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Regulating Irrational Exuberance and Anxiety in Securities Markets

Peter H. Huang *

Abstract: This chapter analyzes the regulatory implications of irrational exuberance and anxiety in securities markets. U.S. federal securities laws mandate the disclosure of certain information, but regulate only the cognitive form and content of that information. An important and unstudied question is how to regulate securities markets where some investors respond not only cognitively to the form and content of information, but also emotionally to the form and content of information. This chapter investigates that question when some investors feel exuberance or anxiety that is unjustified by cognitive processing of the available information. This chapter develops the implications for mandatory securities disclosure of irrational exuberance and anxiety.

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INTRODUCTION

Investing, especially by institutions, can increasingly take advantage of artificial intelligence, nonlinear chaotic models, genetic algorithms, neural network time series forecasting, pattern recognition software, and sophisticated quantitative computer valuation models. Thus, it seems that investing could become progressively more like the behavior described by the rational actor model of law and economics. But, even for institutions, ultimately humans are responsible for investing and feel emotions during investing. Yet, the rational actor model postulates that humans unemotionally maximize expected utility functions.

Behavioral economics advances an alternative to expected utility theory, namely prospect theory. The fact that Professor Kahneman was the co-recipient of the 2002 Nobel Prize in Economic Sciences to is the latest example of the ascendancy of behavioral economics. Behavioral economics has gained much popularity and prestige in recent years. Recently, some legal scholars have applied behavioral economics to analyze legal rules and institutions. These
legal scholars consider the policy and regulatory implications of cognitive limitations by drawing on a literature about information processing errors. But, the scope and normative implications of such legal applications remains the subject of continuing debate.

In addition, while prospect theory provides an alternative model of choice under risk to expected utility theory; prospect theory, expected utility theory, and “virtually all current theories of choice under risk or uncertainty are cognitive and consequentialist.” But, human behavior is not only cognitive, but also emotional; moreover, cognition and emotion are interrelated. For


See, e.g., Louis C. Charland, *Is Mr. Spock Mentally Competent? Competence to Consent and Emotion*, 5 PHIL., PSYCHIATRY, & PSYCHOL. 67, 71-72 (1998) (describing recent neurophysiological, philosophical, and psychological research suggesting that emotions are fundamentally cognitive); Yaniv Hanoch, “*Neither An Angel Nor An Ant*”:
example, investors may be overconfident due to hubris. Yet, “research from clinical, physiological, and other subfields of psychology, ... show that emotional reactions to risky situations often diverge from cognitive assessments of those risks. When such divergence occurs, emotional reactions often drive behavior.”

Behavioral finance, which is behavioral economics over time and under conditions of risk, has revolutionized academic finance. But, while behavioral finance sometimes refers to such emotions as greed and fear, behavioral finance only considers emotions to explain why some investors utilize cognitive biases and heuristics. The main focus of behavioral finance is to demonstrate how investing driven by cognitive limitations explains observed anomalies in asset pricing and impacts asset pricing.

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12 Loewenstein, supra note 9 at .267.
14 John R. Nofsinger, The Psychology of the Investing xi (2002) (stating that “[a]n old Wall Street adage states that two factors move the market: fear and greed. Although true, this characterization is far too simplistic. The human mind is very sophisticated, and human emotions are very complex. The emotions of fear and greed just don’t adequately describe the psychology that affects people.”); Hersh M. Shefrin, Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing (2000) (providing a guide for financial practitioners to behavioral finance).
For example, many individuals and even some financial practitioners over-react to information as well as to what they believe others will do. Some behavioral finance models assume there are noise traders, who are unable to differentiate between payoff-irrelevant information (that is, noise) and payoff-relevant information, due usually to cognitive biases in processing information. Recently, scholars have begun to consider the implications of cognitive biases for securities regulation. This chapter builds upon such legal scholarship that focuses primarily on cognitive biases and heuristics by focusing instead on emotional investing.

Most U.S. federal securities laws focus on the cognitive form and content of certain information. In contrast, many investors respond emotionally to both the form and content of information and while investing, experience a series of “successive emotional states of hope, joy, craving and euphoria,” sometimes followed by anxiety and fear. It is thus not surprising that a moment of introspection reveals that people usually feel many emotions before, during, and after they invest. In fact, certain emotions might exemplify visceral factors that short circuit or trump...
normal logical reasoning.\textsuperscript{21} For example, an investor feeling exuberant may optimistically misperceive or even ignore completely the risk factors associated with a particular security during her investment decision process. Similarly, an investor who feels anxious over a string of accounting scandals and instances of corporate malfeasance may pessimistically misperceive or even ignore completely any sound fundamentals associated with a particular security during her investment decision process. This chapter analyzes the regulatory implications of irrational exuberance and anxiety in securities markets.

People usually answer the question, “what is emotion?” with these synonyms: affect, feelings, or mood.\textsuperscript{22} Even today, the precise definition of an emotion remains contested among researchers.\textsuperscript{23} But, there is a consensus that emotions involve a number of related characteristics, namely great intensity, instability, relative brevity, and a partial perspective.\textsuperscript{24} Before proceeding further, it helps to distinguish among these three related but distinct concepts: emotions, affect, and mood. Emotions describe particular states, like fear, anger, or happiness, that are “intense, short-lived, and usually have a definite cause and clear cognitive content.”\textsuperscript{25} Affect refers to “a feeling state that people experience, such as happiness or sadness. It may also

\textsuperscript{22}ANTONIO DAMASIO, LOOKING FOR SPINOZA: JOY, SORROW, AND THE FEELING BRAIN 27-80 (2003) (arguing that emotions differ from mood and precede feelings).
\textsuperscript{24}AARON BEN-ZE’EV, THE SUBTLETY OF EMOTIONS 13 (2000).
be viewed as a quality (e.g. goodness or badness) associated with a stimulus.” Mood refers to “a feeling (such as having the blues) that is low in intensity, can last for a few minutes or several weeks, has no object or has fleeting objects, and does not have to have a specific antecedent cause or cognitive content.” Scholars often describe the stock market as experiencing (bipolar) mood swings. There is experimental evidence that happy and sad moods have large and consistent effects on estimating subjective probabilities of positive and negative events.

There are (at least) two principal alternative ways to conceive of emotions. First, there is a tradition dating back to Aristotle, Socrates, and Plato that conceives of emotions as factors that disturb rational deliberation, thought, and reflection. Second, there is a more recent view informed by cognitive neuroscience that conceives of emotions as factors that complement rationality in effective decision-making. Naturally, these different conceptions of emotions have diametrically opposed implications for whether and if so, how the law can or should respond to emotional human behavior. The first viewpoint implies that law should be designed to protect us from our emotions, while the second viewpoint implies that law should take a more laissez faire attitude towards our emotions.

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30 See, e.g., ARISTOTLE, THE POLITICS OF ARISTOTLE 146 (Ernest Baker trans. 1946) (stating that “[l]aw … may be defined as ‘Reason free from all passion.’”)
32 See, e.g., THE FEDERALIST NO. 10, at 48 (James Madison) (Clinton Rossiter ed., 1999) (“Where a majority is included in a faction, the form of popular government . . . enables it to sacrifice to its ruling passion or interest both the public good and the rights of other citizens.”).
Asking whether emotional decision-making is socially desirable is akin to asking whether self-interested decision-making is socially desirable. Under certain strong conditions, including but not limited to complete markets and perfect competition, the pursuit of self-interest can lead to socially desirable results in the sense of Pareto efficient outcomes. In other situations, including but not limited to the presence of externalities or public goods and in certain strategic interactions, the pursuit of self-interest can lead to socially undesirable results in the sense of Pareto inefficient outcomes.

Existing legal doctrines provide numerous examples of both conceptions of emotions. Criminal law considers excuses based upon extreme emotional disturbance, the battered woman syndrome, and post-traumatic stress disorder; but it also encourages compassion, mercy, and sympathy. Tort law recognizes some, but not all forms of emotional harm and suffering. Contract law recognizes the formation defense of procedural unconscionability, which can be due to distress, transactional incapacity, or unfair persuasion. The Federal Trade Commission promulgated a rule granting consumers a three day “cooling-off period” during which buyers can rescind their contracts with door-to-door salespeople. There is a similar three day cooling-off period for home equity loans providing buyers with a limited right to rescind certain credit transactions involving their principal dwelling as a security interest. Congress imposed a seven day waiting period on any employee waiver of rights under the Age Discrimination in Employment Act (ADEA). The family law statutes of many states require that (perhaps very

34 See FTC Rule Concerning Cooling-Off Period Made for Sales at Homes or at Certain Other Locations, 16 C.F.R. § 429.1(a) (2002) (mandating that a contract’s front page state that the buyer “may cancel this transaction at any time prior to midnight of the third business day”).
35 See 15 U.S.C. § 1635(a) (2000) (granting borrowers the right to cancel any consumer credit transaction involving their principal dwelling as a security interest before midnight of the third business day after the completion of the contract).
36 See 29 U.S.C. § 626(f)(1)(G) (2000) (mandating that an agreement to waive one’s rights may be revoked up to seven days after its inception).
“yippy skippy”) couples must wait awhile after the issuance of a marriage certificate before they can marry.37 Some of these states also require that a couple may not divorce until after the passage of a mandatory waiting period, that usually exceeds the mandatory prenuptial waiting period.38

Asking whether emotions are good or bad for decision-making is analogous to asking if heuristics are good or bad for decision-making. Sometimes emotions are good for making decisions, while at other times emotions are bad for making decisions; just as sometimes heuristics are good for making decisions, while at other times heuristics are bad for making decisions. The reason for this mixed or nuanced answer is the same in the case of both emotions and heuristics, namely emotions and heuristics act faster than rational deliberation, but precisely because of their speed, emotions and heuristics can mislead us into systematic errors in making decisions.

This chapter focuses on emotions before or during investing, and therefore complements my previous work on anticipated emotions, which are fully and correctly anticipated before or during the decision making process.39 A difficulty with anticipated emotions is that people may

37 See, e.g., N.Y. DOM. REL. LAW § 13-b (McKinney 1999) (“A marriage shall not be solemnized within twenty-four hours after the issuance of the marriage license . . . .”)
38 See, e.g., CONN. GEN. STAT. ANN. § 46b-67(a) (West 1995) (mandating that married couples must wait ninety days after filing a complaint for dissolution or legal separation before the court may proceed).
systematically make prediction errors regarding their future interim or ex post feelings. Because irrational exuberance and anxiety occur before or during the process of decision making, there are no such difficulties with irrational exuberance and anxiety.

The rest of this chapter is organized as follows. Part I provides empirical and experimental evidence of, a case study of, and theoretical models of irrational exuberance and anxiety in securities markets. Part II contributes to the debate over mandatory securities disclosures by examining the implications of irrational exuberance and anxiety for such disclosures. Part II also develops implications of the fact that securities regulators, including but not limited to the SEC, juries, and private litigants themselves experience irrational exuberance and anxiety. Part III provides conclusions.

I. IRATIONAL EXUBERANCE AND ANXIETY IN SECURITIES MARKETS

The chairman of the Federal Reserve Board in Washington, D.C., Alan Greenspan, described stock market investor behavior with the phrase “irrational exuberance” in his now infamous December 5, 1996 speech. Those two words resonated with many commentators in the

media and with the public worldwide. The publication of a book entitled Irrational Exuberance cemented the permanence of that phrase in the popular lexicon about securities markets. What exactly, though, does irrational exuberance mean, as opposed to rational exuberance or irrational anxiety? In this chapter, the phrase irrational exuberance refers to exuberance that is not justified by merely cognitive processing of the available information about securities markets. Thus, rational exuberance refers to exuberance that is warranted by merely cognitive processing of securities disclosures and risks. Irrational anxiety refers to anxiety that is unwarranted by merely cognitive analyses of securities markets fundamentals. Rational anxiety refers to anxiety that is supported by merely cognitive assessments of the costs and benefits of securities investing.

Most people at some point during investing experience fear or hope over their investments. People often make investments motivated by fears. There is the fear of losing money. There is the fear of not keeping up with others or being left out of a bull market. The fear of regret also partially explains why investors often select conventional stock choices, use full-commission brokers rather than discount brokers (the former may give useless advice, but also provide easy scapegoats), and hold onto losing stocks too long. People often avoid purchasing such volatile securities as those of biotech or Internet companies to minimize anxiety. On the other hand, some investors, such as day traders, might engage in risky

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41 ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000).
42 The robust experimental findings that people can be very loss averse and treat out-of-pocket losses differently than opportunity costs have clear implications for the way that people actually invest.
44 Hersh M. Shefrin & Meir Statman, How Not to Make Money in the Stock Market, PSYCHOL. TODAY Feb. 1986, at 52, 56-57 (providing these explanations); SHEFRIN, supra note 14, at 222-224 (discussing the roles of regret and responsibility in active versus passive money management).
45 It is crucial to distinguish anxiety from risk aversion. Anxiety is a dynamic notion that arises because some decision-makers may prefer to not live with a feeling of uncertainty across time periods. Risk aversion is a static notion related to how curved a decision-maker’s utility function over wealth is within a fixed period of time. See Elke U. Weber & Christopher Hsee, Cross-Cultural Differences in Risk Perception, but Cross-Cultural Similarities in Attitudes Towards Perceived Risk, 44 MGMT. SCI. 1205 (1998) (reporting that respondents in the U.S., Germany, the P.R.C., and Poland differed in their risk preferences, but are similar in their attitudes towards perceived risk).
portfolio strategies partly for their excitement. One legal scholar likens euphoric financial market transactions to gambling.\textsuperscript{46} That same legal scholar believes that laws may reduce the irrational exuberance of securities markets.\textsuperscript{47} Arguably, certain policies of the SEC and the Federal Reserve facilitate investor enthusiasm about stocks.\textsuperscript{48} Not only financial rewards, but also excitement and general optimism often motivate the issuers of securities, original investors in initial public offerings (IPOs),\textsuperscript{49} and subsequent early investors.

Irrational exuberance and anxiety raise a couple of questions, namely how and why does irrational exuberance and anxiety persist in light of so-called learning effects and selection effects. Learning effects occur if people learn from their own personal investing experience or those of others and get better at investing over time, as they discover that relying on irrational exuberance and anxiety can yield investment returns that they subsequently realize are financially suboptimal. As with Bill Murray’s character, Phil, in the movie Groundhog Day, noiseless feedback and stationary environments promote learning effects.\textsuperscript{50} But, investing yields very noisy feedback because people can quite naturally (and perhaps even subconsciously) confuse their investment successes with financial insight and confuse their investment failures with bad luck. In addition, empirical evidence suggests that securities markets are highly non-stationary environments. It might seem that institutional and organizational structures can foster

\textsuperscript{49} The original investors in IPOs are typically not individual investors, but institutional investors. See Hillary A. Sale, \textit{Disappearing without A Trace: Sections 11 and 12(a)(2) of the 1833 Securities Act}, 75 WASH. L. REV. 429, 441 (2000) (observing that the class of “first buyers of the securities issued (Original Shareholders)...is usually very limited, including only institutional investors, members of Congress, and those with connections to underwriters.”)
\textsuperscript{50} \textit{GROUNDHOG DAY} (Columbia Pictures Corporation 1993).
learning effects and thus dampen irrational exuberance and anxiety in a manner analogous to how framing dampens endowment effects in corporate agency contexts.\textsuperscript{51} But, irrational exuberance and anxiety are not really biases to be unlearned.

Selection effects occur if securities market pressures weed out irrational exuberance and anxiety. Even when some investors continue to feel irrational exuberance and anxiety over time, perhaps the overall impact of irrational exuberance and anxiety on securities markets will decrease over time due to arbitrage. It might seem that arbitrage is a powerful force that selects for (more) rational investing decision-making and weeds out irrational exuberance and anxiety. But, as is well-known by now, there are costs and limits to arbitrage.\textsuperscript{52} Also, arbitrage is a strong engine of information transfer that travels in two directions. In other words, just as those investors who do not feel irrational exuberance and anxiety can arbitrage away the impact of those investors who do feel irrational exuberance and anxiety, similarly those investors who feel irrational exuberance and anxiety can arbitrage away the impact of those investors who do not feel irrational exuberance and anxiety. The often cited observation that securities markets are the archetypical model of perfectly competitive markets is a true, but moot point if even institutional, professional, or sophisticated investors also feel irrational exuberance and anxiety. In fact, there is anthropological, economic, ethnographic, and sociological evidence that documents how the corporate cultures of many institutional investors foster irrational exuberance and anxiety.\textsuperscript{53} Finally, recent empirical evidence finds that securities market professionals feel the same

\textsuperscript{51} Jennifer Arlen, et al., \emph{Endowment Effects with Corporate Agency Relationships}, 31 J. LEGAL STUD. 1 (2002) (finding that the endowment effect is significantly dampened in experimental agency contexts).
\textsuperscript{52} Andrei Shleifer & Robert W. Vishny, \emph{The Limits of Arbitrage}, 52 J. FIN. 35 (1997) (proving this formally).
\textsuperscript{53} See, e.g., generally MITCHEL Y. ABOLAFIA, \emph{Making Markets: Opportunism and Restraint on Wall Street} (1996) (providing such evidence).
emotions as individual investors do.\textsuperscript{54} Finally, there is anecdotal evidence that even institutional investors feel strong emotions over their investments.\textsuperscript{55}

Although securities markets are highly competitive, valuation in securities markets is an extremely subjective process. Emotional factors often influence the assessment of securities values across investors, just as emotions often affect subjective appraisals of the value of residential properties across home-buyers and homeowners. In fact, because securities, unlike consumer durables and real estate, are never consumed; securities markets, even more than other durable goods markets, involve subjective, often ephemeral and potentially very emotional anticipations of the future. While reasonable people may agree on the past and the present (although there is reason to be skeptical of even these propositions as evidenced by the well-known fallibility of eyewitness testimony and memory), reasonable people often disagree on the future, both in terms of the set of contemplated outcomes and their various relative likelihoods. People are repeatedly caught off guard upon the realization of previously subjectively unforeseen contingencies.

Even before the Securities Act of 1933 and the Securities Exchange Act in 1934 were enacted, and certainly ever since then, it would not be surprising to note that many emotional factors affect investor behavior. The legislative history of both Acts that are the centerpiece of U.S. federal securities regulation contains numerous horror stories. Many of the cognitive psychological insights of behavioral finance were already an accepted part of the folk-wisdom that formed the basis and rationale for our federal system of securities regulation. U.S. securities laws can be understood as an attempt to alter the manner in which investors make decisions by


\textsuperscript{55} See, \textit{e.g.}, ROGER LOWENSTEIN, \textsc{When Genius Failed: The Rise and Fall of Long-Term Capital Management} 75 (2000) (observing that “Long-Term’s traders were not automatons. They debated, sometimes
helping, or forcing, them to make better decisions. For example, the Securities Act of 1933 goes to extremely great lengths to try to structure the investment process/decision into a hyper-rational process in which a reasonable investor, sitting in the calm of her study, reviews only the prospectus of the registration statement, without being influenced unduly by pushy stockbrokers, high-pressure scare tactics, glossy ads or promotional materials, or anything else. The puffery defense attempts to minimize the distortions that can be caused by puffery by placing investors on legal notice that they should ignore puffery, assuming that they can do so. The quiet period; the prohibitions against “conditioning” securities markets by engaging in so-called “gun-jumping” during the period before the filing of a registration statement with the SEC; and the mandatory disclosures required of a securities registration statement are all designed to improve investor decision-making by limiting the influence of distortions on the rational investment process.

But, in light of not only the persistence of, but also the recent growth in irrational exuberance and anxiety, existing federal securities regulations have clearly failed to sufficiently protect investors from their emotional selves or from emotional others. This chapter thus critiques our current federal securities laws on two accounts. First, U.S. federal securities laws fail to incorporate the best model of decision-making, namely one that incorporates the realities and robustness of human emotions. Second, U.S. federal securities laws fail to incorporate the best techniques for teaching investors how to improve their decision-making skills, e.g., the law should be teaching investors to make decisions based on different factors, such as, more forward-looking, rather than backward-looking, information.

hotly, for hours every week, about what the models implied and whether to do what the models recommended.” Italics in original).
The rest of this section of the chapter analyzes the recent experimental and empirical
evidence of and theoretical models about irrational exuberance and anxiety in securities markets.
A recent, comprehensive synthesis of the research on how feelings influence stock pricing also
suggests future directions of research, proposes richer hypotheses, and raises open questions
about how investors’ feelings impact securities prices.57

A. **Empirical Evidence**

An important finding of research on the perception of risk is that “[r]isk is multi-attribute
in nature. It involves such elements as feelings of control, dread, and knowledge. … Risk always
contains an emotional or affective dimension.”58 Investing is clearly risky. Survey evidence
indicates that such emotional factors as catastrophic potential, control, and dread figure
prominently in the perception of financial risks,59 and that “emotional dimensions such as dread
are important in the perceived risk of financial gambles.”60 Studies demonstrate that moods
induced by reading brief newspaper stories reporting on tragic or happy incidents produce large
and pervasive changes in estimates on the frequency of risks, independent of whether the stories
and risks are similar.61 Evidence of the prevalence of affect in forming risk perceptions occurs in
many diverse settings.62

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5180, 1 Fed Sec L Rprr (CCH) at 3056 (Aug. 16, 1971) (detailing the rationales for prohibiting gun-jumping in
terms of curbing the practice of conditioning of securities markets).
manuscript, on file with the author) (synthesizing empirical research on the impact of emotions on stock prices and
developing a theoretical basis for understanding that empirical research).
58 Robert A. Olsen, Behavioral Finance as Science: Implications from the Research of Paul Slovic, 2 J. PSYCHOL. &
60 Id. at 558.
61 Eric J. Johnson & Amos Tversky, Affect, Generalization, and the Perception of Risk, 45 J. PERSONALITY & SOC.
Emotional investing exemplifies Professor Damasio’s theory of the role of emotion in decision-making.\textsuperscript{63} Professor Damasio believes that “[t]he factual knowledge required for reasoning and decision making comes to the mind in the form of images.”\textsuperscript{64} Professor Damasio’s somatic marker hypothesis is that with experience, these images become “marked” by positive and negative feelings linked directly or indirectly to somatic or bodily states.\textsuperscript{65} Professor Damasio’s research documents clinical evidence of patients with damage to the ventromedial frontal cortices of their brains having trouble feeling emotions, associating those feelings with the anticipated consequences of their actions, and making decisions in spite of retaining their basic intelligence, memory, and capabilities for analytical reasoning and for logical thought.\textsuperscript{66} Neurobiological and psychological research demonstrates that people recall new facts better if certain emotions are present during learning than if they are not.\textsuperscript{67} The rest of this section of the chapter analyzes the empirical evidence of emotional investing in experiments, by securities professionals, and in response to on-line brokerage ads.

1. **Experimental Evidence**

The fact that Professor Smith was the co-recipient of the 2002 Nobel Prize in Economic Sciences to is the latest example of the ascendancy of experimental economics.\textsuperscript{68} There is both an increasing appreciation for and application of empirical and experimental methodology to


\textsuperscript{64} Id. at 96.

\textsuperscript{65} Id. at 173-75, 179-80.

\textsuperscript{66} Id. at 53-54; Antonio R. Damasio et al., Individuals with Sociopathic Behavior Caused by Frontal Damage Fail to Respond Autonomically to Social Stimuli, 41 BEHAV. BRAIN RES. 81 (1990).


\textsuperscript{68} Hilsenrath, supra note 4.
study legal rules and institutions. A particular laboratory experiment investigated the behavior of investors when they face what is known as global risk, namely a risk independent of their decisions. Political risk that is not country specific is an example of global risk. The study found that global risk significantly and substantially decreases average investment. This finding is not consistent with such theories of rational decision making in the presence of risk as expected utility theory, prospect theory, disappointment theory, and regret theory. This experimental result is consistent with psychological evidence that anxious people make pessimistic probability estimates, are biased in terms of the amounts and types of information they utilize, and are thus motivated to reduce the level of risks they face.

2. **Empirical Evidence Involving Securities Professionals**

A recent study of professional derivative securities traders documents the importance of emotional responses in their decision-making processes. The study measured physiological characteristics, such as body temperature, cardiovascular data, electromyographical signals, respiration rate, and skin conductance response, during actual trading sessions. The study found

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70 Ronald Bosman & Frans van Winden, Global Risk, Effort, and Emotions in an Investment Experiment (Aug. 2001) (unpublished manuscript, on file with the author) (reporting this finding).

71 *Von Neumann & Morgenstern*, supra note 2.

72 Kahneman & Tversky, *supra* note 3.


significant correlation between electrodermal responses and transient market events, and between changes in cardiovascular variables and market volatility. These data suggest that an important factor in the success of some derivative securities traders is their ability to utilize their emotions to make very rapid trading decisions. In addition, there is anecdotal evidence that even professional traders react emotionally to financial decisions, information, and outcomes.\textsuperscript{77}

A number of empirical studies document a statistically significant effect of weather on stock market prices.\textsuperscript{78} For example, local cloud cover in New York City from 1927-89 was significantly correlated with low daily returns on three U.S. stock indices (the Dow Jones Industrial Average, a New York Stock Exchange (NYSE) / American Stock Exchange (AMEX) equal-weighted index, and a NYSE/AMEX value-weighted index).\textsuperscript{79} In fact, there was a strong positive correlation between morning sunshine at a country's leading stock exchange and the market index stock returns that day at twenty-six stock exchanges internationally from 1982-97.\textsuperscript{80} In addition, seasonal variations in biorhythms and disruptions in sleep caused by changing from and to daylight savings affect stock returns internationally.\textsuperscript{81} Furthermore, returns on international stock exchanges are correlated with fluctuations in the amount of daylight over the year.”

\textsuperscript{76} Lo & Repin, supra note 54.

\textsuperscript{77} See MICHAEL LEWIS, LIAR’S POKER 15 (1989), “He had, I think, a profound ability to control the two emotions that commonly destroy traders – fear and greed – and it made him as noble as a man who pursues his self-interest so fiercely can be.” (assessing the founder and head of Salomon’s legendary bond trading Arbitrage Group, John Meriwether); LOWENSTEIN, supra note 55 at 76-77 (describing the feelings and emotional toll on some principals of the hedge fund, Long-Term Capital Management, during its mounting losses in September 1998).

\textsuperscript{78} Mark Hulbert, Forget About Efficient Markets, Let the Sun Shine In, N.Y. TIMES, June 17, 2001 at C7 (reporting on one such study).


\textsuperscript{80} David A. Hirshleifer & Tyler G. Shumway, Good Day Sunshine: Stock Returns and the Weather, J. FIN. (forthcoming, 2003).

year. A different approach studies the relationship between stock returns and temperature. Another study finds that on average, morning stock returns exceed afternoon returns. All of these studies imply that the moods of individual investors or professional market-makers affect stock prices. In addition, there is empirical evidence that unusually high levels of geomagnetic storms (GMS) have a statistically and economically significant negative impact on world and country-specific stock returns, even after controlling for behavioral, environmental, and well-known market seasonal factors. Finally, other studies speculate that there is a lunar cycle, also known as the circatrigintan cycle, effect in stock prices whereby stock returns are significantly higher on days near a new moon than on days near a full moon.

3. A CASE STUDY OF IRRATIONAL EXUBERANCE: ON-LINE BROKERAGE ADS

A case study of irrational exuberance is provided by emotional on-line investing advertisements that presented visceral and powerful images of on-line investors getting rich quickly. Some individuals exposed to such emotionally appealing on-line brokerage television commercials and billboards are likely to ignore or be insensitive to variations in the probability

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87 Ilia D. Dichev & Troy D. James, Lunar Cycle Effects in Stock Returns (Aug. 2001) (unpublished manuscript, on file with the author) (finding a pervasive pattern of returns in the 15 days around new moon dates being double the returns in the 15 days around full moon dates, for all major U.S. stock indexes over the last 100 years and for nearly all major stock indexes of 24 other countries over the last 30 years); Kathy Yuan, et al., Are Investors Moonstruck? Lunar Phases and Stock Returns (Sept. 5, 2001) (unpublished manuscript, on file with the author) (finding strong
of striking it rich. Some on-line traders will focus instead on the outcome of becoming rich. Television commercials by on-line securities brokerages not only emphasized the personal control, ease, and profitability of such trading, but also were rich in emotional imagery.

Professors Barber, Elsbach, and Odean performed a content analysis of five hundred television commercials from thirteen brokerages. They found that 28% of all commercials between 1990 and 2000 depicted images and messages likely to induce good or positive moods in viewers and the percentage of such commercials more than doubled from 12.39 percent in 1990-1995 to 32.98 percent in 1996-2000. This empirical finding is consistent with and understandable in light of recent psychological experiments demonstrating that people in moderately good or positive moods tend to be less thorough and less vigilant decision-makers, are more subject to cognitive biases, and rely more on heuristics than people in moderately negative moods. On-line brokerages voluntarily ceased the broadcasting of positive emotional commercials due to changes in financial market conditions and moods.

A Discover Brokerage Direct television commercial about on-line trading depicted a conversation between a passenger and a stock-trading tow truck driver, who states, “That’s my home. Looks more like an island. Technically, it’s a country.” Other television commercials evidence across forty eight countries that stock returns on days near a new moon are higher than on days near a full moon).

88 Brad M. Barber, et al., Investing Advice From Television Commercials, prepared for the A.A.R.P.-Public Policy Institute (Nov. 24, 2001).
89 Id. at 16, 25 tbl.1, 27 fig.1b.
included a stock-trading teenager, who owned his own helicopter. A series of Schwab commercials featured such celebrities as teen-age Russian tennis star Anna Kournikova. An E*TRADE advertisement claimed “that on-line investing is ‘A cinch. A snap. A piece of cake.’”

A commentator noted that:

The years prior to 2000 featured a collection of e-trading commercials that could be viewed as hilarious by the seasoned professional and convincing by the novice trader. A typical commercial began by showing a teen-age boy or an elderly woman who appear to be very ordinary, and are treated as such. In the next scene, the other characters, and no doubt the viewers, are surprised to find out that this person is being thanked for bailing out a country, for example. The strong suggestion is that anyone who has a modest savings account can acquire a fortune, and be treated accordingly, if only they start trading on the Internet. For any skeptical viewers having their doubts, a resumption of the news, particularly the business news cable stations, would often turn to factual stories of the day’s new IPO billionaires.

These commercials clearly conjured up mental images of becoming rich quickly and easily. Former SEC Chairman Arthur Levitt said, “Quite frankly, some advertisements more closely resemble commercials for the lottery than anything else. When firms, again and again, tell investors that on-line investing can make them rich, it creates unrealistic expectations. …

93 *Id.*
Many investors are susceptible to quixotic euphoria….”96 New York Attorney General Eliot Spitzer observed that on-line brokerage ads “conveys a message of convenience, speed, easy wealth, and the risk of ‘being left behind’ in the on-line era.”97

Like much advertising, these advertisements do not provide information for viewers to process cognitively, as much as they appeal to viewers’ emotions.98 These commercials were directed at evoking strong positive mental imagery and favorable emotional reactions to on-line investing risks. Such on-line brokerage ads decreased significantly after the bull market ended, further suggesting that the goals of such commercials were primarily to complement an overall mood of irrational exuberance and euphoria that prevailed then in securities markets and to stir up such emotions as hope and greed.99 In a Jan. 26, 2001 report about on-line trading, the SEC expressed concerns that certain types of aggressive on-line brokerage ads may cause investors to possess unrealistic expectations over the risks and rewards of investing.100 In that report, the SEC noted that “[a]dvertising that contains misrepresentations or omissions of material fact may violate the antifraud provisions of the federal securities laws.”101 In 2000 and 2001, the SEC and NASD (National Association of Securities Dealers) formally investigated the advertising practices of E*Trade Group, Inc.102 But, both lengthy investigations resulted in the SEC

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96 Arthur Levitt, Plain Talk About On-line Investing, Speech at the National Press Club (May 4, 1999); see also Report of NASDR Concerning the Advertisement of On-line Brokerages (Sept. 21, 1999).
97 From Wall Street to Web Street, supra note 91, at 4.
101 Id. at n.14; NASD Rule 2210(d); NYSE Rules 472.30 and 472.40.
dropping its fair disclosure case and the NASD settling with E*Trade. The SEC did not publicly state the reasons for its decision to drop the case. Although there is little concern over such types of advertisements in the current anxious securities market environment, similar advertisements may return when an exuberant securities market environment does. In addition, there may be cause for concern over advertisements that exploit investor anxiety in a bear market. Furthermore, SEC releases already express concern over the advertising of such complex financial instruments as collateralized mortgage obligations. For example,

(c)(2) Advertisements concerning collateralized mortgage obligations, advertisements concerning security futures, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide

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with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this paragraph shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.\footnote{SEC Release No. 34-46186, 2002 SEC LEXIS 1792, July 11, 2002, *17-19.}

SROs (Self Regulating Organizations), such as the NASD, also have approval and recordkeeping rules related to complex financial instruments. Also, relevant for whether and how the SEC should regulate such advertisements are Federal Trade Commission (FTC) deceptive advertising cases\footnote{See, e.g., Florence Mfg. Co. v. J.C. Dowd & Co., 178 F. 73, 75 (C.A.2 1910) (stating that “[t]he law is not made for experts but to protect the public,-- that vast multitude which includes the ignorant, the unthinking and the credulous, who, in making purchases, do not stop to analyze but too often are governed by appearances and general impressions”); Aronberg v. FTC, 132 F.2d 165, 167 (7th Cir. 1942) (stating “the buying public does not ordinarily carefully study or weigh each word in an advertisement” and that “[a]dvertisements are intended not ‘to be carefully dissected with a dictionary at hand, but rather to produce an impression upon’ prospective purchasers” (quoting Newton Tea & Spice Co. v. United States, 288 F. 475, 479 (6th Cir. 1923))); Standard Oil Co. of California v. FTC, 577 F.2d 653, 659 (9th Cir. 1978) (stating “that commercial messages might lead the average viewer, in his anxiety …, to overreact even though upon careful reflection he might see for himself the limitations inherent in the advertiser's claim”).} and the FTC’s Policy Statement on Deception.\footnote{An advertisement is deceptive when there is “a misrepresentation, omission or other practice, that misleads the consumer acting reasonably in the circumstances, to the consumer’s detriment.” Policy Statement on Deception, 4 Trade Reg. Rep. (CCH) ¶13, 205 at 20, 917 (FTC Oct. 14, 1983). In determining if an advertisement deceives consumers, the FTC asks what does the advertisement say or imply, and does the advertisement have a reasonable basis for its claims?} Finally, of relevance are the literatures on consumer psychology in general,\footnote{See, e.g., Hanson & Kysar, supra note 104, at 1428-1528 (presenting empirical marketing evidence and consumer behavioral studies of companies manipulating consumer perceptions of risk); Jacob Jacoby, Is it Rational to Assume Consumer Rationality? Some Consumer Psychological Perspectives on Rational Choice Theory, 6 Roger Williams U. L. Rev. 81 n.1 (2000) (citing extensive empirical advertising, consumer behavior, and marketing research about consumer psychology).} and the marketing power of emotions in particular.\footnote{See, e.g., generally JOHN O’SHAUGHNESSY & NICHOLAS JACKSON O’SHAUGHNESSY, THE MARKETING POWER OF EMOTIONS (2003) (providing a systematic account of the significant role that emotions play in marketing and consumer decision-making and shopping experiences).}

There are many other securities areas where investing is more likely to be driven by emotional reactions to rather than cognitive processing of financial risks and information. The analysis of this chapter applies to such areas for drawing legal policy implications that differ...
from those based on unemotional investing. One such area is day trading, and emotional advertisements for day trading. Financial scams by con artists are another such area. Examples of such financial scams are so-called “prime bank programs,” which promise incredible returns from investing in “prime bank” securities. Another example of such a financial scam is that of so-called affinity fraud, which is targeted at members of such identifiable groups as ethnic minorities and religious groups.

B. THEORETICAL MODELS

Neoclassical economic theory already incorporates certain emotions in several ways. First, love or hate can be treated as part of an individual’s tastes or non-monetary utility in the sense of interdependent individual preferences. Second, certain emotional reactions function as commitment devices in multi-person decision environments. Third, game theory can

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110 Rebecca Buckman, Gambling Man: Stock Losses Roiled A Volatile Personality, And Slaughter Ensued, WALL ST. J., Aug. 2, 1999 at A1 (reporting on Mark Barton, a day trader who snapped and went on a killing rampage); Evan Thomas & Trent Gregax, It's a Bad Trading Day ...And It's About to Get Worse, NEWSWEEK 22 Aug. 9, 1999 (same); Rebecca Buckman & Ruth Simon, Day Trading Can Breed Perilous Illusions, WALL ST. J., Aug. 2, 1999 at C1 (reporting on the psychology of day traders and that “[m]ost amateurs can’t ‘clinically distance themselves emotionally from the decisions they make in the market.’”).

111 Anjali Arora & Jamie Reno, Rolling the Dice With a Click of the Mouse: Day Trading is a Seductive but Tricky Game, a Subculture in Which Traders Find That Risks are High and Profits Elusive, NEWSWEEK 30 Aug. 9, 1999 (reporting on affective day trading advertisements and a settlement over deceptive marketing and violations of Massachusetts state securities laws by All-Tech Investment Group, a day-trading firm); Susanne Craig, Regulators Zap Day-Trading Guru Houtkin and All-Tech, WALL ST. J., June 14, 2001 at C1 (reporting on an NASD administrative action against All-Tech Direct Inc., one of the nations’ largest day-trading firms, for misleading statements in advertisements in print, on radio, and on the Internet about how easy it is to profit by day trading).

112 CUNNINGHAM, supra note 28, at 166-78 (describing how con artists utilize affect in succeeding at financial scams).


115 GARY BECKER, Spouses and Beggars: Love and Sympathy, in ACCOUNTING FOR TASTES 231-37 (1996) (proposing formal analytical models of emotions in terms of interdependent utility functions).

accommodate emotions that depend on probability beliefs about strategic behavior. Recently, several economists have urged their fellow economists to study emotions more in their models. A survey of how economic theory views emotions illustrates this renewed interest. That survey, however, criticized the interpretation of emotions as psychic benefits and costs or as merely a source of preferences because such interpretations ignore how emotions affect the ability to make rational choices. This chapter addresses this criticism by explicitly analyzing irrational exuberance and anxiety in securities investing.

1. Psychological Expected Utility Theory and Anticipatory Feelings

A new economic framework introduces a general psychological expected utility model that includes anticipatory feelings prior to the resolution of risk. This model extends the neoclassical expected utility model to incorporate a quite general class of anticipatory feelings, such as anxiety and suspense. This model shows how anticipatory feelings can result in time inconsistency because as time passes, anticipatory feelings and preferences may change. This model has applications to anticipatory pleasure or savoring and implies a resulting preference for commitment devices to facilitate planning and overcome intertemporal inconsistency. Applying this model to suspense and gambling yields the empirically supported prediction that


118 See, e.g., Richard H. Thaler, *From Homo Economicus to Homo Sapiens*, 14 J. ECON. PERSPECTIVES 133, 139-40 (2000) (predicting that economists will pay more attention to modeling emotions); Romer, *supra note 116*, at 439-43 (2000) (distinguishing between decision mechanisms based on thoughts and those based on feelings and arguing for more symmetric treatment by economists of thought and feelings).

119 See generally Camerer, et al., *supra note 10* (discussing the important role played by emotions in a theory of economics that builds upon neuroscience); Camerer & Loewenstein, *supra note 10* (stating that the study of emotion is a promising new direction for the future of behavioral economics); Jon Elster, *Emotions and Economic Theory*, 36 J. ECON. LITERATURE 47 (1998) (surveying the role that emotions play in understanding human behavior).

120 Id. at 73 (1998) (criticizing a psychic cost benefit model of emotions).

people will bet on their emotional favorites in a sporting event. This model is also rich enough to analyze preferences over illusions and the dilemma that a doctor faces about whether to give her patient (more than legally required) detailed information concerning an upcoming medically benign, but subjectively threatening diagnostic surgical procedure. Furthermore, this model has policy implications for the provision to the public of payoff-relevant information by the Federal Reserve and other government agencies. Finally, this model supports recommendations for “psychologically-appropriate” formats of disseminating medical information to the general population and providing medical advice to specific patients at risk of diabetes or breast cancer.

Applying this model to focus on the portfolio decisions of anxious investors demonstrates that a security producing anxiety on the part of its owners commands a lower price and a higher

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122 Id. at 72-73.
123 Id. at 73.
124 Id. at 76. See also Suzanne M. Miller & Charles E. Mangan, Interacting Effects of Information and Coping Style in Adapting to Gynecologic Stress: Should the Doctor Tell All?, 45 J. PERSONALITY & SOC. PSYCHOL. 223, 225-35 (1983) (reporting on a study exploring the interaction between the amount of information provided and personal coping styles of forty gynecologic patients scheduled for colposcopy).
125 Id. at 76-77.
126 Id. at 77. See also Laurette Dube, et al., The Role of Emotions in Health Care Satisfaction, 16 J. HEALTH CARE MARKETING 45, 47-51 (1996) (reporting on how the emotional experience of hospitalization affects health-related outcomes, including patient satisfaction, in a field study of two hundred and eleven adult patients in an acute care hospital); James F. Fries, Reducing the Need and Demand for Medical Services, 40 PSYCHOSOMATIC MED. 140 (1998) (finding that such forms of information-intervention reduces health-care costs and improves outcomes on the order of twenty percent); Barbara E. Kahn & Mary Frances Luce, Understanding High-Stakes Consumer Decisions: Mammography Adherence Following False Alarm Tests, MARKETING SCI. (forthcoming, 2003) (finding that patients receiving false positive mammography results experienced more stress, were more likely to delay mammography and less likely to believe that a positive mammography result indicated breast cancer than patients receiving normal results unless those patients were told they may be susceptible to breast cancer in the future); Matthew E. Kahn, Diabetic Risk Taking: The Role of Information, Education, and Medication, 18 J. RISK & UNCERTAINTY 147, 155-58 (1999) (studying the role of information in diabetic risk taking); Kathryn M. Kash, et al., Psychological Distress and Surveillance Behaviors of Women With a Family History of Breast Cancer, 84 J. NATL CANCER INST. 24, (1992) (reporting on a study of two hundred and seventeen women finding that increased cancer anxiety decreased regular clinical breast examinations and reduced adherence to monthly breast self-examination); Lawrence E. Klusman, Reduction of Pain in Childbirth by the Alleviation of Anxiety During Pregnancy, 43 J. CONSULTING & CLINICAL PSYCHOL. 162, (1975) (reporting that in a study of forty two primiparas and primigravidas in their last trimester of pregnancy, childbirth information from Childbirth Education Association classes and Red Cross prenatal classes reduced significantly measures of anxiety, fear, and self-reported perceptions of pain in labor and delivery, controlling for the amount of anesthesia).
required rate of return than if that security did not cause its owners to experience anxiety.\textsuperscript{127} This model also formally demonstrates that the price of a riskless security is greater than it would be in a world in which investors do not experience anxiety because riskless securities provide the benefit of anxiety reduction.\textsuperscript{128} This model proves that “anxiety will reduce the price of stocks and increase their return relative to the standard [unemotional] model” and that “stock ownership entails psychic costs [because stockholders have] to live with the anxiety that accompanies the holding of a risky portfolio.”\textsuperscript{129} Finally, this model explains how the desire to avoid the stress and anxiety associated with retirement planning can result in people avoiding thinking about, let alone planning for, their retirement until it is too late to avoid anymore.\textsuperscript{130} Such irrational anxiety has very disturbing implications for the social desirability of recent proposals to privatize social security and retirement investment decisions.

Finally, a recent general equilibrium model provides theoretical support for the proposition that feelings affect securities prices.\textsuperscript{131} This model argues that investors’ feelings have an effect on stock prices if three conditions are satisfied.\textsuperscript{132} First, investors do not realize their investment decisions are influenced by fluctuations in their moods. Second, investors’ subjective parameters, such as their judgments of the appropriate discount factor or their levels of relative risk aversion, fluctuate in response to fluctuations in their moods over time. Third, investors uniformly and widely experience the impacts of such fluctuations in their moods on their subjective parameters. This model has closed-form solutions for equilibrium stock

\textsuperscript{127} Caplin & Leahy, supra note 121, at 68.
\textsuperscript{128} Id. at 68.
\textsuperscript{129} Id. at 69.
\textsuperscript{130} Id. at 72.
\textsuperscript{131} Rajnish Mehra & Raaj Sah, Mood Fluctuations, Projection Bias, and Volatility of Equity Prices, 26 J. ECON. DYNAMICS & CONTROL 869 (2002).
\textsuperscript{132} Id. at 870.
prices. The model predicts that, all by itself, a 0.10 percent fluctuation in the beliefs of investors regarding the discount factor can generate a 3-4 percent standard deviation in stock prices. The model also finds a similarly important, but smaller effect on the standard deviation of stock prices due to a fluctuation in risk attitudes.

2. **THE RISK-AS-FEELINGS HYPOTHESIS**

A new theory about decision making under risk, namely the risk-as-feelings hypothesis, focuses on the role of emotions that decision-makers experience leading up to and including the moment of decision making. The risk-as-feelings hypothesis is based upon four well-supported premises. First, emotions can arise without any cognitive antecedents. Second, there are emotional reactions to cognitive evaluations. Third, emotions inform cognitive evaluations. Fourth, emotions play a crucial role in affecting behavior.

Emotional reactions to and cognitive evaluations of risk and information differ for two reasons. First, emotions respond to probabilities and outcomes in systematically different ways than how cognitive evaluations of risk depend on probabilities and outcomes. A fundamental difference between emotional reactions to risk and cognitive evaluations of risk is that anticipatory emotions are insensitive to changes in probability for a wide range of probability values. Expected utility depends linearly and symmetrically on the probabilities and utilities of outcomes. Variations in probability generate corresponding variations in expected utility, holding the utility of outcomes constant. Under prospect theory, cognitive evaluations of risk

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133 *Id.* at 873-76.
134 *Id.* at 878.
135 *Id.* at 881.
136 Loewenstein et al., *supra* note 9, at 267 (proposing this hypothesis).
depend linearly and symmetrically on the probability weighting functions and subjective valuations of outcomes. Variations in probability generate corresponding variations in probability weighting functions, holding the subjective valuations of outcomes constant. In contrast, probability plays a relatively minor role in such anticipatory emotions as irrational exuberance and anxiety.

If potential outcomes have a lot of emotional resonance, such as (perhaps) kisses from your favorite movie star or electric shocks, then their attractiveness or unattractiveness are incredibly insensitive to changes in the probability of that outcome, even if that probability drops from 99% to 1%. For positive outcomes, any departure from certainty induces fear, while any deviation from impossibility produces hope. For negative outcomes, any departure from certainty produces hope, while any deviation from impossibility induces fear.

Second, other causal factors besides probabilities and outcomes influence anticipatory emotions. The risk-as-feelings hypothesis focuses on several emotional factors as having a predictable influence on decision-making. These factors include the vividness of the associations that risks evoke; the time-path of the decision process; and how evolutionarily prepared individuals are for certain emotional reactions. For the purposes of understanding irrational exuberance and anxiety in securities investing, there are two such important determinants, namely imagery and misattribution. An analysis of the phenomenon of misattribution is contained in the next section on the related affect heuristic.

Another account of why anticipatory emotions display probability neglect is that anticipatory emotions are primarily due to mental images of the outcome of a decision. Such images are discrete and so are not much affected by probabilities. Thus, anticipatory emotions

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that arise from such images will be insensitive to changes in probability. An investor’s mental image of what it will be like to participate in an IPO of stock is likely to be approximately the same whether the probability of that stock skyrocketing is 1 in 100,000 or 1 in 100,000,000. In contrast, an investor’s mental image of what it will be like to participate in a stock IPO that skyrockets will likely be very different from that investor’s mental image of what it will be like to participate in a stock IPO that only has a very modest increase.

3. **THE “HOW-DO-I-FEEL-ABOUT-IT” HEURISTIC**

Experimental results and clinical phenomena demonstrate that emotional reactions are fairly independent of, often impervious to, and precede in time, cognitive judgments. Evolutionary forces may explain why affect precedes cognition. A recent study found that “affective processes play a critical role in determining choices and that these affective processes may sometimes influence choice without the decision maker’s awareness.” A large body of empirical psychological research finds that affective impressions attach to images and those affective impressions influence judgments and decisions.

A recent theoretical framework emphasizes the importance of an affect or “how-do-I-feel-about-it” heuristic in guiding decisions and judgments. People utilize this heuristic when
they come to have an emotional, all-things-considered, reaction to make judgments. People utilizing this heuristic essentially ask “how-do-I-feel-about-something” and utilize their answer as the basis for making their judgment about something.\textsuperscript{144}

The affect or how-do-I-feel-about-it” heuristic is related to the mood-as-information hypothesis. This hypothesis argues that people’s moods informs their decisions, even when the causes of those moods are unrelated to their decisions. This phenomenon is known as misattribution. It explains how and why nominally irrelevant feelings or what the famous macroeconomist, Keynes called “animal spirits” influence securities investing.\textsuperscript{145}

The “how-do-I-feel-about-it” heuristic explains public concerns about health and environmental risks, high punitive damage awards, and people’s reactions to contested political events.\textsuperscript{146} The “how-do-I-feel-about-it” heuristic is related to the dual process theory that people process information via two parallel, interactive modes.\textsuperscript{147} The first is a rational, deliberative, and analytical system employing such rules of logic and evidence as probability theory. The second is an experiential system that encodes reality in terms of images, metaphors, and narratives that are imbued with affect and feelings. There is much experimental evidence that a


\textsuperscript{145} \textit{John Maynard Keynes, The General Theory of Employment, Interest and Money} 161 (1936) (stating that “our decisions … can only be taken as a result of animal spirits …, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”); Roberto Marchionatti, \textit{On Keynes’ Animal Spirits}, \textit{52 Kyklos} 415, 431 (1999) (interpreting Keynes’ animal spirits as psychological and emotional factors).


150\, Id. at 40.


152\, \textit{SEC v. Capital Gains Research Bureau, Inc.}, 375 U.S. 180, 186 (1963).}

The Affect Infusion Model (AIM) argues that the extent to which people rely on their feelings to make decisions depends on how abstract, risky, and uncertain those decisions are.\footnote{149} Usually, people who are in rationality utilize high affect infusion strategies (HAIS) in highly complex decisions, such as securities investing. Emotions form a major input of decisions made via HAIS. People usually employ low affect infusion strategies (LAIS) in decisions requiring “little generative constructive processing.”\footnote{150} So, LAIS are more appropriate for decisions that are familiar and low in complexity than for decisions that are infrequent and high in complexity.

\section{II. Mandatory Securities Disclosures}

“Mandatory disclosure is a – if not the - defining characteristic of U.S. securities regulation.”\footnote{151} The Supreme Court stated that the “fundamental purpose” of federal securities regulations “was to substitute a philosophy of full disclosure for the philosophy of caveat emptor … ”\footnote{152} In another famous case, the Supreme Court stated the Securities Act of 1933 and its mandatory disclosure requirements were designed “to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”\footnote{153} Investor protection is clearly a fundamental goal of U.S. securities regulation. In fact, upon clicking on “What We Do” under the heading “About the SEC” on the SEC’s home page, one learns that
“[t]he primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors.”\textsuperscript{154}

There is a long-standing debate over the purpose and effectiveness of mandatory securities disclosure.\textsuperscript{155} An often-cited purpose is to improve the informational efficiency of securities prices.\textsuperscript{156} Critics of this accuracy enhancement efficiency justification argue that mandatory securities disclosure has not achieved this purpose.\textsuperscript{157} Professor Mahoney proposes as an alternative efficiency justification for mandatory securities disclosure reducing the agency costs that arise between investors and promoters and between corporate managers and their shareholders.\textsuperscript{158} Both of these justifications of mandatory securities disclosures focus on the cognitive impacts of increased disclosures.

Mandatory disclosures generate not only information, but also such emotions as perhaps anxiety, embarrassment, euphoria, exuberance, feeling stupid, relief, or shame. For example, mandating disclosure of the realistically very low odds of winning a lottery and the present discounted value of the after-tax prize winnings produces no benefits if such disclosures fail to

reduce the number of lottery ticket buyers, but cause lottery players to feel dumb or foolish and reduce their pleasure from daydreaming about possible future riches. Such emotional consequences of mandatory disclosure can alter behavior. For example, the display by retailers of detailed facts about food content mandated by food labeling acts may result in the so-called “Snackwell Effect,” named for the fat-free cookie that appears to lead to greater consumption.¹⁵⁹

Emotional reactions to securities risks imply emotional reactions to securities information because information is in essence the negative of risk as information involves the reduction of risk. Analogous to fear in the investment context, evaluating strategies for combating terrorism depends on how much fear involves misperception about risk, whether fear is a hedonic loss that should count as being a cost or harm under a cost-benefit analysis, and to what extent fear is contagious.¹⁶⁰ The fact that people feel emotions and would like to minimize anxiety also has novel implications for health and medical regulatory policy.¹⁶¹

Questions about how much and precisely what disclosures federal securities laws should require are analogous to recent questions about how much and precisely what disclosures the federal government should issue about possible terrorist attacks. While non-specific disclosures provide information, they also produce anxiety, fear, and general uneasiness. There is also the

¹⁵⁹ See Catherine Censor Shemo, *Fake Fats, Real Threat*, VEGETARIAN TIMES, Feb. 1997, at 20 (reporting on the impact on dieters being lulled into a false sense of confidence by misunderstanding food labeling information).
danger that over time people become desensitized to many non-specific disclosures, so that a more specific disclosure may fall on deaf ears. Broad and general disclosures also lack the vividness of more specific and narrowly focused disclosures.

Securities disclosures function not only as information and marketing documents, but also as protection from civil liability for securities fraud. Even though there is no analogous marketing role for disclosures about possible terrorist attacks; after Sept. 11, 2001, the U.S. federal government is concerned with a severe public relations penalty for non-disclosures about possible terrorist attacks that is analogous to liability for fraudulent securities non-disclosures.

Another difference between securities disclosures and disclosures about potential terrorist attacks is their actual or intended audience. Some legal scholars believe and argue that the investing public is neither the actual nor intended audience for the disclosures that federal securities laws mandate. Instead, these commentators feel that professional analysts are the audience of much of the accounting and financial disclosures that federal securities regulations mandate. Professional analysts filter that information onto the investing public. Because analysts are professionals who have repeated experience at interpreting such disclosures, they may seem less likely than inexperienced and unsophisticated individuals to feel irrational exuberance and anxiety as the result of securities disclosures.  

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162 See Langevoort, supra note 18, at 173-75 (discussing the SEC’s awkward myth-story of retail investor empowerment). But see Pinter v. Dahl, 486 U.S. 622, 637, n.13 (1988) (stating that the provisions of the Securities Act “are concerned with affording the unsophisticated investor information necessary to make a knowledgeable investment decision”).


164 Similar arguments have been made concerning the relative cognitive competence of judges versus juries. See W. Kip Viscusi, Jurors, Judges, and the Mistreatment of Risk by the Courts, 30 J. LEGAL STUD. 107 (2001) (presenting experimental evidence that jurors deal worse with risk judgments in tort liability cases than judges). But see Hillary
other similar securities in the past, professional analysts may have more vivid reactions to
securities disclosures than laypersons lacking any personal or direct knowledge of similar cases.
Because of their compensation, there may also be serious conflicts of interests between
professional analysts and the investing public that mean analysts could routinely make
unjustifiably optimistic or irrationally exuberant securities recommendations.165

The debate over mandatory disclosure in federal securities regulation ignores the
emotional benefits or costs of such disclosures, in particular, irrational exuberance and anxiety
that potential and existing investors may feel due to disclosures or their absence. Such emotional
benefits or costs affect both individuals in terms of increased or reduced social utility and issuers
of securities in terms of a lower or higher cost of capital due to such emotional reactions. The
heterogeneity of people’s emotional reactions to mandatory securities disclosures complicates if
and how securities regulations should take irrational exuberance and anxiety into account. The
extent to which different people feel irrational exuberance and anxiety from securities
disclosures affects the socially optimal amount of those disclosures. Even holding the content of
disclosed information fixed, anxiety has implications for the form or presentation of that
information.

Because irrational exuberance and anxiety depends more on the possibility than on the
probability of certain outcomes, some people may overreact in their securities investments to
disclosures about material events with positive, but small probabilities of occurrence. Irrational

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165 Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts (Aug.
2002) (unpublished manuscript, on file with the author) (collecting and reviewing the empirical finance literature
about securities analysts); Marcia Vickers & Mike France, How Corrupt is Wall Street: New Revelations Have
Investors Baying for Blood, and the Scandal is Widening, BUS. WK., May 13, 2002 at 36 (discussing analyst conflicts
exuberance and anxiety may also cause individuals to avoid acquiring or processing material information and to avoid thinking carefully about certain financial outcomes. Even if the apocryphal widows and orphans feel irrational exuberance and anxiety, some financial and legal scholars believe that equilibrium securities market prices may accurately reflect all relevant material information if analysts and institutional investors do not experience irrational exuberance and anxiety. But, even were securities professionals and institutions to be immune from irrational exuberance and anxiety, limited arbitrage prevents them from eliminating the impact of those investors who do feel irrational exuberance and anxiety on securities prices.

On the other hand, just as disclosure of information may trigger irrational exuberance and anxiety, lack of disclosure may also trigger fear of the unknown (or a false sense of contentment from limited knowledge) and fear over imagined worst case scenarios (or joy over imagined best case scenarios). Lack of mandated disclosures does not mean lack of irrational exuberance and anxiety because there are many other sources of information or noise besides mandated disclosures, including security analysts, friends, family members, colleagues, investment clubs, and internet chat rooms. Thus, there is a countervailing emotional benefit from disclosure, namely the prevention of irrational exuberance and anxiety that would result from lack of disclosure.

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167 Langevoort, supra note 18, at 154-63 (explaining how internet chat room postings can affect security prices).

168 An analogy is to a patient’s fears and behavior in the medical disclosure context. A patient may imagine and fear the worst if a physician does not disclose certain information about medical risks in a timely fashion. In other words, in both financial and medical contexts, people may infer or imagine bad news from silence and experience fear or anxiety from not knowing enough information.
The above observation helps to explain why some people react with irrational anxiety over companies not expensing stock options utilized to compensate and provide incentives for their executives.169 Not knowing how much those stock options actually cost a company may lead both existing and potential investors to overestimate the cost of granting such executive stock options and experience irrational anxiety from such overestimates or from just not knowing. On the other side of the emotional spectrum from irrational anxiety due to lack of disclosure is possible irrational exuberance or unjustified excitement. In the case of the bull market of the late 1990’s, many investors evaluated companies in the so-called “new economy” based more on irrational exuberance and irrational euphoria than on fundamental analysis.

The key legal policy questions are thus what can and should we do about irrational exuberance and anxiety.170 The Brady Commission formed to examine the 1987 stock market crash advocated circuit breakers to “cushion the impact of market movements, which would otherwise damage market infrastructures.”171 In 1988, U.S. securities exchanges adopted trading halts to essentially provide investors a cooling-off period if the Dow Jones Industrial Average index fell too much too fast.172 Symmetrically, reverse circuit breakers could mandate trading halts for overall securities markets or individual securities if securities price indices or individual securities prices rise too quickly.173 But, experimental studies find not only are circuit breakers

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169 Floyd Norris, Accounting Board Proposes A New Rule on a Hot Topic: Options, NY TIMES, Aug. 15, 2002 at C5 (reporting on the Financial Accounting Standards Board’s proposal to require that stock option valuations be disclosed in quarterly financial statements filed with the SEC); Bill Saporito et al., Wall Street's Verdict: While Washington Dithers on Reform, Investors are Pushing the Stock Market Down, Down, Down, TIME MAG., July 29, 2002 at 18, 23-24 (reporting on investor anxiety from uncertainty over the cost of executive stock option grants).


172 CUNNINGHAM, supra note 28, at 233-36 (describing and critiquing the experience of U.S. securities markets with trading halts).

173 Galbadon, supra note 46, at 283; Galbadon, supra note 47, at 127.
ineffectual, but also that mandated market closures accelerate trading activity. Another experiment finds that circuit breakers do not work to retard bubbles, but instead they actually somewhat exacerbate bubbles for inexperienced subjects.

Instead of circuit breakers, the SEC can require greater firm-specific disclosures that detail how a particular firm’s securities differ from the overall securities markets. Section 13(a) of the Securities Exchange Act provides the SEC with authority to require Securities Exchange Act registered companies to file such information and documents as it deems to be in the public interest. Such additional firm-specific disclosures could be provided in the form of “public reports explicitly addressing the relationship between their earnings, dividends, and prevailing stock prices and perhaps containing management commentary upon the wisdom of this relationship and how long it might be expected to be sustained.” But, such mandatory disclosures presume that individuals can and will cognitively evaluate such disclosures as opposed to increase noise trading. If one believes that individuals should be holding broadly diversified portfolios instead of engaging in dubious individual stock picking, then individuals do not require firm-specific information. If one believes that irrational exuberance and anxiety dominate securities investing, then mandatory disclosure which is the linchpin of U.S. federal securities regulation may have unexpected emotional, if not little or no, effects upon investing.

Answering the questions of whether, what and how much of mandatory securities disclosures are socially desirable requires comparing the unemotional and emotional

175 Ronald R. King et al., The Robustness of Bubbles and Crashes in Experimental Stock Markets, in NONLINEAR DYNAMICS AND EVOLUTIONARY ECONOMICS 183, 194-95, 199 (Richard H. Day & Ping Chen eds., 1993) (reporting this finding).
177 Galbadon, supra note 47, at 128.
consequences of such disclosures with the unemotional and emotional consequences of voluntary securities market disclosures. An emotional cost-benefit analysis differs from the unemotional considerations raised in the past and current debate over mandatory securities disclosures. The relative size of the emotional costs and benefits of mandatory securities disclosures versus the emotional costs and benefits of voluntary securities disclosures will vary depending on the precise nature of the specific disclosures involved.

Finally, there is another set of actors in securities regulation who are subject to irrational exuberance and anxiety, namely the securities regulators themselves, be they SEC Commissioners; SEC staff; lawyers and other professionals at SROs, such as the NYSE or the NASD; members of Congress and their Congressional staff; state attorney generals and their staff; private litigants and plaintiffs’ attorneys; issuers and their counsel; judges; or juries. Certainly, investors do not have a monopoly on feeling irrational exuberance and anxiety. A central message of this chapter is that emotions are ubiquitous and not always necessarily defects in or flaws of human decision-making. Just as (securities) regulators are no less prone to cognitive biases and heuristics than investors are,179 so too (securities) regulators are no less prone to irrational exuberance and anxiety than investors are prone to irrational exuberance and anxiety. Just as behavioral explanations of securities regulations complement and enrich public choice accounts,180 so too for emotional regulatory stories.

It is perhaps no surprise that emotional regulating not only happens, but also systematically differs from unemotional regulating. The social desirability of emotional

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179 Choi & Pritchard, *supra* note 18 (cataloging a series of cognitive biases that may affect SEC officials).
regulating, including but not limited to zealous advocates, passionate public servants, possibly envious or sympathetic regulators, and ideologically fanatical prosecutors, is a difficult question. But, whether or not emotional regulating is socially desirable, it not only exists, but also is likely to continue. In light of the realities of emotional regulating, the SEC in general and its mandatory disclosure regime in particular might do more harm than good and yet persist due to emotional appeal, rationales, and considerations. The history of U.S. federal securities regulation from its very inception in the aftermath of the Great Depression to its most recent Sarbanes-Oxley Act in the aftermath of Enron, Arthur Anderson, Rite Aid, Worldcom, Tyco, Adelphia, Merck, and Global Crossing is that of (possibly benign) neglect of securities markets interrupted by legislation in response to political and public pressure arising from highly visceral and public episodes of banking, corporate, or securities fraud and scandals.181 Mandatory disclosure might be at best, an impotent, and at worst, a socially harmful regulatory policy if the majority of investors experience cognitive biases and utilize heuristics in the processing of information and/or feel irrational exuberance and anxiety before and during their investing process. But, the SEC’s obsession with mandatory disclosure may be due to its emotional resonance with the metaphor of a “level playing field” and the rationale of protecting investors from others and possibly themselves.

III. CONCLUSIONS

This chapter analyzed a still growing, but already large body of empirical and experimental evidence of and theoretical economic and psychological models supporting the

prevalence of irrational exuberance and anxiety. Because the financial and legal implications of irrational exuberance and anxiety differ significantly and systematically from those of unemotional rational investing, further empirical, psychological, experimental, and theoretical financial economic research concerning the applicability, generality, and robustness of irrational exuberance and anxiety is crucial.

An important question for legal policy is to what extent education or experience mitigates irrational exuberance and anxiety. After all, not only did many individual and novice investors lose money by investing heavily in high-technology and internet stocks during the 1990’s, but so did many hedge funds and mutual funds managed by financially sophisticated and experienced investors.\textsuperscript{182} To the extent that individuals are more evolutionarily prepared for certain emotions than others, it may be neither easy nor socially desirable to alter irrational exuberance and anxiety in response to securities disclosures.\textsuperscript{183}

Whether more paternalistic securities regulation than our current federal system of mandatory disclosure is socially desirable depends on to what extent and how others can improve upon the behavior and performance resulting from irrational exuberance and anxiety.\textsuperscript{184} Indeed, if we suspect that most investing is driven by irrational exuberance and anxiety, then securities regulation should focus primarily on emotional reactions to, instead of unemotional processing of, the form and content of mandatory disclosures. If we believe that short of explicit and


\textsuperscript{183} Loewenstein et al., supra note 136, at 279 (discussing and citing research about evolutionary preparedness for certain emotional reactions to risk); Cohen & Dickens, supra note 140 (suggesting evolutionary foundations of emotions); James A. Henderson, Jr. & Jeffrey J. Rachlinski, Product-Related Risk and Cognitive Biases: The Shortcomings of Enterprise Liability, 6 ROGER WILLIAMS U. L. REV. 213, 254 (2000) (pointing out evolutionary advantages of emotions that promote overreaction to risks); Olsen, supra note 140 (discussing evolutionary reasons for the primacy of affect).

\textsuperscript{184} For empirical evidence concerning a similar question about consumption decisions, see Joel Waldfogel, Does Consumer Irrationality Trump Consumer Sovereignty? Evidence from Gifts and Own Purchases (May 13, 2002) (unpublished manuscript, on file with the author).
outright cognitive fraud; judges, juries and the SEC are not well-equipped to evaluate the likely emotional reactions to securities disclosures, then perhaps the SEC should not base federal securities regulation upon a philosophy of mandatory disclosure. But, experts can assist both the SEC ex ante and courts ex post in determining the likely emotional reactions to securities disclosures or marketing hype by conducting empirical surveys of actual people.

An intermediate regulatory strategy is to adopt cautiously paternalistic or asymmetrically paternalistic regulations, namely regulations which greatly benefit people who are prone to mistakes, but only slightly (or not at all) hurt people who are not prone to mistakes.\(^{185}\) It is important here as elsewhere to not view all emotional investing as being synonymous with making investing errors. A fundamental lesson of recent economic, neurobiological, and psychological research (and hopefully, this chapter) is that emotions sometimes are superior to, and sometimes reinforce, but also sometimes work in the opposite direction of unemotional reasoning.\(^{186}\) In particular, there are many varieties of emotional investing and some complement, while others substitute for unemotional investing. Determining how much of emotional investing is “rational” or “reasonable” is difficult, both for any particular investor and for others, such as counterparties (of derivative securities), the SEC, and SROs, such as the NASD, NYSE, and AMEX.

A recent argument proposes not protecting so-called “irrational” investors from themselves in order to reap the public good provided by having equilibrium securities market


prices reflect the private information of those “irrational” investors. But, under a general equilibrium analysis, the price impact and survival of “irrational” investors are two related, yet quite distinct and independent concepts. In other words, in a long-run equilibrium, “irrational” investors can have a significant impact on prices whether or not they survive. Moreover, even if “irrational” investors survive, they may have no price impact. In addition, such a proposal assumes the private information of “irrational” investors have high signal to noise ratios. Although the signal to noise ratio for emotional investing is difficult to determine in general, there are clearly situations where the signal to noise ratio is low. So, for example, emotional investing caused by the on-line brokerage ads described in this chapter is likely to have a low signal to noise ratio and therefore regulating such ads is likely to not have any deleterious effect on the informational efficiency of securities prices.

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