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Regulating Public Offerings of Truly New Securities: First Principles

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The author wishes to thank Professors James Cox and Robert Jackson, and the Honorable Denise Cote for their helpful comments on an earlier draft of this Article.

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Abstract

The public offering of truly new securities involves purchases by investors in sufficient number and in small enough blocks that each purchaser's shares can reasonably be expected to be freely tradable in a secondary market that did not exist before the offering. Increasing the ability of small and medium-sized enterprises (SMEs) to make such offerings has been the subject of much recent discussion.

At the time that a firm initially contemplates such an offering, unusually large information asymmetries exist between its insiders and potential investors. These can lead to severe adverse-selection problems that prevent a substantial portion of worthy offerings from being successfully marketed. A regime relying solely on market-based antidotes to this problem—signaling, underwriter reputation, and accountant certification—and backed only by liability for intentional affirmative misrepresentation will fall well short of being a solution. This shortfall suggests a role for regulation.

This Article goes back to first principles to determine the proper content of such regulation. The relevant questions include: What should issuers be required to disclose at the time of the offering and thereafter? Under what circumstances should various offering participants be liable for damages if, at the time of the offering, there were misstatements or omissions? And should this regime be mandatory or optional? The answers are then used to critically evaluate a number of recent U.S. reforms aimed at increasing SME offerings by lessening regulatory burdens. These include Securities Act Rule 506(c), Regulation A+, and the new crowdfunding rules.

Keywords: corporate finance, financial markets, innovation, regulation

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REGULATING PUBLIC OFFERINGS OF TRULY NEW SECURITIES: FIRST PRINCIPLES

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ABSTRACT

The public offering of truly new securities involves purchases by investors in sufficient number and in small enough blocks that each purchaser's shares can reasonably be expected to be freely tradable in a secondary market that did not exist before the offering. Increasing the ability of small and medium-sized enterprises (SMEs) to make such offerings has been the subject of much recent discussion.

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INTRODUCTION

The world of public securities offerings can be divided sharply into two archetypical categories. One relates to offerings by established issuers of securities that are identical to securities already trading in liquid, efficient secondary markets. The other relates to public offerings by issuers new to the market whose securities are not already

trading in some kind of secondary market. This Article lays out some first principles with regard to this second kind of public offering.[1] As the term is used here, an offering is "public" if a large enough group of portfolio investors each purchases a small enough block of securities that the amount purchased can be reasonably expected to be freely tradable subsequently in some kind of a secondary market.[2] Thus, for example, under U.S. law, an offering involving a general solicitation made pursuant to the provisions of Rule 506(c)[3] could be a public offering, even though it does not require registration under the Securities Act of 1933 (Securities Act).[4] The same can be said of an offering made under Regulation A+.[5]

The first category—offerings of securities of a type already trading in a liquid, efficient market—was the focus of much regulatory concern and reform in the three preceding decades, starting with the integrated disclosure and short-form registration reforms in the 1980s and culminating with the Securities and Exchange Commission's (SEC) 2005 Offering Reforms,[6] which included automatic shelf registration for offerings of well-known seasoned issuers. The current decade has seen a shift in the focus of regulatory reform to the second category—offerings of truly new securities. A number of factors have been driving this change in focus. One relates to an increased concern with promoting innovation to stimulate the rate of economic growth. This concern is combined with the belief that potential early investors

1. For a parallel effort with respect to the first category of transactions, see generally Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009) [hereinafter Fox, *Civil Liability*] (discussing disclosure obligations of established issuers and the structure of liabilities for their breach).

2. There are, of course, many offerings that may be in need of regulation but that do not fall neatly into one of these two categories. One example would be an offering where there is secondary trading already in identical securities, but the secondary market cannot be properly described as liquid and efficient. Another example would be an offering where there is no secondary trading prior to the offering and one cannot reasonably expect such trading to develop after the offering, given the limited number of purchasers purchasing relatively small blocks. Such situations have been subject to cogent analysis elsewhere by Professors Donald Langevoort and Robert Thompson. *See* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 372 (2013). Still, a significant portion of all new issues of securities does fall into one of the two archetypical categories set out here.

3. 17 C.F.R. § 230.506 (2015).

4. Securities Act of 1933 § 4(b), 15 U.S.C. § 77d(b) (2012).

5. 17 C.F.R. §§ 200, 230, 232, 239, 240, 249, 260 (2015).

6. *See generally* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,026, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

in innovative new companies will be more willing to commit funds if they anticipate that a public-offering exit for their investments will be available in the future if the firm succeeds.[7] Another relates to worries, arising since the 2008–2009 financial crisis, that small and medium-sized enterprises (SMEs) have been having greater difficulty obtaining bank financing because banks are cutting back on lending to repair their balance sheets and meet new capital requirements.[8] In the wake of the crisis, there is also interest in restoring, on a sounder basis than before, residential mortgage securitizations, another type of truly new securities offering.

In response, there have been a variety of reforms, some already implemented and others just recently proposed, aimed at promoting public offerings of truly new securities. Many of these actual or proposed reforms grow out of provisions of the JOBS Act[9] and the FAST Act[10] and the SEC's efforts at their implementation. These reforms, in one way or another, ease or entirely eliminate the burdens that the Securities Act registration process imposes on the various participants in the offering at the time that it occurs and that the Securities Exchange Act of 1934's (Exchange Act) continuing-disclosure requirements impose on the issuer thereafter.[11] This easing can take the form of reducing or eliminating what is required to be disclosed. It can involve reducing or eliminating previously imposed restrictions on communications or on the timing of the transaction. It can also take the form of reducing the likelihood of litigation by altering the standard of liability applicable to participants in the offering if sued by purchasers claiming to have been damaged by a material misstatement or omission during the offering process. The effort across the Atlantic to create a new European capital market

7. *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 266 (1999).

8. *See* Gert Wehinger, *Bank Deleveraging, the Move from Bank to Market-Based Financing, and SME Financing*, OECD J., Jan. 2012, at 65, 68–70.

9. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-06, § 302(a), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d (2012)).

10. Fixing America's Surface Transportation (FAST) Act, Pub. L. No. 114-94, §§ 71001–71003, 129 Stat. 1312, 1784 (2015) (codified at 15 U.S.C. § 77f (Supp. III 2015)).

11. *See generally* Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013) (discussing the impact of loosening regulations from the JOBS Act and other reforms on early-stage capital raising).

reflects similar concerns,[12] as do efforts in emerging economies such as Brazil to connect SMEs with the capital markets.[13]

Much of the discussion of these reforms has taken place without a frame of reference. Reform proponents have tended to tell an overly simple story. In the U.S. discussion, for example, the starting point is the clearly correct proposition that the burdens imposed by the Securities Act and the Exchange Act, because of their fixed-costs aspects, fall particularly heavily on smaller firms. The proponents then go on to argue that more offerings by such firms are a good thing and thus these burdens should be lightened for them. Reform opponents have a simple story as well. They simply fear that reducing the burdens will result in more investors putting up good money and later, unfairly, having nothing to show for it.

This Article seeks to add rigor to the debate. Absent regulation, the determination of which public offerings go forward and succeed at raising funds, and which do not, is determined by tort law and the market-determined terms of contracts into which offering participants enter. The issue is whether, and, if so, under what circumstances, government regulation should be added to the mix. Such regulation can help determine what should be disclosed both at the time of the offering and thereafter. It can also determine the circumstances under which various offering participants should be held liable for damages if, at the time of the offering, there were misstatements or omissions of required disclosures. This Article goes back to first principles as a guide to answering these questions from the points of view of promoting efficiency and fairness.

Any time an issuer first contemplates a public offering of truly new securities, the information asymmetries between persons associated with the issuer and potential investors are particularly large because, unlike an established issuer whose securities are trading in an efficient market, much less is typically known about the issuer and the persons associated with it. Also, there is no price in the secondary trading market to serve as some kind of valuation of the securities being offered. These two observations are relatively self-evident, but they

12. *See generally Action Plan on Building a Capital Markets Union*, COM (2015) 468 final (Sept. 30, 2015) (discussing reforms to increase financing for European SMEs).

13. INT'L GROWTH & EMERGING MKTS. COMM. OF THE INT'L ORG. OF SEC. COMM'RS, SME FINANCING THROUGH CAPITAL MARKETS 62 (2015), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD493.pdf [https://perma.cc/JL88-SZBK].

have several less obvious implications that are important to answering the basic questions posed here.

First, the presence of these information asymmetries can lead to a severe adverse-selection problem.[14] This problem will prevent a substantial portion of worthy offerings from being successfully marketed unless, as an antidote, investors are made confident that issuers are providing a certain level of credible disclosure at the time of the offering. A regime relying solely on market-based antidotes to these problems—signaling, underwriter reputation, and accountant or credit-rating certification—and backed only by liability for intentional affirmative misrepresentation is, in many circumstances, not a sufficient solution. More specifically, the larger the number of offerees, the lesser their financial sophistication, and the smaller the absolute number of dollars each is likely to invest, the less likely it is that such a regime will be an adequate solution. One option is for the government or a respected private entity to offer to issuers a regime that requires them to make certain disclosures but to make its adoption optional so that similarly situated issuers not adopting the regime would still be allowed to make offerings. For a variety of reasons, however, this is unlikely to be a complete solution to the problem.

Second, the adverse-selection problem will not be solved by disclosure rules alone. There must be appropriately negative consequences for untruthful or incomplete answers. As the consequences become more severe, however, not only are more unworthy offerings blocked, fewer worthy offerings go ahead as well. Getting the balance right requires a focus on what kind of liability—strict, strict with a due-diligence defense, or negligence—should be imposed on issuers, on underwriters and others in the distribution process, and on accountants and other certifiers to deter dishonesty and to assure the optimal level of care by each.

Third, the severity of the adverse-selection problem at the time of a public offering of truly new securities can also be ameliorated by the prospect of a certain level of ongoing periodic disclosure thereafter. This is because the ongoing-disclosure regime, through a variety of mechanisms, improves an issuer's corporate governance discipline. This in turn renders less important the fact that, at time of the offering,

14. Adverse selection occurs when a potential market participant with a high-quality offering decides not to enter the market because persons on the other side of the market cannot distinguish it from participants with lower-quality offerings. For a more detailed discussion of this concept, see *infra* Part I.

investors typically know relatively less about the intentions and abilities of the managers of issuers of truly new securities compared to what they know with respect to established issuers trading in efficient liquid markets.

Finally, a public offering of truly new securities is not a silver bullet for the capital-raising problems of all firms that, up until this point, have been privately held. A public offering can benefit society by providing an issuer with a promising investment project not just funding but a critical gateway to getting its securities publicly traded. Publicly traded securities are more valuable because they are more liquid. A public offering can also do harm, however, by providing an issuer seeking to implement an unpromising investment project with a route by which to fund it, thereby squandering society's scarce savings that could otherwise go to a more worthwhile project. Appropriate attention to the first principles discussed here can help design a regulatory system that can improve the terms of the tradeoff between these potential benefits and harms. The hard reality, though, is that there are considerable economies of scale involved in complying with such a regime. This means that there will be a size of issuer and a size of offering below which such offerings become too expensive to be worthwhile even if the regime is at the optimal point on the frontier of this tradeoff. Not every company with a worthy new real investment project is a good candidate for a public offering.

This Article proceeds as follows. Part I considers the especially severe information-asymmetry problem that plagues primary offerings of truly new securities. As a result, the market for such securities can partially or totally unravel. Part II considers market-based solutions for these problems—signaling, investment bank intermediation, expert certification, and buyer search—as well as the shortcomings of exclusive reliance on such solutions. Part III considers the rationale for having, as a further antidote to the adverse-selection problem, a government-designed affirmative-disclosure regime, whereby an issuer making an offering is required to answer certain questions. It addresses as well the question of whether this regime should be imposed on all issuers making such offerings or only those that volunteer to be subjected to it. Part IV considers the rationale, under either such regime, for mandating the imposition of liability on issuers, issuer directors and officers, underwriters, dealers, and experts such as accountants or rating agencies when there have been material misstatements or material omissions of what was required to be disclosed. It considers as well, for each of these potential defendants,

the appropriate standards for imposing such liability with regard to questions of fault and due diligence and to burdens of evidentiary persuasion. Part V applies the preceding discussion to reforms intended to ease the burdens associated with offerings by smaller, new corporate issuers and considers as a general matter the role that the size of the issuer and the offering should play in the strictness of offering regulation.

I. THE INFORMATION-ASYMMETRY PROBLEM

When an issuer first contemplates making a public offering of truly new securities, there exist particularly large information asymmetries. This is a very different situation from a public offering by an established issuer that trades in a liquid, efficient market and has a publicly known track record over a period of time. Potential investors in an offering by an issuer of truly new securities are likely to have little knowledge of the issuer's past performance, if indeed it has one, and of the capabilities of the issuer's managers. Potential investors are also unlikely to have much knowledge of the inclination, if any, of the issuer's managers, or of any remaining control shareholders, to divert issuer cash flows to themselves after the offering. There is also no price in the secondary trading market, which, for an established issuer, is, according to the efficient-market hypothesis, an unbiased evaluation of the offered securities based on all publicly available information. The existence of this severe information asymmetry can lead to adverse-selection problems that, absent an antidote, will lead to many worthy offerings being saleable only at prices so low that making the offering will not be worthwhile to the issuer and its control shareholders.

A. Adverse Selection in Markets Generally

Before considering information-asymmetry models specifically focused on markets for securities, it is helpful to review briefly some more general models that relate to all markets. To understand the basic problem posed by asymmetric information, consider a competitive market where some potential sellers are prepared to sell what they know to be a high-quality version of a product and others are prepared to sell what they know to be a low-quality version. The product's quality is not observable to potential buyers and none of the buyers know which sellers are high quality and which are low quality. As Professor George Akerlof showed in his classic 1970 article concerning adverse selection (or the "lemons problem"), if nothing alters this

asymmetric-information situation, the low-quality version of the product can drive the high-quality version out of the market.[15]

To illustrate, assume, for example, that the buyers know that 50 percent of the sellers are offering the high-quality version and 50 percent the low-quality version. Assume that if both kinds of sellers were offering the product in the market and, contrary to the facts as I am setting them out, the buyers knew the quality of what they were buying, the market-clearing price would be one hundred dollars for the high-quality version and eighty dollars for the low-quality version. Assume also that the market is competitive: the quantity sold by any given seller or purchased by any given buyer will not affect price. Given that buyers in fact do *not* know the quality of the product being offered by any of the sellers, rational buyers would pay all sellers ninety dollars per item. This would be the expected value of a purchase because there would be a 50 percent chance it was from a high-quality seller and a 50 percent chance that it was from a low-quality seller. This result would not be an equilibrium solution, however. Suppose, for example, that the high-quality sellers' reservation price—the cost to them of parting with their goods—is anything greater than ninety dollars. Under these circumstances, the potential high-quality sellers would not enter the market in the first place. The buyers would then know that only the low-quality version would be available and the product would be priced accordingly. This information asymmetry would cause a loss in economic welfare. If everyone were fully informed, there would have been transactions in the high-quality version of the good between willing buyers and sellers. Their mutual willingness to enter into the transactions would have shown that they each expected to gain from doing so. The absence of their opportunities to do so means the loss of these expected gains.

B. Application in Securities Markets

In the seminal adverse-selection model with respect to securities, Professors Stewart Myers and Nicholas Majluf demonstrate that a firm with what its insiders know is a profitable, positive net present value (NPV) real investment project[16] proposal may pass up implementing

15. *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 491–93 (1970).

16. An investment project's NPV equals its expected future net revenues discounted to present value less the project's cost. *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 85–89 (8th ed. 2006).

the project if new securities must be issued to finance it.[17] The securities of such a firm are the high-quality version of the product discussed above. The market cannot distinguish them from the securities of firms with less promising projects. The market thus prices the securities of all the firms in the pool at a lower price reflecting the average expected return for the total pool. This lower pooling-equilibrium price per security would require the firm with the positive NPV project, in order to raise enough cash to finance its implementation, to issue more securities than if they could be sold at a higher price. Issuing more securities obliges the firm to pay more in expected future dividends or interest. The project, despite being more promising than most, may still not generate sufficient expected cash flow to justify these greater expected obligations, in which case the issuer will not make the offering. Unless another form of financing can be found, society will lose because scarce savings will go instead to a less promising project.

Now imagine a range of potential issuers in terms of their share qualities, with the worst having shares that would be worth nothing to anyone purchasing them because of some mix of poor expected underlying cash flow and diversions by control shareholders. The highest-quality issuers, as described just above, would not enter the market in the first place. But now the next-highest-quality issuers would be in the same position as the highest-quality issuers would have been if they had stayed in the market. This is because the price offered to these next-highest-quality issuers would be an average of the expected value of their shares and the values of the shares of all the lower-quality issuers. So now these next-highest-quality issuers would not enter the market. Moving down the list in terms of the quality of an issuer's shares, this story can be repeated again and again. In the end, in the absence of any antidotes to this adverse-selection problem, the market unravels completely, just like the high-quality product in the example in the initial discussion of adverse selection,[18] and there are no share offerings to portfolio investors.

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17. Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, 13 J. FIN. ECON. 187, 187 (1984). A positive NPV project is one where the project's cost is less than the expected future net revenues from the project discounted to present value at a rate of market return for cash flows with comparable risk. BREALEY, MYERS & ALLEN, *supra* note 16, at 17. Because this market rate of return represents the opportunity cost of implementing the project, implementing the project enhances economic welfare in society.

18. *See supra* Part I.A.

In the real world, when a market for offerings by a given type of issuer just opens, there may be an initial burst of irrational exuberance such that the full impact of adverse selection may not be felt immediately. As a result, a number of unworthy, as well as worthy, offerings will succeed in being marketed.[19] Over time, though, many of the issuers of the unworthy offerings will not perform well for reasons that were known at the time of the offering but not disclosed. Thus, even if the rational-actor assumption in the adverse-selection model described above is not fully correct, without some kind of antidote to the information asymmetries, the unraveling of the market that it predicts will happen eventually.[20]

C. The Additional Problem of No Guidance from Secondary-Market Prices

It is important to see that this adverse-selection problem is much more severe in the case of a possible offering of truly new securities compared to an offering by an established issuer whose identical securities are already trading in an efficient secondary market. The potential investor in an offering by an established issuer of this type has the guidance of the price in the secondary market, which, because the market is efficient, is as good an estimate as can be obtained of the security's value based on publicly available information.[21] Thus she can be confident that the price she pays in the offering, if it is close to the secondary-market price, is, in terms of what is publicly known, fair and unbiased even if she personally obtains none of this information. In contrast, there is no price to provide such guidance in the case of the offering by the issuer of the truly new security. Thus the rational investor, before contemplating a purchase in a public offering of truly

19. *See* Robert Forsythe, Russell Lundholm & Thomas Rietz, *Cheap Talk, Fraud, and Adverse Selection in Financial Markets: Some Experimental Evidence*, 12 REV. FIN. STUD. 481, 482–85 (1999) (discussing experimental evidence that investors will credit false claims not policed by tough sanctions so that the signaling model will fail).

20. The German effort to facilitate public offerings by SMEs by setting up a new market with less stringent requirements for initial public offerings (IPOs) is an illustration of the problem. It had initial success followed by collapse. *See* Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475, 502–07 (2011); Hans-Peter Burghof & Adrian Hunger, Access to Stock Markets for Small and Medium Sized Growth Firms: The Temporary Success and Ultimate Failure of Germany's *Neuer Markt* 4 (Oct. 2003) (unpublished manuscript), http://ssrn.com/abstract=497404 [https://perma.cc/G3WM-3DNL].

21. The efficient-market hypothesis from financial economics holds that the prices of securities of large, established issuers trading in liquid markets fully reflect all publicly available information. *See* BREALEY, MYERS & ALLEN, *supra* note 16, at 337–41.

new securities, must either acquire and analyze this information herself or rely on an advisor who does this for her. And if this information is not conveniently available to her or her advisor in a credible and easily usable fashion, the market for such an offering is even further handicapped relative to the market for an offering by an established issuer.[22]

D. The Social-Welfare Challenge Posed by Information Asymmetries

To understand the economic-welfare implications of the information asymmetries discussed above, engage in a brief thought experiment that contrasts two hypothetical worlds. They share in common that public offerings of truly new securities are the only way of funding proposed new real investment projects, but they differ sharply as to who knows what.

The first is a nirvana world with no information asymmetries. In such a world, everyone's expectations concerning a possible new offering would be based on the aggregation of all bits of information that initially are known by anyone in the world. Funds would find their way from investors to real investment projects in every instance where it was mutually advantageous for this to happen. Every offering would, based on all known information, be priced properly. In the process, the economy's most promising proposed real investment projects would be implemented going down the list in rank order to the point where society's scarce savings were exhausted.

The second is a world with the large information asymmetries that exist in the real world when an issuer first contemplates making a public offering of truly new securities. Unlike the real world, however, these asymmetries are not ameliorated by any market-based antidotes or regulatory interventions, nor are there alternative mechanisms for allocating scarce savings to proposed real investment projects. As described above, the market for offerings of truly new securities would unravel completely.[23] There would be no real investment because there would be no way for savers and proponents of new real investment

22. In contrast, for registered public offerings of large, established issuers in the United States, the issuer need make available to prospective investors only a brief prospectus, under the theory that the efficient-market hypothesis assures that all publicly available information is reflected in the securities' secondary-market trading price. *See* Fox, *Civil Liability*, *supra* note 1, at 243–45, 243 n.10.

23. *See supra* Part I.B.

projects to connect. As a result, there would be a huge shortfall in economic welfare in comparison to the first world.

The task then is to design a financial system that minimizes this economic-welfare shortfall. We need to move as far as possible from the second world toward a system that allocates society's scarce savings among all the proposed real investment projects in the economy in the way it would be allocated in the first world. To do so in a cost-effective way, however, we need to take account of the fact that all mechanisms of allocating savings to fund real investment projects consume real resources as they deal with the problems posed by the initial information asymmetries.

In thinking about such a system, the first thing to note is that public offerings of truly new securities are not in fact the only mechanism by which scarce savings are allocated to proposed real investment projects. There are a variety of institutions, ranging from commercial banks, insurance companies, and investment banks to investment funds including venture capital, that provide debt and equity financing privately. Existing issuers can also finance projects from their internal cash flows. Existing publicly traded issuers can make public offerings of securities identical to what is already trading in the market. Given that there is a tradeoff between the costs of dealing with initial information-asymmetry problems and the capacity of a financial channel to find the most promising real investment opportunities, for many proposed projects, one or more of these other mechanisms for deciding funding is superior to a public offering of truly new securities.

Nevertheless, there are promising proposed projects for which such an offering is the best funding vehicle and that will not be funded if this vehicle is not available. There are multiple reasons for this. A claim on a dollar of future expected cash flow is more valuable if it is publicly traded than if it is not because it is more liquid and can easily be included in a risk-reducing diversified portfolio.[24] Moreover, the public market for new issues of securities seems more sensitive to the potentialities of innovative proposed investment projects than internal funding by existing, established publicly traded firms.[25]

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24. *See, e.g.*, William L. Silber, *Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices*, 47 FIN. ANALYSTS J. 60, 60, 62 (1991) ("Companies issuing restricted stock alongside registered securities trading in the open market usually offer a price discount on the restricted securities to compensate for their relative illiquidity.").

25. *See generally* Merritt B. Fox, *Promoting Innovation: The Law of Publicly Traded Corporations*, 5 CAPITALISM & SOC'Y 1 (2010) (arguing that the diversity of potential providers of funds in an IPO and of the information channels by which they become informed makes this

Thus, there will be a significant loss in economic welfare to the extent that adverse selection prevents the market for public offerings of truly new securities from functioning. Minimizing this loss is what prompts the discussion that follows.

II. MARKET-BASED SOLUTIONS TO ADVERSE-SELECTION PROBLEMS

This Part considers the extent to which market-based antidotes to the adverse-selection problem would, by themselves, allow a market for truly new securities to function. The only parts of the legal system on which these antidotes rely are contract and tort law. There are a number of such antidotes: signaling, investment bank intermediation, expert certification, and reliance on the search by other buyers. In the discussion that follows, it is useful, before considering models specifically focused on markets for securities, to return to the example of the high- and low-quality products used above to explain adverse selection.

A. Signaling

One market-based antidote to adverse selection—captured by signaling models in information economics[26]—starts with the assumption that the potential sellers of the high-quality version of a product can credibly and economically communicate the quality of what they are selling to the market. The sellers of the low-quality version might stay silent. But, because it would be disadvantageous for any seller of the high-quality version not to affirmatively communicate the quality of what it is selling, buyers would infer that any seller that remains silent is selling the low-quality version. The credibility of a seller's claim of high quality depends on the negative consequences that it would suffer should its claim prove to be untrue. These negative consequences could be in the form of legal liability or a loss in reputation.

Modifying our earlier example involving the high-quality and low-quality versions of a product, all the sellers of the high-quality product assert that their product is high quality and none of the sellers of the low-quality product do. Buyers can tell which is which and will be

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form of external finance more receptive to innovative investment proposals than is the case with internal finance).

26. The seminal article is Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

willing to pay one hundred dollars for the high-quality product, thus assuring that it will be available in the market.

Signaling will fail to eliminate the information-asymmetry problem, however, if a seller's claim of high quality is not completely credible. This will happen if buyers believe that a low-quality seller's expected gain from falsely claiming to be high quality can in some circumstances exceed its expected cost. Signaling will also partially or totally fail if buyers believe that a high-quality seller might sometimes stay silent because there may be a cost to the seller of some other kind in making the truthful claim of high quality. This cost might be greater than the gain in terms of avoiding an adverse-selection discount.

The concept that signaling can be an antidote for adverse selection in securities markets was first worked out in a model by Professor Stephen Ross.[27] Ross considers the situation where there is a hierarchy of issuers with respect to a particular factor that could affect each of their respective future cash flows. The issuer with the most favorable situation with regard to this factor discloses this fact. In doing so, it distinguishes itself from all the others, none of which can truthfully claim that its situation is that favorable. The issuer with the next most favorable situation discloses this fact so that market knows that, although its situation is not as favorable as the first firm, it is more favorable than all the remaining firms. This scenario repeats itself all the way down the ladder. The issuer with the least favorable situation may stay silent, but the market will infer from its silence that it is at the bottom of the hierarchy.

For a number of reasons, however, this sort of signaling is not likely to be a complete cure for information asymmetries in securities markets. To start, silence is not a complete substitute for affirmatively disclosing a lack of good news, because the market knows that there are reasons other than a lack of good news why an issuer would choose to remain silent. For example, a corporate issuer may choose not to disclose certain information, even if favorable, because revealing it to the market makes it available to competitors, major suppliers, and major customers in ways that would be damaging to the profitability of the issuer's business.[28] Also, the silence of an issuer concerning a

27. *See generally* Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177 (Franklin R. Edwards ed., 1979) (synthesizing various disclosure issues and formulating an economic framework within which disclosure issues can be examined).

28. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 687 (1984).

certain factor at most only conveys that its situation is less favorable than that of the issuers that do disclose something concerning the matter. Silence does not convey how much less favorable. Thus, disaster might be looming but the market is unaware.[29]

Signaling also only works if the buyers whose actions set the price are attentive to the absence of disclosure on a topic and are sophisticated in the inferences that they draw from this silence. This may describe the situation in the case of a public offering by an established issuer whose identical securities shares trade in a liquid, efficient secondary market. In this situation, the secondary-market price is determined by "smart money" traders, and the secondary-market price, in turn, is the primary determinant of the price in the issuer's new public offering. It may also describe the situation in the case of a private offering to a limited number of financially sophisticated persons who are each making a substantial investment.[30] It does not describe well a public offering of truly new securities.

B. Intermediation

A second way that the asymmetric-information problem may be ameliorated is through the intermediation of a merchant that purchases the items for resale, reliably identifies which items are high-quality versions of the product and which are low-quality ones, and credibly communicates the quality of what it resells to the buyers. The merchant can profit from doing this by obtaining part or all of the gains from trade from the sale of the high-quality version. In our ongoing product

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29. Commentators have noted that, for this kind of reason, reality does not conform with signaling theory's prediction that voluntary disclosure will result in the market being fully informed. *See* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 745 (1984); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 5–7 n.24 (1983). Coffee points out that the market was not able, from the silence of the issuers involved, even to begin to infer in advance that New York City and the Washington Public Power System would each experience disastrous defaults. Coffee, s*upra*, at 745. These were the two largest defaults of publicly issued securities in the history of the United States, but the issuers, as municipal entities, were exempt from the mandatory-disclosure system under the federal securities laws. *See* Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: A Reevaluation*, 36 BUFF. L. REV. 15, 18–19, 40–44 (1987).

30. Commentators have suggested that this concern explains the distinction that the Securities Act and the SEC make between public offerings of securities, where registration involving mandatory affirmative disclosure is required, and certain offerings that are limited to more sophisticated investors that are exempted from such registration. *See* DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, GAME THEORY AND THE LAW 94, 96 (1994). As is discussed more in Part IV, *infra*, although this rationale might explain some kind of limited offering exemption from registration, it does not explain the breadth of the current exemption.

example, these gains from trade would be the difference between the high-quality sellers' reservation price and the one hundred dollars that the buyers would be willing to pay.[31]

The intermediating merchant's claim of high quality could have greater credibility than that of the seller because the merchant is better capitalized and hence is more likely to be able to pay if it is sued for making a false claim. The greater credibility could also be because the intermediating merchant, as a more frequent player than the seller, has developed a more substantial reputation for telling the truth than has the seller, which in turn makes costlier the loss in reputation that would result from falsely claiming that a product is high quality when it is not.

Underwriters perform this intermediating merchant function with securities. Standard models of the role of underwriters of publicly offered corporate equities and bonds suggest that they use their reputation to certify that the offering price fairly reflects what is known by the issuer's insiders but not known, or at least not known for sure, by the market.[32] The asymmetry between the insiders and the market may arise because potential investors are not sure that the issuer has disclosed all relevant negative information possessed by insiders. It may also arise because the insiders know positive information but do not disclose it publicly out of concern that to do so would inform competitors, suppliers, customers, or regulators in ways that would harm the issuer. Or it may be that the insiders truthfully disclose positive information but investors do not find their disclosure fully credible because it might also be in the interests of these insiders to make such a disclosure when it is not true.

In a firm-commitment underwriting, the underwriter engages in a due-diligence investigation of the issuer. Then, as a frequent repeat player whose credibility is developed over time, it "leases" its reputation to the issuer by purchasing, and then reselling, the securities on the basis of the issuer's disclosures. These models suggest that an underwriter engages in due diligence to the extent that, at the margin, the cost of doing so equals the benefit to its reputation in terms of its ongoing capacity to reduce the adverse-selection-induced discount imposed by the market on the future offerings that it underwrites.[33]

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31. *See* Akerlof, *supra* note 15, at 496.

32. *See* James R. Booth & Richard L. Smith, II, *Capital Raising, Underwriting and the Certification Hypothesis*, 15 J. FIN. ECON. 261, 261–65 (1986); Ann E. Sherman, *Underwriter Certification and the Effect of Shelf Registration on Due Diligence*, 28 FIN. MGMT. J. 5, 5–7 (1999).

33. Booth & Smith, *supra* note 32, at 267.

The effectiveness of this mechanism in ameliorating information asymmetry has its limits, however. An underwriter has difficulty designing an optimal incentive scheme for its agents. On the one hand, it wants its compensation arrangement to spur its agents to obtain fee-generating new underwritings. On the other hand, such a compensation arrangement is likely to undermine the underwriter's ability to ameliorate information asymmetries because the arrangement will tempt its agents to please the issuers that they solicit for underwritings by forgoing a serious due-diligence investigation and by failing to insist that the issuers' disclosures be consistent with whatever negative information is found by the investigation that they do conduct. In other words, there is the risk that, in seeking underwritings, these agents will free ride on the underwriter's previously established reputational capital. The underwriter's credibility can, of course, also be enhanced by a legal regime that, under specified circumstances, imposes liability on it for misstatements.[34]

C. Third-Party Certification

A product certifier that reliably identifies which items are high-quality versions of the item and credibly communicates what it has discovered to the market performs a similar function to that of the intermediating merchant. Relative to intermediation, this solution to the adverse-selection problem has the advantage of not requiring that the skills of quality assessment and those of merchandising be found in the same entity. Moreover, compared to the intermediating merchant, a certifier has the credibility advantage of not being able to make an "end-game" profit by falsely claiming that the product it is selling is high quality and receiving a high-quality product price. For securities, the certifiers are auditors and, in the case of bonds and securitizations, rating agencies. Reputational capital models similar to those

34. Judge Weinstein, in one of the early seminal cases concerning Securities Act Section 11's imposition on underwriters of strict liability subject to an affirmative due-diligence defense in cases involving misstatements in registered offerings, justified requiring underwriters to "assume an opposing posture with respect to management" by saying that the "average investor probably assumes that some issuers will lie, but he probably has somewhat more confidence in the average level of morality of an underwriter who has established a reputation for fair dealing." Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971).

constructed for investment banks have been constructed as well with respect to auditors[35] and credit-rating agencies.[36]

Certifiers are sellers of information and as such face a problem not faced by sellers of most products. Any one paying recipient can often costlessly reproduce the certifier's "product" and pass it on to others, who then have no need to pay the certifier to get it. Thus, unlike most other products, there are no additional sales to help compensate the seller for the initial fixed costs of developing the product. Given that providing reliable assessments is costly, these incentives problems reduce generation of such certifications.

One work-around to this problem is to have the issuer, rather than the potential securities buyer, pay for the certification. This arrangement creates its own credibility problems, however. To attract more issuers to purchase its services, the certifier too has incentives (though, again, perhaps only end-gamed ones) to attract business by engaging in a light investigation or failing to pass on or account for some negative information that it does find.

Moreover, it is difficult to design negative legal consequences for certifiers that incorrectly identify as high-quality securities ones that are really low quality. Unlike an investment bank, the certifier does not profit from a successful sale. Unless the certifier takes on the very different role of being an insurer of all the possible ways that a security could fall short of what was expected, the certifier's revenues, measured on a per-unit-sold basis, will be small. A prospect of high liability for an erroneous rating may thus drive all certifiers out of the market. Because of this problem, the liability rules applicable to a certifier are likely to require a payout of damages only for the most egregious errors. Thus the certifier, unlike the merchant, may need to rely primarily on reputation, not vulnerability to legal sanction, as its source of credibility.

The failure of certifiers to fully solve the securities-offering information-asymmetry problems has a history. The credit-rating

35. *See generally* Linda Elizabeth DeAngelo, *Auditor Independence, "Low Balling," and Disclosure Regulation*, 3 J. ACCT. & ECON. 113 (1981) (suggesting that "low balling" would not impair auditor independence partly because auditors, in deciding whether to cheat, consider loss in future audit fees resulting from the loss of reputation).

36. *See generally* L. McDonald Wakeman, *The Real Function of Bond Rating Agencies*, 1 CHASE FIN. Q. 18 (1981), *reprinted in* THE MODERN THEORY OF CORPORATE FINANCE 410 (Clifford W. Smith, Jr. ed., 2d ed. 1990) (suggesting that bond ratings mirrored the market's assessment of a bond's risk partly because bond-rating agencies depend on their reputation to obtain business).

scandals in connection with mortgage-backed bonds are still fresh in our memories.[37] To find other examples, we need look back no further than the scandals in the reporting of corporate financials from the early 2000s to see how problems such as agency problems within the certifying organization and oligopoly within the industry reduce the effectiveness of this information-asymmetry antidote.[38]

D. Buyer Search

Suppose that, contrary to the initial adverse-selection story told above, some or all the buyers can individually ascertain whether the particular item that a seller is offering is the high- or low-quality version of the product but can do so only at a cost. A buyer who acts in this fashion will be willing to pay her reservation price for an item that she identifies as high quality, and others can learn something about the product's quality from observing her purchase. Search models in information economics can be complex and depend critically on the assumptions made, but generally they suggest that a critical factor in the success of buyer search in ameliorating adverse-selection problems is the cost to the buyer of "visiting" a seller and testing its product.

The following variation on our ongoing adverse-selection product example set out above illustrates the point. Assume that any given seller must choose the price at which it offers all its items to the market; that is, it engages in a mass offering and cannot price discriminate among buyers. Also assume that each seller offering the product at any given price will get the same total number of visits by potential buyers. A certain percentage of these visitors are testers—persons who, at a cost to themselves, can ascertain the quality of what the seller is selling—and the remainder are nontesters. The more expensive testing is on average, all else equal, the smaller the percentage of the visitors that are testers. Relative to the nontesters, testers either put a higher value on the difference between the high- and low-quality product or can ascertain the difference at less personal cost, perhaps because of accumulated skill. Finally, assume that there are economies of scale so

37. *See* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 120–24 (giving background on the 2008 financial crisis and discussing the role of credit agencies in how it unfolded).

38. *See* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 108–92 (2006); Merritt B. Fox, *Gatekeeper Failures: Why Important, What to Do*, 106 MICH. L. REV. 1089, 1097–1108 (2008) (book review).

that in equilibrium it is not worthwhile for a seller to be in business if the seller does not receive a certain minimum number of buy orders.

Consistent with the original example, a tester is willing to pay one hundred dollars for an item that her test reveals is high quality and eighty dollars for an item that her test reveals is low quality. A nontester is willing to pay a seller the expected value of her purchase. If testing were sufficiently expensive that no potential tester would engage in testing and every seller were offering the product to the market, the potential tester and nontester each would, as in the original example, know that 50 percent of the sellers are offering the high-quality version and 50 percent the low-quality version, but neither set of potential buyers could tell at an affordable price which is which. Because the high-quality version is worth one hundred dollars to her and the low-quality eighty dollars, each buyer would be willing to pay ninety dollars. Again, however, this is not an equilibrium solution. Assuming that ninety dollars is below the high-quality sellers' reservation prices, there will be no sales by high-quality sellers to nontesters. The same result would prevail if the cost of testing were somewhat less but sufficiently high that the percentage of visitors that would find it worthwhile to test is small. The potential number of purchases from high-quality sellers made by testers would be sufficiently low that each high-quality seller, for economy-of-scale reasons, would find it not worthwhile to sell at all. Under these circumstances, the equilibrium solution would again be the same as in the original example: no sales of the high-quality version of the product.

Now suppose that testing is inexpensive. Consider the resulting change in the nontesters' expectations in equilibrium. Again, if every seller were offering the product, as in the original example, the nontester would know that 50 percent of the sellers are offering the high-quality version and 50 percent the low-quality version. Again, this is not an equilibrium situation. With inexpensive testing, testers will be a much larger portion of the visitors to all sellers, including to the high-quality ones, and these testers will be willing to pay the seller of the high-quality product one hundred dollars per unit. Thus high-quality sellers may receive enough orders to stay in business at their offer price. Moreover, the mere fact that a given seller is selling at a high price and is in business filling orders will suggest to the nontester an increased possibility that the seller is high quality. Of course, a low-quality seller could try to masquerade as a high-quality one by offering a similarly high price. But if testing is inexpensive, the masquerader too

will be visited by many testers, each of whom will be unwilling to buy at the high price, and, given the economies of scale, the loss of customers would be too costly for the masquerade to be a successful strategy. Thus, in equilibrium, nontesters too may think it is likely that a high-price seller is also a high-quality seller, so that they too are willing to pay the high price. In other words, if buyer search and testing are sufficiently inexpensive, they can eliminate the adverse-selection problem even though not everyone tests.

This example illustrates the importance of institutions, whether private or public, that reduce the cost of buyer search and testing. Standardization of the language of seller disclosure, such as the posting of gasoline mileage calculated in a regulated way on all new autos for sale, is an example. The value of low-cost search and testing may even call for standardization limiting the variation of certain characteristics of the product where the variation is of little or no value to buyers and makes comparisons more difficult.[39]

More generally, the fact that in many situations a buyer can reduce information asymmetries by engaging in search and testing suggests something about appropriate liability rules. To the extent that such actions by buyers are the most cost-effective way for these asymmetries to be reduced, sellers and merchants should be given a defense against liability actions brought by nontesting buyers based on a claim that the seller or merchant failed to disclose the discoverable problem in the product's quality.[40]

Applying these models to securities, two particular features of an offering improve the chances that buyer search can help resolve its adverse-selection problems. One is that the offering must be at the same price to all offerees. The other is that some investors each invest a substantial amount of money in the offering. The more dollars an investor is seeking to invest, the lower the cost of doing the investigation per dollar invested. The presence of the large investors reassures the smaller ones.[41]

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39. *See* Alan Schwartz & Louis L. Wilde, *Competitive Equilibria in Markets for Heterogeneous Goods Under Imperfect Information: A Theoretical Analysis with Policy Implications*, 13 BELL J. ECON. 181, 181–83 (1982) (proposing policy prescriptions after setting out a model somewhat resembling the example in the text).

40. This concept is comparable to the analysis in accident law to the role of defenses based on the concept of contributory negligence. *See* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 9–21 (1987).

41. Internet-based solicitations of accredited investors based on Securities Act Rule 506(c), *see infra* Part V.B, provide an example. Successful such offerings involve substantial investments

III. AFFIRMATIVE-DISCLOSURE REGIMES

The story so far can be summarized as follows. When an issuer is first contemplating a potential public offering of truly new securities, information asymmetries abound. Unless the adverse-selection effects from these asymmetries are ameliorated in some fashion, the resulting discount in price that investors are willing to pay may well make the offering not worth making. This represents an economic loss to society if the offering is one that would have proceeded in a world where there were no such asymmetries. There are several market-based antidotes that help ameliorate these adverse-selection effects: signaling, investment bank intermediation, certifiers, and buyer search. These antidotes are not, either individually or in combination, fully effective cures to the problem, however. Thus, if we rely on just these solutions, many worthwhile real investment projects will still not be funded.

This shortfall in adverse-selection amelioration raises the issue as to whether there is a role for government-based regulation to supplement what parties can accomplish just using contract and tort law. Specifically, three questions need to be answered. First, would it be useful to have a government-designed affirmative-disclosure regime, whereby an issuer making an offering that is subject to the regime is required to answer certain questions? Second, if it would be worthwhile to have such a regime, at least for offerings with particular characteristics, should the regime be imposed on all issuers making such offerings or only on those that volunteer to be subjected to it? Finally, when an issuer or other person associated with an offering makes a material misstatement in connection with the offering or fails to properly answer a question imposed by the disclosure regime, should regulation create for investors one or more causes of action for damages that go beyond what is available to the investors under tort law and under the terms of the contracts they enter into with regard to the offering? The first two of these questions are the topic of this Part, and the final question is the topic of Part IV.

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by well-known angel investors or venture capital firms, and the other investors rely on the expertise of these substantial investors. Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 565 (2015).

A. The Rationale for an Affirmative-Disclosure Regime at the Time of the Offering

The signaling model has two key points of failure when applied to the real world. One is that not all statements that issuers make are fully credible. The solution to this is straightforward: increase the negative consequences that result from making false statements. The other is that investors are unable to interpret the silence of issuers in a way that permits investors to infer with full accuracy the true situation concerning what has not been said. The solution to this second point of failure is an affirmative-disclosure regime. When an issuer is making a public offering that is subject to an affirmative-disclosure regime, it must answer certain questions. Requiring an issuer to answer a question clears up whatever ambiguity would otherwise have arisen if the issuer had remained silent concerning the matter, at least assuming the answer is credible.

The basic mechanism of the signaling model is that one can infer that a bad state of affairs exists from an issuer's silence about a particular matter. This is because, according to the model, if the situation were better, the issuer would say so. Consider, from the discussion above, some of the reasons why, in the real world, silence may be ambiguous concerning the actual state of affairs. One reason is that a bad state of affairs in fact does not exist but the issuer finds that disclosing the actual good state of affairs is costlier to it than whatever it would gain in terms of a better price for its securities. As noted above, this could be the case, for example, where disclosure of the information would disadvantage the issuer with regard to the terms it can negotiate with its major suppliers and customers or in terms of its competition with other firms. Another reason that silence may be ambiguous is that a low-quality issuer's silence may only reveal that it is inferior to other issuers, not how inferior it is. Subjecting the issuer to an affirmative-disclosure regime that includes a question about the matter resolves ambiguity arising for any of these reasons because the issuer needs to disclose what the actual state of affairs is.

Moreover, in contrast to the simple signaling models in the economics literature involving just a single feature of a product, issuers in the real world possess, or are in a good position through investigation to discover, a large range of different kinds of information that can help predict their future cash flows and hence affect the desirability of their shares. For many of these kinds of information, most investors will not have the ability to make very accurate negative

inferences from silence on any given subject. One reason is that they may lack the necessary sophistication. Another reason may be bounded rationality. Each of the thousands of issuers in the market either says something, or remains silent, about each of a myriad of different matters that might affect its future cash flows. Investors rationally may be unable to cost-effectively process all the data that would be needed to make distinctions among all these issuers based on whether they were silent or said something.[42] Finally, investors may be unable to make the correct inferences from silence because they have a behavioral tendency not to recognize negative implications of silence with respect to some of these kinds of information.[43] An affirmative-disclosure regime can help correct investors' inability to make appropriate negative inferences from silence that arises from any of these problems. A negative disclosure with respect to a given matter stands out more than silence with respect to the matter, thereby making the information more salient.

A rule mandating disclosure of any given kind of information can also reduce the cost of making distinctions among issuers with respect to the matter involved by regularizing the language used by all issuers discussing the matter. Such a rule will thus help an individual investor, or her advisor, identify more easily which offerings are low quality. It will also enhance the functioning of one of the other market-based antidotes to adverse selection: buyer search. By lowering the cost for potential buyers who do search and test, those investors who do not search and test are better able to rely, as signals of quality, on the price established by the actions of investors who do.

B. The Rationale for a Periodic-Disclosure Regime After the Time of the Offering

Potential investors in an offering by an issuer of truly new securities are likely to have little knowledge of the capabilities of the issuer's managers and their willingness to work hard. Nor will they have much knowledge of the inclination, if any, of these managers, and

42. Russell Korobkin makes a similar point with respect to the limited capacity of market forces to police the fine-print terms in consumer contracts because, due to bounded rationality, consumers cannot absorb, analyze, and act on this information. *See* Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1206–07 (2003).

43. *Id.* at 1247–54. This is an application of the more general principle in behavioral economics of the "what you see is all you get" phenomenon. *See generally* DANIEL KAHNEMAN, THINKING, FAST AND SLOW (2011).

of any control shareholders still remaining after the offering, to divert issuer cash flows to themselves. Disclosure at the time of the offering can only do so much to reduce the asymmetry between what investors know and what these insiders know about their own capabilities and inclinations. The more effective the ongoing constraints are on managers and control shareholders to act in a way that maximizes the value of the shares held by outsiders, the less this asymmetry between the insiders and investors matters. This is because the managers and any remaining control shareholders may, undisclosed, have less-than-pure motives or poor managerial capabilities, but this fact is less important for the value of the shares going forward if those insiders are more constrained. The less important the asymmetry, the fewer stock sales are blocked that would have occurred absent the asymmetry.

The prospect that an issuer will be subject to an effective ongoing mandatory issuer-disclosure regime—a regime that requires an issuer to regularly update its disclosures—can reinforce the constraints that corporate law and reputational concerns put on diversions. More generally, there is a general recognition that transparency is necessary for good corporate governance.[44] Such disclosure can reveal failures by an issuer to follow the procedures, such as an informed independent director or shareholder vote, for approving transactions in which the managers or control shareholders have an interest.[45] More disclosure, by making prices more accurate, also makes share-price-based compensation a more effective device to incentivize managers to act in a share-value-maximizing way. More ongoing disclosure has an additional function if the initial public offering (IPO) results in a sufficient dispersion of share ownership that no control shareholder remains. Without a control shareholder, there is no one to discipline the firm's managers if they are lazy, incompetent, or divert funds to themselves. Substitute discipline, however, comes from the threat of hostile takeover or pressure by activist hedge funds. More disclosure makes these disciplinary mechanisms more effective by making

44. *See, e.g.*, ORG. FOR ECON. CO-OPERATION & DEV., OECD PRINCIPLES OF CORPORATE GOVERNANCE 29–32 (2004) (proposing that "corporate governance framework should promote transparent and efficient markets" to effect positive economic performance); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 244, 263–69 (2002) (arguing that corporate transparency facilitates the separation of ownership from control).

45. *See* DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 31–32, 104 (2016) (explaining the importance of SEC mandatory-disclosure rules for reducing such self-interested behavior by managers and control shareholders); Bernard S. Black, *The Legal and Institutional Preconditions of Strong Securities Markets*, 48 UCLA L. REV. 781, 808 (2001) (same).

management shortcomings more evident to the market and by reducing the risk associated with purchasing a substantial block of shares. The existence of more effective disciplinary devices incentivizes managers not to misbehave in the first place, and facilitates managerial replacement when it nevertheless does occur.[46]

C. Mandatory Versus Optional Initial Offering and Ongoing-Disclosure Regimes

For the issuers adopting it, a system that makes available for voluntary adoption a regime asking certain questions will be just as effective at resolving the signaling model's ambiguity of silence as an identical disclosure regime system that is mandatorily imposed on all issuers. Moreover, if issuers have a choice of multiple regimes, a voluntary system could have the advantage of promoting regulatory competition. With such competition, regulators might be spurred to find the set of questions that most effectively reduces adverse selection while imposing on the issuers the least costs in terms of providing the disclosure.[47] Alternatively, the different competing regimes might provide issuers with a menu of choices where one regime would be most effective for one type of issuer and another regime more effective for another type of issuer.[48] Indeed, the disclosure regime need not even be governmentally based, as proposals to use stock exchanges instead illustrate.[49] A governmentally run regime will have advantages, however, in terms of the powers of investigation of any centralized enforcer and the capacity to impose strict sanctions for violations.

Still, a voluntary system is likely, from a social-welfare point of view, to be undersubscribed and require less than the optimal level of disclosure. For reasons discussed below, an issuer will decide whether to sign onto such a regime based on its calculations of the private costs and private benefits that will arise from the disclosure that the regime

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46. All of these points are worked out in more detail in Fox, *Civil Liability*, *supra* note 1, at 258–59.

47. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2365–72 (1998).

48. Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 922–24 (1998); Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207, 231–32 (1996).

49. *See generally* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925 (1999) (proposing an exchange-administered enforcement regime for fraud-on-the-market claims).

requires. However, its private costs are likely to be higher than the social costs of this disclosure and its private benefits are likely to be less than the social benefits. In addition, if not all issuers in a market are subject to a disclosure regime, there will not be as much reduction in the cost of making distinctions among issuers. Thus the costs of individual investor decisionmaking are reduced less and the adverse-selection-ameliorating benefits of buyer search and testing will not be as great. When issuers can choose from among multiple disclosure regimes, similar problems arise.[50]

1. *Private Costs of Issuer Disclosure Exceed Social Costs.* For each individual issuer, a disclosure involves two different kinds of costs: "operational" costs and "interfirm" costs. Operational costs are the out-of-pocket expenses and the diversions of management and staff time that issuers incur to provide the information. Interfirm costs arise from the fact that the information provided can put the issuer at a disadvantage relative to its competitors, major suppliers, and major customers.

Operational costs are costs both to the individual firm and to society as a whole. Interfirm costs are costs only to the individual firm. They are not social costs because of an externality: the disadvantages to the issuer from the disclosure are counterbalanced by the advantages it confers on the other firms. Thus, at all levels of disclosure, an issuer's private marginal cost of disclosure will exceed the marginal social cost by an amount equal to these interfirm costs associated with any particular disclosure level.

2. *Social Benefits of Issuer Disclosure Exceed Private Benefits.* Information disclosed by one issuer does not just reduce information asymmetries with respect to its own offering. The information can be useful as well in analyzing other issuers and thus reducing the consequences of information asymmetries for the offerings of the other issuers. It can also improve the liquidity of secondary trading in securities of other issuers by reducing information asymmetries among the traders in that market. In addition, by making share prices of these other issuers more accurate and making the environment in which they are operating as firms more transparent, it can make more effective the

50. *See generally* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (discussing benefits and costs of mandatory regulation of disclosures, nonregulation, and issuer choice regimes).

constraints on their managers to operate their firms in a share-value-maximizing way in the same way that their own firm's disclosures do.[51] One issuer's disclosures could, for example, reveal something about possible trends for the industry as a whole and thus help clarify the extent to which the performance of each of the issuer's competitors was due to its managers' efforts versus the state of the larger market.[52] The disclosing issuer's share price can only capture the resulting reduction in the adverse-selection-induced discount and expectations of its improved liquidity and share-value-maximizing managerial behavior. It cannot capture the similar reductions in the adverse-selection-induced discount enjoyed by other issuers resulting from the first issuer's disclosures, nor the improvements in the secondary-market liquidity of the securities of these other issuers or in their corporate governance. Therefore, the private benefit to the disclosing issuer will be less than the social benefit.

3. *Impact on Issuer Disclosure Behavior.* Because an issuer's disclosure involves both social costs and social benefits, each issuer has some socially optimal level of disclosure, where the marginal social cost equals the marginal social benefit. Unregulated, however, an issuer will choose the level of disclosure where the marginal private cost equals the marginal private benefit. Because the issuer's private costs of disclosure exceed the social costs and its private benefits fall short of the social benefits, the issuer's choice will be below the socially optimal level of disclosure.[53] With a mandatory-disclosure regime that sets the required disclosure level at the higher socially optimal level, any one issuer must disclose more than is privately optimal, but this issuer will benefit from the additional disclosure of all the other issuers in the market because they are also being subject to the same mandate.

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51. *See supra* Part III.B.

52. *See* Easterbrook & Fischel, *supra* note 28, at 685.

53. I have considered in more detail elsewhere the divergence of the private and social costs and benefits of issuer disclosure and the consequent tendency of unregulated issuers to disclose below their socially optimal level. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532–51 (1997); *see also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1490–91 (1992) (explaining that, if left to states, the laws passed would likely produce less disclosure in the United States); Easterbrook & Fischel, *supra* note 28, at 684–85 (discussing voluntary disclosure); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 846–74 (1995) (discussing the history of disclosure in the United States).

This private-versus-social cost consideration is a powerful reason for imposing mandatory periodic disclosure on publicly traded corporate issuers because of the corporate governance and liquidity enhancement benefits to corporate issuers as a group that result from the increased overall level of disclosure.[54] Derivatively, it argues for imposing the same regime on new corporate issuers as they join the group of publicly traded issuers at the time of an IPO.[55]

IV. MANDATED LIABILITY TERMS

Absent a regulatory intervention, the question of liability of issuers, issuer directors and officers, underwriters, dealers, and experts such as accountants or rating agencies for misstatements and omissions of required disclosures will be determined by tort law and the terms of the contracts these various parties enter into with regard to the offering. These contracts will also determine the standards for imposing such liability with regard to questions of fault, due diligence, and burdens of evidentiary persuasion. As a general matter, a contractual representation is a warranty. When the representation turns out to be false, the party who has made it is liable, without any need for the claimant to show fault.[56] Only the counterparty to whom the claim was made can be a claimant, however. As for any other actions based on a false statement of one of the offering participants, the tort of deceit requires, among other things, that the claimant show that the statement was made with scienter and that the claimant relied

54. I discuss these points in more detail elsewhere. *See* Fox, *Civil Liability*, *supra* note 1, at 253–67.

55. In comparing a system where an issuer can choose its disclosure regime with a mandatory system, the argument for a mandatory approach is in one respect weaker in the case of a firm just going public than in the case of one that is already publicly traded and has a dispersed ownership structure. The insiders of a firm that is just going public are selling their shares in the offering and/or diluting their continuing share ownership in the company. Thus, if they are allowed to choose their disclosure regime, they will have an interest in choosing the regime that yields the highest share price. Because they make their decision based on the issuer's private costs and benefits, the required level of disclosure of the regime that they choose will, for the reasons discussed in the text, be lower than what is socially optimal. There is, however, at least a floor set by the insiders' desire to maximize share price. The managers of an already public firm, in contrast, may well choose a regime that requires even less disclosure than would the regime that would yield the highest share price. The less the market knows about what is going on inside the firm, the more protection the managers have against hostile takeover and the pressures on managers brought by activist hedge funds. The managers may well find that this added protection is worth more to them than whatever they are giving up due to a lower share price.

56. *See* RESTATEMENT (SECOND) OF CONTRACTS § 164 (AM. LAW INST. 1981) (stating that a contract is voidable if assent was induced by material misrepresentation, even absent fraud).

on the statement in deciding to purchase the security.[57] The issue addressed here is what considerations might justify regulatory intervention to alter this basic scheme.

A. The Rationale for Imposing Liability on Operating Corporate Issuers

The rationales for a mandatory-disclosure regime set out just above imply that the regime should call for a higher level of disclosure than would occur if the private parties were left to contract disclosure terms on their own and to rely on contract and tort law remedies to police misrepresentations. These mandatory-disclosure rules will not accomplish their purpose if they are not complied with. Issuer liability is one way to encourage compliance. Because the parties would not agree on their own to terms requiring the higher level of disclosure called for by the mandatory regime, they also cannot be expected to agree to socially cost-effective terms concerning compliance-inducing issuer liability when this level of disclosure is not provided.

The analysis of issuer liability must be seen in light of the ideal set out earlier: assuring, to the extent practicable and cost-effective, that all available information is reflected in price. When this happens, society's scarce savings are steered to the proposed real investment projects in the economy that available knowledge suggests are the most promising.[58]

Consider the situation where the total available information known by insiders of the firm, including its nonpublic information, suggests that its proposed real investment project is not a good use of the economy's scarce savings, given the greater promise of proposed projects of other firms. If the information possessed by insiders is disclosed, its offering's prospective market price would be sufficiently low that the proceeds would be less than the discounted present value of additional payouts that the firm would need to make later due to the share dilution (or additional debt service) resulting from the additional securities outstanding. Thus, the issuer will not proceed with the offering and will not invest in the project. Doing so would reduce the value of the firm.[59]

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57. *See* W. PAGE KEETON, DAN D. DOBBS, ROBERT E. KEETON & DAVID G. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 105 (5th ed. 1984).

58. *See supra* Part I.D.

59. For a general discussion of discounted present value and the comparative opportunity costs of risky investments, see BREALEY, MYERS & ALLEN, *supra* note 16, at 16–17.

The issuer may be tempted, however, not to disclose whatever is negative in the information possessed by the insiders, or even to make false positive statements. If it does not disclose the negative information or makes false positive statements, it may be able to get a high enough price in a securities offering to make the offering and the investment in the unpromising project worthwhile. The prospect of liability reduces or eliminates this temptation because it would require the issuer to return to investors the amount by which the offering price was inflated due to the violation of the disclosure rules.[60]

B. The Choice of Liability Regime for the Issuer

The question remains what the nature of this issuer liability scheme should be. One possibility is an absolute strict issuer liability regime, as is in fact imposed on issuers pursuant to Section 11(a) of the Securities Act for disclosure violations in offerings subject to Section 5 registration. Another is absolute issuer liability with a defense if the top officials of the issuer engaged in adequate due diligence. This is similar to the liability scheme under Sections 11(a) and 11(b) of the Securities Act currently imposed on the officials themselves and on underwriters. A third possibility is scienter-based issuer liability, where liability is imposed on the issuer only if the plaintiff investor proves that the top officials were aware of the information or were highly reckless in not knowing of it. This is the liability scheme under Section 10(b) and Rule 10b-5 of the Exchange Act,[61] the only federal-

60. *See* Forsythe et al., *supra* note 19, at 482–84 (discussing experimental evidence that an absence of sanctions for false claims can lead investors to purchase inferior securities). Section 11(e) of the Securities Act provides a somewhat different damages formula, in essence giving the plaintiff a prima facie case for the difference between the price paid and the price at time of suit. 15 U.S.C. § 77k(e) (2012). The defendant has the burden of proving what damages would be under the formula suggested in the text. *Id.* The defendant enjoys a reduction in the prima facie measure of damages only to the extent that it can make this showing. *Id.*

61. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206–14 (1976) (declining to extend liability under § 10(b) and Rule 10b-5 of the Exchange Act to include negligent conduct). Although there is not complete agreement among the federal circuits as to which individual or individuals within a corporation's organization need to possess knowledge of facts that render the corporation's statement false or misleading for the statement to constitute a Rule 10b-5 violation by the corporation, the focus of most courts tends to be on the top officials. The Ninth Circuit, for example, affirmed the dismissal of a complaint against an issuer because insufficient evidence was alleged that the CEO, who spoke the alleged misstatement, knew the information rendering it false. *See In re* Apple Comput., Inc., 127 F. App'x 296, 303 (9th Cir. 2005) ("A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time that he or she makes the statement." (citing Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435–36 (9th Cir. 1995))). Similarly, the Fifth Circuit has stated

securities-law bases for a damages suit against an issuer when the sale of securities by an issuer involving a misstatement is neither registered under the Securities Act nor made pursuant to Regulation A+.[62]

1. *What Constitutes an Omission or a False or Misleading Statement of Fact?* The starting point in the analysis of this question is to note that, whichever liability scheme is chosen, a necessary condition is the existence of a violation of the disclosure regime's rules by the issuer. This requires that material information required to be disclosed was in fact not disclosed, or that the issuer made a statement covered by the disclosure regime that was materially false or misleading. In other words, at the time of the offering, someone in the world must have possessed material information that was either omitted contrary to the rules or that renders false or misleading some affirmative statement by the issuer. Such knowledge, if it is known by someone in the world, would normally be possessed by at least some individuals within the issuer's organization. The fact that this information is deemed material means, according to the standard definition, that there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy, sell, or hold the issuer's shares.[63] If the issuer has properly functioning channels of internal intelligence, information of this importance would likely become available to the top officials of the issuer in the ordinary course of day-to-day business. These top officials are ultimately responsible for the content of the issuer's disclosures in connection with the offering. For example, under the Securities Act registration procedures, these officials are required to sign the statement.[64]

> For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.

Southland Sec. Corp. v. INSpire Ins. Sols. Inc., 365 F.3d 353, 366 (5th Cir. 2004).

62. *See infra* Parts V.B–C.

63. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231–32 (1988); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

64. Section 11 imposes absolute liability also on these top officials, subject to a due-diligence defense. In applying this statutory scheme, however, the courts have acted in a way consistent with the view in the text that all material information about the issuer has very likely been made available to its top officials. The courts almost conclusively presume that an issuer's top officials know such information despite the theoretical availability of a due-diligence defense. *See* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 577–78 (E.D.N.Y. 1971) (explaining how

2. *Comparing Strict Absolute Liability to Scienter-Based Liability.* Consider first an issuer liability scheme whereby liability is only imposed on the issuer if some relevant top official has scienter with respect to this information, in essence the Rule 10b-5 damages action scheme. This liability scheme has three distinct disadvantages relative to absolute strict issuer liability. First, a scienter requirement creates incentives to distort the functioning of an issuer's channels of internal intelligence so as to keep its top officials from receiving information that indicates that a planned offering's disclosures violate the disclosure rules. The benefit to the issuer is that, with the top officials in the dark, the issuer could violate the rules free of any liability and be able to keep the gains from the resulting inflated price of its offering. Such distorted channels of internal intelligence, however, will obviously degrade the issuer's ability to make efficient operating and real investment decisions as a firm. Hence they will damage the overall efficiency of the economy.

Second, to the extent that such distorted channels succeed in protecting top officers from information, an offering that might not be worthwhile at a price that reflects this information can proceed without its disclosure. As a result, the economy's scarce savings will be misallocated to an inferior investment project.

Third, a liability system for top officials requiring a showing of scienter significantly expands the range of facts that will be in contention in litigation because it introduces the additional issue of who knew what. This increases the amount of society's scarce resources that will be consumed by each side in any case where suit is brought. Moreover, with the plaintiff investor facing higher costs if she brings a suit, a disclosure violation is less likely to trigger such suit. The resulting diminished likelihood that the issuer will have to pay damages reduces deterrence.[65]

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insider directors are presumed to have greater knowledge of corporate affairs, making it almost impossible for them to establish a due-diligence defense); Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case*, 55 VA. L. REV. 1, 22, 30–38 (1969).

65. Absolute strict liability, in making suits easier to bring, will also increase the number of suits where, despite an issuer having a properly functioning intelligence system, the top management in fact did not know the relevant information. In such a situation, the prospect of liability would have no influence on behavior and hence no deterrence value. The additional social resources expended by the parties in such actions would thus serve no useful social purpose. The analysis in the text suggests that such situations will be rare, however, and so the gain from increased deterrence is the more important consequence of suits being easier to bring.

3. *Comparing Strict Absolute Liability to Absolute Liability with a Due-Diligence Defense.* Absolute strict issuer liability also has advantages relative to a second possible liability standard—strict issuer liability with a defense available when the issuer can show that its top officials engaged in adequate due diligence[66]—though the advantages are fewer than when the comparison is with scienter-based liability. A more detailed analysis of the operation of such a due-diligence defense follows in connection with the discussion below of underwriter liability.[67] A couple of observations with regard to its operation when applied to the issuer are appropriate here, however. Unlike scienter-based issuer liability, allowing the issuer a due-diligence defense would not likely create incentives to distort the functioning of an issuer's channels of internal intelligence. This is because credible evidence that a firm distorted its channels of communication to keep its top officials in the dark would prevent the firm from being able to maintain the due-diligence defense and thus the firm would be absolutely liable anyway. On the other hand, allowing the defense would still enlarge the range of facts that will be in contention in litigation, thereby increasing the social resources that will be expended by each side in any case where suit is brought and reducing deterrence by making suits costlier for plaintiff investors to bring. Relative to requiring plaintiffs to show scienter, however, these effects would be modest because the defense would be difficult to maintain given the likelihood that the top officers would find out the information in the ordinary course of business.

C. The Rationale for Underwriter Liability

Even if an issuer is subject to absolute strict liability and it is costless for a plaintiff investor to bring a suit for damages on any occasion where an issuer engaging in a securities offering violates the mandatory-disclosure rules, deterrence would not be fully effective. One reason is that the undisclosed information that makes the offering statement disclosures in violation of the rules often relates to the possibility of an event that ultimately bankrupts the issuer, particularly an issuer publicly offering truly new securities. Bankruptcy can render the issuer partially or totally judgment-proof. Another is that the

66. Absolute liability subject to a due-diligence defense is in fact essentially the liability scheme for issuers in connection with Regulation A+ offerings pursuant to Securities Act Section 3(b)(2)(D), which, in turn, imposes the liability scheme set out under Section 12(a)(2). *See* 15 U.S.C. § 77c(b)(2)(D) (2012).

67. *See infra* Part IV.D.

issuer's agents, including its top officials, may engage in a kind of "emphasis on the positive" or "keep the boss happy" groupthink. As a result, even where relevant information is available to the top managers, it is downplayed. Hence the top managers become blinded to its importance and thus to the liability that would flow from its nondisclosure.

The rationale for adding underwriter liability to the scheme starts with the fact again that a disclosure violation can allow a public offering to proceed that otherwise would not, with the resulting misallocation of society's scarce savings.[68] As developed below, underwriter liability can help make up for these two sources of shortfall in the ability of issuer liability to deter such violations. In the stages leading up to a public offering, the underwriter is in a much better position to discover information related to potential disclosure violations by an issuer than are the prospective investors. The prospect that the underwriter will face liability for investor losses if it is aware of such undisclosed information will likely lead the underwriter to force the issuer to disclose it. If the issuer does not comply, the underwriter is likely to refuse to proceed with the offering. The expected cost of participating in the offering without the disclosure is just too high. Just as with issuer liability, the conclusion that the parties would not, on their own, negotiate the socially justified higher level of disclosure called for by the mandatory rules also implies that they cannot be counted on to negotiate socially cost-effective terms with regard to compliance-inducing underwriter liability.[69]

1. *Issuer Bankruptcy.* Assume, as happens not infrequently, that information exists suggesting the possibility of an event that, if it occurs, will bankrupt the issuer. Assume also that the increased likelihood of bankruptcy suggested by the information is sufficiently great that the information would be considered material and its nondisclosure would violate the disclosure regime's rules. Not disclosing the information would inflate the price at which the securities could be sold. Both the issuer's top management and the underwriter know the information, and each will act rationally in the face of whatever liability regime it faces.

With these assumptions in mind, consider a regime where the underwriter is potentially liable as well as the issuer. Relative to the

68. *See supra* Part I.D.

69. *See supra* Part IV.A.

issuer, the underwriter has less to gain, and, if liable, more to lose on an expected basis, from the nondisclosure of this information. In terms of gain, the underwriter's percentage commission is just a small fraction of the sales price of the offering and thus it gets only a small fraction of the violation's inflation in price; all the rest of the sales-price inflation goes to the issuer.[70] In terms of loss, at the time that the issuer officials are deciding whether to make the offering without disclosing the information, they know that if the event ultimately does not occur, the issuer will enjoy the upside of a more favorable price. If the event ultimately does occur, the issuer will be judgment-proof and thus will not be able to pay investors the damages assessed against it in litigation.

On an expected basis, the issuer may thus rationally find it worthwhile to make the offering without disclosing the information. The calculation of the underwriter is much different. Its upside, if the event does not occur, is only the small fraction of the inflation in the offering price. If the event does occur and the issuer becomes judgment-proof, the underwriter will be liable for the full amount. The underwriter is much more likely to be good for the judgment and thus required to pay. This is because the underwriter is likely to start off well capitalized and subject to a more diversified set of risks. So, its net worth usually will be at most only mildly affected by the event that bankrupted the issuer. In sum, even based just on the calculations considered so far and assuming that the underwriter does in fact know the information, making the underwriter liable in addition to the issuer can significantly add to the likelihood that the information will be disclosed.

2. *Issuer Irrationality.* Now consider an additional source of issuer-liability-deterrence shortfall: the possibility that the issuer's top officials, despite having the relevant information available to them, do not rationally perceive the violations imbedded in their planned disclosures and the future liabilities that these violations would engender. As a consequence, with only issuer liability, these officials might proceed with the offering without disclosure even though this is not the rational share-value-maximizing decision. Agents of the underwriter are from an organization separate from that of the issuer.

70. This is so even if compliance with the disclosure rules would make the offered securities look sufficiently less attractive that the offering would not proceed at all, in which case the underwriter would lose the small fraction of what the total offering amount would be sold for with the breach, whereas the issuer would lose the whole rest of the value of the deal to it.

This is important from a behavioral and group-dynamics point of view because persons who are members of a single organization, including those near or at the top, are prone to engage in "emphasis on the positive" or "keep the boss happy" groupthink.[71] This is a danger when an issuer is going through the group decision process of deciding the disclosures to provide in connection with a securities offering. The underwriter's agents are outside the issuer organization and are less likely to be trapped by this tendency. Thus they are better able to appreciate the liability implications of available information. Also, the process of generating a registration statement involves dialogue among many different people from the underwriter's and issuer's organizations. Agents of the underwriter, because they are not part of the issuer's hierarchy, will feel freer to pose hard questions to the issuer's top officials than do more junior individuals within the issuer's own organization.[72]

D. The Choice of Liability Regime for Underwriters

Again there is the question of what the nature of this underwriter liability scheme should be: scienter-based liability, strict absolute liability, or absolute liability with a due-diligence defense.

1. *Scienter-Based Liability Versus Strict Liability With or Without a Due-Diligence Defense.* As with issuer liability, scienter-based underwriter liability has distinct disadvantages relative to the other two possible regimes. First, scienter-based underwriter liability less effectively counteracts the shortfalls in the deterrence value of issuer liability. This is because, under such a scheme, the underwriter is less likely to face liability in situations where issuer-liability deterrence has failed. If a plaintiff investor does bring suit, the underwriter will escape liability unless the plaintiff can affirmatively prove that the underwriter

71. *See, e.g.*, IRVING L. JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES 197–98 (1972). Donald Langevoort, in his recent book, emphasizes the capacity of a firm to irrationally underestimate the negative future consequences of disclosure violations because of the tendency of people to engage in self-deception in situations of ambiguity, the tendency for overconfident people to make it to top managerial positions, and pressures at all levels to accentuate the positives that inevitably arise from the development of team cohesion. LANGEVOORT, *supra* note 44, at 28, 36, 40–41.

72. *See id.* at 88. The view that the underwriter can enhance compliance with the disclosure rules by playing a somewhat adverse, devil's advocate role vis-à-vis the issuer has deep roots in the jurisprudence of liability under Section 11 of the Securities Act. *See, e.g.*, Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581–82 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696–97 (S.D.N.Y. 1968).

was aware of the information the nondisclosure of which renders the issuer's offering materials in violation of the rules. Even if the underwriter did know the information, the plaintiff may not be able to prove this fact because of difficulties in obtaining the relevant evidence. Moreover, because the requirement adds to the cost of the plaintiff investor bringing suit, fewer suits will be brought. Second, under a scienter-based underwriter liability regime, an underwriter will not face liability if it in fact had not learned the information.

Beyond this, and most seriously, a scienter-based regime actually creates a disincentive for the underwriter to engage in due diligence in which, because of a concern with its reputation, it would otherwise have engaged. This is because in a scienter-based liability system, the underwriter cannot be liable for what it does not find out.

2. *Strict Liability With or Without a Due-Diligence Defense.* The foregoing discussion suggests that strict underwriter liability with or without a due-diligence defense is preferable to scienter-based underwriter liability. But which form of strict liability is preferable?

a. Assuming a Costless, Error-Free Determination of the Due-Diligence Defense. If the underwriter is strictly liable and is allowed no due-diligence defense, rationally it will perform due diligence up to the point at which, at the margin, the cost of expending additional effort is greater than the resulting decrease in expected damages as the result of an investor suit. As we have seen, the measure of these damages is, roughly, the inflation in the offering's price as a result of the offering document's misstatement or omission.[73] In other words, the underwriter will keep looking for possible problems until the point where the cost of further search is greater than its assessment of (x) the probability, based on what it has found so far, of finding additional, as yet undetected, problems, multiplied by (y) the amount by which the disclosure violations associated with these additional possible problems would inflate the price of the offering. The underwriter would be faced with what information economists refer to as an optimal-stopping problem.[74]

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73. *See supra* Part IV.B.

74. The optimal stopping problem concerns when it is the optimal time to take a certain action, in this case to stop looking for possible problems. For an application of optimal stopping in a somewhat different legal context, see Alan Schwartz, *Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship*, 14 J. LEGAL STUD. 689, 697–700 (1985).

What would be the effect of providing such an underwriter with a defense if it can show that it engaged in a reasonable due-diligence effort? This is the regime under the Securities Act for registered public offerings, where Section 11(a) imposes absolute liability on the underwriter and Section 11(b) modifies this by allowing the underwriter the affirmative defense that it engaged in a reasonable investigation and reasonably believed there was no disclosure violation.

The first point to note is that a rational underwriter will expend the same level of effort with or without the defense if the determination of whether the defense was met could be made through costless and perfectly accurate adjudication. To see this, first consider the position of an underwriter where the defense is available. Because the standard for the investigation is reasonableness, the underwriter is entitled to be free of liability if it expends effort in due diligence at least up to the point that, at the margin, additional effort will cost the underwriter more than the expected improvement in the wealth position of investors through the disclosure of additional problems that would inflate the price that investors need to pay if not disclosed.[75] It would be irrational for an underwriter to expend less effort than what meets the reasonableness standard. If it does expend less effort, the defense will not be available and so it will be absolutely liable and face expected costs of liability—damages equal to the amount by which the nondisclosure of the undetected problem inflates price—that are greater than the costs of the additional effort that would detect the problem. On the other side, it would also be irrational for the underwriter to expend, at least for fear-of-liability reasons, more effort than what meets the reasonableness standard because doing so is not necessary to avoid liability.

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75. Section 11(c) of the Securities Act, for example, provides that "the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c) (2012). This implies some kind of cost-benefit analysis: a prudent man would not, at the margin, spend more on investigation than the expected value of the poor returns that would be avoided by not purchasing assets the inferiority of which would only be revealed by more intense investigation. This point is affirmed by the holding in *In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489, 1496–1500 (N.D. Cal. 1992), *aff'd in part*, *rev'd in part*, 38 F.3d 1078 (9th Cir. 1994), *amended by* 50 F.3d 615 (9th Cir. 1995), which granted summary judgment to underwriters with respect to certain misstatements, the falsity of which could have been ascertained with more intensive due diligence, but where the court found no issue of fact that the underwriter did not make reasonable efforts. Similarly, the court in *BarChris* stated in dicta that accountants need not be held to a standard higher than that of their profession. *BarChris*, 283 F. Supp. at 703.

Now consider the position of the underwriter if the defense were not available. It would again be irrational to do less than the standard for exactly the same reason: it will be absolutely liable and the costs of a more thorough investigation are less than the amount of expected liability that the more thorough investigation would avoid. And it would be irrational to do more than the standard because, although the underwriter now will be liable for undetected problems even if its investigation meets the reasonableness standard, the expected costs of liability from these more hidden problems are less than the costs of the additional effort needed to detect them.

In sum, under the assumption that the determination of the due-diligence defense is costless and error-free, the underwriter will expend the same level of effort in due diligence with or without a due-diligence defense. Thus, in the choice as to whether or not to permit underwriters a due-diligence defense, the fear that, absent the defense, underwriters will expend too much effort searching for problems that are too insignificant or too unlikely to be worth the trouble would not be a good reason for providing the defense.[76]

b. Taking Account of the Cost of Determining the Due-Diligence Defense and the Chance of Judicial Error. A significant consideration against providing the due-diligence defense to underwriters relates to the real-world facts that there are costs that come from enlarging the range of facts that will be in contention in litigation and that there is a possibility of judicial error in their determination. Again, enlarging the range of facts in contention means that each side will consume more of society's scarce resources in battle. Also, because a plaintiff investor's cost of bringing suit is higher, the underwriter is less likely to face suit even when it did fail to perform a reasonable investigation. With the resulting reduction in the underwriter's expected damages payments if it fails to perform a reasonable investigation, the underwriter will not have as strong incentives to act in the ways that counteract the shortfalls in the deterrence value of issuer liability.

The possibility of legal error further weakens these incentives. The underwriter, when deciding how much due-diligence effort to make, knows that a court may find that its investigation was sufficient to meet

76. The foregoing discussion shows that the underwriter will engage in the optimal amount of search with absolute strict liability. It will engage in the same amount of diligence under a strict-liability regime with a due-diligence defense if the determination of whether the defense is met can be costlessly adjudicated free of error. If this determination is not costless or error-free, the availability of the defense will, as discussed below, reduce the amount of diligence.

the defense when in fact it was not. If this happens, the underwriter will not have to pay damages. Relative to a strict absolute liability regime, the possibility of this error reduces the expected cost of failing to conduct an adequate investigation. Thus, it reduces the incentives to conduct such an investigation. Of course, the court also might err in the other way and find that the investigation was not sufficient when in fact it was. That possibility, however, simply puts the issuer in the same position as if it did not have the defense.

c. Absolute Strict Liability Ties a Due-Diligence and an Insurance Function. There is also a significant consideration in favor of providing the due-diligence defense, however. Without the defense, some firms will be inefficiently discouraged from being in the underwriting business because providing underwriting services would require tying together two rather different businesses. One is the investigation of issuers and merchandising of securities—traditional functions of investment banks. The other business is insuring investors against risks that exist but are not worth searching out to eliminate—what we might call the "pure insurance" business. Even though, in a competitive equilibrium, any potential underwriter would be able to pass on to investors the expected payouts for this pure insurance, some such potential underwriters, although well suited to provide investigation and merchandising services, are not well suited to perform the pure insurance business. Being well suited to provide the pure insurance business would require quite different firm qualities: some combination of substantial capital on hand to cover years where actual aggregate payouts exceed the level of expected payouts and a large scale of operations in terms of the number of offerings underwritten so that, through the law of large numbers, its actual aggregate annual payouts would be very unlikely to deviate sharply from the expected level of payouts.

d. Conclusion. It is hard to know for certain whether, for offerings by ordinary operating corporate issuers, the favorable or the unfavorable considerations with respect to the defense predominate. It should be noted, however, that the concerns about costs and legal error associated with providing the defense are softened by the nature of the facts in contention. The primary issue before a court will not be whether the underwriter knew the information that rendered the issuer's offering disclosures in violation of the rules but what the underwriter did to conduct its investigation. Such conduct is relatively

easily ascertainable and objectively measurable, which reduces both the cost of having them in contention and the likelihood of judicial error.

V. REFORMS AIMED AT SMALLER CORPORATE ISSUERS

Parts I–IV of this Article go back to first principles to answer a number of questions. First, should the government provide a system of disclosure regulation at the time of the offering of truly new securities and thereafter, and if so, under what circumstances? Second, if there is such a regulatory regime, should it be mandatory or should an issuer be able to choose whether to be subject to it? Third, which participants in the offering, if any, should be held civilly liable for damages if, at the time of the offering, there were misstatements or omissions of required disclosures? Fourth, for any participant that is liable, what should the standard be? This final Part applies what has been learned to evaluate the contemporary legal treatment of public offerings of truly new securities in the United States.

Traditionally, essentially all offerings of truly new securities that would be considered "public" as the term is used here[77] were subject to the disclosure-oriented registration process under Section 5 of the Securities Act. Exemptions from this registration process were available for certain offerings based on such factors as the limited number of offerees; the sophistication, wealth, and prior knowledge about the issuer held by the offerees; and the amount being raised. But in general the exempted offerings would not be considered public in this sense.

Compliance with this regulatory scheme is expensive and involves fixed-cost elements that mean that there are considerable economies of scale in terms of offering size. Typically, the smaller the firm, the smaller the scale of the proposed project that it seeks to fund. So, when a smaller firm contemplates a public offering of truly new securities to fund such a project, the size of the offering that it can plausibly justify is likely to be smaller. The smaller the size of the offering, the greater the cost per dollar raised for compliance with the traditional regulatory structure. In sum, the smaller the size of the firm, the less likely it is that a public offering of truly new securities will be an economically sensible way of raising capital. Concern that most firms below a certain size cannot practically use a public offering of truly new securities as a

77. *See supra* Introduction.

means of raising capital has led in recent years to the development of alternative, more lenient regimes for certain kinds of public offerings, culminating with Rule 506(c) and Regulation A+ and the crowdfunding rules.

As will be developed below, aspects of these reforms seem ill-advised. The main features of the Section 5 registration process adhere closely to what is called for by the first-principles analysis in Parts I–IV, whereas certain important features of these alternative regimes do not.

A. The Section 5 Registration Process

The traditional Section 5 registration process, combined with its civil-liability provisions under Section 11, has four core components. First, rather than relying on signaling backed by scienter-based liability for material misstatements, the regime requires issuers to affirmatively answer a set of questions. Second, this regime is mandatorily applied to all securities offerings not explicitly exempted. Third, the issuer, by conducting a registered IPO, automatically becomes subject to the Exchange Act's mandatory ongoing periodic-disclosure regime as well. Fourth, in the event that the registration statement contains a disclosure violation,[78] the issuer is faced with strict absolute liability, and the underwriter is faced with absolute liability subject to an affirmative due-diligence defense.[79] These core elements thus largely correspond with what the analysis in Parts I–IV suggest would be optimal.

B. Rule 506(c) Offerings

Rule 506(c),[80] promulgated by the SEC in 2013[81] pursuant to a mandate under the JOBS Act enacted in 2012,[82] allows any issuer to

78. Securities Act Section 11(a) provides, without qualification, that each person signing the registration statement is liable if it contains a material misstatement or omission. The issuer is one of the required signatories. 15 U.S.C. § 77k(a).

79. Securities Act Section 11(a) provides, without qualification, that an offering's underwriters are liable if the registration statement contains a material misstatement or omission, but Section 11(b) provides that notwithstanding 11(a), an underwriter will not be liable if it can sustain a due-diligence defense. *Id.* § 77k(b).

80. 17 C.F.R. § 230.506 (2015).

81. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771 (July 24, 2013) (codified at 17 C.F.R. pts. 230, 239, 242).

82. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 302(a), 126 Stat. 206, 315 (2012) (codified at 15 U.S.C. § 77d).

make a public offering of truly new securities without going through the traditional Securities Act registration process. Most commentators have not fully grasped how potentially revolutionary this exemption is.

1. *Required Structure of the Offering.* The exemption from registration has remarkably few restrictions and a Rule 506(c) offering is less burdened by regulation than a traditional one in a number of ways. The issuer may engage in a general solicitation to raise an unlimited amount of money from an unlimited number of investors as long as it takes reasonable steps to verify that each actual purchaser is an "accredited investor." In general, an individual qualifies as an accredited investor if she has an income of at least $200,000 or net assets (not including her primary residence) of at least $1 million.[83] Because most of the individually held stock in the country is held by such persons, this restriction does not cut out a substantial amount of potential demand that would have been present with a registered offering.[84] Rule 506(c) has no affirmative disclosure obligations associated with it, and an offering under the rule does not trigger an obligation to provide ongoing periodic disclosure. The issuer is subject only to scienter-based liability under Rule 10b-5 for any material misstatements it makes in connection with the offering. Because the exemption is only available to issuers,[85] the offering cannot be made pursuant to a firm-commitment underwriting, whereby an investment bank buys the securities from the issuer and resells them in the offering to the public. The absence of a restriction on general solicitation means, however, that a broker can be used to solicit purchasers. The broker would also be subject only to scienter-based Rule 10b-5 liability and only for any material misstatement that the broker itself makes.

2. *Subsequent Trading of Shares.* The only way that a Rule 506(c) offering is more burdened by regulation than a traditional registered offering is that the offered securities are "restricted." This means that purchasers in the offering can only resell their shares pursuant to Securities Act registration or an exemption therefrom.[86] Here too,

83. 17 C.F.R. § 230.501(a).

84. *See* Fatih Guvenen, *Do Stockholders Share Risk More Effectively than Nonstockholders?*, 89 REV. ECON. & STAT. 275, 281 (2007).

85. 17 C.F.R. § 230.506.

86. For a discussion of rules and statutory provisions that lead to this result, see Bradley Berman & Steven Bleiberg, *Restricted Securities vs. Control Securities: What Are the Differences?*, INSIGHTS: CORP. & SEC. L. ADVISOR, Dec. 2013, at 1–7.

however, recent reforms take much of the sting out of this disadvantage and offer the prospect that the securities will be relatively freely tradable soon after the offering.

a. Rule 144. One route to relatively free secondary-market trading is via Rule 144,[87] which in recent years has been subject to easing amendments several times. As a result, restricted shares of an issuer not providing Exchange Act periodic disclosures become unrestricted after being held for a period of only one year in the hands of one or more investors unaffiliated with the issuer.[88] As unrestricted shares, they can be traded freely between any two persons. Liquidity will be maximized if the issuer chooses to list its stock on the New York Stock Exchange (NYSE) or NASDAQ, but doing so will, under Sections 12 and 13 of the Exchange Act, trigger imposition of the Act's ongoing periodic-disclosure requirements that is otherwise avoided by doing a Rule 506(c) offering rather than the traditional registered offering.

Alternatively, the stock could start trading on an electronic trading venue that is not registered as an exchange under the Exchange Act, such as OTCQX or OTCB. Unlike the NYSE or NASDAQ, trading on this kind of venue would not by itself trigger imposition of the Exchange Act's periodic-disclosure requirements. The other periodic-disclosure-requirement trigger, Exchange Act 12(g),[89] is based on the number of shareholders of record, a number that was increased in 2012 by the JOBS Act from 500 to 2000.[90] A smaller issuer utilizing a Rule 506(c) offering would be unlikely to trigger the requirements this way for many years, if ever, after the offering. This is because the typical shareholder only has a beneficial ownership of her shares, with record ownership being held by a nominee of her broker, who is the same record owner for many of the broker's other customers who beneficially own the issuer's stock.[91]

87. 17 C.F.R. § 230.144.

88. *Id.* § 230.144(d)(1)(ii).

89. *Id.* § 240.12g-2.

90. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 326 (2012) (codified as amended at 15 U.S.C. § 78*l*(g)(1)(a) (2012)).

91. *See* Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 358 (2004).

b. Securities Act Section 4(a)(7). A second route to relatively free secondary-market trading is via Securities Act Section 4(a)(7),[92] a new registration exemption enacted under the FAST Act in late 2015.[93] Under this exemption, as a general matter, a purchaser in a 506(c) offering would be able to resell her shares without any waiting period, as can each subsequent holder, as long as, in each case, the subsequent purchaser is an accredited investor and the seller does not engage in a general solicitation. This would appear to allow shares acquired in a 506(c) offering to be freely traded immediately after the offering on electronic trading venues such as SharesPost and the NASDAQ Private Market, venues that restrict themselves only to orders placed by accredited investors.

3. *Evaluation.* Recall that the essential problem with the public offering of truly new securities is the adverse selection that arises from a situation of severe information asymmetry: potential investors know much less about the issuer and the persons associated with it than they do in an offering by an established issuer, and there is no price for the same security established in an efficient secondary market to guide them. Without solutions to this information-asymmetry problem, the market will unravel. A Rule 506(c) offering relies almost entirely on the market-based solutions to this problem discussed in Part II, with little regulatory intervention to ameliorate any of the shortcomings of these solutions.

a. Signaling. As we have seen, signaling can fail to solve the adverse-selection problem for a number of reasons: issuer claims of high quality are not fully credible, issuers have reasons not to disclose positive information and so silence does not necessarily mean that the issuer is low quality, silence by a low-quality issuer does not reveal how much worse it is compared to the issuer that is affirmatively disclosing facts demonstrating its high quality, and many retail investors are not attentive to the absence of disclosure on each of a myriad of different topics nor sophisticated in the inferences that they draw.

The traditional registration process ameliorates all of these problems and the Rule 506(c) offering process ameliorates none of them. The traditional procedure increases the expected cost of making

92. 15 U.S.C. § 77d(a)(7) (Supp. III 2015).

93. Fixing America's Surface Transportation (FAST) Act, Pub. L. No. 114-94, § 76001, 129 Stat. 1312, 1787–89 (2015) (codified as amended at 15 U.S.C. § 77d (Supp. III 2015)).

a misstatement for an issuer by substituting absolute strict liability for the much harder-to-prove scienter-based liability. Scienter-based liability, as discussed in Part IV, less effectively deters misstatements and omissions of mandated information because it makes a claim harder to bring, consumes more social resources when litigation does occur, and encourages firms to inefficiently distort their internal information systems to keep top officials ignorant of material information that, if disclosed, would lower share price. By mandating disclosure concerning many matters, the traditional registration process clarifies the ambiguity that silence has under the 506(c) procedure with regard to these matters and makes clear the extent of the differences between the superior and inferior firms. Required disclosure also makes these many matters more salient to retail investors and their advisors than would be the case if they had to sort out which firms made disclosures and which remained silent.

b. Intermediation. The Rule 506(c) offering process, unlike the traditional registration process, does not allow for a firm-commitment underwriting. This forecloses an investment bank from lending its reputation to the offering by purchasing the securities and reselling them to the public. The 506(c) procedure, because it permits general solicitation,[94] does allow the involvement of brokers, who also can lend their reputation to the offering. This is likely to be less effective at combating adverse selection than a firm-commitment underwriting, however. This is because a broker has much less at stake with respect to each deal in which it is involved, so there is less value in achieving, and thereafter protecting, a reputation for only marketing-quality, truthful issuers. Also, the broker is liable only for its own misstatements, not the issuer's, and claimants must prove the broker had scienter. In contrast, the underwriter is potentially liable for the issuer's misstatements under the standard of strict liability subject to a due-diligence defense, which encourages the bank to investigate the issuer and insist on disclosure of what it finds.

c. Third-Party Certification. Third-party certification by accountants and other experts is as available to an issuer under the 506(c) process as under the traditional registration process. The traditional registration process creates greater incentives than the 506(c) process for the certifier to be truthful and fully informed,

94. 17 C.F.R. § 230.506.

however, because it backs up the certifier's potentially somewhat tenuous concerns about reputation in the statements it makes with strict liability subject to a due-diligence defense, not just Rule 10b-5 scienter-based liability.

d. Buyer Search. There is little reason to believe that the 506(c) offering process does a better job than the traditional registration process at ameliorating the shortcomings of buyer search as a way of combating adverse selection. It may in fact do a worse job. Although the 506(c) process confines purchasers to accredited investors, a large portion of all retail purchasers in a traditional registered offering would fall into this category anyway. So the 506(c) restriction does little to increase the percentage of buyers that would be sophisticated enough to do effective diligence on the quality of an issuer. The lack of restriction on the number of investors means that the issuer has no reason, just to fit the requirements of the exemption, to try to raise the total funds it needs from a smaller number of investors who each invest more and thereby to create greater economies of scale for investor diligence. Most importantly, the Rule 506(c) offering process, unlike the traditional registration process, does not require that all investors be offered the securities at the same price.[95] This means that even if a retail investor knows that some large sophisticated institutional investors are purchasing shares in the offering, she cannot rule out the possibility that the offering appears to them to be a good deal only because they are being offered a lower price than she is being offered.[96]

e. Conclusion. Congress, though perhaps not fully aware, was starting a brave experiment in mandating that the SEC adopt Rule 506(c). The experiment may prove that the traditional regulatory approach to the public offering of truly new securities has been an unnecessary burden. The analysis in Parts I–IV suggests, however, that there is a good chance that it will end poorly.

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95. Rule 506(c) offerings permit issuers to offer varying sale prices to different purchasers for the same securities, depending on factors such as quantity purchased and the desirability of the prospective purchaser as a shareholder. *See* 17 C.F.R. § 230.506(c).

96. This problem could be cured by a contractual provision between the issuer and purchasers providing that they are all paying the same price. It is not clear, however, that retail investors have sufficient sophistication for this to become a standard term. Retail investor sophistication would need to be great enough that satisfying the resulting market demand for such a term is more profitable than engaging in price discrimination among investors.

The most innocuous scenario by which it ends poorly is that the shortcomings catalogued above are indeed important, but these shortcomings are recognized by the market from the outset. Under this scenario, the Rule 506(c) procedure simply generates little interest by issuers seeking to make public offerings of truly new securities.[97]

A more harmful scenario by which the experiment ends poorly would be for these shortcomings to be indeed important, but the shortcomings are not at first recognized by the market. Under this scenario, a substantial number of 506(c) offerings funding negative NPV projects go forward, offerings that would not have succeeded if the issuer had been required to use the traditional registration process. Thus the market for 506(c) offerings does not unravel immediately. Rather, the unraveling does not occur until an economic downturn or the equivalent of the 2001 bursting of the tech bubble. This turn of events will reveal the substantial number of offerings that, unknown to their investors, were low quality from the beginning.

A final way for the experiment to end poorly would be for these shortcomings to turn out to be less severe than I suggest and for a whole alternative system to develop for firms to go public and be publicly traded without being subject to either mandatory offering or periodic disclosure. Because of this alternative system's lower private costs to issuers, it would gradually hollow out the traditional system where issuers are subject to mandatory offering and periodic disclosure. But, as discussed in Part IV, the private costs of disclosure are greater than its social costs and the private benefits less than its social benefits. So the level of disclosure associated with this increasingly dominant alternative system would be below what is socially optimal.

C. Regulation A+

The JOBS Act also amended the Securities Act to add to its provisions relating to exempt securities Sections 3(b)(2) through 3(b)(5).[98] Under these amendments, the SEC was directed to establish what is known as Regulation A+, an alternative system to the traditional registration process that would be available for a public

97. Figures comparing the amount of funds raised during the first two years of the availability of this kind of 506(c) by such a method versus by IPOs can be found in SCOTT BAUGUESS, RACHITA GULLAPALLI & VLADIMIR IVANOV, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF THE MARKET FOR UNREGISTERED SECURITIES OFFERINGS, 2009–2014, at 2, 11–15 (2015).

98. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012) (codified as amended at 15 U.S.C. § 77c(b) (2012)).

offering of truly new securities as long as the offering, combined with any subsequent offering within twelve months, does not in total exceed $50 million.[99] Regulation A+ in many ways resembles the traditional registration process but is simpler and less burdensome on issuers. The SEC adopted final A+ Rules in the spring of 2015.

1. *Required Structure of the Offering.* Under Regulation A+, the issuer may engage in a general solicitation to raise money from an unlimited number of investors. Unlike a 506(c) offering, a firm-commitment underwriting may be used in connection with the offering. Like with a traditional registered offering, and unlike a 506(c) offering, there is no need for the investors to be accredited. There is mandatory affirmative disclosure at the time of the offering, but less is asked than in a traditional registered offering. There is also a periodic-disclosure obligation but again it is less burdensome than standard Exchange Act periodic reporting. The standard of liability imposed on the issuer for misstatements made in connection with the offering is strict liability subject to a due-diligence defense. Underwriters and brokers are subject to liability under the same standard as well.

2. *Subsequent Trading of Shares.* Shares purchased in a Regulation A+ offering are unrestricted, which means they can be traded freely between any two persons as soon as they are purchased in the offering, the same situation that prevails with a 506(a) offering because of Rule 144 but a year faster. Thus again the issuer can maximize liquidity by listing its stock on the NYSE or NASDAQ if it is willing to have Exchange Act periodic-disclosure obligations imposed upon it. Alternatively, it can have its shares trade on less liquid OTCQX or OTCB venues and would only need to provide the less burdensome level of periodic disclosure required by Regulation A+.

3. *Evaluation.* From the foregoing, we can see that a Regulation A+ offering differs from a traditional registered offering in two important ways. One is that the issuer, though strictly liable, has a due-diligence defense.[100] The other is that less is asked of the issuer in the

99. JOBS Act § 401, 15 U.S.C. § 77c(b)(2).

100. Regulation A+ provides for Securities Act Section 12(a)(2) liability and allows for a due-diligence defense pursuant to 15 U.S.C. § 77k. *See* 17 C.F.R. §§ 200, 230, 232, 239, 240, 249, 260.

form of mandatory disclosure both at the time of the offering and periodically thereafter.[101]

a. Lower Liability Standard. The analysis in Part IV suggests that there is little justification for allowing an issuer a due-diligence defense just because the issuer is smaller or is raising less than $50 million. Regardless of these factors, the misstatement or omission of required information would inflate the price of the security above its value. Allowing the issuer a due-diligence defense, although not nearly as serious a problem as requiring the claimant to show scienter, lessens deterrence by making it harder to succeed against an issuer that has made a misstatement or omitted mandated information. Moreover, the suits that are brought consume more social resources than in an absolute strict-liability regime because more issues are at play. The fact that the issuer is smaller or is raising less than $50 million is really irrelevant and in no way reduces the force of these observations.

b. Less Required Disclosure. Whether less disclosure should be asked of an issuer if it is smaller or is raising less than $50 million is a more complicated question. One argument for asking less is that the most persuasive argument in the first place for making an affirmative-disclosure regime mandatory rather than voluntary—that the social costs of an issuer's disclosure are less than its private costs and the social benefits greater than its private benefits—is less compelling in the case of a smaller firm making a smaller offering.[102] The simple idea here is that the actions of such a firm have less impact on the rest of the world and so the deviation between its social and private costs and benefits is smaller. Less should be required of such a firm above what would be required by the regime that the issuer would voluntarily choose based on its private calculations of cost and benefit. Consequently, the mandatory regime should require less of it relative to what is required of a larger firm making a larger offering. It is important to note, though, that this argument has no force in terms of the minimum level of disclosure needed to avoid adverse selection.

The other rationale for requiring less disclosure from a smaller firm making a smaller offering is that the offering of such a firm poses offerees with a less complicated financial proposition and so less

101. The lesser ongoing reporting requirements are provided by 17 C.F.R. § 240.15c2-11. *See id.* §§ 200, 230, 232, 239, 240, 249, 260.

102. *See supra* Part III.C.

information is needed. In essence, this is an argument that the smaller firm making a smaller offering is typically less complicated and so a set of questions that is appropriate for an adequate understanding of a more complicated firm is overkill for a simpler, smaller firm. Whether the current set of questions in connection with the traditional registered offering is in fact tilted toward what needs to be known about a more complicated firm is an open question, however. Most of the questions concern matters about which an investor would want information whether the firm was simple or complicated. More complicated firms just need to give longer answers.

D. Crowdfunding

The JOBS Act also amended the Securities Act to create a new Section 4(a)(6) exemption from Section 5 registration for "crowdfunded" offerings.[103] The SEC adopted rules for this exemption effective in the spring of 2016.[104] The idea is that capital is raised for a project through the pooling of numerous very small share purchases. Investors become aware of the offer from the website of a broker-dealer or a registered funding portal. An issuer can only raise up to $1 million in this fashion in any twelve-month period,[105] and so these are offerings that could not possibly be economically feasible as traditional registered offerings. Individual purchasers are limited in the amount they can invest, with investors with incomes or assets of less than $100,000 generally limited to 5 percent of their income and with better-off investors generally limited to 10 percent of their income.[106] There is required disclosure at the time of the offering, but it is considerably less than what is required under a traditional registered offering or even a Regulation A+ offering.[107] A crowdfunding offering does not trigger an obligation to provide Exchange Act periodic disclosure until the firm reaches $25 million in assets.[108] No general solicitation is allowed beyond the information available on the website posting the offering.[109] The exemption is only for issuers and so the offering cannot be pursued

103. JOBS Act § 302, 15 U.S.C. § 77d(6) (2012).

104. Crowdfunding, 80 Fed. Reg. 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274).

105. 15 U.S.C. § 77d(6)(A).

106. *Id.* § 77d(6)(B)(i)–(ii).

107. *See id.* § 77d-1(b) (specifying disclosure requirements for issuers involved in small, crowdfunded transactions).

108. 17 C.F.R. 240.12g-6 (2015).

109. *Id.*

via a firm-commitment underwriting.[110] The issuer is strictly liable with a due-diligence defense.

The preceding evaluations of the different components of the 506(c) offering process and Regulation A+ offering process largely cover the components of the crowdfunding offering process one way or the other. Again, there appears to be no justification for providing the issuer with a due-diligence defense. The low level of affirmative disclosure, especially when combined with sharp limits on individual investments, raises serious concerns that adverse selection will cause the market for these offerings to unravel sooner or later, notwithstanding the idea that, given "wisdom of crowds," some worthwhile investment projects will get funding that would not have been able to receive funding from traditional non-public-offering sources.[111]

One way of looking at crowdfunding offerings is to note that most states provide legalized space for certain kinds of gambling notwithstanding the fact that the odds are always against the gamblers. Given the existence of a demand for opportunities to gamble, why not channel it into an activity that at least might occasionally fund a worthwhile project that would not otherwise have received funding, especially where income- and wealth-related caps protect the gamblers from damaging themselves too much when the gamble does not work out? Indeed, it is possible that if investors approach crowdfunding offers the same way that gamblers approach a casino or a race track, the market will not unravel despite experience demonstrating over time that the average offering has a low, or even negative, expected return.

CONCLUSION

Absent regulation, the determination of which public offerings of truly new securities go forward and succeed at raising funds, and which do not, is determined by tort law and the market-determined terms of contracts into which offering participants enter. This Article has gone back to first principles to answer whether, and, if so, under what circumstances, government regulation should be added to the mix. This

110. *Id.*

111. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 114 (expressing optimism that the "wisdom of crowds" aspect of internet solicitation will substantially mitigate the adverse-selection problems associated with a low-disclosure offering to ordinary investors); Ibrahim, *supra* note 41, at 596–98 (same).

regulation can relate to what the issuer should disclose at the time of the offering and thereafter. It can relate as well to the circumstances under which various offering participants should be held liable for damages if, at the time of the offering, there were misstatements or omissions of required disclosures.

These questions are live issues because numerous reforms have been made in recent years to lessen the burdens of regulation on smaller issuers making small offerings. The rationale for lessening the burden on smaller issuers is that the cost of the traditional registration process has scale economies associated with it that make offerings by them too expensive to be worth undertaking. This Article expresses skepticism about many of these reforms. Specifically, it suggests that these reforms ignore the fact that the core components of the traditional public-offering registration process play an essential role in countering the adverse-selection problem that inevitably accompanies a public offering of truly new securities. The analysis here advises against structural changes contained in some or all of these reforms, such as eliminating mandatory disclosure altogether, imposing on issuers a lower standard than strict absolute liability, and eliminating the possibility of underwriter intermediation. A more promising approach would be to review the questions that must be answered under the traditional registration process. Ones that add more cost to the process for smaller issuers than they reduce adverse selection should be eliminated. But such regulatory downsizing can only be taken so far. A certain minimum range of mandated questions will need to be kept if we wish to sustain a market for most offerings of truly new securities, at least outside of the small bets at stake in crowdfunding. Even if it is possible to scale back the range of questions in the way described here, the hard reality is that, for firms below a certain size, the cost of what is still required will make a public offering and public trading of their shares an impractical form of finance.

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