of regulators has been recognized in the literature before. In fact, regulation is often equated with rulemaking rather than with proactive enforcement, which in this Article's theory is a crucial element of regulatory functions. Shavell, for example, examines the difference between liability and safety regulations for accidents.\textsuperscript{56} He conjectures that liability is invoked after harm has been done. By contrast, regulation determines a certain level of care the regulator finds desirable, which is imposed on economic actors ex ante. Shavell argues that since the regulator cannot observe the level of risk, ex ante rule making will not be optimal.\textsuperscript{57} This argument is well taken when lawmakers cannot easily adjust the law over time. Legislatures, for example, face higher procedural constraints and costs in changing the law than regulators do and therefore cannot easily adjust the rules in response to observed changes. Regulators, by contrast, have more limited lawmaker powers—only those the legislature delegates to them—but can make changes more flexibly. In addition, and crucially from the point of view of

\begin{footnotesize}
\textsuperscript{55} Regulators are not always successful in implementing such rules. Recall that the U.S. Securities and Exchange Commission, under its former chair Arthur Levitt, Jr., made a 2000 proposal to Congress to constrain auditing firms from taking on consulting business for the same firms they audit, but that this attempt was stopped by strong opposition from auditing firms and did not find support in Congress. See Jackie Spinner, "You Were Right:" Lawmakers Face SEC Chief Who Warned of Auditors' Conflicts, WASH. POST, Jan. 25, 2002, at E1. The article describes the lobbying efforts by Arthur Andersen and other firms to prevent this measure. See id.


\textsuperscript{57} Shavell, Liability and Safety Regulation, supra note 56, at 273-74.
\end{footnotesize}
the incomplete law concept, regulators are not only rule-makers but also law enforcers.

E. Institutional Choice

The previous section analyzed the major characteristics of courts and regulators as holders of residual LMLE powers. This section seeks to identify the factors that will determine the optimal allocation of LMLE power to either courts or regulators. It should be noted at the outset that there is no regime choice issue in the first best world, where law is complete and an optimally designed law fully can deter harmful actions. The goal here is to optimize the allocation of LMLE powers in a world of second bests where law is incomplete.

Already, some drawbacks of courts as holders of residual LMLEP have been identified and comparative advantages of regulators noted. Regulation is also not without cost. The direct costs of regulation include the funds needed to hire monitors and investigators, to maintain filing systems, and to launch lawsuits. The indirect costs of regulation are comprised of the costs market participants incur because they have to comply with regulation and that society incurs when regulators either over- or under-enforce the law. Just like courts and legislatures, regulators may err by either over- or under-enforcing the law. Their advantage is that—absent incentive problems—they can correct for past errors on their own initiative and in a flexible and responsive manner. Over-regulation occurs when a regulation imposes costs that outweigh the benefits of proactive law enforcement, i.e., when it enjoins too many potentially beneficial actions or when well-intentioned regulation stifles economic activities in other ways. Regulators may also under-enforce because they face resource constraints, misallocate their resources, or fail to detect harmful actions.

58. Shavell points out that regulators operate even when there is no harm. Shavell, Liability Versus Regulation, supra note 56, at 364. The same is true for courts, of course, unless a legal system relies exclusively on ad hoc dispute settlement institutions. However, courts may shift to different subjects when there is a drop in litigation, whereas regulators are much more specialized law enforcers.

59. On the tradeoff between monitoring and investigating and the cost implications of these regulatory enforcement mechanisms, see Dilip Mookherjee & I. P. L. Png, Monitoring vis-à-vis Investigation in Enforcement of Law, 82 AM. ECON. REV. 556, 557 (1992). Using a formal model to compare the
Recognizing these limits of law enforcement by courts, on the one hand, and of regulators on the other, the question is under what conditions it may be optimal to allocate LMLEP to courts, to (re-)allocate them to regulators, or to complement court enforcement with regulatory enforcement. While holding incentive problems and the vulnerability to corruption constant, two important factors are suggested: standardization and the level of expected harm (externality).

Standardization refers to the ability to describe actions and outcomes at reasonable cost so that regulators can exercise their proactive law enforcement powers effectively. The effectiveness of proactive law enforcement hinges on the ability of regulators to monitor the market and identify types of actions and outcomes that reasonably may be expected to result in harmful outcome. The assessment of which actions or outcomes fulfill these conditions may change over time. Yet it is essential that regulators be able to identify and standardize in order to use their resources effectively and avoid the pitfall of over-enforcing. Take the example of securities regulation, which is analyzed in greater detail in Part IV below. If regulators are unable to distinguish whether harm to the investing public results from the very act of issuing securities, from issuing securities to small investors, from certain companies issuing securities, or from companies issuing securities without informing investors about key aspects of the company and its future growth potential, then they are unable to determine what actions they should prevent or may use their powers to prevent public offering altogether. Only when the “right” harmful actions have been identified can a regulator take the relevant actions.

This insight has important implications for proactive law enforcers and the timing of ex ante lawmaking. Take the example of German stock exchange regulation in the late 19th century. After a serious crash of the markets, German

tradeoffs, Mookherjee and Png conclude that the use of these alternative enforcement devices should be tailored to the severity of the offense. Smaller offenses should not be investigated, merely monitored. Larger offenses should be investigated in accordance with their severity, and fines should be maximized. Id.

lawmakers believed that the major harm resulted from exposing ignorant, small investors to the whims of large corporations.\textsuperscript{61} They therefore reasoned that small investors should be prevented from investing in large publicly held enterprises and effectively prevented these investors from acquiring shares in joint stock corporations by stipulating that each share had to be issued and sold for no less than the nominal value of R.M. 1,000—which was beyond the reach of most investors at the time.\textsuperscript{62}

Meanwhile, most legal systems focus on disclosure obligations and do not attempt to regulate who may or may not invest in large corporations.\textsuperscript{63} The identification of this problem and the kind of information that is deemed relevant for investors has made it possible to devise a proactive enforcement regime. Securities regulators can monitor disclosure and can further stipulate the kind of information that needs to be disclosed. The relevance of individual items whose disclosure is required is often debated.\textsuperscript{64} Nevertheless, there is little disagreement over the importance of disclosure, though there is still debate about whether disclosure should be mandatory.\textsuperscript{65}

The second factor that determines the optimal regime choice is the level of expected harm. The constraints of ex post lawmaking and reactive law enforcement may be tolerable when the expected level of harm is low, for example, when the harm victims might suffer is small or when only a few victims are affected by harmful actions. Noise emission by an individual household will affect only the immediate neighbors, who can identify the cause and therefore are able to bring action and seek remedies using courts as reactive law enforcers. By contrast, when a factory emits pollutants, many more people

\textsuperscript{61} Id. at 56.


\textsuperscript{64} For a major attack on the SEC’s disclosure regime, see \textbf{GEORGE J. BENSTON, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA} 189-92 (1976).

may be affected. As long as the level of harm they suffer is limited, it may be sufficient to provide enforcement through the court system and to create incentives for using the court system by allowing class action suits, granting treble damages, and the like. If, however, the level of expected harm is substantial, as in the case of nuclear power plants, court enforcement will not be effective. It will typically come too late, after harm has been done. Shifting to a proactive law enforcement regime that seeks to prevent the occurrence of harm through entry barriers, continuous monitoring, and investigation, will therefore be superior.

To summarize, regulators perform different functions than courts. As proactive law enforcers, regulators can enjoin actions and initiate enforcement procedures, which is an important advantage over courts when law is incomplete. As continuous lawmakers, they can change rules in response to variations in markets they observe, independent of whether violations have occurred, or when others have brought problems to their attention. Still, even these factors do not lead to regulators in all areas of the law and cannot justify the establishment of regulators in all cases. The cost of proactive law enforcement by regulators can be justified only when actions can be standardized and when these actions are likely to create substantial harm and negative externalities, which cannot be fully remedied by reactive law enforcement.

This Article suggests that financial markets are an area where regulation can be justified, i.e., the benefits of introducing regulators may offset the costs of doing so. If cheating is restricted to a couple of shareholders, it will not undermine the viability of financial markets. Widespread stock fraud, however, can seriously undermine investors' confidence in capital markets and hurt the economy.66 This happened in

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66. See generally Bernard Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. REV. 782, 804-15 (2001) (arguing that a strong public securities market depends on investors' confidence that corporate insiders will not engage in self-dealing transactions). The proposition that mandatory disclosure can help avoid externalities is highly disputed in legal literature. Proponents of this proposition include Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1435, 1490-91 (1992) (arguing that disclosure rules by states would result in sub-optimal levels of disclosure, as disclosure by a public company confers positive externalities on other com-
the stock market crash of 1929. More recently, the disclosure that several companies' earnings reports were seriously misleading has led to an erosion of investor confidence in the United States, as evidenced by the dramatic decline of stock markets. This has led some commentators to draw parallels to the events of the late 1920s and the regulatory responses that followed in the early 1930s. More generally, the history of the law governing financial markets, which is further addressed in Part IV below, demonstrates the ingenuity of market actors in developing schemes to defraud investors in ways that time and again proved to be beyond the reach of existing law. Attempts to deter such actions by enhancing the completeness of case or statutory law alone have proven to be unsuccessful because the law constantly lagged behind new market developments, including new methods of cheating investors. The inability of lawmakers to prevent harmful actions in the future simply by making law more complete eventually gave way to the emergence of regulators, first in the form of stock exchanges, and later in the form of state regulators. These agents have enhanced, though not perfected, the effectiveness of law enforcement in the field of securities regulation. This history seems to be repeated with the establishment of a new regulatory body for overseeing accounting

67. See Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 23-33 (1983) [hereinafter Seligman, Historical Need] (discussing the link between securities fraud and the 1920s bull market which preceded the 1929 crash); Peter J. Dennin, Which Came First, the Fraud or the Market: Is the Fraud-Created-the-Market Theory Valid Under Rule 10b-5?, 69 Fordham L. Rev. 2611, 2615 (2001) (noting that Congress passed the Securities and Exchange Act in order to reduce the securities fraud which had contributed to the 1929 crash).


70. See discussion infra Part IV.
firms, which had been left out of the 1993-34 regulatory framework.71

This theory is also consistent with the account of contemporary observers of the rise of the regulatory state in the U.S. Landis, who later served as chairman of the SEC, explained the emergence of the administrative process in his 1938 book as the growing complexity of social and economic relations in the process of industrialization on the one hand, and the inadequacy of judicial lawmaking and law enforcement under these conditions on the other.72 He described the need for “uninterrupted supervisory interest”—what today would be called monitoring—as “incompatible with the demands of judicial office”73 and the need for uniformity in applying law to different cases. In his view, this could be achieved by the judicial process only through the time-consuming process of appeal to higher courts.74 In addition, he argued that the process of litigation had left “too much in the way of the enforcement of claims and interests to private initiative.”75 The slow process of adjudication created “the demand for a power to initiate action.”76 Landis also pointed out that an important difference between the judicial process and the administrative process is the latter’s power of independent investigation, which he deems crucial both for initiating enforcement and for the development of adequate rules.77

Landis recognized that the administrative process often combines lawmaking and law enforcement functions, which, in accordance with the classic division of powers, should be vested with different branches of the government.78 Moreover, he argued that this combination of lawmaking and law en-

73. Id. at 33.
74. Id. To these considerations, he adds the idea that lawmaking in some areas requires practical expertise rather than general judicial reasoning (“[T]here are certain fields where the making of law springs less from generalizations and principles drawn from the majestic authority of textbooks and cases, than from a ‘practical’ judgment . . .”). Id.
75. Id. at 34.
76. Id. at 35.
77. Id. at 37-41.
78. “No one can fail to recognize that there are dangers implicit in this combination of functions in an administrative agency.” Id. at 95.
forcement powers was a response to the inadequacies of the judicial process. In his view, judges and judge-made law were slow to respond to changes in the environment.\textsuperscript{79} He also suggested that the administrative process was not without checks, including the narrow scope of jurisdiction regulators possess as compared to courts; the professionalism of the regulator; the need to produce facts to sustain an order; the independence of administrative tribunals, which was ensured by a division of labor within the administration; and, finally, judicial review of administrative orders.\textsuperscript{80}

III. INCOMPLETENESS OF LAW AND RELATED THEORIES

This section places the incomplete law framework in the context of related literatures, including the incompleteness of contracts, the indeterminacy of law, and theories on regulation. It does not attempt a comprehensive survey of these literatures but rather seeks to distinguish this framework from related theories.\textsuperscript{81}

A. Incomplete Contract Theory

The incomplete law concept is inspired by the incompleteness of contracts theory as developed in the literature of economics. The notion that contracts are incomplete is now widely recognized.\textsuperscript{82} The concept was introduced as a critical ingredient to explain property rights and the boundary of the firm.\textsuperscript{83} According to incomplete contract literature, a contract is complete if all relevant contingencies and corresponding control rights—the contractual rights and obligations of the

\textsuperscript{79} See id.

\textsuperscript{80} See id. at 98-101.

\textsuperscript{81} Part II of this Article discusses the law enforcement literature at some length, so it is not addressed in this section.

\textsuperscript{82} For discussions about the theoretical foundation of incomplete contracts see Hart & Moore, supra note 16, and Eric Maskin & Jean Tirole, Unforeseen Contingencies and Incomplete Contracts, 66 Rev. Econ. Stud. 83 (1999).

parties—are specified unambiguously.\textsuperscript{84} Complete contracts ostensibly resolve all possible future disputes between the contractual parties ex ante.\textsuperscript{85} A contract is incomplete when some relevant contingencies are missing, or some items are specified ambiguously.\textsuperscript{86} As a result, the contract is not legally enforceable and cannot independently resolve future disputes. Parties will therefore need to make provisions allocating residual rights to make decisions when unspecified events happen.\textsuperscript{87} The incomplete contract literature has only begun to be absorbed by legal scholars.\textsuperscript{88}

The main difference between the incomplete law concept and the incomplete contract theory is the subject of inquiry. The incomplete contract literature is concerned with private contracts among economic agents and seeks to optimize the allocation of residual rights in economic efficiency terms.\textsuperscript{89} The focus of the incomplete law concept is the legal system, i.e., the multitude of social contracts that bind lawmakers, law enforcers, and all individuals under their jurisdiction for long periods of time. A major concern for the allocation of residual lawmaking and law enforcement powers is that in a country governed by the rule of law, law must in principle be general and apply equally to all individuals. These principles limit the extent to which law enforcement can be optimized by writing as complete a law as might otherwise be possible (i.e., by writing multiple single case laws). They also limit the scope for renegotiation, as retroactive lawmaking is restricted by principles such as \textit{nulla poena sine lege}. This is particularly true in the area of criminal law. The incompleteness of contract theory does not face similar constraints. It can therefore experiment more freely with determining the optimal allocation of residual rights of contracts and strategies to enhance the com-

\begin{itemize}
\item \textsuperscript{85} Id.
\item \textsuperscript{86} Id.
\item \textsuperscript{87} Michel Nakhla, \textit{Information, Coordination, and Contractual Relation in Firms}, 23 Intr’l Rev. L. & Econ. 101, 105 (2003).
\end{itemize}
pleteness of contracts. Moreover, the incomplete contract literature assumes the existence of courts to enforce contracts. When law is incomplete and LMELP are allocated differently, this will affect contract enforcement and have implications for the design of contracts ex ante. Introducing the incomplete law concept therefore opens the door to endogenize legal and contractual design issues, which should stimulate further research and analysis.

B. Indeterminacy of Law

This Article's contribution is not to restate the basic observation that neither statutory nor case law can unambiguously predict the outcome of a particular case. This is a well-known fact. Instead, its major contribution is to provide an analytical framework based on the notion that law is incomplete for purposes of understanding differences in the design and functioning of legal institutions.

Legal literature has long recognized the phenomenon herein called "incomplete law," and has referred to it as the "indeterminacy" of law. Legal philosophers, foremost among them H.L.A. Hart, have argued that it is "a feature of the human predicament" that we simply cannot "regulate, unambiguously and in advance, some sphere of conduct by means of general standards to be used without further official direction on particular occasions." The world is simply too complex.

Compared with this Article's approach, indeterminacy literature—or rather the various indeterminacy literatures—tend to have a strong normative connotation. An important

90. See, e.g., id. at 91, 93 (proposing a strategy designed to give parties an incentive affirmatively to choose the contract provision they prefer ex ante, thereby enhancing the completeness of the contract).


92. In the words of Hart, "If the world in which we live were characterized only by a finite number of features, and these together with all the modes in which they could combine were known to us, then provision could be made in advance for every possibility." He adds, "Plainly this world is not our world." Id.

93. An exception is a recent Article by Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 COLUM. L. REV. 1908 (1998), which applies the "indeterminacy" concept to explain the political economy of rule making. He suggests that the legal profession in the state of Dela-
issue in the critical legal studies literature that addresses the problem of indeterminacy is the compatibility of indeterminate law with rule of law. The "discovery" that law is not as firm a guide for resolving cases as legal formalists would have it (legal formalism is often described as the idea that judges are subject to the law and that alone) sheds doubts on the administration of justice by judges accountable only to the law. The indeterminacy debate seeks to critique or reconcile—depending on which side of the debate one stands—basic principles of justice and rule of law with the argument that law does not determine outcome but at best constrains the choices law enforcers face. By contrast, from the vantage point of the incomplete law concept, this Article suggests that core features of the rule of law (such as generality of and the principle of equality before the law) imply that the law is incomplete, or that incomplete law and rule of law go together.

ware has a vested interest in writing highly indeterminate corporate law, because this gives it a comparative advantage over other states. Delaware competes to be the location for incorporation of major companies against states that could easily copy Delaware corporate law—as some have in fact done—to undermine Delaware’s dominant role. Indeterminate law, however, requires substantial involvement of legal professionals in applying the law to real cases. The specialization of the legal profession in corporate law in Delaware is difficult for other jurisdictions to emulate, and is valued by shareholders, managers, and other corporate stakeholders that benefit from high-quality corporate law. See id. at 1910-12.

94. Radical critiques have used the concept of legal indeterminacy to argue that "law is politics" and to debunk the concept of the rule of law as a myth. Since law does not determine the outcome of a particular dispute, other factors, including political preferences of judges or the political clout of the parties to the dispute, must. There is a range of more nuanced uses of the concept. Many have rejected the radical notion of indeterminacy and distinguish law’s ability to determine outcome (which it cannot) from the law’s ability to constrain outcomes (which it does). The emerging consensus appears to be that law is neither radically indeterminate nor fully determinate. For an excellent summary of this debate with further references, see Lawrence B. Solum, Indeterminacy, in A Companion to Philosophy of Law and Legal Theory 488 (Dennis Patterson ed., 1996).

95. See id. at 488-89.

96. This is similar to Friedrich A. Hayek’s proposition that any attempt to write precise law undermines the impartiality of the legislatures and is therefore inconsistent with the rule of law:

If the state is precisely to foresee the incidence of its actions, it means that it can leave those affected no choice. Wherever the state can exactly foresee the effects on particular people of alternative courses of action, it is also the state which chooses between the
The focus of this analysis, however, is different. Starting from the premise that law is incomplete and recognizing that important constraints in the design of legal institutions follow from the rule of law, this Article investigates possible institutional responses to incomplete law problems, in particular the allocation of residual lawmaking and law enforcement powers. It attempts to determine which among several options is superior given certain identified conditions and constraints. It is worth mentioning that some legal indeterminacy literature (e.g., Hart) has made observations about the function of courts and of regulation. However, to the best of our knowledge, these insights have not been developed into a full-fledged, conceptual framework suitable for analyzing legal institutions, and, in fact, they have been largely ignored by theories on regulation.

C. Theories on Regulation

There is a substantial literature on regulation in economics, political science, and law. A popular treatment of regu-
tion in economics literature regards it as "any" intervention by the state to address market failures when there are externalities and/or informational problems. 98 That literature, however, does not differentiate between types of non-market forces. By contrast, this Article identifies structural differences in the timing and process of lawmaking and law enforcement that distinguish these agents and help explain why, under certain conditions, vesting one or the other with residual lawmaking and law enforcement powers may be superior. By defining regulation as proactive law enforcers and courts as reactive law enforcers, one can easily show that if the only concern is market failure, there may be no need for regulation. This is because court-enforced law may be able to solve market failure problems effectively. A complete, court-enforced law requiring compulsory insurance, for example, could solve insurance market failure problems. Insurance market failure is associated with the fact that most potential insurers are under-insured. 99 Similarly, a complete, court-enforced law requiring compulsory warranty for any product sold could solve the used car market failure problem caused by informational asymmetry and externalities in the market. 100 Such a law would essentially eliminate the problem of asymmetry between buyer and seller by shifting liability to the seller. These solutions would be costly, but they demonstrate that complete law could solve information problems and, by implication, show that market failure alone is not sufficient to justify regulation.

The core of this Article's argument is that law is incomplete and that, under incomplete law, reactive law enforcement is often insufficient to achieve optimal levels of law enforcement. Moreover, courts cannot perform the same functions as regulators, as this would violate their role as impartial arbiters. If courts performed the same proactive enforcement and ex ante lawmaking functions, this would turn them into regulators. Given incomplete law and these constraints on courts, court-enforced law incurs deterrence failure problems.

98. ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 5-10 (1980).

99. Id.

The introduction of a different agent as a proactive law enforcer—a regulator—can improve this situation.\(^{101}\)

This is not the first time it has been suggested that enforcement by regulators may, under certain conditions, be an improvement over law enforcement by courts. A recent paper by Glaeser, Johnson, and Shleifer suggests that enforcement by regulators may be more effective than enforcement by courts when the enforcement requires investment in costly evidence collection, because it is easier to design incentives for regulators than for courts to optimize their law enforcement activities.\(^{102}\) Although complementary, this theory differs from that approach. As shown in the model,\(^{103}\) under incomplete law, court-enforced law may suffer from deterrence failure problems even when the problem of evidence has been resolved. A similar case is made in the discussion of the electricity theft cases in Part II of this Article.\(^{104}\) Thus, it is suggested that the problem law enforcers face is not limited to the collection of evidence, and there may be a need for regulators—in addition to courts—to ensure effective law enforcement even under the assumption that both agents are optimally incentivized.

This argument also differs from the public choice literature on regulation, which was inspired by the work of Stigler\(^ {105}\)

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101. A fully developed positive theory of regulation would have to account for the process by which new forms of law enforcement (proactive as opposed to reactive) become law, which requires a full account of political dynamics. Nevertheless, the fact that many countries faced with the problem of rapid socioeconomic change selected similar solutions does suggest that politics—which we presume to be different across countries and to serve different interest groups—cannot fully explain the emergence of regulators.


104. *See supra* text accompanying notes 33-38.

and Posner\textsuperscript{106} in the early 1970s. The emergence of regulators and the regulatory state is explained in this literature primarily by interest groups' desire to establish an agency that would protect or enhance their interests.\textsuperscript{107} A substantial literature along this line of thinking has emerged to explain the behavior of regulators, both in support of and as a critique of public choice literature.\textsuperscript{108}

The incomplete law concept is complementary to the public choice theory of regulation. Indeed, although shifts in political bargaining power may explain the timing of the estab-


\textsuperscript{107} Id. at 341-42.

\textsuperscript{108} Meanwhile, this approach has come under increasing criticism for failing to account fully for the justification as well as the behavior of regulators. In what might be regarded a comprehensive critique of the public choice literature, Cass Sunstein, \textit{After the Rights Revolution: Receiving the Regulatory State} (1990), identifies eight ends for which regulation may be undertaken: response to market failure; public-interested redistribution of resources; achievement of collective desires and aspirations; promotion of diverse experiences and preferences; reduction of social subordination; reduction of undesirable preferences; prevention of outcomes that may prove irreversible and harmful to future generations; and achievements of interest group transfers. Id. at 48-71. Note that some of these explanations are fully consistent with our theory, in particular the desire to prevent outcomes that may prove irreversible. As argued above, in these cases reactive enforcement by the courts is not sufficient, and thus a shift of law enforcement rights to proactive enforcers, such as regulators, becomes crucial. Recent behavioral and psychological research, including controlled experiments, have shown that individuals do not act only in their own self-interest. This literature has questioned the basic assumptions of the public choice literature. This change in the administrative law literature is reflected in Symposium, \textit{Getting Beyond Cynicism: New Theories of the Regulatory State}, 87 Cornell L. Rev. 267 (2002). At this symposium, the public choice perspective was represented by Jonathan R. Macey, \textit{Cynicism and Trust in Politics and Constitutional Theory}, 87 Cornell L. Rev. 280 (2002). Most of the other papers presented alternatives for understanding the functioning of regulators. See, e.g., Edward L. Rubin, \textit{Public Choice, Phenomenology, and the Meaning of the Modern State: Keep the Bathwater, but Throw Out That Baby}, 87 Cornell L. Rev. 309 (2002) (proposing a theory based on phenomenology). For an approach that uses cognitive psychology, see Jeffrey J. Rachlinski \& Cynthia R. Farina, \textit{Cognitive Psychology and Optimal Government Design}, 87 Cornell L. Rev. 549 (2002). The differences between the various approaches to analyzing agency behavior in the administrative law literature are neatly captured in an essay by Jerry L. Mashaw, \textit{Essay: Deconstructing Debate, Reconstructing Law}, 87 Cornell L. Rev. 682, 682 (2002), which describes the two factions as "idealists" and "realists."
lishment of regulators and the powers allocated to them, some critical features and functions of regulators cannot be explained by public choice literature. For example, regulatory functions as defined here—proactive law enforcement and continuous lawmaking—emerged in different countries in response to very similar events. An example is the growth of stock markets and the challenges transactions in financial instruments posed to existing enforcement mechanisms (see Part V, infra). This finding is difficult to reconcile with the prevailing public choice explanations, which focus almost exclusively on the United States.

The incomplete law concept as developed in this Article is probably closest to Goldberg’s work. Goldberg suggested twenty-five years ago that regulation might best be understood as a device to manage long-term contracts, which create serious enforcement problems. This argument can be extended to the analysis that understands laws as social contracts between the state and multiple current and future addressees.

D. Summary

The notion that law is incomplete is closely related to a number of existing theories and consistent with contemporary analysis of the emergence of financial market regulation in the first half of the 20th century. The novelty of this Article’s analytical framework is that it allows assessment of the design and evolution of legal institutions as well as legal systems. Incomplete law is the foundation of this analytical framework. The allocation of residual lawmaking and law enforcement powers and the detailed analysis of how institutions differ in the way in which they use these powers are its analytical tools. This Article uses this framework to analyze law enforcement, but the implications of this theory go much further. In particular, the theory can be used to compare legal systems—as suggested by the brief discussion of civil law versus common law countries—


and to analyze lawmaking and law enforcement in countries where the choice of legal institutions may be more limited.\footnote{111}  

IV. THE EVOLUTION OF FINANCIAL MARKET REGULATION IN ENGLAND 

This Part uses the development of financial market regulation in England as an illustration of the theoretical framework that was developed in Part II. Since financial market regulation is too broad a subject, the analysis is limited to the legal regime governing misrepresentation of information when shares are offered to the public. 

The choice of jurisdiction was motivated by several factors. England was not only the first industrializing economy but also among the first to develop a sophisticated financial market for corporate securities.\footnote{112} As the mother country of the common law and a legal system widely considered to have effective courts,\footnote{113} England offers an excellent case for testing the effectiveness of judge-made law in coping with the challenges of rapid socioeconomic and technological change that accompanied the development of financial markets. Common law is known to evolve incrementally as new cases are brought to court. In fact, a major part of judicial reasoning is to distinguish new cases from old ones and to determine whether existing law extends to factually new cases. While theorists of the common law do not use the term “incompleteness of the law,” the idea that the common law is constantly challenged by new developments is widely acknowledged.\footnote{114} As noted above, some scholars have argued that this process is more likely to 

\footnote{111} This line of research is pursued in Pistor & Xu, Beyond Law Enforcement: Governing Financial Markets in China and Russia, in Building a Trustworthy State (Janos Kornai & Susan Rose-Ackerman eds., forthcoming 2004).  


\footnote{114} Standard textbooks on legal methods discuss this concept. For example, see Ginsburg, supra note 26, at 1-2.
achieve efficient law than top-down legislated law.\textsuperscript{115} Using the case law on misrepresentation of information as an example, this Article seeks to explore the effectiveness of lawmaking and law enforcement in the hands of courts in an area that was and remains highly susceptible to socioeconomic and technological change.

Moreover, in light of the extensive literature on the emergence of the regulatory state in the U.S. since the late 19th century,\textsuperscript{116} it seems advisable to focus on a different country, where political and economic conditions were quite different. In fact, financial market regulation in the United Kingdom prior to the state’s assumption of greater regulatory powers with the Big Bang reforms in 1986 has been lauded as vastly superior to the regulatory model created in the U.S. following the 1929 stock market crash.\textsuperscript{117} However, closer inspection reveals that regulatory functions emerged in England long before the Big Bang reforms of 1986. Since the late 19th century, the Companies Act (CA) incorporated many provisions on disclosure that later became part of the securities regulations in the U.S.\textsuperscript{118} Further, the London Stock Exchange (LSE) gradually assumed the right to screen companies that wished to list on the exchange and to issue disclosure rules.\textsuperscript{119} As explained below, these powers were not as extensive as those exercised by the New York Stock Exchange (NYSE), but they existed nevertheless. In addition, the Department of

\begin{itemize}
  \item[117.] See Benston, \textit{supra} note 64, at 189-92. For a more recent attack on federal regulation of financial markets, see Romano, \textit{supra} note 65, at 2367-68.
  \item[118.] See \textit{infra} text accompanying notes 296-297.
  \item[119.] See \textit{infra} text accompanying notes 240-253. This Article does not distinguish between state and non-state regulators because the analysis is focused on the responsibility of issuers of securities to ensure that investors receive relevant and truthful information before investing. From the perspective of the issuer, the distinction between state and non-state regulators is less important than the function performed by these agents.
\end{itemize}
Trade and Industry, as well as Company Registrars, carried out some functions that were centralized by U.S.-style securities regulation. Similar trends are found in Germany, the third example included in this analysis. Common shifts from reactive to proactive law enforcement and reallocation of law-making powers to regulators (be they state or private) in several countries suggests that factors other than those usually addressed in public choice literature might have been at work.

Finally, recent literature attributes the emergence of financial market regulation to failures in the judicial system, in particular endemic judicial corruption in the U.S. in the 19th century. While there are some allegations that English courts were less rigorous with the well-off gentlemen who came before them as directors or company promoters than with smaller thieves or embezzlers, there is less concern with judicial failure in England during this period. Since this Article argues that regulation that emerged in response to the fundamental problem of incomplete law could not be solved even by a well-functioning court, for analytical purposes it is useful to choose a country less tarnished by judicial malperformance during this crucial period. In fact, little evidence is found in the case law discussed below that judges misinterpreted the law or that courts were of low quality. The rulings were consistent with existing case law. They operated within institutional constraints defined by statutory and case law and by the design of courts as impartial arbiters, that is, as reactive law enforcers. Within these constraints they did as well as any court might have. In other words, our reading of the case law does not suggest that the problem of incomplete law the courts faced could have been overcome had they only been of better quality. Rather, it is a fundamental problem of the proper allocation of lawmaking and law enforcement rights.

In the subsequent analysis, the evolution of contract and tort law in relation to misrepresentation of information in a prospectus is first addressed. Part IV.A analyzes legislative re-

120. See infra text accompanying notes 253-262.
121. See infra Part V.B.
sponses to the challenges posed by the evolving securities market. Finally, Part IV.B discusses the emergence of a regulatory framework, which added proactive law enforcement by regulators to the classic reactive law enforcement by courts.

A. The Incompleteness of Criminal, Contract, and Tort Law

In the 19th century, England assumed a leading role in the development of liquid markets for corporate securities.\textsuperscript{124} The emergence of a market for financial instruments raised the fundamental question of whether and to what extent existing law was applicable to these transactions. Under English law, shares were considered personal property which could be used and transferred as any other asset.\textsuperscript{125} By implication, general principles of criminal, contract, and tort law applied. The major principles of these areas of the law had been developed over centuries. The evolving market in securities rendered many of these principles highly incomplete, as transactions in rights challenged basic assumptions that had earlier determined the threshold for criminal or civil liability and the allocation of risks between the parties to the transaction.

1. Criminal Law

As in other areas of the law, criminal law in England developed primarily through case law. The first statutory law to address the scope of criminal liability of those responsible for publishing and disseminating a prospectus was the Larceny Act of 1861.\textsuperscript{126} It established criminal liability for directors,

\textsuperscript{124} Even in England, corporate securities surpassed government bonds as the dominant paper traded on stock exchanges only in the second half of the 19th century. In 1853, 70.2\% of the securities were issued by the British government or other U.K. public bodies. In 1903, they accounted for only 15.8\%. The most substantial increase came from securities issued by financial institutions (from 1.1\% in 1853 to 6.3\% in 1903) and commercial enterprises (from 1.8\% in 1853 to 9.6\% in 1903). Railway securities made up the largest fraction of non-state securities (18.5\% in 1853, 44.1\% in 1903), but the growth can be attributed largely to listings of foreign, in particular U.S., railway companies. For details, see Tables 3.2 (listing nominal values of securities quoted in pounds) and 3.3 (listing the percentages of nominal values of securities quoted) in \textit{Ronald C. Michie, The London Stock Exchange: A History} 88-89 (1999).


\textsuperscript{126} The Larceny Act, 1861, 24 & 25 Vict., c. 96, § 84 (Eng.).
company managers, and others who *knowingly* included in the prospectus false information that was material.\footnote{127} The Act clearly required intent, which not only proved difficult to establish—a problem of evidence—but also raised a more fundamental legal question about the appropriate liability threshold for the actions concerned.\footnote{128} It is also noteworthy that the crime is only a misdemeanor, not a felony. Moreover, the Act addresses only the inclusion of false information, not the omission thereof.\footnote{129} Case law increasingly revealed that the lack of disclosure was at least as damaging to investors as the inclusion of false information.\footnote{130} The failure of earlier lawmakers to incorporate this concern into the Act's provisions is a good example of their inability to foresee important and relevant future contingencies.

Comprehensive criminal statistics are not available, but secondary sources suggest that relatively few criminal charges were brought successfully against key figures in the speculative bubbles England experienced in the 19th and early 20th centuries.\footnote{131} One explanation is the rather high threshold criminal charges had to meet.\footnote{132} This is fully consistent with this

\footnote{127} The Act reads as follows:

> Whosoever, being a director, manager, or public officer of any body corporate or public company, shall make, circulate, or publish, or concur in making, circulating, or publishing, any written statement or account which he shall know to be false in any material particular, with intent . . . to induce any person . . . to intrust [sic] or advance any property to such body corporate or public company . . . shall be guilty of a misdemeanor . . .

\footnote{128} *Id.*

\footnote{129} *Id.*

\footnote{130} See infra text accompanying notes 133-137.

\footnote{131} For a detailed account, see Robb, *supra* note 123, at 162-64.

\footnote{132} Another reason is the lack of capacity. In this regard, it is noteworthy that England established a public prosecutor only in the 1870s. Previously, victims of criminal acts acted as prosecutors. David Philips, *Crime and Authority in Victorian England: The Black Country 1835-1860* 96 (1977). Fraud actions were notoriously difficult to prove. Only after WWII was an Anti-Fraud taskforce established at Scotland Yard. The Roskill Report, completed in 1986, found fraud prevention still highly wanting. This led to the creation of the Serious Fraud Office (SFO), which is part of the U.K. criminal justice system. See Ronald Howe, *The Story of Scotland Yard* 150 (1965); James J. Fishman, *Enforcement of Securities Laws Violations in the United Kingdom*, 9 INT'L TAX & BUS. LAW 131, 169 (1991); Michael Levi, *The Roskill Fraud Commission Revisited: An Assessment*, 11 J. FIN. CRIME 38, 39 (2003);
Article's theoretical analysis. Recall that criminal law is subject to the *nulla poena sine lege* principle, which constrains state power to prosecute and punish only on the basis of a firm legal foundation. At the same time, this makes criminal law incomplete in the sense of Type II incompleteness, because items that are not clearly specified in the law will not result in criminal liability.

Over time, the courts relaxed these principles somewhat, but only reluctantly, as demonstrated in a finally successful criminal charge against a famous company promoter of the 1920s, Kysant.\textsuperscript{133} The prospectus of a mail steam shipping company promoted by the defendant disclosed adequate figures about the performance history of the company in question. It did not mention, however, that in recent years business had slowed considerably and the company had substantial trading losses.\textsuperscript{134} The court considered the 1861 Larceny Act, which establishes criminal liability only for the inclusion of wrongful information.\textsuperscript{135} In an appeal against the lower court's conviction, the King's Bench had to clarify whether it was permissible in criminal law to extend the wording of the statute and convict under the law for omitting information from a prospectus. The lower court had instructed the jury that the criminal act must be "strictly construed." Nevertheless, it maintained that criminal liability for omitting facts was covered by the wording of the statute.\textsuperscript{136} The King's Bench agreed. Even though each statement in the prospectus was literally true, the entire prospectus could be regarded as false because of its omissions.\textsuperscript{137} This clarification came over sixty years after the Larceny Act had been adopted.

Criminal convictions remained a rare event even after courts established a broader scope of application for the Larceny Act. The legislature attempted to enhance the state's ability to punish violators by revising criminal statutes as well as by allocating additional resources to law enforcement agen-

\textsuperscript{134} \textit{Id.} at 443-44.
\textsuperscript{135} \textit{Id.} at 442-45.
\textsuperscript{136} \textit{Id.} at 444-45.
\textsuperscript{137} \textit{Id.} at 448-49.
cies. In 1939, the Prevention of Fraud (Investments) Act was adopted to address the outbreak of fraudulent share-pushing in the late 1930s. The Act was replaced in 1958 by another Act of the same name. It extended criminal liability to reckless inclusion of wrongful information in secondary offerings and also mentions the omission of material facts, where previously only intentional acts could be punished. In addition, the Act now imposed criminal liability on the dissemination of information concerning the issuance of securities unless this was done by way of a prospectus that complied with the provisions of the Companies Act—even if the information as such was correct.

2. Contract Law

Contractual claims under common law require the existence of a contractual relation between buyer and seller. They could therefore be brought only by investors who bought securities directly from the person (or agent) responsible for the misrepresentation of information, not by shareholders who acquired their shares on the secondary market. Contractual relations establish special obligations between the parties, obligations which neither of them owes to others, which makes

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138. Prevention of Fraud (Investments) Act, 1939, 2 & 3 Geo. 6, c. 16 (Eng.).
140. Prevention of Fraud (Investments) Act, 1958, 6 & 7 Eliz. 2, c. 45 (Eng.): see Rider, supra note 139, at 523 n.43.
141. § 13(1)(a). The provision reads as follows:
13.—(1) Any person who, by any statement, promise or forecast which he knows to be misleading, false or deceptive, or by any dishonest concealment of material facts, or by the reckless making of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another person—
(a) to enter into or offer to enter into—
(i) any agreement for, or with a view to, acquiring, disposing of, subscribing for or underwriting securities . . .
shall be guilty of an offence, and liable to imprisonment for a term not exceeding seven years.
142. Id. § 14.
contractual claims relatively easy to establish. At the same
time, courts sought to balance the rights and responsibilities of
the contracting parties. A crucial doctrine of contract law
courts redefined in light of new case law involving securities
was caveat emptor (let the buyer beware). The rule dates back
to the early 16th century.\footnote{144} Under this principle, failure to
examine a good properly destroys a claim based on con-
tract.\footnote{145} The doctrine assumes that both parties have equal ac-
cess to information and reflects what was perceived to be a
natural allocation of responsibilities between buyer and seller
with inherently conflicting interests. Trade in financial instru-
ments differs from trade in real assets in that it is more dif-
ficult for the buyer to examine the good he is purchasing. In
fact, reliance on information provided by others, including
the seller or intermediary, is the hallmark of financial market
transactions. When transactions in securities expanded, the
courts therefore faced the challenge of redefining the scope of
the seller’s obligation to provide the buyer with information
and the scope of the buyer’s obligation to make use of sources
of information that were readily available to him.\footnote{146}

The most important contractual remedy is rescission, i.e.,
the undoing of the contractual relationship. Existing contract
law ruled out the right to rescind a contract if the buyer had
affirmed the contract after the discovery of the facts that
would allow him to rescind the contract. An obvious example
is the continued use of the good even after the defects are
known.\footnote{147} The complex relationship between investor/share-
holders and the corporation raised new questions as to what
amounted to an affirmation of contracts: selling the shares;
advising a broker to sell them; attending a shareholder meet-
ing?\footnote{148}

\footnote{144} The formulation of this doctrine apparently goes back to Anthony
Fitzherbert’s 1533 Boke of Husbandrie, in which he warns the potential buyer
of a horse: “[l]f he be tame and have ben ridden upon, then Caveat
emptor.” ANTHONY FITZHERBERT, BOKE OF HUSBANDRIE (London, Thomas
Berthelet 1533); see HEINZ-DIETER ASSMANN, PROSPEKTHAFTUNG [PROSPECTUS
LIABILITY] 21 n.18 (1985) [hereinafter ASSMANN, PROSPEKTHAFTUNG] (attrib-
uting the phrase to a 1534 version of the text).

\footnote{145} M. P. FURMSTON, CHESIRE, FIGOOF AND FIRMSTON’S LAW OF CONTRACT

\footnote{146} See infra Part IV.A.2.a.

\footnote{147} See infra text accompanying notes 164-168.

\footnote{148} See infra Part IV.A.2.b.
Finally, courts had to come to terms with the problem of balancing the rights of shareholders and creditors in a company with limited liability. The first statutory corporate law passed in England, the Companies Act of 1844, allowed for free incorporation of companies subject only to registration, but did not grant shareholders limited liability by law.\textsuperscript{149} Limited liability was accomplished only in 1855.\textsuperscript{150} The implication of this change was that creditors contracted only with the corporation, not its shareholders, and therefore could enforce their claims only against the corporation. This new arrangement affected the contractual relation between the company and its shareholders. Should rescission of the contract be allowed even when the company was bankrupt, with the implication that investors would receive their money back before creditors could enforce their claims?\textsuperscript{151}

The following analysis will discuss how courts have handled these three problem areas: \textit{caveat emptor}, affirmation of contracts, and the balancing of shareholders' and creditors' contractual rights.\textsuperscript{152}

\begin{enumerate}
\item \textit{Caveat Emptor}

To illustrate the incompleteness of existing contract law with respect to trade in securities, consider the following case. In 1865, Mr. Briggs acquired shares in a malt company. He had read the prospectus, which listed the production and storage of hops and malts as the firm's main business activities.\textsuperscript{153} He was not aware, however, that the provisions of the prospectus were inconsistent with the articles of association.\textsuperscript{154} The latter were accessible through the Registrar of Companies, and indeed, the prospectus explicitly referred to this document.\textsuperscript{155}

\end{enumerate}

149. An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies, 1844, 7 & 8 Vict., c. 110, §§ 1, 15 (Eng.)


151. \textit{See infra} Part IV.A.2.c.

152. These three areas are only a selection of the legal challenges transactions in securities posed to lawmakers and law enforcers, but a very instructive one.

153. \textit{Ex parte} Briggs, 1 L.R.-Eq. 484 (1866).

154. \textit{Id}.

155. \textit{Id}.
Mr. Briggs consulted the articles of association only after the shares had been allotted, and he discovered a clause that permitted the directors of the company “to make advances of money upon hops and other produce to the growers, producers, or sellers thereof, and to such other persons as they shall think fit, and upon such security, negotiable or otherwise, as they shall deem expedient.”156 In other words, beyond the production and storage activities, the company also purport to engage in financial activities. Upon learning this, Mr. Briggs advised his broker to sell the shares; when this was impossible because trading in the shares had been suspended, he sought to rescind the contract.157 The court held that “the applicant for shares cannot plead ignorance of the clauses of the articles of associations.”158 Affirming the applicability of caveat emptor to transactions in securities, the court thus made it clear that it was the duty of the buyer to consult material readily accessible to him.159 Nevertheless, it did not take a final view on this issue, because it rejected the appeal for different reasons.160

This ruling did not put matters to rest. The law was still incomplete because it did not specify the extent of the buyer’s obligation to inform himself. In a case decided by the House of Lords only a year later, it was held that where the prospectus was plainly false, the seller could not defend himself by suggesting “that [the buyer] might have known the truth by proper inquiry.”161 The relevant prospectus had disguised the facts that the concession for constructing a railway in Venezuela had yet to be acquired from middlemen, and that the cost of this transaction would consume ten percent of the capital the company was claiming it raised for the purpose of exploration.162 Instead, the prospectus created the impression that the necessary concessions had already been acquired. Under these circumstances, the buyer had every right, in the words of Lord Chelmsford, to “retort upon his objector, ‘You,
at least, who have stated what is untrue, or have concealed the
truth, for the purpose of drawing me into a contract, cannot
accuse me of want of caution because I relied implicitly upon
your fairness and honesty."\textsuperscript{163}

Given the information asymmetry between parties to secu-
rities transactions, the courts qualified the \textit{caveat emptor}
doctrine so that dishonest issuers could not use it as a simple
defense. The result was that the doctrine became less rigid, cre-
ating Type I incomplete law (broad, ambiguously defined
standards). As a result, the scope of contractual remedies was
enlarged, but at the cost of greater uncertainty about the obli-
gations buyers and sellers owed each other, creating more,
rather than less, demand for clarifying litigation.

\textbf{b. Affirmation of Contract}

According to contract law as it developed by the mid-19th
century, a claim to rescind a contract could fail if the buyer
took actions that affirmed the contract after he learned the
facts that supported rescission.\textsuperscript{164} Existing law did not specify
the types of actions that would be regarded as affirmation in
the context of securities trading. Courts increasingly became
concerned that buyers of securities would gamble on a happy
outcome and hold the seller responsible if the the gamble did
not work in their favor.

In \textit{Ex parte Briggs}, discussed above, the court suggested
that by requesting a broker sell his shares, Briggs acted as the
owner of shares, which indicated that he affirmed the contract
and thus forfeited his right to rescind it.\textsuperscript{165} Since at the time
he knew of the contents of the articles of association and thus
knew the facts that allowed him to rescind the contract, he
implicitly affirmed the contract.\textsuperscript{166} In the same spirit, the
chancery court denied a shareholder the right to rescind a
contract after he actively had supported the continuation of an
investment project—despite the fact that its terms clearly dif-

\textsuperscript{163} \textit{Id.} at 121.

\textsuperscript{164} \textit{Horst Roller}, \textit{Die Prospekthaftung im Englishen und im Deut-
schen Recht} [\textit{Prospectus Liability in English and German Law}] 127

\textsuperscript{165} \textit{Ex parte Briggs}, \textit{supra} note 153, at 487.

\textsuperscript{166} \textit{Id.} at 487.
ferred from those in the prospectus. Affirming the court’s decision, the Court of Appeals explained that the shareholder had the option to remonstrate at once, require that the prospectus be acted on, and otherwise rescind. After the buyer supported the deviation from the prospectus in an attempt to salvage the investment project, he was bound by the terms of the agreement. As a result, the company had the right to request the unpaid amount of shares to which he had subscribed.

Other actions that were deemed by the courts to amount to affirmations of contracts included attending shareholder meetings and voting on shareholder issues. But could silence also be regarded as affirmation? In *In re Scottish Petroleum Company*, a shareholder had subscribed to shares and paid part of the purchase price in the belief that the directors named in the prospectus would actually carry out their duties. When two of the directors resigned shortly after his shares were allotted, he requested to withdraw from the shareholder register and asked that his money be returned. The company refused, and after some communication back and forth the issue was left unresolved. A year later, the company was liquidated and the receiver continued prior demands to the shareholder to pay the unpaid capital. The court held that, in principle, the early resignation of the directors could justify the rescission of the contract. However, the inaction on the part of the shareholder after the company denied his request for rescission was regarded as an affirmation. While some time to take additional action is permissible, once a shareholder knows all the facts, “he ought to lose [sic] no time in repudiating.” But does the same apply in cases where the shareholder did not know these facts? Could he then later rescind

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167. See Sharpley v. Louth & E. Coast Ry. Co., 2 Ch. D. 675-77, 684 (G.A. 1876). In this particular case, the relevant shareholder was a local activist who strongly supported the construction of seventeen miles of railway to link the town to nearby places. Sufficient funding could not be raised. *Id.* at 663-64. Subsequently, he supported a shorter link, which eventually failed as well. *Id.* at 666-67.

168. *Id.* at 685.

169. 23 Ch. D. 413 (C.A. 1883).

170. See *id.* at 434.

171. See *id.* at 432.

172. *Id.* at 434.
based on fraud? In 1896, the House of Lords argued that a shareholder who was not aware of fraud but discovered it when the company charged him with payment for shares to which he had subscribed could rescind.\textsuperscript{173} He could even wait until the company sued him before he declared rescission.\textsuperscript{174}

The cases demonstrate that affirmation of contracts developed a new meaning in the context of the relation between shareholders and corporations. Courts decided these cases on the basis of established legal principles. They changed law at the margin, but each new solution eventually gave rise to new litigation, as private actors tested the limits of the law or new developments questioned the scope of its applicability.

c. Rescission of Contract and Creditor Rights

Where rescission was possible and no affirmative action had been taken, shareholders could still lose their right to rescind to creditors of the company. Obviously, shareholders’ requests to have their money returned or to be relieved of the obligation to pay the full amount to which they had subscribed always were a potential risk for creditors. Yet this was a logical result from the recognition of the concept of limited liability, which was enshrined in the law in 1855.\textsuperscript{175} Creditors had claims against the corporation, not directly against shareholders. But did this enable shareholders to rescind their contracts after the firm had become insolvent, entered into bankruptcy, or was liquidated? Courts were called upon to specify the meaning of this highly incomplete law and to determine the rights of shareholders against those of creditors.

In \textit{Oakes v. Turquand},\textsuperscript{176} the court ruled that once creditors proceeded to enforce their claims against the corporation by filing for bankruptcy, shareholders had to fulfill their responsibilities.\textsuperscript{177} Shareholders lost their rights to rescind

\begin{footnotes}
173. See Aaron’s Reefs, Ltd. v. Twiss, [1896] A.C. 290-91 (1896) (appeal taken from Ir.).
174. See \textit{id.} at 293.
175. Limited Liability Act, supra note 150; see Pistor et al., \textit{The Evolution of Corporate Law}, supra note 62, at 807.
176. 2 L.R.-E. & I. App. 325 (1867).
177. See \textit{id.} at 352-53. Interestingly, the court itself notes the challenge posed to the law by these new companies. Lord Cranworth plainly stated that “\textit{w}hen it became the habit and interest of persons engaged in commerce to unite in great numbers for carrying on any particular trade, it soon
\end{footnotes}
against the corporation. 178 The converse question—whether shareholders retained their right to rescind until the filing of bankruptcy—remained subject to further litigation. In 1879, the court indicated that the formal commencement of liquidation procedures was not required and that insolvency was sufficient. 179 The issue arose when a shareholder commenced proceedings to rescind his contract prior to the beginning of liquidation procedures but only after the company had become insolvent. In the eyes of the court, it was not the formal initiation of the procedure that was crucial but the fact that after the company became insolvent, the assumption of new liabilities was an issue for the creditors, not the company. 180 However, in a case where a shareholder filed an affidavit stating his intention to file a counterclaim before the bankruptcy of the company was initiated, it did not matter that rescission was declared formally only after the commencement of liquidation. 181

d. Summary

The basic principles of contract law date back centuries, but the scope of their applicability has changed over time. Differences in the nature of assets or the types of transaction render existing law incomplete. The development of securities markets created new challenges for contract law (e.g., much more serious information problems and much more liquid markets) and questioned the allocation of risks, rights, and responsibilities that had been developed for different types of transactions. As the cases discussed above show, courts proved quite capable of adapting existing legal principles to the changing environment, but they did not succeed in creating

became evident that the ordinary provisions of the laws of this country were ill adapted to the business of such bodies.” Id. at 358.

178. Id.

179. See Tennent v. The City of Glasgow Bank, 4 App. Cas. 622 (1879) (appeal taken from Scot.).

180. Id. However, the court refrained from establishing any general rules and limited its holding to the facts of the case at hand. There, the company directors indicated that they would initiate the liquidation procedures voluntarily, so although the creditors could have initiated it, they did not. At this point, the shareholder lost his right.

complete law, as each solution created new questions. In fact, not infrequently, courts broadened the scope of existing contract law principles to encompass cases where victims would otherwise be left without a remedy. Once courts accepted that *caveat emptor* did not block contractual remedies where the defendant acted fraudulently, the door opened for further challenges to the doctrine. Similarly, while courts held that only bankruptcy would stand in the way of rescission claims, the case of insolvency was still undecided. It also became apparent that contract law did not offer significant remedies for buyers of securities. Liquid markets in securities often meant that by the time the buyer of securities discovered a problem, the article had changed hands several times. As a result, the current holder often was not in privity with the original seller and so did not have a contractual claim against the person responsible for the misrepresentation—i.e., the corporation, its directors, or promoters. Moreover, the high turnover of companies entering and quickly exiting the market often meant that contractual claims were worthless by the time the fraud was discovered. Many claimants therefore chose to base their claims on tort, suing companies, their directors, and promoters for deceit.

3. **Tort Remedies**

Unlike contractual claims, claims based on tort do not require a direct contractual relation between plaintiff and defendant. Investors who relied on wrong or fraudulent information could therefore invoke liability against a broader range of actors under tort principles. The downside from the cheated investor's point of view is that the threshold for tort liability is higher than for contractual claims. Tort law historically required that the plaintiff prove intent or at least

182. *See* H. A. Shannon, *The Limited Companies of 1866-1883*, 4 Econ. Hist. Rev. 290, 292 (1993). Shannon calculates that of the 6,111 companies registered as limited liability companies from 1866 to 1874, 1,878, or approximately 31%, were abortive; from 1875 to 1877, the rate was 33%; from 1878 to 1880, 45%.


gross negligence to establish the defendant's liability. More importantly from the vantage point of incomplete law, the principles of tort law had developed based on assaults against property, personal integrity, or life. Existing principles could be adapted easily to clear cases of embezzlement but did not fit cases of misrepresentation of information as well. Simply stated, the evolution of securities markets necessitated the transition from a tort regime developed for “blue collar” type actions to one that could address “white collar” type ones.

By the mid-19th century, the basic requirements for a successful deceit claim could be summarized by the formula that “but for” the wrongful information, the other party would not have entered into the contractual arrangement. This formula was, however, of little help in determining how much weight would be given to the fraudulent information, which could be the sole, primary, or one of many causes that led to the acquisition of shares. Would any mistake, including misjudgments about future developments in the prospectus, give rise to liability? What was required to establish intent by the seller: Must he have positively known that the information was objectively false? What if he believed that the information was true, though his belief might have been unreasonable? And finally, would buyers on the secondary market have a claim based on tort if they bought securities relying on the prospectus disseminated for the initial public offering?

Tort law as it existed prior to the development of securities markets did not offer clear-cut answers to most of these questions and was thus highly incomplete.

a. Misrepresentation of Information

A prospectus was the instrument used by companies and their promoters to attract investors. It was used both to provide information about the investment project and as a tool for advertising. Since 1844, companies wishing to issue shares

185. See, e.g., Thomas Atkins Street, Theory and Principles of Tort 11 (1906) (noting that actual intent was required for a successful assault claim).
to the public have been required to publish a prospectus, but the law was initially silent on the contents of this document.\textsuperscript{187}

In 1867, a shareholder launched a lawsuit against a company and its directors, claiming that he had been misled by a provision in the prospectus stating that the directors and their friends had acquired large proportions of shares in the company. In fact, none of them had taken a substantial stake.\textsuperscript{188} The shareholder argued that he had relied on this statement when subscribing to shares in the company, which meanwhile had been liquidated.\textsuperscript{189} An important question in this case was whether the information about the stakes held by directors and their friends was material to the transaction. The court stated that it was, without giving much guidance as to how to distinguish between information that was material and information that was not.\textsuperscript{190} Obviously, materiality is a highly incomplete concept, the applicability of which can hardly be determined absent detailed knowledge of a specific case. This decision implied that residual lawmaking powers were best allocated to an agent—such as a court—capable of exercising residual lawmaking powers after the facts have become known.

In another case the same year, the question arose of whether the omission of information could constitute deceit.\textsuperscript{191} The company in question had failed to disclose to potential investors a deed from which it inherited a huge liability from its legal predecessor.\textsuperscript{192} While the court determined that the omission of material fact could amount to a misrepresentation of information,\textsuperscript{193} the company had already entered the liquidation phase, and the court denied recovery for the shareholders in favor of creditors.\textsuperscript{194} Under the existing statutes, the shareholders had not discovered the fraud until it was too late. In response to this case, the Companies Act (CA) was

\textsuperscript{187} An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies, 1844, 7 & 8 Vict., c. 110 § 4 (Eng.).

\textsuperscript{188} \textit{See} Henderson v. Lacon, 5 L.R.-Eq. 249, 251-52, 257-58 (1867).

\textsuperscript{189} \textit{Id.} at 251-52.

\textsuperscript{190} \textit{Id.} at 261-62.

\textsuperscript{191} \textit{See In re} Overend, Gurney & Co., 3 L.R. 620-22 (L.R.-Eq. 1867). For criminal law, the same question was addressed in \textit{The King v. Kilsant} (Lord), 1 K.B. 442, 448-49 (C.A. 1931). \textit{See supra} note 133 and accompanying text.

\textsuperscript{192} \textit{See} 3 L.R. at 619.

\textsuperscript{193} \textit{Id.} at 624-25.

\textsuperscript{194} \textit{Id.} at 633.
amended and a provision inserted to require that a prospectus soliciting shareholders "shall specify the Dates and the Names of the Parties to any Contract entered into by the Company, or the Promoters, Directors, or Trustees thereof . . . and any Prospectus or Notice not specifying the same shall be deemed fraudulent . . . ."195 The provision, however, had relatively little effect.196 It could not possibly improve information transparency. Listing all contracts was more likely to confuse investors and certainly did not ensure that they would be able to identify which contracts were potentially harmful to their interests. Moreover, listing the dates and names of the parties to the contracts did not reveal their contents. A more specific regulation of items requiring disclosure in a prospectus can be found in the revised CA of 1900.197 The law still required that contracts be listed but excluded contracts carried out in the ordinary course of business or those concluded more than three years prior to the publication of the prospectus.198 Companies were also required to state a place and time where these contracts could be examined.199 These revisions reflect attempts by lawmakers to specify disclosure requirements and thereby enhance the completeness of law regulating misrepresentation of information. They also demonstrate the sharp learning curve for lawmakers, who were continually caught short by new developments that resulted from legislative responses and highlighted the incompleteness of the law. By the time the CA was revised in 1928 (consolidated in 1929),200 a detailed schedule listing the items that needed to be disclosed in a prospectus was included in the law.201 In sum, by the late


197. 63 & 64 Vict., c. 48, § 10(1) (Eng.). The items that required disclosure included the memorandum of association, § 10(1)(a), the number of shares, § 10(1)(b), and the names, descriptions, and addresses of directors and proposed directors, § 10(1)(c), among others.

198. Id. § 10(k).

199. Id.

200. The Companies Act, 1929, 19 & 20 Geo. 5, c. 23 (Eng.).

201. Id. at § 35(1).
1920s a comprehensive system of extensive ex ante disclosure rules, stipulated in the Companies Act and combined with reactive enforcement by the courts, had been established.

Not every misstatement gave rise to an action under existing case law—only those designed to induce investors to buy. The difficulty of determining causality between misrepresentation in the prospectus and harm suffered by an acquirer of shares is illustrated by another case. The prospectus of a company invited subscriptions for debentures. It stated that the money was intended for alterations in the buildings of the company, to purchase horses and vans, and to develop the trade of the company, whereas, in fact, the money was intended to cover existing liabilities. The court held that this statement induced investors to believe that the debentures would be a charge on the property and, since this was not the case, held the directors to be liable. The trial court, whose ruling was affirmed by the Court of Appeals, used this case to summarize the major elements of an action based on deceit. First, the prospectus must include not only “a mere statement of possibility, or of a contingency, or of an intention as to what might occur according to the person who is making the statement, but there must be something which amounts in the opinion of the Judge or jury . . . to a statement of a fact as existing which is not in truth existing.”

The rather ambiguous phrasing demonstrates how difficult it was for judges to draw the line between facts and opinion. Second, the statement must have been made fraudulently. Fraudulent action, according to the court, did not require the willful telling of a lie. It was deemed sufficient that a person make factual statements “recklessly, and so to speak, in a gambling spirit” and willfully abstain from making additional inquiries, thereby endorsing a statement without which investors would not have parted from their money.

This definition of fraudulent behavior is quite narrow. By requiring recklessness, the court implied that there was no lia-

203. *See id.* at 459-61.
204. *See id.* at 484-85.
205. *See id.* at 465.
bility for negligent misstatements.\textsuperscript{207} It is in the context of this earlier case law that the landmark case of \textit{Derry v. Peek},\textsuperscript{208} decided in 1889, must be assessed. The prospectus of a railway company stated that approval had been granted by the relevant state authorities to convert an animal powered track into a steam powered one.\textsuperscript{209} In fact, approval had been granted only for parts of the track. After the company was bankrupt, the directors were sued for compensation by shareholders who had lost their money.\textsuperscript{210} The House of Lords confirmed that the statement in the prospectus was objectively incorrect. But it relieved the directors—"five men of good character and conduct"—of liability, because they honestly believed in the correctness of their statement.\textsuperscript{211} Without proof of fraud—and the burden of proof lies with the plaintiff—an action of deceit could not be maintained. The House of Lords reviewed earlier cases in an attempt to discern general principles of tort law. It criticized attempts to do justice in individual cases rather than sticking to principles of established law.\textsuperscript{212} "It might, perhaps, be well to enact that in prospectuses of public companies there should be a warranty of the truth of all statements,"\textsuperscript{213} but existing law did not include such a provision. Essentially, the message was that it was not for the courts to fill this gap and write a more complete law but for the legislature to do so.

Applying the framework of incomplete law, by unambiguously stating that negligent misrepresentation was not sufficient for establishing fraud, \textit{Derry v. Peek} specified—and thereby narrowed—the scope of actions that could give rise to liability. The law as stated in this decision required a high and subjective threshold for liability and did not merely circumscribe areas that could result in liability. The rationale, according to the court, was to avoid discouraging risk-averse people from engaging in financial market activities ("[t]he objection is . . . to the danger of driving respectable and responsible

\textsuperscript{207} See id.
\textsuperscript{208} 14 App. Cas. 337 (1889).
\textsuperscript{209} The prospectus stated explicitly that "the company has the right to use steam or mechanical motive power, instead of horses." \textit{Id.} at 338.
\textsuperscript{210} See id.
\textsuperscript{211} \textit{Id.} at 345.
\textsuperscript{212} \textit{Id.} at 352.
\textsuperscript{213} \textit{Id.}
men from being promoters, and of substituting for them those who are neither . . ."), 214 i.e., to prevent over-enforcement of the law.

The legislature responded to the court’s request for legislative intervention by lowering the threshold for liability through the Directors’ Liability Act (DLA) 215 a year after Derry v. Peek was decided. Under this Act, directors and company promoters could be held liable for negligent misrepresentation of information.216 The Act stipulates that any untrue statement in the prospectus or other notice concerning the issuance of shares gives rise to liability, unless those responsible for the statement can prove that they had “reasonable ground to believe, and did up to the time of the allotment of the shares, debentures, or debenture stock, as the case may be, believe, that the statement was true.” 217 In effect, the law lowered the threshold for liability by shifting the burden of proof on the issue of whether the defendant had grounds to believe that the statement was true.Absent such proof, misrepresentations resulting in injury gave rise to liability.218 Had the Act been adopted prior to Derry v. Peek, there is little doubt that the directors involved would have had to compensate shareholders.

The threshold for liability was lowered further with the adoption of the Misrepresentation Act in 1967.219 This Act does not specifically target securities but deals more generally with misrepresentation of information.220 Under its provisions, even innocent misrepresentation can lead to liability, unless the offender demonstrates that he reasonably believed in the truthfulness of the information.221 In terms of this Article’s conceptual framework, the DLA, and later the Misrepresentation Act, shifted the incompleteness problem from a Type II to a Type I problem. They thereby signaled to courts

214. Id.
215. Directors’ Liability Act 1890, 53 & 54 Vict., c. 64 (Eng.); see Mahoney, Mandatory Disclosure, supra note 195, at 1088 (noting that Parliament’s response to Derry was passage of the 1890 Act).
216. Id. § 3.
217. Id. § 3(a).
218. Id. § 3.
219. Misrepresentation Act, 1967, c. 7 (Eng.).
220. Id.
221. Id. § 2(1).
that the scope of their residual lawmaking powers was more extensive than previously assumed and included cases that earlier would have been dismissed.

b. Liability to Whom?

Another issue that repeatedly gave rise to litigation was to whom directors, company promoters, and others responsible for the contents of the prospectus would be liable. As the above examples show, the information included in or omitted from a prospectus is crucial for establishing liability. For actions based on tort law, a contractual relation with the acquirer of shares was not required. This did not mean, however, that anyone who relied on the prospectus would have a claim. In order to establish liability, “there must be something to connect the directors making the representation with the party complaining that he has been deceived and injured by it . . . .”222 When the plaintiff acquired shares not directly from the company but on the secondary market, the court held that the prospectus was issued for the initial public offering. Absent any direct communication with secondary buyers, the directors were not liable to those who acquired shares on the secondary market.223

This left secondary buyers for the most part without a real chance for recovery of their losses, since the immediate seller was not the one who had created or disseminated the fraudulent information. This escape hatch allowed issuers of shares to develop schemes by which they would target secondary buyers with a prospectus or other information without being held liable for incorrect information contained therein. Courts were soon forced to address such schemes, since previous case law had virtually opened the door for the design of strategies to circumvent this Type II incomplete law.

In the 1870s, a father and son set up a company to explore a gold-bearing reef in Transvaal. Investors were invited to buy shares. The prospectus included information on the yield of gold from a ton of quartz which was objectively incorrect. The plaintiff did not buy shares upon receiving the prospectus. However, a few weeks later, a major newspaper carried an article with the headline “A Big Jump in Sutherland

223. Id. at 410-13.
Reefs," alleging a very rich discovery of gold. The plaintiff then bought shares on the secondary market, basing his decision on the prospectus—which he had kept—and the good news reported, only to learn later that the son had initiated the newspaper article, and it was part of a fraudulent scheme designed by father and son. The court distinguished this case from Peek v. Gurney by holding that the publication of the prospectus and the instigation of the newspaper article was part of a comprehensive scheme designed to induce those that had earlier read the prospectus to buy. It therefore held in favor of the investor. The definition of what would qualify as a comprehensive scheme and thus extend the liability of those responsible for the contents of the prospectus to buyers on the secondary market, however, was left unqualified. Once again, case law rendered existing principles less, rather than more, complete, establishing only some broad guidelines to delineate the scope of liability.

Changes in financial practice over time created questions about the principle that the prospectus was targeted only at initial purchasers. In 1996, a case was brought by an investor who had acquired securities of an unlisted company both in the initial public offering and subsequently—in a much larger amount—on the secondary market. For both investment decisions the buyer had relied on the information contained in the prospectus, which proved to be incorrect. The defendant argued that it could not be held liable for the shares acquired on the secondary market since the prospectus was directed only to initial buyers. Yet the court held for the plaintiff, pointing out that commercial practice had changed substantially over the years. The court's decision explained that the purpose of a modern prospectus is not merely to induce investors to make purchases during the initial offering, but also to induce the public to make after-market purchases. In light of this change in practice, the relation between the issuer and the secondary buyer consisted of sufficient proximity to establish liability. The decision acknowl-

225. See id. at 374, 377-78.
226. See id. at 381.
228. Id. at 1363.
229. Id.
edged the principle that there must be a special relation between plaintiff and defendant in a tort action based on deceit but greatly expanded the scope of relations that fell into this category.\footnote{Id. at 1363-64.}

c. Summary

Until well into the 19th century, the major category of tort actions was deeds committed against persons or assets. With the development of financial markets, words achieved an importance that necessitated a reassessment of the type of actions that could give rise to tort liability. Courts struggled to balance the interests of investors in effective legal protection against the need to limit the scope of liability to avoid suffocating markets. Courts were also careful to guard well-established legal principles of tort law against hasty overhaul addressed to only one segment of the market (securities transactions). These multiple objectives led to the development of clearer, more complete case law in only a few cases. More often than not, courts simply stretched existing principles to encompass the new cases, thereby blurring lines and creating more incomplete law. Examples include the acknowledgment that words could weigh as heavily as deeds; the extension of the scope of liability to claimants that had acquired securities only on the secondary market and not in the initial offering; and the lowering of the threshold for liability from gross negligence to simple negligence. This strategy increased uncertainty about what actions would lead to liability and thus undermined the deterrence effect of the law. An exception to this rule is \textit{Derry v. Peek}, a case in which the court rejected the idea of holding directors liable for negligent misconduct and deferred the right to make such a decision to the legislature.\footnote{See supra text accompanying notes 208-214.} The legislature did intervene, creating a law substantially broader than existing common law and therefore reducing Type I incompleteness while increasing Type II.

The case law discussed above is not erroneous or “bad” law. In each case, courts faced the dilemma of adhering to well-established legal principles or changing them to fit the needs of the new types of cases before them. Given the limited information they possessed about the nature of market trans-
actions at the time, their decisions are justifiable. Had courts been more responsive to changes in the market, legislative intervention may not have been necessary on some occasions. However, it is doubtful that this would have been sufficient to ensure effective law enforcement and thereby prevent the growing need for a proactive law enforcer—the regulator.

B. The Emergence of a Regulator

The above discussion has shown that neither case nor statutory law offers fully satisfactory solutions in this area, which not only is subject to considerable change over time (and therefore remains highly incomplete despite efforts to adjust), but also can produce substantial negative externalities. This section explores the emergence of regulatory functions in England. As noted, this Article does not emphasize the nature of the regulator, i.e., whether it is a private (for example, a stock exchange) or state actor. It is mainly interested in regulatory functions, including residual lawmaking and proactive law enforcement, which in England have been carried out by both private and state institutions. The major stock exchange in England, the London Stock Exchange (LSE), increasingly had assumed regulatory functions. In addition, the Department of Trade and Industry was vested with regulatory powers by the legislature. Recent changes have consolidated regulatory functions in the Securities and Investment Board (SIB), later renamed the Financial Services Authority (FSA), which now regulates, inter alia, the issuance of shares to the public.

Evidence of the stock exchange's assumption of regulatory functions over issuers of securities is available as early as 1827. The minutes of the foreign stock exchange stated that the exchange's committee in charge of admitting securities had refused the admission of securities by a foreign state on the grounds that it was in default on previous obliga-


234. The foreign stock exchange subsequently merged with the London Stock Exchange. See Michie, supra note 124, at 57-58.
tions. The case demonstrates the exchange's willingness and capacity to stop actions—the issuance of securities to the public—which were likely to result in harmful outcome. The incident, however, remained an isolated event, and general rules for the admission of securities were not established for some time. Securities were admitted on an *ad hoc* basis, with primary consideration given to the expected liquidity of the shares and thus to their profitability for members of the exchange.

It took some time for the LSE to recognize the role it needed to play in protecting not only the interests of the exchange and its members, but also of the broader investor community—that in fact, these objectives were linked. The crucial role of the exchange in protecting investor interests in England was underlined by the fact that public offerings were made through the exchange. The two acts—issuance of shares and listing them on an exchange—were conducted as one, subjecting virtually all publicly traded companies to the rules of the exchange. It is therefore not surprising that stock

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236. See *Michie*, supra note 124, at 83-84.

237. See *Coffee, The Rise of Dispersed Ownership*, supra note 60, at 37, 39-44. The LSE was much less proactive than the NYSE in developing into a regulatory agent by exercising proactive law enforcement and ex ante lawmakers' powers. Coffee relates these differences to the structures of the exchanges, *id.* at 37, 39-40, their rules on membership, *id.* at 37, and the competition they faced in their respective markets, *id.*

238. This practice is in marked contrast to the practice in continental Europe and the U.S. In continental European countries, listing is separate from the public issuance of shares. In fact, France and Germany require that shares be placed before the company can be registered—although it is of course possible to place the shares among a smaller circle of shareholders and disseminate them more widely through a subsequent increase in capital and secondary offering, or for the original shareholders to sell them after the company has been established. See Friedrich Kessler, *The American Securities Act and its Foreign Counterparts: A Comparative Study*, 44 Yale L.J. 1133, 1136 (1955). The major difference between the U.S. and England is that in the U.S. many companies are traded over-the-counter rather than on an official exchange. See *L. C. B. Gower, Some Contrasts Between British and American Corporation Law*, 69 Harv. L. Rev. 1369, 1381 (1956). For an analysis of the differences in issuance between continental Europe and the U.S., see Kessler, supra, at 1136-55. For a comparison of British and American laws governing initial public offerings after the adoption of the Securities and Ex-
exchanges regularly were blamed for stock market scandals.\textsuperscript{239} This practice may help explain why regulation exclusively by the stock exchange rather than a state regulator survived in England for much longer than in the U.S. It also became increasingly clear that the quality of the securities traded affected the business of the exchange and its members.

Towards the end of the 19th century, the LSE developed some screening devices, primarily in the form of disclosure requirements. These requirements were minor by today's standards but exceeded the requirements of existing law at the time.\textsuperscript{240} The rules required the submission of a copy of the prospectus and a statutory declaration stating the amount of stock allotted to the general public, the amount paid up, and a confirmation that the securities were ready to be issued. In the case of new companies, a statement of capital and the nominal value of shares had to be submitted.\textsuperscript{241} Only companies that complied with these requirements would be quoted on the exchange.

Initially, the exchange did not have much capacity to engage in continuous monitoring. However, it reconsidered its law enforcement role in the 1930s. By that time, the market for domestic corporate securities had become the exchange's core market; by 1928-29, the exchange's disclosure requirements surpassed those of statutory law.\textsuperscript{242} Nevertheless, investor confidence was falling in the wake of widespread share-pushing schemes in the early 1930s, which neither the law nor the exchange's regulations had been able to prevent. The LSE

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240. The first comprehensive set of disclosure rules were incorporated in the English CA in 1900. See supra note 197 and accompanying text.

241. Morgan & Thomas, supra note 235, at 152-53. By contrast, Michie argues that the LSE did not assume this type of power before the end of World War I, when state pressure became an important factor in inducing the exchange to assume regulatory powers on its own rather than accepting state regulation. See Michie, supra note 124, at 266-68.

came under increasing pressure to either improve its regulatory regime or face more extensive state intervention. The LSE reacted by imposing more stringent disclosure requirements and enhancing its capacity to screen the information that was submitted. That this amounted to an improvement of the exchange's regulatory capabilities was recognized by the 1948 revision of the Companies Act, which established the most extensive legal disclosure requirements under English law thus far. Notably, however, the revision exempted companies that had made adequate disclosure under the exchange's rules, a clear indication that lawmakers were satisfied with the exchange's activities.

After 1948, the LSE further extended its role as regulator, requiring the submission of audited financial statements. In addition, after 1954 disclosure of directors' remuneration was required, and after 1965, semi-annual reports. To ensure the accuracy of information submitted, the exchange relied extensively on intermediaries such as issuing houses, sponsoring brokers, and professional auditing bodies. In addition, through its own Quotations Department, the LSE reviewed the information submitted and on this basis approved or disapproved securities' quotations—a proactive law enforcement function. The benchmark for the Quotations Department remains not simply a list of detailed items but a broad—in the terms of this Article, highly incomplete—rule that requires companies to submit all information necessary for investors to make an informed judgment.

244. Id. at 265-68.
245. 11 & 12 Geo 6, c. 38 (Eng.).
246. See id. §§37-46 (listing disclosure requirements).
247. See id. § 39.
248. Initially, financial statements for the past ten years had to be disclosed. In 1973, this was reduced to five years. See Benston, supra note 64, at 27. Today, three audited financial statements for a period of only three years is sufficient. See London Stock Exchange Listing Rules § 6(e)(4) (2002), available at http://www.fsa.gov.uk/pubs/ukla/chapt06-3.pdf.
249. Benston, supra note 64, at 27.
251. Benston, supra note 64, at 27.
252. As of April 2002, the Admission and Disclosure Standards of the LSE include a provision that issuers must comply with all provisions set forth in
change thereby reserves the right to make more tailored requests of information from specific companies. The LSE continues to change its disclosure requirements, in marked contrast to the statutory legal framework which hardly changed after 1948.253

The only agent that functioned as a state regulator of issuers prior to the Big Bang reforms of 1986 was the Board of Trade (BT) (later the Department of Trade and Industry, DTI). The 1948 CA explicitly allocated to the BT the power to initiate investigations, request books and information from corporate directors, and bring proceedings in the name and on behalf of shareholders.254 The BT had the power to adapt the disclosure requirements stipulated in the law, i.e., to exercise residual lawmakers powers over these issues.255 Important strings were attached, however, namely that these regulations could not "render more onerous the requirements" stipulated in the law.256 This provision substantially restricted the BT's residual lawmakers powers. Perhaps not surprisingly in light of these constraints, the DTI did not develop into an active regulator. It did not publish detailed rules and regulations regarding disclosure requirements, nor did it routinely examine reports that companies submitted. The only cases in which the BT took action were those in which injury had resulted from fraud or misfeasance.257 In other words, the BT adopted a passive and primarily reactive enforcement policy.

The Big Bang reforms of 1986 constituted a major overhaul of the system of financial market regulation in the U.K. by establishing a state regulator for financial markets. Nevertheless, the exchange's jurisdiction over newly issued shares to the public was not fundamentally altered. Part IV of the 1986 Financial Services Act (FSAct) on "official listing of securities"

253. For a critique of this statutory framework, see GOWER, supra note 250, ¶ 3.12, at 21.
254. 11 & 12 Geo. 6, c. 38, §§ 165(b)-169.
255. Id. § 454(1).
256. Id. § 454(3).
257. BENSTON, supra note 64, at 23.
explicitly designates the Council of the Stock Exchange as the “competent authority” for this part of the Act.258 This jurisdiction extended not only to securities traded on the official exchange, but also to securities admitted to alternative trading systems and those that were to be placed on markets of other E.U. member states.259

To be sure, the fact that the FSAct explicitly delegated regulatory functions to the stock exchange marked a change in the history of financial market regulation. Whereas previously the stock exchange exercised rulemaking autonomously, it now carried out this function on behalf of and under the supervision of the state regulator. The state’s role was further strengthened with the adoption of the Financial Services and Market Act (FSMA) in 2000.260 The new law took away much of the power that had been delegated to the exchange under the 1986 law. The authority to define listing standards and approve the issuance of shares moved from the exchange to a state agency, the Financial Services Authority (FSA).261 The shift from self-regulation to state regulation had many causes, of which the effectiveness of the LSE as lawmaker and law enforcer is only one. This Article does not seek to explain the timing of this shift and leaves a closer investigation of the pros and cons of self- and state regulation to future work. However, it is worth noting that this enlarged role of state regulators and greater division of labor between self- and state regulators was


in line with developments in other highly industrialized countries, most notably the U.S.\textsuperscript{262}

The history of financial market regulation in England exemplifies that without a responsive and proactive LMLE agent, legislatures and courts could not make and enforce law efficiently. Flexibility of the rules determining under what conditions companies could issue shares to the public was crucial in order to keep up with market developments at home and abroad. While statutory lawmakers made some remarkable progress in enhancing disclosure rules in 1928-29 and 1948 in particular, over the next decades the legislature again fell behind market developments and left the field to the exchange.\textsuperscript{263} With regard to law enforcement, it was apparent even in the 19th century that law enforcement by courts exclusively was insufficient. The amount of injury caused by harmful actions, not only to the immediate parties concerned (i.e., shareholders of a particular company) but also to investors at large and to the reputation of financial markets, were evidence of serious under-enforcement problems.\textsuperscript{264} The LSE may have assumed more extensive regulatory functions only reluctantly. It is in fact likely that—fearing the loss of companies to competitive exchanges—it would have further delayed this process had the government not threatened legislative intervention, which the exchange preempted by developing its own regulatory capacity.\textsuperscript{265} The main point, however, is that regulatory functions were taken up by the exchange in response to the problem of existing law's under-deterrence and the resulting widespread violations of investors' rights.

\section*{V. Incompleteness of the Law in Comparative Perspective}

England is not the only country that struggled with the problem of law enforcement in an area in which constant change tended to render laws highly incomplete. Other countries faced similar problems. A more detailed comparison of responses to the problem of incompleteness of financial market law is beyond the scope of this Article. A brief summary of

\begin{flushleft}
\textsuperscript{262} See discussion infra Part V.A.
\textsuperscript{263} See supra text accompanying notes 242-253.
\textsuperscript{264} See supra Part IV.A.
\textsuperscript{265} See supra notes 237-247 and accompanying text.
\end{flushleft}
the experiences of the United States and Germany, however, will demonstrate, first, that effective regulatory functions (proactive law enforcement combined with flexible lawmaking) emerged in different countries in response to similar problems and, second, that misallocation of lawmaking and law enforcement powers may influence the development of financial markets in the long term.

A. United States

The general legal provisions dealing with misrepresentation of information in the United States were similar to those of the U.K. prior to the Director's Liability Act of 1890. As in the U.K., case law increasingly revealed the limitations of these principles in ensuring effective law enforcement in financial markets where asymmetry of information was endemic and rapid economic change suggested high levels of incompleteness of the law.

Nevertheless, courts did not feel compelled to develop principles to mimic English statutory law. Although the "citadel of privity of contracts" was somewhat eroded by the late 1920s, American courts refused to hold directors, company promoters, or accountants liable for negligent misrepresentation of information. In fact, courts extensively cited Derry vs. Peek, the decision that had triggered the passage of Director's Liability Act in the U.K.

As late as 1931, the Court of Appeals of New York held that negligence was reserved for contractual relations between the defendant and the plaintiff or required at least a duty on the part of the defendant "to act with the same care that would have been due under a contract of employment." Negli-

266. See discussion supra Part IV.A.
268. 14 App. Cas. 337 (1889).
270. See Ultramares Corp. v. Touche, 174 N.E. 441, 444 (N.Y. 1931). Ultramares addressed the question of whether an accounting firm should be held liable for certifying accounts that had been forged. While it was positively ruled that the accountants did not know about the fraudulent action, it...
gence was not sufficient for tort liability where deceit alone was alleged.271

In part, the problem of under-enforcement that resulted from the incompleteness of law was mitigated by the stock exchanges' assumption of extensive proactive law enforcement powers. In the U.S., the New York Stock Exchange (NYSE), formally established in 1817, quickly emerged as dominant.272 The original constitutive acts regulated members and traders. As early as 1853, however, the exchange stipulated requirements for companies that wished to be listed on the exchange. These companies had to provide complete statements of shares outstanding and capital resources.273 In 1869, a rule was introduced that required all shares be registered with a bank or other appropriate institution.274 In 1895, NYSE recommended, but did not mandate, that all companies submit annual reports with income statements and balance sheets.275 In 1923, it established a fraud bureau,276 and in 1926 it tight-
ened listing requirements, encouraging companies to give equal voting rights to shareholders.277

These attempts to develop a set of rules and proactive enforcement devices aimed at protecting shareholders protected only investors of companies listed on NYSE.278 Realizing the limits of its own regulation as well as the competition from other exchanges, NYSE supported the enactment of the federal securities regulations in 1933 and 1934.279 Since then it has focused its efforts on continuous disclosure over initial offerings of shares, which are covered by the registration requirements of the 1933 Securities Act (SA).280

From the vantage point of the theory of incomplete law, the most important contribution of the 1933-34 securities regulations was the creation of a regulator (the SEC) that combined ex ante rulemaking with proactive enforcement powers, including the right to monitor, investigate, enjoin actions, impose fines, or seek court sanctions.281

Individual states had addressed the problem of stock fraud for over two decades already. By 1933, 47 states and Hawai'i had adopted so-called “blue sky laws,” which included regulations for persons or entities wishing to sell securities to their residents.282 Most states introduced registration requirements for securities issued and/or traded within its jurisdiction, allowing screening of issuers and proactive enforcement of laws through entry requirements.283 Thirty-eight of the states also revised and extended their anti-fraud provisions.284 The most sweeping definition of fraudulent behavior can be found in New York’s Martin Act of 1921 (§ 352).285

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278. Seligman, Historical Need, supra note 67, at 15.

279. Id. at 55.


285. Martin Act, N.Y. GEN. BUS. LAW § 352 (McKinney 1996); see Loss & Cowett, supra note 282, at 24 (discussing courts’ broad interpretation of fraud under the act). Essentially, any action that had the appearance of fiction, deception, or fraud could trigger intervention by the Attorney General.
Federal regulators faced a choice among different regulatory philosophies. One possibility was to follow the New York example and rely primarily on reactive enforcement of anti-fraud provisions. The other was to expand proactive law enforcement, which was the option chosen. The core provision of the SA is that the distribution of any security is unlawful unless it has been registered and is accompanied by a prospectus that meets the other requirements stipulated in the act. The definition of what constitutes a security under the act is very comprehensive. The registration requirement is not equivalent to approval power, which would be the clearest

§ 352(1). He could investigate, subpoena witnesses, and require the submission of books and paper. § 352(2). Failure to comply with a subpoena was deemed a misdemeanor. § 352(4)-(5). In addition, the Attorney General had the right to enjoin either a violation of the act or the sale of securities by the defendant in any capacity within the state. § 353(1). Violation of any injunction could be penalized with a fine of U.S. $3000. § 359-g(1).

286. Loss & Seligman, Fundamentals, supra note 196, at 28.


289. Id. § 77e(b).

290. See id. § 77b(a)(1). The definition is as follows:

The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or
form of proactive enforcement. Still, the SEC can use its powers to delay or even stop the issuance of securities at the registration stage. 291

The SEC also exercises extensive residual lawmaking powers. These powers allow the SEC to regularly "make, amend, or rescind" those rules it deems necessary to carry out the provisions of the law, "including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical and trade terms" under the Act. 292 In order to ensure compliance with these rules and the provisions of the law, the SEC is vested with proactive enforcement powers. In particular, the SEC may administer oaths and affirmations, subpoena witnesses, take evidence, and demand the production of books, papers, or other documents which it deems relevant or material to inquiry. 293 These proactive enforcement powers are complemented with the right to initiate formal proceedings for a stop order and to initiate court proceedings, including preliminary injunctions to enjoin actions. 294

This brief overview shows that the U.S. did not follow the English example of gradually adapting liability rules long before moving to a system of regulation. Unlike England, American states' law had never regulated information disclosure to shareholders or investors, other than the right to request information. As described above, England gradually required that more and more items be disclosed and linked liability to compliance with disclosure provisions in the CA. 295

interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. See also § 77ddd(d) (indicating that the SEC may exempt "any security" from the provisions of the Act).

291. Id. § 77h(e).
292. Id. § 77s(a).
293. Id. §§ 77s(b).
294. Id. §§ 77h(e), t(b).
295. In France, audited annual reports to shareholders were mandatory as early as 1867, according to the French commercial code, and in Germany as early as 1861. Norbert Horn, Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920): Deutschland, England, Frankreich und die USA im Vergleich [Enterprise Organization in the Securities Law of High Industrialization (1860-1920): Germany, France and the USA in Comparison], in RECHT UND ENTWICKLUNG DER GRÖßUNTERNEHMEN IM 19. UND FÜRHER 20. JAHRHUNDERT [LAW AND THE FORMATION OF THE BIG ENTERPRISES IN THE 19TH AND 20TH
When the scope of possible harm that could result from misinformed investors became apparent, the U.S. in effect attempted to skip this process of trial and error by immediately moving toward a system based on proactive enforcement. But trial and error did take place in the U.S. The states’ experimentation with blue sky laws and the history of NYSE offer important insights into the benefits of a system that offered not only reactive but also proactive enforcement. The timing of the establishment of a financial market regulator was most likely influenced by political factors. However, the fact that both stock exchanges and the majority of state legislators recognized the need for a different allocation of residual lawmaking and law enforcement powers suggests that political factors were not alone in triggering the emergence of a regulator for financial markets.

A similar case can be made for the current proposal to create a regulator for auditors. Auditors were among the few financial intermediaries left out of the securities regulations put in place in the 1930s and early 1940s. To this date, they are largely self-regulated. Self-regulation, however, proved ineffective in preventing auditing firms from taking responsibilities as consultants, which increasingly resulted in conflict of interest problems. Moreover, existing criminal sanctions for misstatement of information in reports were ineffective in deterring companies such as Enron, Worldcom, and others from grossly misleading investors about companies’ values and the amounts of their earnings. Against this background, the

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296. See Benston, *supra* note 64, at 33.

297. *See Benston, supra* note 64, at 33.


proposal to establish a new regulator for auditors and auditing firms and to enforce law proactively so as to prevent actions that may result in substantial harm is not only a plausible approach, but one that might be more effective than raising the level of punishment in the hope of deterring similar actions in the future. The Sarbanes-Oxley Act of 2002 combines different approaches to lawmakers and the allocation of LMELP. This may stem as much from political compromise as from a lack of understanding of the tradeoffs required by these different mechanisms. This Article’s theory suggests that the allocation of lawmakers and law enforcement powers to a body that can perform regulatory functions and take proactive measures against potentially harmful actions will be more effective than increased criminal sanctions. While the latter may send signals to the public at large, the former will be more effective in ensuring that the law actually will be enforced. An important condition, of course, is that this regulatory body have the political stature and independence to live up to its task.

B. Germany

A similar general trend in devising alternative enforcement mechanisms in other countries can be observed. Com-


301. Unfortunately, the track record of the new accounting industry oversight board has not been very positive in this regard. The first chair appointed to the body, William Webster, resigned on November 12, 2002, only days after Harvey Pitt, the former chairman of the SEC, resigned his post. Press Release, SEC, SEC Accepts Resignation of Judge Webster (Nov. 12, 2002), available at http://www.sec.gov/news/press/2002-159.htm; Jeanne Cummings et al., Rapid Exit: SEC’s Pitt Resigns Amid Controversy Over Webster Job, Wall St. J., Nov. 6, 2002, at A4. Pitt’s resignation has been linked to his support for Webster’s candidacy and appointment to the accounting industry oversight board, despite the fact that he knew that Webster had headed the board of directors’ auditing committees at U.S. Technology, a company that was facing investor suits for alleged accounting fraud, and Pitt did not report these facts nor his knowledge of these facts to the other commissioners. Cummings, supra, at A4. On May 21, 2003, the SEC appointed William J. McDonough to be chair of the body. Press Release, SEC, SEC Unanimously Approves William J. McDonough as Chairman of Public Company Accounting Oversight Board (May 21, 2003), available at http://www.sec.gov/news/press/2003-63.htm.
parative analysis also reveals where the allocation of LMLEP may go astray.

Germany is typically characterized as a late developer in the process of industrialization. As such, it can be said to have benefited from the experiences of other countries. Yet this seeming advantage also preempted the experimentation and flexibility in lawmaking that could be observed in England.

As in other countries, in Germany the early stages of the development of securities markets and laws governing corporations and securities was closely related to railway construction in the mid-19th century. In 1838, Prussia enacted a law on railway companies, followed in 1843 by a corporate law. By upholding the requirement of state approval for the establishment of companies with limited liability (the concession system), these laws sought to prevent speculative bubbles of the kind that England experienced during the railway mania. Thus, the lesson of England was to seek control of the formation of capital markets, not to encourage it. However, an increasing amount of litigation suggested that the law was not very effective in preventing company fraud and thus protecting investors. Where fraud did occur, investors had recourse to general principles of contract or tort law that had been codified in regional codes (for example in Saxony and Prussia), or could be derived from the *ius commune*. As else-

302. Alexander Gerschenkron, Economic Backwardness in Historical Perspective 6-7 (Frederick A. Praeger 1965) (1962). Indeed, the dominance of banks over equity markets in Germany has been explained as the desire to catch up with the leading industrial power, England, which warranted other strategies to accumulate capital within a much shorter period of time. Id. at 14. For a critical assessment of the role of banks in early industrialization in Germany, see, however, Jeremy Edwards & Sheilagh Ogilvie, Universal Banks and German Industrialization: A Reappraisal, 49 Econ. Hist. Rev. 427 (1996).


304. Id. at 30-31.

305. Id. at 39.

306. The *ius commune* are Roman law principles that were recognized as the general principles of law throughout the continent and complemented
where, the law was not very effective in addressing the problem of misrepresentation of information, albeit for slightly different reasons. Judges and legal scholars agreed that the publication of a prospectus that included wrongful information alone was not sufficient to establish liability.\textsuperscript{307} They reasoned that the prospectus created only a \textit{demonstratio}—a general notification addressed at potential investors—about securities to finance a particular undertaking, which should induce investors to make an offer for buying these securities but was not a binding offer on the part of the company, much less a binding agreement.\textsuperscript{308}

The Lucca-Pistoja case of 1861,\textsuperscript{309} a landmark series of cases on misrepresentation of information in prospectuses, demonstrated the limits of contract and tort law in dealing with the challenges of securities market development.\textsuperscript{310} Similar to many of the English cases discussed above,\textsuperscript{311} the undisputed facts that can be discerned from the series of lawsuits that were filed in relation to this incident are as follows: Goldschmidt Bank in Frankfurt published an invitation for acquisition of bonds in a company that was constructing a railway track from Lucca to Pistoja (Italy).\textsuperscript{312} According to the invitation, the operating company had obtained approval from the government of Tuscany to issue bonds worth 5.25 Million Liras, 3 Million of which had been reserved for underwriting in Germany.\textsuperscript{313} The offer was immediately oversubscribed.\textsuperscript{314} After the company collapsed and it transpired that the prospectus omitted crucial information, investors who had lost their money sued Goldschmidt Bank.\textsuperscript{315}

Since the bank itself was not the issuer and had not acquired the bonds in its own name, it could be held responsible

\begin{footnotes}
\item\textsuperscript{307} Assmann, \textit{Prospekthaftung}, supra note 144, at 41-42.
\item\textsuperscript{308} Id. at 45-46.
\item\textsuperscript{309} Assmann, \textit{Prospekthaftung} refers to a series of court decisions arising from the same fact pattern as the "Lucca-Pistoja" case. See id. at 48.
\item\textsuperscript{310} See id.
\item\textsuperscript{311} See supra Part IV.A.
\item\textsuperscript{312} See Assmann, \textit{Prospekthaftung}, supra note 144, at 48.
\item\textsuperscript{313} See id.
\item\textsuperscript{314} See id.
\item\textsuperscript{315} See id.
\end{footnotes}
only as an intermediary. According to the law, intermediaries were liable only for intentional wrongdoing. The question courts needed to resolve was whether under the relevant Roman law doctrine, actio enti, intentional wrongdoing required only the suppression of relevant information, or also the intent to cheat, which was disputed. German courts held that liability for fraud required that the offender knew or reasonably could have known that the information was wrongful—not unlike English case law prior to the enactment of the Directors’ Liability Act in 1890. This interpretation was confirmed by the Reichsgericht in 1886 and upheld in subsequent decisions.

The existing legal remedies for fraud were put to a new test when Germany liberalized its corporate law in 1870 and allowed companies to register freely without a special concession granted by the state. Shortly after this change, Germany experienced a major boom and subsequent crash (1871-1873) which resulted in two legislative responses: the tightening of the corporate code in 1884 and the enactment of the Stock Exchange Law (Börsengesetz, hereinafter SEL) of 1896. In combination, these statutes sought to establish comprehensive control over the process of company formation and listing on an exchange, as it was in these areas that lawmakers identified the greatest problems. Unlike English or U.S. legislation, German lawmakers responded by greatly restricting the use of the corporate form and imposing legislative restrictions on access to stock markets. It also placed stock markets

316. See id.
317. See id.
318. See id.
319. RGZ 39, 245 (247).
320. Id.
321. See Pistor et al., The Evolution of Corporate Law, supra note 62, at 810-11.
322. See id.
324. The dissemination of shares outside these two processes was left unregulated by German law. As Max Weber pointed out even prior to the passage of the 1896 law, this design created incentives to avoid the official exchange. See Max Weber, Die Ergebnisse der deutschen Börsenquête [The Results of the German Stock Exchange Survey], 44 Zeitschrift für das Gesammtes Handelsrech [Journal of Complete Commercial Law] 29, 45 (L. Goldschmidt et al. eds., 1896).
squarely under the supervision of the state. Thus, Germany is an example of a legal system that responded to the problem of under-enforcement by greatly expanding ex ante lawmaking, not by changing the allocation of LMLEP. This Article suggests that this response, which took the form of a “backlash,” was detrimental to the further development of stock markets in Germany.

Under the SEL, stock exchanges, of which there were many scattered throughout the country, were placed under state control by requirements of regional state licensing. The law explicitly delegated important law enforcement powers to the exchanges. Each stock exchange was required to establish an admissions office to scrutinize companies prior to admission to the exchange. The admissions regulations, however, were drafted by the Upper House of the Parliament, not the stock exchanges. Thus, the legislature retained residual lawmaking powers over this crucial area. The fact that the legislature retained lawmaking rights over this area seems to have retarded the evolution of listing standards, as the rule making process in the Upper House proved much more cumbersome than comparable processes at the London and New York stock exchanges.


326. See Mark J. Roe, Backlash, 98 Colum. L. Rev. 217 (1998) (analyzing the “backlash” that occurs when politics disrupt efficient markets).


328. This office was staffed by the exchanges with representatives from major banks and large industrial enterprises. Heinz Bremer, Grundzüge des deutschen und ausländischen Börsenrechts [Fundamentals of German and Foreign Capital Markets] 29 (1969).
The SEL also included liability rules for misrepresentation of the prospectus.\footnote{329. See Assmann, Prosekthaftung, supra note 144, at 61.} Responsible parties were defined as those that published the prospectus or initiated its publication.\footnote{330. See id. at 63.} In practice, this meant that banks, which acted as the main company promoters, were the most likely defendants in liability suits.\footnote{331. See id. at 62.} These provisions proved to be of little practical relevance. First, they covered only the listing process, which companies could avoid by issuing shares outside the exchange.\footnote{332. Id.} Second, they did not tighten liability requirements, as the U.K. Directors' Liability Act of 1890 had done.\footnote{333. See supra text accompanying notes 215-218.} Thus, only intent established liability.\footnote{334. This was in contrast to an earlier draft that had sought to establish the standard of diligence in one's own affairs (diligentia quam in suis). See Assmann, Prosekthaftung, supra note 144, at 63.} The German Supreme Court did not clarify until 1998 that gross negligence was sufficient.\footnote{335. Michael Kort, Neuere Entwicklungen im Recht der Börsenprosekthaftung (§§ 45 ff. BörsG) und der Unternehmensberichtshaftung [Recent Developments in the Law of Capital Market Prospectus Liability and Corporate Disclosure Liability] (§ 77 BörsG), 44 Die Aktiengesellschaft [The (Joint) Stock Corporation] 9, 10 (1999).} Third, the provisions captured only misrepresentation of information in the prospectus issued for the purpose of listing a company on the exchange and did not cover the circulation of information for other reasons.\footnote{336. See Assmann, Prosekthaftung, supra note 144, at 62-63.} Fourth, the defendant could choose to remedy the claim by taking back the security and refunding the original sale price.\footnote{337. See Börsengesetz [Capital Market Law], v. 22.6.1896 (RGBl. S. 157) Section 44 states that there is no liability for misrepresentation of information if the issuer offers to take back the security in exchange for the purchase price. However, the 1998 revision of the law did away with this requirement; the law now states that even if the acquirer of the security is no longer in possession of the paper, the acquirer may request compensation. On this change in the law, see Kort, supra note 335, at 13.} Giving the defendant this choice implied that investors who had since sold the securities on the secondary market had preempted their ability to bring a lawsuit, as they were unable to return the security should the defendant choose rescission rather than compensation. This requirement was justified by the
need to limit the potential number of claimants and to ensure some certainty (Rechtssicherheit) for the issuer of a prospectus. Finally, there were serious questions as to whether only the original acquirer of securities or also secondary buyers had a claim.

The German law has remained remarkably stable. Political and economic circumstances may not have been very conducive for the development of a vibrant stock market for much of the 20th century. Still, few attempts were made in the first decades after WWII to facilitate financial market development through legal and institutional reforms. The major tool for regulation of financial markets was the stock exchange law and the state-sponsored listing requirements. Stock exchanges operated under the supervision of regional governments. A federal securities regulator, the Bundesaufsichtsamt für das Wertpapierwesen [Federal Supervisory Agency for Securities] (BAW) was established in Germany only in 1994. Its original enforcement powers were quite limited when compared to the U.S. Securities and Exchange Commission, or even the English Financial Services Authority. Prior to the enactment of the Law on Prospectuses in 1998, the lawmaking and law enforcement powers of the BAW were largely confined to insider trading. Under the 1998 law, the BAW can now im-

338. See Kort, supra note 335, at 13. On this requirement of the earlier laws, see Assmann, Prospekthaftung, supra note 144, at 386.

339. See Kort, supra note 335, at 12.


342. See Second Law on Financial Market Subsidies, supra note 340. See also James H. Fries, Jr., An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland, 19 B.C. Int'l & Comp. L. Rev. 1, 43 (1996) (enumerating the powers of the BAW). Even with regards to insider trading, the law enforcement powers of the BAW were quite limited. They included monitoring, such as the right to request additional information from likely violators. In-
pose fines of up to DM 1 Million on companies for failure to issue a prospectus or inclusion of fraudulent information in the prospectus. However, it cannot bring civil suits against wrongdoers. Thus, the law enforcement powers as well as the scope of lawmaker powers of the BAW have remained much more limited than those of the SEC in the U.S. or the FSA in the U.K.

C. Summary

This brief overview of financial market regulation in the U.S. and Germany demonstrates that different legal systems have allocated residual lawmakers and law enforcement powers in different ways. In the U.S., the SEC was given extensive lawmakers and law enforcement powers under the 1933 and 1934 legislation. Courts still play an important role in enforcing violations of stock fraud laws. In fact, some authors suggest that the scope of private action has greatly expanded after the enactment of the SA and the SEA. Arguably, however, many potentially harmful actions never make it to the courts, because they are caught preemptively by a regulator or are not even attempted because the likelihood of discovery is sufficiently high.

In contrast, in Germany the legislature long retained residual lawmakers powers over determining the contents of listing requirements. Reactive law enforcement by courts was not very effective because of the difficulties shareholders

vestigations of and punishment for share price manipulations were not part of its portfolio. See Alfred Kueppers, Germans Look Longingly at SEC Model, Wall St. J., Sept. 6, 2001, at A15.

343. See Sales Prospectus Law § 17(3).
344. See Sales Prospectus Law. However, § 8(e) authorizes the BAW to prohibit public offers that do not comply with the Act's requirements. See also Marc I. Steinberg & Lee E. Michaels, Disclosure in Global Securities Offerings: Analysis of Jurisdictional Approaches, Commonality, and Reciprocity, 20 Mich. J. Int'l L. 207, 223 n.108 (1999) (noting the powers conferred by § 8(e)).
345. For a discussion of the powers of the SEC, see supra text accompanying notes 291-294. For a discussion of the powers of the FSA, see supra text accompanying notes 258-262.
346. See supra text accompanying notes 291-294.
347. See, e.g., Jesse Choper et al., Cases and Materials on Corporations 304 (5th ed. 2000).
348. See supra text accompanying notes 327-328.
faced in demonstrating loss, causality, and intent or gross negligence.\textsuperscript{349} The stock exchanges in all jurisdictions examined developed into the most important proactive law enforcers prior to the establishment of state regulators, given their power to refuse listing or to delist companies.\textsuperscript{350} However, by placing shares outside the exchange, companies could circumvent the regulatory reach of the exchange.\textsuperscript{351} In fact, in the post-war era, the unofficial market has played a substantial role in German financial market development. Law enforcement for these markets was left to the courts. A remarkable set of legal cases developed in dealing with misrepresentation of information—a reminder that the notion that courts’ LM powers are limited in civil jurisdictions does not apply where there are obvious gaps in statutory law.\textsuperscript{352} In light of the problems a reactive law enforcement regime faces in financial market regulations, however, the evolving case law could not substitute for a better regulatory regime.

VI. Conclusion

This Article develops the theory of incomplete law and uses it to analyze the emergence of regulatory functions in financial markets and assess the allocation of LMLEP in different jurisdictions. It argues that law is intrinsically incomplete: Because lawmakers are unable to foresee all future contingencies, they cannot write complete law. It further argues that if law is incomplete, law enforcement that relies exclusively on deterrence combined with reactive law enforcement will be sub-optimal. Therefore, other means of lawmaking and law enforcement are required to achieve optimal law enforcement. This Article suggests that proactive law enforcement combined with the right to adapt rules flexibly can enhance

\begin{enumerate}
\item<sup>349</sup> See supra text accompanying notes 309-320, 334-339.
\item<sup>350</sup> See supra text accompanying notes 240-241 (England), 273-277 (U.S.), 328 (Germany).
\item<sup>351</sup> See supra text accompanying notes 278 (U.S.), 332 (Germany); but see supra text accompanying note 238 (England).
\item<sup>352</sup> Liability for misrepresentation of information was based on liability for pre-contractual obligations (\textit{culpa in contrahendo}), a flexible interpretation of when a contract was deemed to have been concluded, and the recognition of implied contractual obligations. These judge-made legal principles were often more stringent than those established by the SEL. See ASSMANN, PROSPEKTHAFTUNG, supra note 144, at 21.
\end{enumerate}
law enforcement. Given that law is incomplete, perfect law enforcement is unachievable. The question, therefore, is what the optimal solution is in a world of only second-best options.

This Article suggests that regulators are agencies vested with proactive law enforcement and residual lawmaker powers. It explains the emergence of regulators as a response to the problem of ineffective enforcement of highly incomplete law. Regulators perform functions that distinguish them both from legislatures as lawmakers and from courts as holders of residual lawmaker and reactive law enforcement powers. While the scope of their lawmaker rights is limited, they are more flexible in adapting law over time than legislatures are. As proactive law enforcers, they can initiate actions and exercise enforcement rights in situations where courts, by design, must be passive and wait for others to bring action.

The theory is applied to the evolution of financial market regulation in England. This shows that even in late 19th century England, a country with a well-functioning court system and access to courts for enforcement of investors' rights, courts as reactive law enforcers faced severe problems in ensuring effective law enforcement. Over time, regulators increasingly assumed residual lawmaker and proactive law enforcement powers. Self-regulatory bodies, such as the stock exchanges, spearheaded this development. This evolutionary process suggests that theories that regard the emergence of regulation primarily as a result of interest group pressure or as intervention by an expanding state apparatus fail to explain the whole story. Developing listing and disclosure requirements was the stock exchanges' response to the problem of under-enforcement against stock frauds, which ultimately threatened their business of organizing a viable market for corporate securities. The limits of the exchanges' capacities help explain why state agents eventually took over. \textsuperscript{353} They can regulate not only official exchanges, but also securities traded elsewhere. With the growth of unregulated markets, this became ever more important.

Comparisons with other jurisdictions, including Germany and the U.S., lend support to this argument. In the U.S., the New York Stock Exchange also preceded state and federal reg-

\textsuperscript{353} A detailed analysis of the shift from self-regulation to state regulation is beyond the scope of this Article.
ulation. The shift to a federal regulatory regime as early as 1933 is related to the repercussions of the 1929 market crash. Germany has long focused on regulating exchanges rather than the market for securities—leaving the latter by default to case law. Facing challenges of under-enforcement and E.U. harmonization requirements, a more general regulatory framework was recently established. The important point is that analyzing the emergence of financial market regulators from a theoretical and comparative perspective suggests that political conditions may determine the timing and scope of regulatory functions, but that alone they do not explain the fundamental rationale for their development.

This Article is only the first step in developing and applying the analytical framework of incomplete law and the corresponding allocation of LMLEP. In order to make its arguments more clearly, it focused on the basic aspects of legal institutional design, assuming that lawmakers and law enforcers are benevolent. The next step is to analyze lawmakers' and law enforcers' incentive problems and political concerns. Different ways of allocating LMLEP will have different implications for lawmakers' and law enforcer's incentive problems. Moreover, Type I and Type II incomplete law may offer different opportunities for corruption, rent seeking, and the like. Factoring in these issues should improve understanding of law enforcement and legal institutional design.