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Civil Liability and Mandatory Disclosure

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Abstract

This paper explores the appropriate system of civil liability for mandatory securities disclosure violations by established, publicly traded issuers. The U.S. system's design has become outmoded as the underlying mandatory disclosure regime that has moved from an emphasis on disclosure at the time that an issuer makes a public offering, to an emphasis on the issuer's ongoing periodic disclosures. An efficiency analysis shows that, unlike U.S. law today, the relevant actors should have equally great civil liability incentives to comply with the disclosure rules whether or not the issuer is offering securities at the time.

An issuer not making a public offering of securities should have no liability because the compensatory justification is weak. Deterrence will be achieved instead by imposing liability on other actors. An issuer's annual filings should be signed by an external certifier - an investment bank or other well capitalized entity with financial expertise. If the filing contains a material misstatement and the certifier fails to do due diligence, the certifier would face measured liability. Officers and directors would be subject to similar liability. Damages would be payable to the issuer. When an issuer is making a public offering, it would be liable to investors for its disclosure violations as an antidote to what otherwise would be an extra incentive not to comply.

This design would address two major complaints concerning the existing U.S. civil liability system: underwriter Section 11 liability for a lack of due diligence concerning disclosures that in modern offerings underwriters have no realistic ability to police, and litigation-expensive issuer class action fraud-on-market liability. The system suggested here would eliminate both sorts of liability. But unlike elimination reforms proposed by underwriters and issuers, it would retain deterrence by substituting in place of these liabilities more effective and efficient civil liability incentives for disclosure compliance.

Keywords: mandatory disclosure, securities law enforcement, securities litigation, securities class actions, fraud on the market suits

JEL Classifications: K22, K41, K42

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Corporate transparency has been increasingly recognized as a key element in financial market development and in economic growth more generally. Mandatory disclosure regimes are intended to promote corporate transparency by requiring issuers to disclose information about themselves that they might otherwise not be inclined to release. A system that permits civil damages actions against persons associated with a mandatory disclosure violation can create incentives to encourage compliance. This Article addresses what the optimal design of such a system of civil damages would be in the case of established issuers trading in major securities markets. This "start from scratch" inquiry is timely both in the United States and abroad. In the United States, civil liability is an established tool to encourage compliance, but the existing system has come under intense strain. Abroad, interest in civil liability is just awakening and countries have the opportunity to write on a clean slate.

This paper seeks to answer five questions. Who should be civilly liable for damages when a disclosure violation occurs? According to what standard? For how much? To whom? And should it matter whether or not the issuer is selling securities at the time of the violation? A central thesis of the paper is that the answers to these questions should reflect the more modern understanding that the primary way that

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mandatory disclosure increases social welfare is by enhancing economic efficiency through better corporate governance and increased liquidity, not by providing investor protection. Approaching the design of the liability system from this perspective suggests a whole new set of insights on many of the traditional liability issues.

Part I establishes the need for a fundamental reevaluation of how to design a system of civil damages for mandatory disclosure violations. Parts II and III develop the argument that a mandatory disclosure regime should require a similar level of disclosure whether an issuer is offering securities or not. Accordingly, any accompanying system of civil liability should be designed to provide the relevant actors with equally strong incentives to comply under either circumstance. Part II analyzes the pathways through which increased disclosure improves corporate governance and enhances liquidity. This analysis shows that the social interest in the disclosures of established issuers trading in major markets is equally great whether or not the issuer is making a new offering of securities. Part III demonstrates the affirmative harm that results from imposing greater expected liability for mandatory disclosure violations on the relevant actors (other than the issuer) when an issuer is making a public offering than when it is not. This harm arises because of the resulting inefficient distortion in the issuer management's choice of sources of finance.

Part IV sets out my proposed optimal civil liability system. The proposal is constructed under the assumption that a country has decided it is socially desirable to have a mandatory disclosure regime with a system of civil liability to encourage compliance. Under my proposal, there would be no issuer liability for misstatements in periodic filings when the issuer is not offering securities. This means that in the United States, fraud-on-the-market suits for such violations would be eliminated. There would also be no underwriter liability for issuer misstatements at the time of a securities offering. In place of these two types of actions, issuers would be required to have their annual periodic filings certified by an investment bank or other well capitalized entity with substantial financial expertise that would be subject to measured liability if the certifying entity failed in its due diligence. Officers and directors would be subject to a similar liability scheme. There would be issuer liability for disclosure violations when the issuer publicly offers its securities, as an antidote for the extra motives to defy mandatory disclosure regulations at such a time.

Part V considers the proposed system in the context of other recent scholarly discussion on the subject. Part VI considers how the proposed scheme could be implemented in the United States. Part VII concludes.

I. THE NEED FOR A FUNDAMENTAL REEVALUATION OF CIVIL LIABILITY DESIGN

The moment is ripe for a fundamental reevaluation of how to design a system of civil liability for mandatory securities disclosure violations. In the United States, the existing system's increasing strain has led to a variety of calls for reform. Parochial interests spur many of the proponents and opponents of these reforms, as would be expected in a pluralistic democracy. To resolve their contending claims, a conceptual framework is needed that reflects the realities of contemporary markets and a modern understanding of corporate governance and financial economics. Countries abroad that are considering initiating civil liability systems for the first time need such a framework at least as much, given the value of getting the system's design correct from the start. For these countries, the existing U.S. system, given its problems, is no longer an obvious model to imitate.

A. The United States

The civil liability system in the United States was initially designed in the early 1930s with the enactment of the Securities Act of 1933 (the "Securities Act")[1] and the Securities Exchange Act of 1934 (the "Exchange Act").[2] Much has changed over the last 75 years. Capital markets have become much more liquid and better informed, developments that in turn have led to fundamental changes in corporate governance.[3] Understanding of financial economics has advanced

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[1] 15 U.S.C. §§77a — 77aa (2005) [hereinafter Exchange Act].

[2] 15 U.S.C. §§78a —78lll (2005) [hereinafter Securities Act].

[3] Jeffrey Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1469—71 (2007) (attributing the development of the modern U.S. corporation's orientation toward share value maximization and the prevalence of the independent director dominated monitoring board to an increase in the informedness of share prices

enormously: a field that was once an intellectual backwater is now a fertile source for Nobel prizes. The primary focus of the underlying disclosure regime for established issuers has shifted from new securities offerings to ongoing periodic reporting, largely as a result of Securities and Exchange Commission ("SEC") rulemaking.

In response to these changes, Congress, the SEC and the courts have made piecemeal adaptations to the 1930s designed civil liability system. What we have today, however, falls far short of what a modern understanding suggests is the civil liability system that would most effectively and efficiently support our current system of mandatory disclosure.

1. The Traditional Approach

The primary focus of the U.S. mandatory disclosure regime was traditionally on an issuer's disclosure at the time that it was making a public offering of securities. Under the Securities Act, the offering was required to be registered, which involved filing a statement with the SEC that answered a variety of disclosure prompting questions. Persons associated with the offering faced a comprehensive system of civil damage liability. Absolute liability was imposed on the issuer for investors' damages arising from a material misstatement in the registration statement.[4] Absolute liability subject to a "due diligence" defense was imposed on the issuer's top officers and directors and on the investment banks underwriting the offering.[5] This imposition of absolute

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and the liquidity of capital markets).

[4]Section 11(a) of the Securities Act provides that any person acquiring a security whose registration statement contains "an untrue statement of a material fact or [omits] to state a material fact required to be stated therein or necessary to make the statements therein non misleading" may bring an action for damages against, among others, the directors and top officers of the issuer, the offering's underwriters and every other person who signs the registration statement, which includes the issuer. 15 U.S.C. § 77k(a) (2006).

[5]Section 11(a), as just noted, imposes absolute liability on each of these actors. Section 11(b) frees each of these actors (but not the issuer) from this liability if the actor can affirmatively establish that "he had, after reasonable investigation, reasonable ground to believe and did believe " that the registration did not contain the untrue statement or omission triggering the Section 11(a) claim. 15 U.S.C. § 77k(b)(3)(A) (2006).

liability subject to a due diligence defense was intended to motivate each of the non-issuer actors, particularly the lead underwriter, to do an independent investigation of the issuer and to participate actively in the drafting of the registration statement.[6]

In contrast, while issuers with publicly traded shares were required on an ongoing basis to make periodic disclosures on forms 10-K, 10-Q and 8-K filed pursuant to the Exchange Act, misstatements in these filings traditionally did not give rise to any effective kind of civil liability in most situations.[7]

2. Modern Developments

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[6] *See* Edward Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME L. REV. 755, 767—70 (1981); Feit v. Lesco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968). Commentary by persons intimately involved with the creation of the Securities Act confirm that this *in terrorem* arrangement for imposing damages in the absence of adequate investigation was a critical part of the legislative plan to promote full disclosure. *See* William O. Douglas & George Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 173 (1933); Felix Frankfurter, *The Securities Act: II*, FORTUNE, Aug. 1933, at 54, 108.

[7]As a formal matter, a material misstatement in any of these Exchange Act periodic filings is subject to liability pursuant to Section 18 of the Exchange Act. 15 U.S.C. § 78r (2000). Court decisions, however, have concluded that to succeed, the plaintiff must establish "eyeball reliance" on the misstatement in the filed document. Ross v. A.H. Robbins, 607 F.2d 545, 556—58 (2d Cir. 1979). This requirement cuts out most investors since the typical investor, when making a buy or sell decision, does not read the issuer's actual Exchange Act filings. At most, she would find out about a misstatement in such a filing only indirectly, by learning information based on the misstatement contained in an online, newspaper or analyst report. Also, because the eyeball reliance requirement involves particularized proof with regard to each claimant, class actions are not practical. Without the availability of a class action, most securities claims are not worth the costs of pursuing. As a result of these factors, Section 18(a) has largely been considered a "dead letter." *See* DAVID. L. RATNER & THOMAS LEE HAZEN, SECURITIES REGULATION: CASES AND MATERIALS 328—31 (5th ed. 1996). Liability for such a misstatement was also not available based on Exchange Act Section 10(b), 15 U.S.C. § 78j(b) (2000), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006), at least as a practical matter, until the issuance of court decisions, discussed *infra* note 13, broadening the interpretation of the Rule's "in connection with the purchase or sale of a security" requirement and facilitating class actions by allowing a presumption of reliance based on the "fraud-on-the-market" theory.

Two developments over the last twenty-five years have radically altered this picture. Both are related to the increasing acceptance of the efficient market hypothesis (EMH) from financial economics, which holds that the prices of securities of large, established issuers trading in liquid markets fully reflect all publicly available information. One development is the underlying mandatory disclosure regime's movement toward a "company registration" approach. The other is the rise of the fraud-on-the-market class action. These two developments create multiple strains that undermine both the policy rationale for the existing system of civil liability and its political support.

a. The movement toward company registration and the question of underwriter liability. Under the company registration approach, a large, established, publicly traded issuer would register just once, provide information thereafter on a periodic basis, and then be able to offer and sell securities whenever it wishes without the need to register the securities themselves.[8] The U.S. movement toward company registration, though still not complete, has, for large, established issuers, switched the regime's primary regulatory focus to these issuers' ongoing periodic disclosures.[9] Such issuers, as a practical matter, can offer their

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[8] The core logic of company registration is that established issuers are already required on a continuing basis to answer most of the questions that they have traditionally been asked to answer when they registered new offerings and that no useful purpose is served in requiring them to be answered again at the time of each securities offering. According to the efficient market hypothesis, for an established issuer whose shares trade in a thick, efficient market, its answers to these questions in its periodic filings will already be reflected in the prevailing secondary market price at the time of the new primary offering. The price of the shares in the new offering will be determined primarily by this secondary market price. The origins of the company registration concept are in a 1966 article by Milton Cohen. Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1341—42 (1966). It subsequently formed the organizing principle behind the American Law Institute's proposed codification of federal securities law. *See* ALI FEDERAL SECURITIES CODE (1980). Congress never enacted the wholesale reform of the securities acts envisioned in the ALI Code, but the ideas in the Code and in Cohen's article have animated much SEC rulemaking over the last few decades. See *infra* note 9.

[9] This shift began with the SEC's adoption of Regulation S-K in the 1970s, which served as the basis for coordinating disclosure under both the Securities Act registration requirements for new offerings and the Exchange Act periodic disclosure requirements by having the requirements for each incorporate by reference questions set

out in a single regulation. 17 C.F.R. §229 (2005). This development was followed in the early 1980s by adoption of Rule 415 "shelf registration" and S-3 "short form" registration. Rule 415, 17 C.F.R. § 230.415 (2000), permits, for large established issuers, a single registration statement to register a set number of securities that could be offered from time to time over a two-year period and which would incorporate subsequent periodic disclosure filings by reference as amendments to the original "shelf" registration statement. SEC Securities Act Release No. 6499, 48 Fed. Reg. 52,889 (1983), reprinted in [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,449, at 86,335 (Nov. 17, 1983). Rule 415 was a departure from the traditional position of the SEC not to permit an issuer to register securities that it does not intend to sell immediately. The traditional position was based on an interpretation of the language of § 6(a) of the Securities Act, 15 U.S.C. § 77f(a) (2000) and reflected a policy against the sale of securities on the basis of stale information. *See* In re Shawnee Chiles Syndicate, 10 S.E.C. 109 (1941).

The S-3 short form registration procedure takes advantage of the fact that under the periodic reporting requirements of the Exchange Act, a registered issuer must annually file a Form 10-K, which covers a wide range of questions about the issuer's business, finances, and management, a quarterly report on Form 10-Q, and, when certain "extraordinary events" happen, a "current report" on Form 8-K. SEC Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,382-85 (1982), reprinted in Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 62,994-99 (Mar 3, 1982). The S-3 form allows large, established, thickly traded issuer to incorporate by reference into its registration statement the information provided in its 10-K, 10-Q, and 8-K filings over the preceding year. The only information relating to the affairs of the issuer that must actually be set out in the registration statement is, in most cases, the use of proceeds and a description of any material change since the last 10-K not already described in a subsequent 10-Q or 8-K.

In the first half of the 1990s, the SEC took steps that further reduced the central role that the registration statement and prospectus traditionally played in regulating the offering process, loosening the rules on pre-filing publicity and pre-effectiveness written promotions. *See* John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company-Registration*, 52 WASH & LEE L. REV. 1143, 1150-55 (1995) [hereinafter *Re-engineering*]. In 1996, the SEC's Advisory Committee on the Capital Formation and Regulatory Process (the "Advisory Committee"), chaired by then Commissioner Steven Wallman, issued a report exploring what a full fledged company registration system would look like and recommending a voluntary pilot program. *See* Securities and Exchange Commission, Report of the Advisory Committee on the Capital Formation and Regulatory Processes, Fed. Sec. L. Rep. (CCH) No. 1726 ("Wallman Report"). The SEC's initial response, in November 1998, was the release of its "Aircraft Carrier" proposal. SEC Release No. 33-7606 (Nov. 3, 1998).

Although criticisms of the "Aircraft Carrier" proposal led to its abandonment by the SEC, a modified version, generally referred to as the "offering reforms," was adopted in late 2005, by means of a number of new or amended rules. Securities Act Release No. 33-8591, 70 Fed. Reg. at 44,722 (Dec. 1, 2005). While not fully abandoning the traditional transactional basis of disclosure regulation, the reforms took shares at any time that they decide, without delay or significant additional disclosure beyond their most recent periodic filings. Registration of the offering is still required as a formal matter, however, which has important implications for liability.

The Securities Act system of liability for misstatements at the time of an offering of new securities, while still fully workable for a new issuer doing an initial public offering (IPO), does not fit well with this movement toward company registration for large, established issuers that are already publicly traded. The speed with which new securities issues can be brought to market by such issuers makes it impossible for the underwriter, as a practical matter, to do due diligence and thus to play its traditional gatekeeper role in assuring that what is disclosed about the issuer at the time of offering fully and truthfully meets the regulations.[10]

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the regulatory regime, particularly for large, established publicly traded issuers, yet further in the direction of company registration by their even greater emphasis on Exchange Act periodic disclosure. The starting point is amended Rule 405, which provides a definition for "Well Known Seasoned Issuers" ("WKSIs"), a category intended to cover large, established, publicly traded corporations of a kind that can be expected to be thickly traded and followed by analysts in the market. 17 C.F.R. § 230.405 (2007); Securities Offering Reform, Securities Act Release No. 33-8591, 70 Fed. Reg. 44,722, 44726-44727 (Aug. 3, 2005). WKSIs are permitted under the amended Rule 415 to register "for the shelf" an unlimited number of shares to be offered (subject to a refiling requirement every three years) at any point in the future, from time to time or on a continuous basis. 17 C.F.R. § 230.405 (2007). Under this "automatic shelf registration" procedure, payment of registration fees are allowed on a "pay as you go" basis, rather than at the time of registration, as was required previously. 17 C.F.R. § 230.456 (2007). Immediate "takedowns" of securities so registered can occur without any delay for possible SEC review of updating filings. 17 C.F.R. § 230.415(a)(5) (2007). Because of a change in Rule 415(a)(4), shares registered pursuant to the automatic shelf registration procedure may also be used for "at the market offerings" made directly into the secondary market, either by the issuer itself or with the aid of a broker. Unlike before, there is no need to name an underwriter in the registration statement and no limit on the number of shares so offered. 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 550 (4th ed. 2006)

[10] In theory, since the underwriter continues to face Section 11 liability, it could insist that the offering be held up until it had completed a proper due diligence investigation. The problem is that there is real cost to the issuer if the underwriter insists on such a delay. This cost was not present before the short form and shelf registration reforms made speedy registration possible. For a fuller discussion of the reasons why short form and shelf registration led investment banks to stop performing their traditional due diligence role, see Merritt B. Fox, *Shelf Registration, Integrated*

Yet these offerings are still registered and, as the recent *Worldcom*[11] decision makes clear, the standard of liability imposed on the underwriter has not significantly changed. Thus underwriters have moved from being a force to promote disclosure to being merely an insurer for disclosure failure.[12] Underwriters argue that this role serves little social purpose and should be eliminated. [13]

Disclosure, and Underwriter Due Diligence: An Economic Analysis, 70 VA. L. REV. 1005, 1025—30 (1984) [hereinafter *Shelf Registration*].

[11] *In re* Worldcom Inc. Sec. Litig., 346 F. Supp. 2d 628, 662—64 (S.D.N.Y. 2004).

[12] In Professor Coffee's view, underwriters could simply regard the risk of liability from not doing due diligence as a necessary cost of doing business in order to compete and provide the issuer with quick access to the market. They could raise their fees or increase insurance coverage to compensate for this risk. John C. Coffee, *Due Diligence After WorldCom*, NEW YORK L.J., Jan. 20, 2005, at 5.

[13] Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, 46 Fed. Reg. 42,020, 42,029—30 ("[T]his reduction in preparation time, together with competitive pressures, will restrict the ability of responsible underwriters to conduct what would be deemed to be a reasonable investigation, pursuant to Section 11, of the contents of the registration statement. . . . [I]ssuers may be reluctant to wait for responsible underwriters to finish their inquiry, and may be receptive to offers from underwriters willing to do less."). *See also* SEC File Nos. S7-925, S7-896, S7-869 (Commission files containing letters from various underwriters and their representatives all urging relaxation or elimination of underwriter liability); *Hearing on Shelf Registration*, SEC File No. S7-925, at 10 (1982) (testimony of Gordon Macklin, President, NASD); *Id.* at 18 (testimony of Bruce A. Mann, Partner, Pillsbury, Madison & Sutro, Esqs.); Committee on Federal Regulation of Securities, *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185, 1239 (1993) ("The 'integrated disclosure system' and the expansion of shelf registration statements have called into question whether underwriters any longer 'sponsor' an issue in a meaningful way, as opposed to delivering advice and distribution services"); Letter from ABA Committee on Federal Regulation of Securities, Business Law Section, to David B.H. Martin, Director, Division of Corporation Finance, SEC (Aug. 22, 2001), http://www.abanet.org/buslaw/committees/CL410000pub/comments/20010822010000.pdf ("[t]he benefits of 'on demand' financing . . . are undermined by continuing to impose on financial intermediaries and other 'gatekeepers' the responsibility . . . to do a sufficient due diligence investigation . . . without recognizing and making allowances for their difficulty or even inability to do so. It is not possible for underwriters and others to meet this standard in the current financing environment").

b. Class action damage suits. Two judicial developments - the broadened interpretation of when an issuer misstatement can be considered "in connection with the purchase or sale of a security" under Rule 10b-5 and the creation of the presumption of reliance under the fraud-on-the-market theory - made practical class action law suits based on material misstatements in an issuer's Exchange Act periodic disclosure filings.[14] Prior to the late 1980s, an issuer that had made such a statement, even with scienter, faced little or no threat of civil damage liability. Thereafter such an issuer began to be subject to potentially enormous liability based on the losses of all the investors who purchased shares during the period that the misstatement inflated the price and who still held them when the market became aware of the truth. The rise of the fraud-on-the-market class action thus created strong new incentives for an issuer to comply with its periodic disclosure obligations. Considered in isolation, these new incentives were a good development, given the shift in focus of the underlying regulatory regime to periodic disclosure. There is a widespread feeling, however, that the incentives

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[14] The starting point for the development of "fraud-on-the-market" class actions against an issuer for damages suffered as result of an issuer misstatement goes back 40 years. In *S.E.C. v Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968), the court found that whenever an issuer makes a statement that is "reasonably calculated to influence the investing public," such statement satisfies Rule 10b-5's requirement that it be "in connection with the purchase or sale of a security," even if neither the issuer nor its managers buy or sell shares themselves. *Id.* at 859—61. This potential liability did not become a serious threat to most issuers, however, until class actions became possible with the development of the fraud-on-the-market theory of reliance, which was first enunciated in the lower courts in the 1970s and was affirmed by the Supreme Court only in 1988. Basic Inc. v Levinson, 485 U.S. 224 (1988). A material public misstatement by an official of an issuer whose shares trade in an efficient market will, under the efficient market hypothesis (EMH), affect the issuer's share price. This effect provides a plaintiff with a way of showing "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." *Id.* at 243. This is an alternative to the showing of traditional reliance, which involves showing that the misstatement induced the plaintiff into purchasing or selling the security. In the case of a falsely positive statement, for example, allowing the plaintiff to show reliance by establishing that defendant's misstatement caused the plaintiff to pay too much rather than that it caused the defendant to enter into what turned out to be an unfavorable transaction, eliminates the need to make particularized claims of reliance for each purchaser. Thus common issues of fact predominate and class actions become possible. Prior to the fraud-on-the-market presumption of reliance that made class actions practical, the individual investor rarely found the prospective recovery of just her own damages sufficient to justify the cost of bringing suit.

come at great social expense.[15] As the scandals of the early 2000s and the huge number of recent accounting restatements suggest,[16] they are also far from totally effective. Such shortcomings have led some to call for eliminating, or substantially curtailing, fraud on the market class actions.[17] These calls have gained additional momentum as a result of

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[15] *See*, *e.g.*, John C. Coffee, Jr., *Reforming the Class Action*, 106 COLUM. L. REV. 1534, 1565—66 [hereinafter *Reforming*]. For the years 2000 through 2005, total annual securities class actions settlements have averaged about $4.1 billion. LAURA E. SIMMONS & ELLEN M. RYAN, POST-REFORM ACT SECURITIES SETTLEMENTS: 2005 REVIEW AND ANALYSIS (Cornerstone Research 2005), http://securities.cornerstone.com/pdfs/settlements_2005.pdf. Studies suggest that contingent fee awards to plaintiffs' lawyers in securities class actions average around 30%. FREDERICK C. DUNBAR & VINITA M. JUNEJA, RECENT TRENDS II: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? tbl. 4 (Nat'l Economic Research Assocs., Inc. 1993) (attorneys' fees averaged 31.32% of settlements in a sample of 135 cases from July 1991 through June 1993); FREDERICK C. DUNBAR, TODD S. FOSTER, VINITA M. JUNEJA & DENISE N. MARTIN, *RECENT* TRENDS III: WHAT EXPLAINS SETTLEMENTS IN SHAREHOLDER CLASS ACTIONS? ii (Nat'l Economic Research Assocs., Inc. 1995) (Although average settlements fell between 1993 and 1994, plaintiffs' attorneys' fees remained constant, averaging one-third of the settlement awards. Plaintiffs' attorneys' fees averaged $1.96 million in 1993 and $2.03 million in 1994). If we assume that defendants' lawyers are paid fees comparable in amount, this would suggest that the total annual legal expenses associated with these actions averaged about $2.5 billion ((.30 + .30) x $4.1 billion). The plaintiffs' expenses come out of the judgment or settlement and hence diminish what would otherwise be paid to former shareholders of the issuer. The issuer defendant's expenses are ultimately borne by its shareholders at the time suit is brought. Other social costs include use of the judicial system and the time and attention of the issuer's executives devoted to the litigation.

[16] JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 15 (2006) [hereinafter GATEKEEPERS] (describing the rash of financial scandals, of which Enron and Worldcom were the most spectacular examples, whereby issuers attempted to maximize the market price of their securities by creating misimpressions as to what their future cash flows were likely to be, and the hundreds of resulting restatements).

[17] *See also* Anjan V. Thakor with Jeffrey S. Nielsen & David A. Gulley, U.S. Chamber Inst. for Legal Reform, The Economic Reality of Securities Class Action Litigation 5 (2005), available at http://www.instituteforlegalreform.com/pdfs/EconomicRealityNavigant.pdf; Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, The Unintended Consequences of Securities Litigation 14 (2005), available at http://www.instituteforlegalreform.com/pdfs/UnintendedConsequencesThakor.pdf;

prominent persons expressing concern about the competitiveness of U.S. capital markets versus those abroad and suggesting that securities class actions are part of the problem.[18]

I will argue in Part IV that both underwriter liability at the time of new offerings and fraud-on-the-market actions based on periodic disclosure violations should indeed be eliminated, but only as part of fundamentally redesigned system of civil liability that creates in their place new, more efficient and effective incentives for periodic disclosure compliance.

B. Other Countries

Abroad, civil liability is not an established tool to encourage mandatory disclosure compliance. With the increasing concern for corporate transparency, however, interest is growing. The starting point for this increasing concern with transparency is the increasing recognition of the value of deep, vibrant equity markets and of the

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Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 646 (1996); Coffee *Reforming, supra* note 15 at 1585-86.

[18] The Committee on Capital Markets Regulation, also known as the "Paulson Committee", claims, for example, that there has been a reduction it the competitiveness of U.S. capital markets versus markets abroad as a result in part of the costs imposed on issuers by fraud-on-the-market class actions and the uncertainty that they create. The Committee calls for reforms that would effectively reduce or eliminate such actions. For example, it calls upon the SEC to impose a stricter standard than most courts have adopted concerning what must be shown to demonstrate that the market for a security is sufficiently efficient to justify application of the fraud on the market theory. INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 81-82 (Nov. 30, 2006), http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. (calling for adoption of the rule in *In re Polymedica Securities Litigation* that plaintiffs must show that the market price fully reflects *all* publicly available information. 432 F.3d 1, 26 (1 Cir. 2005) (emphasis added)). More importantly, the Committee calls for the SEC to permit managers, with the approval of shareholders, to adopt charter amendments barring shareholders from bringing fraud-on-the-market damage actions in court at all. Such claims would instead be heard in arbitration. If the charter amendment so provided, the claims could only be brought individually by each shareholder, not by a class action. *Id.* at 109–10. As noted above, this would largely eliminate issuer liability altogether since, for most investors, individual actions do not have the prospect of sufficiently large recovery to merit the costs of bringing the action.

dispersed pattern of corporate ownership that they permit.[19] By making it easier for issuers to raise funds and investors to invest, such markets and ownership structures facilitate the transfer of funds from stable or declining firms, with substantial cash flows but few promising new investment projects, to growing, often new, firms, with less cash flow but many promising investment projects. By making diversification easier, dispersed ownership promotes the more efficient allocation of risk. The liquidity that deep, vibrant markets provide both lowers the cost of capital for issuers and increases investor utility.[20] By giving venture capitalists an option to exit start-ups through the sale of their interests in an IPO, such markets promote innovation.[21] Share prices in such markets also more efficiently impound information held by diverse persons that is relevant to predicting an issuer's future cash flows and in so doing help managers to make decisions based on more accurate cash flow projections.

Vibrant, deep equity markets and dispersed ownership structures in turn appear not to be possible without a high level of corporate transparency.[22] Transparency has also been heralded as necessary more

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[19]Ross Levine, *Financial Development and Economic Growth: Views and Agenda*, 35 J. ECON. LIT. 688 (1997); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 832—34, 835—38 (2001) (collecting studies showing relationship between strong securities markets and economic growth). For empirical evidence that the direction of causation leads from financial development generally (both in the form of a banking sector and of stock markets) to economic growth and not the other way around, see Raghuram G. Rajan and Luis Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559–86 (1998). For further discussion of the advantages of dispersed ownership, see Erik Berglof & Stijn Claessens, *Corporate Governance and Enforcement* 3, 12, 47, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625286.

[20] See Part II.D *infra.*

[21]Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets,* 47 J. FIN. ECON. 243 (1999).

[22] Black, *supra* note 19, at 783, 834—35 (collecting empirical studies showing relationship between transparency and depth of equity markets measured by indicators such as the ratio of stock market capitalization to GDP); Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L REV. 333, 376—87 (same); Hazem Daouk et al., *Capital Market Governance: How Do Security Laws Affect Market Performance* 25, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=702682 (study linking transparency

generally for good corporate governance.[23]

Several countries have implemented, or are considering implementation of, laws that would promote civil liability for disclosure violations. In Canada, where securities regulation is primarily a provincial responsibility, Ontario, the leading financial province, has recently enacted new legislation making it easier for investors to sue in the event of issuer misstatements.[24] Korea has provided for securities class actions for the first time.[25] Sweden, France, Spain, Germany, Norway and the Netherlands have each adopted reforms that remove some of the traditional roadblocks to U.S. style class actions.[26] The

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to cost of capital and liquidity); Eirk Berglof & A. Pajuste, *Corporate Governance in Central and Eastern Europe, in* GLOBAL COMPETITIVENESS AND CORPORATE GOVERNANCE (P. Cornelius & B. Kogut eds., 2003) (how countries markets in transition countries with poor transparency were quickly transformed, after initial privatization auctions created dispersed ownership, to concentrated ownership economies); COFFEE, GATEKEEPERS, *supra* note 16, at 109 (dispersed ownership and the separation of ownership from control not possible without reliable, audited financial statements), John C. Coffee, *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, in CORPORATE GOVERNANCE LESSONS FROM TRANSITION ECONOMY REFORMS 274-281(M. Fox & M. Heller eds, 2006) (comparing the disappearance of market trading for most of the nearly 1500 Czech issuers created by the privatization in the early 1990s with the better performance of the Polish capital markets and attributing the difference in part to very poor issuer disclosure in the Czech Republic with relatively high quality issuer disclosure in Poland).

[23]*See, e.g.*, OECD Principles of Corporate Governance (2004); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002) (corporate law is ineffective without transparency).

[24] On December 31, 2005, Bill 198 to the Ontario Securities Act became effective, which effectively eliminated the need for plaintiffs to establish reliance or loss causation. *Canada introduces securities disclosure liability*, CANADA INT'L FIN. L. REV., Jan. 1, 2006. *See also* Bradley Davis, *Focus on Corporate Commercial Law: Bill 198 Will Bring a New Era in Class Action Litigation in 2006*, THE LAW. WKLY., Oct. 14, 2005.

[25]*Assembly Passes Watered-Down Class Action Bill*, KOREA TIMES, Dec. 23, 2003, *available at* 2003 WLNR 16653327

[26]Stefano M. Grace, *Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the Acquis Communautaire*,15 J. TRANSNAT'L. L. & POL. 282, 290—97 (2006). Peter Geier, *A Wary Europe Moves a Step Closer to Class Actions*, NAT'L L.J., Dec. 5, 2006, *available at* http://www.law.com/jsp/article.jsp?id=1165244464820#; German Federal Ministry of

governments in Ireland and Finland are considering such reforms as well.[27] The Parmalat scandal has led prominent academics to call for such reforms in Italy also.[28]

In each of these countries, the full efflorescence of U.S. style securities class actions is not something that can be expected anytime soon given, depending on the particular country, some mix of the absence of a contingent fees for plaintiffs lawyers, the existence of a "loser pay" rule concerning the victor's legal fees, an "opt in" rather than an "opt out" structure of class action, and the lack of explicit reference to securities fraud as being among the kinds claims that can be brought collectively.[29] Still, even these first tentative steps signal a change in atmosphere that suggests an increasing chance that in the future more issuer disclosure violations will lead to civil liability. This change in atmosphere gains added importance because it comes against the background of a recent body of scholarly literature arguing the private damage suits have a special role to play in the enforcement of securities disclosure laws.[30]

II. THE SOCIAL VALUE OF DISCLOSURE AND THE IRRELEVANCE OF WHETHER AN ISSUER IS OFFERING SECURITIES

Justice, press release describing the German "Capital Markets Model Case Act", http://www.bmj.bund.de/media/archive/1056.pdf.

[27]Peter Geier, *supra* note 26.

[28] Guido Alessandro Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case* (ECGI - Law Working Paper No. 40/2005, May 2005), *available at* http://ssrn.com/abstract=730403.

[29] For recent overviews of "collective action" reforms in Europe, see Heather Smith, *Is America Exporting Class Actions to Europe?,* AM. LAW., 28 February 2006, available at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1141047298349; *Class Actions*, GLOBAL DISPUTE RESOLUTION (Linklaters, New York, N.Y.), Feb. 2008, http://linklaters.com/pdfs/publications/Litigation/Classactions.pdf.

[30] Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *What Works In Securities Laws?* 61 J. FIN. 1 (2006) (empirical study finding a relationship between the availability of private enforcement of securities laws and capital market development); Berglof & Claessens, *supra* note 19, at 15, 22; Katharina Pistor, Martin Raiser & Stanislaw Gelfer, *Law & Finance in Transition Economies*, 8 ECON. OF TRANSITION 325 (2000); Black, *supra* note 19, at 796; Jennifer Arlen, *Public versus Private Enforcement of Securities Fraud* (Unpublished paper on file with author).

What is the social interest in the level of an issuer's disclosure and is it more intense when an issuer is making a public offering of securities? In the discussion below, I conclude that for an established issuer trading in an efficient market, society has an equally great interest in the issuer's disclosure whether it is offering securities at the moment or not. Thus a mandatory disclosure regime should require the same level of disclosure under both circumstances and corporate decisionmakers should have equally strong incentives to comply. The system of civil liability for violation of these disclosure rules, as one source of compliance incentives, should be designed accordingly.

The basis for this conclusion is that the primary social benefit from a higher level of disclosure by established issuers is not the protection of investors from unfair prices or risk. Rather, the primary benefits are a more efficient allocation of resources in the economy as a result of improved corporate governance (corporate managers selecting more accurately the most promising from among all the proposed investment projects in the economy, and operating better their existing projects), increased capital market liquidity and the consequent reduction in the cost of capital, and the reduction in resources used by secondary market investors to gain advantages over each other in a race to discover information already known by issuers but unannounced.[31] These benefits

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[31] There has been a growing recognition over the last twenty-five years of the importance of economic efficiency as a goal for disclosure regulation. Professor Coffee, for example, states: "Th[e] focus on fairness, rather than efficiency, is not surprising because proponents of a mandatory disclosure system have historically stressed the former over the latter. Nonetheless, the strongest arguments for a mandatory disclosure system may be efficiency-based." John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 751 (1984) [hereinafter *Market Failure*]. *See also* Steven A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory, in* ISSUES IN FINANCIAL REGULATION 191 (Franklin Edwards ed., 1979); Zohar Goshen & Gideon Parchomosvsky, *The Essential Role of Securities Regulation*, 55 DUKE L. J. 711, 713 (2006). For other perspectives on the efficiency-enhancing features of securities disclosure, see Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 985, 1006 (1992); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995) (arguing that the goal of disclosure should be focused on, and limited to, helping investors uncover breaches of contractual or fiduciary obligations).

The growing importance of efficiency is also illustrated by the enactment in the United States of The National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (to be codified as amended in scattered sections of 15 U.S.C.), which amended the Securities Act to add Section 2(b) providing that:

generally arise equally whether or not the issuer is offering securities at any given moment.

A. Disclosure's Irrelevance to Investor Protection.

Disclosure by established issuers trading in major markets is not necessary to protect investors against either unfair prices or risk.[32] The markets in which the shares of such issuers trade are efficient. According to the efficient market hypothesis, the price of such a share is unbiased - as likely to be below the share's actual value as above - whether there is a great deal of information publicly available about the issuer or very little. In other words, greater disclosure is not necessary to protect investors from buying its shares at prices that are, on average, unfair, i.e., greater than their actual values. Issuer disclosure may reduce risk - on average bringing price closer, on one side or the other, to actual value - but the only kind of risk that it reduces is *unsystematic* risk. Simply by being diversified, investors can protect themselves from this unsystematic risk much more effectively and at less social cost than by

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote *efficiency, competition, and capital formation*.

15 U.S.C.A. §77b(b)(2005) (emphasis added). The 1996 Act made an essentially identical amendment to the Securities Exchange Act by the addition of Section 3(f). *See* 15 U.S.C.A. § 78c(f)(2005).

[32] I have considered the points discussed here in significantly more detail elsewhere. *See* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2532—44 (1997) [hereinafter *Disclosure in a Globalizing Market*].

increases in issuer disclosure. The weakness of the investor protection rationale for mandatory disclosure is important because, as will be discussed in Part IV, this in turn suggests that the compensatory justification for awarding damages to investors who suffer secondary market trading losses as a result of a mandatory disclosure violation is weak as well.[33]

B. Disclosure's Role in Improving Corporate Governance

Disclosure does, however, enhance efficiency by improving corporate decisions relating to which proposed new investment projects in the economy are selected for implementation and how already existing projects are operated.[34] The starting point in establishing this proposition is to note that it is in the best interests of public shareholders that management make these decisions in a way that maximizes share value, i.e., maximize the future expected cash flows for the rest of the life of the firm, discounted to present value, paid to the holder of the share. When corporations operate in competitive markets and are properly regulated to account for externalities, management decisions meeting this criterion maximize overall social wealth as well. Under these circumstances, at the margin, what the corporation pays for its inputs equals the value of what it takes from society and what it sells its output for equals the value of what it gives back. Thus decisions that maximize the difference between the two – the net cash flows generated by the corporation over its life discounted to present value – maximize the corporation's contribution to society. These are the same decisions as the ones that maximize share value.

The decisions that maximize share value are not necessarily the decisions that maximize the utility of the managers. This is particularly so in corporations with dispersed ownership, where no one shareholder has a sufficiently large holding to have the incentives and ability to closely monitor management. The deviations between the decisions that maximize managerial utility and the ones that maximize share value are

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[33] See *infra* IV.B.1.

[34] For further discussion and empirical evidence, of how corporate disclosure and the resulting increase in share price accuracy lead to the improved allocation of resources in the real economy, *see* Merritt B. Fox et al., *Share Price Accuracy and Economic Performance: The New Evidence*, 102 MICH. L. REV. 3 (2003) [hereinafter *Share Price Accuracy*].

the "agency costs of management." The central task of corporate governance for dispersed ownership corporations - the typical ownership pattern for large U.S. corporations - is to construct for managers a structure of incentives - carrots and sticks - that in a cost effective manner minimizes these agency costs of management.[35]

A high level of disclosure reduces the agency costs of management by two routes. The first route is disclosure's beneficial effects on the *legal* mechanisms for assuring good corporate governance. Disclosure makes the exercise of the shareholder franchise more effective and assists shareholder enforcement of management's fiduciary duties. The second route is through its beneficial effects on existing *market* mechanisms that help align managerial interests with those of shareholders: the hostile takeover threat and share price based management compensation.

In each case, a higher level of reliable issuer disclosure improves corporate governance by getting more information into the hands of the relevant actors. This increase in information goes beyond the raw contents of the issuer's disclosures. The content of these disclosures reduces the costs for analysts, the media and speculative traders to perform their respective jobs. It does so both by providing feedstock for further investigation and analysis and by reducing the costs of verification of already available information. These cost reductions increase the activity level of each of these groups and hence result in the generation of further new information.[36] In the cases of the media and, to some extent, analysts, this additional information is made public. The rest of the information generated by analysts is given confidentially to speculative traders, who combine it with information they generate themselves, to trade in ways that move price. The resulting movement in price is, of course, public and constitutes new information in and of itself. Thus, for example, a sudden drop in an issuer's share price may

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[35]Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305 (1976). For a discussion of the differences in typical ownership patterns between the United States and other countries as well as differences in views concerning the goal of share value maximization, see *infra* note 79 and accompanying text.

[36]For evidence that analyst coverage can reduce the agency costs associated with dispersed share ownership, which separates ownership from control, see John A. Doukas et al., *Security Analysis, Agency Costs, and Company Characteristics,* 56 FIN. ANAL. J. 54 (2000).

signal that analysts or speculative traders have developed information, not publicly disseminated, of some management failing. They are more likely to develop such information with a higher level of reliable issuer disclosure.

1. Legal Mechanisms

The shareholder franchise and the fiduciary duties of management are both legal mechanisms designed to encourage managers to choose new investment projects and operate existing ones in ways that maximize share value. Disclosure enhances the effectiveness of both these mechanisms and does so in a way unrelated to whether or not the issuer is offering new securities.

a. Shareholder franchise. Disclosure can enhance the effective exercise of the shareholder franchise because a better informed shareholder is more likely to vote in an election for directors for the candidates who will maximize share value. Similarly, such a shareholder is more likely to vote in favor of the share value maximizing outcome with respect to all other matters subject to shareholder vote, such as an amendment to the articles of incorporation, a merger, or ratification of a transaction in which management is interested.

Disclosure's beneficial effects on shareholder voting works primarily through the information it provides to the larger shareholder, i.e., the institution or wealthy individual that holds between perhaps a fraction of one percent and a few percent of the issuer's outstanding shares. For most publicly traded corporations that lack a controlling shareholder or group, shareholders of this kind hold in aggregate sufficiently large portions of the total shares outstanding to play a potentially critical role in voting.[37] Unlike the typical small individual

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[37]Jay C. Hartzell & Laura T. Starks, "Institutional Investors and Executive Compensation" (September 2002). AFA 2003 Washington, DC Meetings 7 (in a sample including all the firms in the S&P 500 Index, the S&P Midcap Index, and the S&P Smallcap Index, the average aggregate institutional holdings are 53.1% of shares outstanding and the average holdings of the top five institutional investors in a firm is 22% of the outstanding shares and 44% of the aggregate institutional holdings.) *Accord* Anthony Saunders, Marcia Millon, Alan J. Marcus, & Hassan Tehranian, "The Impact of Institutional Ownership on Corporate Operating Performance" 14 (November 7, 2003). NYU Stern Finance Working Paper No. 03-033 (in a sample of the firms in the S&P 100, 59.3% of shares outstanding were held by institutions and the average holdings of the top five institutional investors in a firm is 20.1% of the outstanding

shareholder, the larger shareholder has a big enough stake that it finds the kind of information provided to it for free by issuer disclosure worth learning. But familiar collective action problems mean that if this information were not provided for free, the shareholder would not affirmatively seek to ferret out the information on its own, at least to the extent that would be socially optimal.[38]

The corporate voting franchise has taken on new importance in recent years. Institutional investors have begun to vote in like fashion against management with respect to certain kinds of corporate governance issues, in part prompted by information services such as ISS, which, while creating their own agency problems, solve the shareholder voting collective action problem to some extent. Admittedly, the focus of these institutional investors seems to be toward systemic changes in U.S. corporate governance, where the same information, relating to the superiority of one corporate governance practice versus another, is relevant to each institution's votes with respect to many different corporations. There is substantial evidence, however, that activist hedge funds have been able to target individual firms[39] and accomplish changes in management, managerial policy and corporate governance in ways that appear to be share value enhancing.[40] The more firm specific

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shares).

[38] For a more detailed discussion of these collective action problems, see Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROB. 113, 116—18 (1999) [hereinafter *Required Disclosure*]. Ideally the amount of information that should be made available to each such larger shareholder would be the amount that a single owner of the same enterprise would want from an agent who was managing the enterprise if the enterprise instead had a single owner ownership structure. This is because there are substantial externalities when this larger shareholder receives information since it increases the likelihood that the shareholder will exercise its franchise in a way that will enhance the interests of all shareholders.

[39]The contrast between institutional investor votes and activist hedge fund votes is established in Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881&high=%20marcel%20kahan. But see Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA.L.REV. 675 (2007) (shareholders as a more general matter have little influence through their franchise).

[40]William W. Bratton, *Hedge Funds and Governance Targets*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928689&high=%20william%20bratton (hedge funds have a high

information that these funds have, the more effective they can be. This firm specific information is the kind of information that comes from greater issuer disclosure.

More generally, in recent years there has been a substantial movement seeking to enlarge the shareholder role in selecting directors. This has taken a variety of forms: the SEC's intermittent consideration of rules to permit, under certain circumstances, shareholder use of the company proxy to nominate directors,[41] corporations on their own adopting requirements that directors can be elected only upon the vote of an absolute majority and of shareholders,[42] and reforms to permit internet

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record of success in using the proxy system to achieve corporate change) Alon Brav et al., *Hedge Fund Activism, Corporate Performance, and Firm Performance,* http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf (activists at least partially successful at achieving corporate change two-thirds of the time and there are statistically significant abnormal returns in the range of 5%-7% around the time of the announcement that a hedge fund has become active with respect to a particular issuer).

[41] The SEC, by twice putting out for comment proposals to provide shareholder access to the company proxy under certain defined circumstances, flirted with increasing the shareholder role in the selection of the directors of public companies. Security Holder Director Nominations, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 23, 2003). Shareholder Proposals, 72 Fed. Reg. 43, 466, 43, 469 (Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240). Ultimately, however, it decided that it would maintain the Rule 14a-8(i)(8) exclusion of election-related shareholder proposals from company proxy materials and would amend the rule to clarify that it excludes not just proposals for a specific person to be nominated or elected director, but also proposals relating to the procedures for nomination and election. Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 70,450, 70,453 (Dec. 11, 2007) (to be codified at 17 C.F.R. pt. 240).

[42] Notwithstanding the retrenchment at the SEC, increasingly corporations on their own have adopted a majority-voting standard for director elections. See Kara Scannell, *SEC Proxy Plan May Spur Debaate — Agency Takes Up Issues of Shareholders' Access, Directors' Accountability*, WALL STREET J., Dec. 26, 2006, at B6; *Business Brief – AT&T Inc.: Majority Voting Standard Is Adopted for Some Elections*, WALL STREET J., Nov. 21, 2006, at A11; *Food Brief – McDonald's Corp.: Bylaws are Amended to Address Uncontested Director Elections,* WALL STREET J., Nov. 15, 2006, at B12; Neal E. Brunette & John D.Stoll, *GM Board Declines to Discuss Meeting on Alliance, Turnaround*, WALL STREET J., Oct. 4, 2006, at A2; Jared A. Favole, *Delaware Lets Firms Enact Rule On Majority Vote*, WALL STREET J., Oct. 4, 2006.

proxy voting.[43]

b. Fiduciary duties. A high disclosure regime enhances the effective enforcement of management's fiduciary duties because managers are not likely otherwise to provide information voluntarily about their breaches of fiduciary duty.[44] A rule requiring the issuer to report all material transactions that it enters into in which managers or directors have an interest provides an example of how mandatory disclosure can help. Once the existence of such a conflict of interest transaction is known, shareholders can force management to meet its burden of establishing the validity of the transaction. To do this, management must show either that appropriate procedures have been followed in the transaction's authorization to remove the taint of the conflict or, alternatively, that the terms of the transaction are fair to the issuer. Without shareholders knowing of the existence of such a transaction, this fiduciary-breach-reducing burden placed on management by corporate law is meaningless.[45]

It might be argued that a manager who is willing to engage in a transaction that is unfair to the corporation would also be willing to violate disclosure rules in order to cover the transaction up and so the disclosure regulations would have no deterrent effect. This argument, however, ignores the fact that the transaction itself, or its effects, may ultimately become visible, at which time it may be easier, from a fact finding point of view, for a court to reach the conclusion that there has been a disclosure violation than that unfairness has occurred. Even more important, the habit of engaging in a wide range of required disclosures may make it harder for a manager to rationalize breaking the disclosure regulations than to rationalize entering into a questionable transaction that the manager persuades himself is good for the corporation as well as himself. This is especially so because disclosure regulation tends to bring with it the involvement of gatekeepers such as accountants and

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[43]Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, Investment Company Act Release No. 27,182, 70 Fed. Reg. 74,598 (proposed Dec. 15, 2005)(to be codified at 17 C.F.R. pts. 240, 249, and 274).

[44] *See* Mahoney, *supra* note 31.

[45] For a more detailed discussion of these points, see Fox, *Required Disclosure*, *supra* note 38 at 118—20. *See also* Roe, *supra* note 23.

lawyers.[46]

2. Market Mechanisms.

A high level of disclosure reduces the agency costs of management through its beneficial effects on two market mechanisms that help align managerial interests with those of shareholders: the hostile takeover threat and share price based management compensation.

a. The market for corporate control. More information and the resulting increase in price accuracy improves the control market's effectiveness in limiting the agency costs of management. A potential acquirer who believes that a target is mismanaged must determine whether it is worthwhile to pay what would need to be paid in order to acquire a target. To make this determination, the potential acquirer must make an assessment of what the target would be worth in its hands. This assessment is inherently risky. Greater disclosure, however, reduces this risk. Because the potential acquirer's management is risk averse, this reduction in the riskiness of its assessment means that a smaller apparent deviation between incumbent management decisionmaking and the decisions that would maximize share value is needed to impel the potential acquirer into action.

With greater disclosure, incumbent managers will therefore be less tempted to operate existing projects in ways that sacrifice profits to satisfy their personal aims, to implement negative net present value projects in order to maintain or enlarge their empires, or to hold onto assets that would be more valuable in the hands of another firm. And those who nevertheless do these things are more likely to be replaced. Disclosure performs this helpful role regardless of whether the issuer is offering new securities.

b. Share price based managerial compensation. Greater

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[46]Corporate managers and directors also, of course, have a duty of care. Because of the business judgment rule, however, successful legal action against breaches of this duty are extremely rare. *See* Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 801 (1999) (noting the rarity of adjudicated breaches of the duty of care). Disclosure however does enhance the functioning of substitute deterrents to duty of care violations: the shareholder franchise discussed here and market mechanisms for reducing managerial agency costs - the takeover threat and share price based compensation - discussed just below. *See also* Goshen & Parchamovsky, *supra* note 31, at 741—42.

disclosure can reduce the agency costs of management in a second way, by increasing the use of share price based managerial compensation. The problem for managers with share price based compensation, compared to straight salary with the same expected value, is the undiversifiable unsystematic risk it imposes on the manager. More disclosure makes share prices more accurate, which reduces this unsystematic risk. As a result, a manager, when offered a total compensation package with a given expected value, will be willing to take a larger portion of it in share price based form if the issuer is operating under a high disclosure regime.[47]

With a larger portion of compensation in share price based form, as with a more effective market for corporate control, incumbent managers will have greater incentives not to operate existing projects in ways that sacrifice profits to satisfy their personal aims and not to implement negative net present value projects in order to maintain or enlarge their empires.

It might be argued that the scandals of the early 2000s, which mostly arose out of a management desire to report higher than actual earnings in order to maintain or increase share price,[48] illustrates that share price compensation is more effective at promoting disclosure violations than good management. There are two responses. First, these problems arose in significant part from the design of the compensation packages, which had insufficient emphasis on longer run share performance.[49] Long run share performance is much harder to manipulate through earnings management.[50] Second, the scandals

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[47] There is empirical evidence that a reduction in the riskiness of an issuer's stock will increase the proportion of stock-based compensation that a manager is willing to accept. Clifford G. Holderness, Randall S. Kroszner & Dennis P. Sheehan, *Were the Good Old Days That Good? Changes in Managerial Stock Ownership Since the Great Depression*, 54 J. FIN. 435 (1999).

[48] COFFEE, GATEKEEPERS, *supra* note 16, at 55—56, 62—64 (2006).

[49] *Id*. at 55.

[50] The most common ways of inflating current earnings are to recognize revenues prematurely, to postpone recognition of expenses, and to capitalize expenditures that will not in fact contribute to future profitability and hence are properly categorized as expenses. Each of these acts will reduce earnings in the future and therefore have a depressing effect on future share price. Thus it is harder for managers to use earnings manipulation to increase the rewards they receive if the share price based compensation plan emphasizes the longer run and hence captures this later

simply point out the importance of having effective enforcement of disclosure rules, without which share price based compensation's high powered incentives for genuinely good corporate performance will not work.

C. Disclosure's Potentially More Direct Effect on Project Choice

Disclosure induced increased share price accuracy for established firms may also more directly improve the selection of proposed new investment projects in the economy, though the importance of this more direct route is a matter of debate. Strict, classical corporate finance theory suggests that share price accuracy's effect on project choice occurs only as a result of its impact on the quality of corporate governance, through its enhancement of the various mechanisms discussed above that prompt managers to maximize share value. The classical theory posits that when an established issuer with sufficient internal funds considers a proposed investment project, the terms at which outside funds can be obtained should not influence the decision of a share value maximizing management as to whether to implement the project. A more nuanced, institutionally oriented view, however, suggests that share price *will* affect an issuer's decision whether or not to undertake a proposed investment project. Under this second view, however, share price will usually have this effect whatever source of funds would be tapped to implement the project, whether it be publicly offered equity, privately placed securities, bank loans or internally generated funds.

Whichever view is correct, the important point to grasp from the discussion below is that disclosure by an established, publicly traded issuer is not significantly socially more important when the issuer is offering new securities to the market than the rest of the time. Either share price has no effect on the decision whether to invest, even when shares are offered, or share price does affect the investment decision, but does so whether a share offering is the source of finance or not.

1. Classical Finance Theory

Classical finance theory's conclusion that an issuer's share price should not affect its project choice decisions reflects the basic Modiglani and Miller tenet that investment and financing decisions should be

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depression in price.

separate.[51] The share value maximizing rule for *real investment* decisions is that the issuer should not undertake a proposed investment project unless the project has a positive or zero net present value ("NPV"), i.e., that the expected future net revenues from the project discounted to present value exceed or equal the project's cost.[52] The discount rate is determined by the market price of alternative expected cash flows available for purchase in the market that have comparable amounts of undiversifiable risk.[53] Thus the two factors needed to make the net present value determination-the expected net revenues from the project and the discount rate - are both independent of the issuer's current share price. Only projects with positive net present values allow the firm to earn a higher risk-adjusted expected return on the amount needed to fund the project than investors can receive by just investing these same funds in the market. Thus only positive net present value projects add to the value of holding a share.[54]

The share value maximizing rule for *finance* is that the issuer should raise external funds if and only if the funds received are greater than the discounted present value of the expected future cash flows that must be paid out in return. In case of external equity finance, the funds received are the share price (less the transaction costs of the offering), and the future cash flows that must be paid out are expected dividends and other shareholder distributions on the newly issued shares for the rest of the issuer's life. Thus, for a manager seeking to maximize the value of her firm's currently outstanding shares, share price is important to the finance decision concerning whether to raise funds by issuing new shares, but is not important to the real investment decision as to whether to implement any particular project.[55] Only the investment decision

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[51]Merton H. Miller & Frances Modiglani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. FIN. 411 (1961).

[52]STEWART C. MYERS, RICHARD A. BREALEY & FRANKLIN A. ALLEN, PRINCIPLES OF CORPORATE FINANCE 17 (2006).

[53]*Id.* at 215-17.

[54]By the same logic, implementing projects with a zero net present value have no effect on share value and implementing negative net present value project decreases share value.

[55] The importance of these rationales for separating the finance and investment decisions can be seen in the case of a firm that has over-priced shares, but only a negative NPV investment project under consideration, i.e., the expected rate of return

affects the allocation of real resources in the economy and hence its capacity to enhance social welfare through the provision of goods and services for consumption.

2. Institutional Finance Theory

There is nevertheless a significant chance that share price will affect a firm's real investment decision as to whether or not to undertake a proposed investment project. This is obvious when the firm does not have sufficient internal funds to finance the project and share price is inaccurately low. Under these circumstances, if a public offering of equity would, at the accurate price, represent the least cost method of external finance, implementing the project may not be share value maximizing even if the project has a positive net present value. This is because funding the project by a share offering at an inaccurately low price may, due to the dilution resulting from the higher number of shares that must be issued to raise a given amount of funds, depress share value more than the adoption of a positive net present value project would increase share value. If, for example, because of the agency costs of debt, alternative forms of external finance are sufficiently more costly than would be equity finance if the share price were accurate, then these alternative forms of external finance would also not be used. Hence, because the share price is inaccurately low, the project would not be undertaken even though it is socially desirable.

If share price is inaccurately high, a firm that only has a negative net present value project idea may both engage in a sale of new equity, as classical finance theory would suggest it should, and also, contrary to classical theory, implement the project. Raising the funds through a new equity sale followed immediately by a distribution of the proceeds might be awkward. Using the cash to implement the project instead, even though doing so is not share value maximizing, would avoid this awkwardness and at the same time satisfy the managerial preference for larger firm size. Thus an inaccurately high share price may lead to the implementation of projects that are socially undesirable.

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on the project is below what shareholders could earn if they received an amount of dividends equal to the cost of the project and reinvested this amount in the market in securities with risk comparable to that of the project. Separating the finance from the investment decisions suggests that the firm should sell additional shares, but should not invest the proceeds in the project. The proceeds should instead be paid out to the shareholders as additional dividends. *See* Daniel Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 701—02 (1981).

The institutional finance theory account so far might appear to suggest that share price accuracy, and hence disclosure, does matter more at a time when an issuer is considering a public offering of shares. There is more to the story, however. Even where the firm does have sufficient internal funds or a public equity offering is not the least cost method, share price may have an effect on whether the project is implemented. On the supply side, share price can affect the cost of financing a project by affecting the terms demanded by the intermediaries constituting the other available external sources of funds.[56] On the demand side, for several reasons, an inaccurate share price can affect management's willingness to use funds to implement a new project, whatever their source.

The first demand side effect of an inaccurate share price is that it can affect management's willingness to use debt financing because of the prospect that the firm will subsequently want to counterbalance any new debt with new equity financing in order to maintain a perceived optimal debt/equity ratio. If share price is inaccurately low, managers may be unwilling to take on additional debt to finance a positive net present value project because of the prospect that the counterbalancing equity financing will, through dilution, be too costly to current shareholders.[57]

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[56] *See* HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 123 (1979).

[57] BREALEY, MYERS & ALLEN, *supra* note 52 at 488—90. In the situation where top management is reasonably confident that the share price is too low because of information it has that has not been credibly disclosed to the market, there may be a corrective to this distorting effect of an inaccurate share price. Normally such a deviation between share price and management's perception of share value will disappear fairly soon, before the equity offering to rebalance the debt/equity ratio would need to occur.

This corrective is less likely to be at work, however, in the case of an issuer that does not disclose at a high level because of it not being subject to rigorous mandatory disclosure regulations and not otherwise having an overall policy of providing high disclosure. Two factors make the manager of such an issuer less likely to perceive the inaccuracy in share price. First, the manager receives a smaller flow of information in the first place. The exercise of gathering and presenting information for SEC filings is consciousness raising. Thus, less of the negative or positive information that exists somewhere within the firm (perhaps in some kind of disaggregated form) makes its way into the awareness of top management. This is because top management is not forced to answer the questions that would be asked as part of a high disclosure regime. Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure,* 96 COLUM. L. REV. 1335 (1996); FOX, *Required Disclosure*, *supra* note 38, at 123-25.

A second demand side effect of an inaccurate share price relates to its distorting effect on the determination by firm management of the appropriate discount rate with which to calculate the future expected cash flows from a proposed project. This determination should, in theory, use only the pricing of securities in the market representing alternative cash flows that have an amount of undiversifiable risk comparable to that of the proposed project. Because companies with similar already existing projects often have many other different kinds of projects as well, however, identifying which securities are claims on cash flows that in fact come close to having unsystematic risk comparable to that of the proposed project is inexact at best. And even if firms with such securities can be properly identified, determining what their prices say about the appropriate discount rate is difficult because it requires assessing, and separating out, the market's assumptions about the expected rates of growth in the other firms' cash flows implicit in their share prices. As a result of these difficulties, managers, in their determination of the discount rate to use to determine the net present value of a proposed project, may be influenced by the discount rate implied by the price earnings ratio of their own firm. To the extent that they do this, there is an inverse relationship between the discount rate they use to calculate the project's net present value and the issuer's share price. This leads to more projects appearing to have positive net present values than is actually the case when share price is inaccurately high and the opposite when it is inaccurately low.[58]

Finally, because of concern with public perceptions, low share price can more generally constrain the use of both external and internal

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Second, managers do not have a monopoly of wisdom on the implications of a particular piece of information within their possession for their firm's future cash flows. When disclosed, the impact of the piece on price reflects the combination of the piece itself combined with the expertise and other information held by myriad persons in the market who analyze the piece's implications. When less information is disclosed, part of the reason that the price is less accurate relates to these factors that are outside of the understanding of managers and hence that they are not aware of.

[58]Again, if management knows that the share price is too high or too low because of information in its possession, the inaccurate price may not have this effect. See note 57 *supra.* But also again, the managers of lower disclosure issuers are likely to be less aware of price inaccuracies. *Id.*

funds.[59] This constraint arises because a low share price can trigger investor attention. Since a primary investor concern is that firms retain too much cash flow which they invest in negative net present value projects,[60] a low share price may put management on the defensive concerning this issue even when in fact it has positive net present value project proposals available for implementation.

D. Disclosure's Role in Increasing Secondary Market Liquidity.

Theory and empirical evidence both suggest that greater disclosure increases liquidity and reduces a firm's cost of capital. To the extent that liquidity can be increased in a cost effective way, scarce resources in our economy will be allocated more efficiently.

1. The Theoretical Link between Disclosure and Efficiency

More disclosure reduces illiquidity in the secondary market for an issuer's shares. Insiders and their tippees can make supranormal profits by engaging in trades based on non-public information. Market makers and specialists cover the expected costs of being on the other side of such trades through their "bid/ask" spread, i.e., the extent to which the price at which they accept buyer orders exceeds the price at which they accept seller orders.[61] The bigger the spread, the less liquid are the issuer's shares, and the less valuable they are to hold. When an issuer offers shares in the primary market, the larger that investors anticipate this spread will be in the future, the lower the price at which the issuer can sell the shares and hence the higher the issuer's cost of capital.[62] Ongoing periodic disclosure, by reducing the amount of non-

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[59] *See* MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 282-87 (1987) [hereinafter FINANCE AND INDUSTRIAL PERFORMANCE].

[60] *See infra* notes 71-73 and accompanying text.

[61] Lawrence R. Glosten and Paul Milgram, *Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*,, 14 J. FIN. ECON. 71 (1985). LARRY HARRIS, TRADING & EXCHANGES: MARKET MICROSTRUCTURE FOR PRACTITIONERS 287– 91, 299 – 302 (2003).

[62]The cost of capital is larger because the prospect of a larger bid/ask spread results in the same issuer expected future cash flow being discounted to present value at a higher discount rate.

public information and hence the opportunities for insiders and tippees to engage in such trades, should therefore reduce bid/ask spreads, increase liquidity, and, as a consequence, reduce the cost of capital.[63]

2. Empirical Evidence That Disclosure Increases Liquidity

Empirical support for the proposition that disclosure increases liquidity and reduces the cost of capital comes from recent work by Hail and Leuz concerning the effect on a foreign firm's cost of capital when it cross lists on the NYSE or NASDAQ, which subjects the firm to the U.S. Exchange Act disclosure regime.[64] Because the United States has stricter, more effective disclosure rules than other countries, such a cross listing requires the firm to provide a higher level of disclosure than before. Foreign issuers experience a price jump when undertaking such cross listings. Hail and Luesz decompose this price jump in order to isolate the effect of the cross listing on the market's expectations of the firm's future cash flows from any effect on the rate at which the market discounts these cash flows, i.e., from any effect on the firm's cost of capital. The market's anticipation of greater ongoing disclosure

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[63] For models working these points out more rigorously, see Robert E. Verrecchia, *Essays on Disclosure*, 32 J. ACCOUNTING & ECON. 91 (2001) (disclosure reduces information asymmetries and lowers a firm's cost of capital); David Easley & Maureen O'Hara, *Information and the Cost of Capital*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=300715&high=%20maureen%20oh ara (same).

[64]Luzi Hail & Christian Leuz, *Cost of Capital and Cash Flow Effect of U.S. Cross Listings*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938230&high=%20luzi%20hail. *See also* Hail & Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?*, 44 J. ACCOUNTING RES. 485 (June 2006) (cross country comparison finding inverse relationship between the effectiveness of a securities regime generally and the cost of capital). For other empirical studies showing that greater disclosure leads to increased liquidity and a lower cost of capital, see Michael Welker, *Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets*, 11 CONTEMP. ACCT. RES. 801 (1995) (presenting empirical findings that a "well-regarded disclosure policy" reduces information asymmetry and thus increases liquidity in equity markets); Christine A. Botosan, *Disclosure Level and the Cost of Equity Capital*, 72 ACCT. REV. 323 (1997) (presenting empirical findings that for firms that attract a low analyst following, greater disclosure is associated with a lower cost of equity capital); Christian Leuz & Robert E. Verrecchia, *The Economic Consequences of Increased Disclosure*, 38 J. ACCT. RES. SUPPLEMENT 91 (2000) (presenting empirical findings from a study of German firms that increased disclosure leads to a lower cost of capital).

following the cross listing can increase its expectations of the firm's future cash flows for two reasons. One is signaling: the firm's willingness to submit its claims of a bright future to greater scrutiny can lead to an increase in the outside market's *perception* of the level of the firm's future cash flow even assuming no change in the future behavior of the firm and hence no change in actual cash flows. The other reason is bonding: greater scrutiny will lead to changes in firm behavior that will increase *actual* future cash flows. While a substantial portion of the price jump following a U.S. cross listing can be explained by the change in expectations caused by signaling and bonding, there remains a significant residual that can best be explained by the cross listing having led as well to a reduction in the rate at which future expected cash flows are discounted and hence the firm's cost of capital. Hail and Luesz attribute this lower cost of capital to the increase in the expected level of disclosure that accompanies a U.S. cross listing. They find no comparable results for a foreign firm's over the counter (OTC) cross listing in the U.S. (the so called "pink sheets" market), or for a Rule 144A offering (under which unregistered shares of foreign issuers can be traded in the United states among large institutional investors),[65] neither of which trigger the need to comply with the U.S. periodic disclosure requirements.

3. Efficiency Effects of Higher Liquidity

Equity markets involve the purchase and sale of future dollars. The sellers in primary equity markets are issuers or entrepreneurs. The shares they sell are claims on future dollars in the form of expected future dividend streams. These issuers and entrepreneurs receive in return current dollars that they invest in real investment projects. In contrast, the sellers in secondary equity markets are shareholders who wish to obtain current dollars by giving up already outstanding shares, i.e., previously issued claims to an issuer's future dividend streams. A secondary market seller of shares gives up these claims on future dollars to obtain current dollars for one of three reasons: to consume more than her current income, to readjust her financial portfolio for risk related reasons, or to speculate that the share price will go down in the future (relative to a future price that reflects the market expected rate of return for cash flows with the share's same level of systematic risk). The buyers of the shares purchased in both the primary and secondary

[65] 17 C.F.R. §230.144A (1990).

markets are the counterparts of the sellers in the secondary market. They give up current dollars to obtain claims on future dollars to: have a place to store the savings generated by their current consumption being less than their current income, readjust their financial portfolios, or speculate that the share price will go up in the future (again relative to a future price that reflects the expected market return). Whichever of these three reasons motivates a potential buyer, if she anticipates a low level of liquidity in the secondary market at whatever time she might wish to sell in the future, the share she is considering purchasing is worth less to her. Her anticipation of a high bid/ask spread at the time that she sells means that she anticipates a lower sale price. As a result, she will not be willing to pay as much to purchase the shares today.

The depressing effect on the price of shares offered today in the primary market from the anticipation of a low level of liquidity in the future secondary market creates an inefficiency in the economy to the extent that the level of expected liquidity could be cost effectively increased. In welfare economics terms, the anticipated illiquidity results in a "wedge" between the value of what the savers - purchasers of future dollars – expect to receive and what the entrepreneurs or issuers - suppliers of future dollars in the form of future dividend streams – expect to give up. The same level of expected future dividend stream is worth less to savers today if liquidity in the future is expected to be low than if it is expected to be high. As a result, resources are allocated less efficiently.[66]

At the margin, with a given supply of investment opportunities, a reduction in expected future secondary market illiquidity makes each expected future dollar of expected dividend stream more valuable and sell for a higher price today and hence lowers the cost of capital. In longer run equilibrium, such a reduction in expected illiquidity will likely both stimulate entrepreneurial activity, drawing out more investment opportunities since they can be sold for more, and increase the amount of savings supplied, since an expected dollar of dividend will be more valuable. The important point is that these liquidity based efficiency benefits of disclosure are no greater at the particular moment

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[66] HARRIS, *supra* note 61 at 214–15. More liquidity also lowers the transaction costs associated with speculative trading based on acquiring a variety of bits of publicly available information and analyzing them to make more accurate predictions of an issuer's cash flows. Thus it stimulates such activity and in the process increases share price accuracy. *Id.* Thus disclosure's enhancement of liquidity also provides a second, more indirect, way that it improves share price accuracy, with the attendant social benefits described *supra* in Parts II.B and II.C.

that an issuer is offering shares than any other moment, because they relate to the expectation of the level of liquidity in the future secondary market for the shares involved.

E. Minimizing Information Costs: the Issuer as Least Cost Provider and Precaution Costs

Many secondary market speculative investors expend resources in a race with each other to obtain information useful for better predicting an issuer's future cash flows. Those who obtain the information first have a trading advantage over the others. There are social benefits associated with this race since the knowledge that is discovered through trading is impounded in share price and adds to its accuracy. More accurate share prices, as we have seen, improve corporate governance and hence the efficiency of resource allocation. But, depending on the particular information involved, the cost of the resources expended in the race may exceed the social benefit from the increase in share price accuracy.[67] This is very likely to be the case where the information is either already known to the issuer or can be easily discovered by it. In these situations, the issuer is clearly the least cost provider. Thus an additional function of issuer disclosure is to save the resources that investors would otherwise expend on the race to be first to determine these types of information.[68]

Moreover, the more credible the issuer's statements, the less investor resources need to be expended as a matter of precaution to try to confirm what the issuer has stated. One source of credibility is the prospect of the issuer facing sanctions, including civil liability, should the information it provides not be accurate. Other sources of credibility include privately imposed sanctions (for example from a stock exchange), certification by a gatekeeper that risks its reputational capital or faces possible liability if an issuer's statement is false, or just an established reputation for truthfulness on the part of the issuer itself.

Again, the efficiency benefits of credible issuer disclosure as a way of reducing real resources spent on the race to be first and on

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[67]*See generally* Jack Hirshliefer, *The Private and Social Value of Information and the Reward to Inventive Activity,* 61 AM. ECON. REV. 561 (1971).

[68] Frank H. Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA L. REV. 669, 681–82 (1984).

precautionary checking are no greater at the particular moment that an issuer is offering shares than any other point in time.

F. Conclusion

This review shows that *issuer disclosure has substantially equal social value whether or not the firm is selling equity at the time*. Upon reflection, this showing is obvious in the case of the impact of disclosure on the effectiveness of the shareholder franchise, fiduciary duties, the market for corporate control, share price based managerial compensation, market liquidity and minimizing information costs. But, as we have seen, it is also largely true in terms of the more direct effects of disclosure on project choice.

The fact that disclosure is socially equally valuable whether or not the issuer is currently engaging in an equity offering has two important implications. First, the disclosure rules should require the same level of disclosure whether or not the issuer is selling securities. As a formal matter, for established, publicly traded issuers, this is largely true today in the United States. Indeed, this has been the guiding principle of the movement over the last 25 years away from a transactionally based system of disclosure regulation toward a system of company registration.[69] Second, and a key point of this Article, civil liability should be structured in such a way that corporate decisionmakers have equally strong incentives for disclosure regulation compliance whether or not the firm is publicly offering equity at the time. As we will see, this is not true today in the United States because the system of civil liability is still built on the vestigial remains of the old transactional emphasis in disclosure regulation.

With these goals in mind, it is important to take account of the fact that when an issuer is making a public sale of equity, the issuer has an extra motive to defy mandatory disclosure regulations not otherwise at work. The extra motive arises because suppression of negative required information will permit the issuer to sell the offered securities for more, and hence benefit directly from the higher price. Thus, at the time of equity sales, the civil liability system must provide an antidote for this extra motive on top of its ordinary incentives for compliance.

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[69] *See supra* notes 8-9 and accompanying text.

III. AVOIDING FINANCING SOURCE DISTORTIONS

Efficiency requires that management choices between internal and external finance and among sources of external finance should reflect the social costs and benefits of the choices involved. Because the social value of an issuer's disclosure is equally great regardless of what source of finance an issuer uses, a system that imposes a greater expected civil liability for a disclosure violation (net of any expected private gains from the violation) when managers choose one kind of financing, rather than another, introduces an inefficient distortion.

The current liability system in the United States, which arose out of the traditional transactionally focused approach to disclosure regulation, violates the principle that the civil liability system avoid such distortions. It imposes significantly heightened risk of liability on managers and other non-issuer actors if a violation occurs at the time that an issuer is publicly offering new securities. Unlike the heightened liability imposed on the issuer at the time of a public offering, the heightened liability imposed on managers and other non-issuer actors is not counterbalanced by greater private gains from the violation.[70] Thus, the heightened liability on persons other than the issuer discourages public equity offerings relative to other sources of investment funds, both internal and external.

A. Increased Reliance on Internally Generated Funds

One alternative to funds raised by a public offering of equity is internally generated funds. Consider, however, the position of the managers of a firm with insufficient internal funds to finance all its positive net present value projects. Given the heightened liability that a public offering of equity imposes on non-issuer actors, the managers may decide not to seek such financing. Doing so would increase their own liability risks for any disclosure violations that may exist in the issuer's filings. Even more important, perhaps, is the potential liability on the part of the underwriters, the expected costs of which will be passed on to the issuer in the form of higher fees that are avoided if the issuer does not finance by such public offering.

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[70] The prospect of issuer liability counteracts any expected gain that managers or other non-issuer actors would otherwise derivatively enjoy as a result of the issuer selling its shares at an inflated price due to a disclosure violation.

Two kinds of social losses may flow from this decision. First, some of the issuer's positive net present value projects may not be funded. There are no internal funds available for them and, as will be discussed below, the illiquidity of privately offered securities causes such securities to sell at a discount. This discount can be sufficient to make some otherwise attractive positive net present value projects not worthwhile.

Second, when some firms leave positive net present value projects unimplemented because of a decision not to seek external funds, a cover is provided for the inefficient behavior of another group of firms. These are firms that have more internally generated funds than they have positive and zero net value projects and that are using these surplus internal funds to finance negative net present value projects. The fact that a firm is not seeking external finance is a signal that it may be one of these surplus internal funds firms that is investing in negative net value projects. This signal is blurred, however, when firms with unimplemented positive net present value projects are also not seeking external finance.

This blurring of the signal is a serious problem because both theory and empirical studies suggest that managers with surplus internally generated funds typically use at least some of these funds to implement negative net present value projects rather than paying them out in dividends. Because managers tend to benefit both from the process of growth and from running a firm of larger absolute size, managers who still have internal funds available after they have exhausted their firm's positive and zero net present value investment opportunities are likely to find it in their personal interests to implement negative net present value projects in addition.[71] The chance that their share value diminishing

[71] I have argued elsewhere that to the extent that the managers of a management controlled firm can do so without risk of a hostile takeover, it is in management's best interests to maximize the firm's aggregate available cash flow (AACF), i.e., its aggregate future earnings, before deductions for depreciation and management compensation and expenses, discounted to present value at a rate reflecting management's time preference and risk aversion. FOX, FINANCE AND INDUSTRIAL PERFORMANCE, *supra* note 59, at 121—27. The greater AACF, the greater the capacity of the firm over time to satisfy the interests of each of the top managers: compensation, luxury perquisites, respect, power, affection of those around him and a sense of rectitude. Striving to make AACF as large as possible also implies, after deduction for management compensation and expenses, the largest possible growth in firm assets (subject, of course, to the constraint that each project invested in is not expected to actually lose money). The idea that managers gain utility simply from the size of the firm they run has a long history. *See, e.g.*, FRANK KNIGHT, RISK, UNCERTAINTY, AND

behavior is detected and stopped is lessened by the very fact that firms with surplus internally generated funds do not engage in outside finance. Thus the real investment choices of their managers are not subjected to the discipline and scrutiny of the market.[72] There is substantial empirical evidence that the investment projects chosen by firms relying predominantly on internal finance are considerably inferior to projects chosen by other firms, an inefficiency which has significantly damaged the economy's growth in productivity.[73]

Since the late 1980s, hostile takeovers may have reduced the scale of this problem. The associated high transactions costs associated with such takeovers, however, make this an expensive control device to the extent that other less costly control devices are available, such as eliminating the current liability system's signal-blurring distortion of the financing choices of firms that have less internally generated funds than positive net present value projects.

B. Increased Reliance on Alternative Sources of External Finance

Other ways for managers to provide investment project funds while avoiding the heightened liability associated with a domestic public offering of equity involve raising the funds externally, but by some other

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PROFIT (1921); JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT; R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION (1945). Moreover, the greater the rate of growth of the assets, the more opportunities for promotion, thereby improving the relations between top managers and those directly below them. OLIVER WILLIAMSON, MARKETS AND HIERARCHIES 120 (1975). The idea that managers of public corporations will under many circumstances have an interest in investing in negative net present value projects is also behind Jensen's so-called "free cash flow" hypothesis. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (May 1986).

[72] *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends,* 74 AM. ECON. REV. 650, 654 (1984); FOX, FINANCE AND INDUSTRIAL PERFORMANCE, *supra* note 59 at 132—40.

[73] *See, e.g.*, GORDON DONALDSON, CORPORATE DEBT CAPACITY (1961); William J. Baumol et al., *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STAT. 345 (1970). For a critical review of these and several other studies, along with an estimate of the magnitude of the effects on the economy, see FOX, FINANCE AND INDUSTRIAL PERFORMANCE, *supra* note 59, at 233—37. *See also* Jensen, *supra* note 71; Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive,* 88 COLUM. L. REV. 891, 898 (1988).

route. Examples would be private placements of equity, sales of securities the secondary trading of which will be confined to a market consisting of large institutional investors (in the United States, Rule 144A)[74] and public offerings of equity restricted to foreign investors (in the United States, Regulation S).[75] To the extent that the distortion introduced by this heightened liability leads to greater use of these forms of finance rather than simply not funding positive net present value projects, there are again social costs. Securities sold pursuant to these vehicles have reduced liquidity due to resale restrictions that are necessary to prevent the vehicles from being used as conduits for unregulated domestic public offerings. Reduced liquidity makes the securities less valuable to their purchasers and so the proceeds received by the firm from such sales are discounted substantially.[76] This reduced liquidity creates the same kind of social welfare loss as the welfare loss discussed above associated with illiquidity arising from lack of disclosure.[77] Greater use of non-public external finance also results in more legal and administrative resources being devoted to the determination of whether a method of raising funds in fact avoids being a domestic public offering and is hence exempt from registration, as well as to the determination of when and how the investors buying the securities can resell them.

Another alternative to a public offering of equity is a public offering of debt. A public debt offering must be registered under the Securities Act and hence also leads to heightened liability for non-issuer

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[74] A publicly traded U.S. issuer is not permitted, however, to use Rule 144A to avoid Securities Act registration of an offering if its common stock.17 C.F.R. § 230.144A (2007).

[75] 17 C.F.R. §230.901-.905 (2007). Regulation S provides a safe harbor from registration of foreign debt and equity offerings. The conditions for falling within the safe harbor differ depending on whether an issuer is foreign or domestic, whether it is registered under the Exchange Act and providing Exchange Act periodic disclosure and whether it is offering debt or equity securities.

[76] Studies attempting to separate the effects of resale restrictions from other factors tending to discount the price of restricted stocks, such as the cost private investors incur to assess the quality of the issuing firm and to monitor it, estimate the illiquidity discount to be between 7% and 20%. Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, 72 Fed. Reg. 36,822, 36,838 n.175 (July 5, 2007) (citing studies estimating the illiquidity discount excluding other price-discounting factors of restricted stocks).

[77] *See supra* Part II.D.3.

actors. Compared to a misstatement at the time of a public equity offering, the same misstatement at the time of a public debt offering would, under many circumstances, be less likely to be considered material and hence lead to liability. Even if it does, it would generally result in smaller damages. The lower likelihood of liability and smaller potential damages are because the misstatement will typically create a larger misperception concerning the size of the residual available for equity than concerning the likelihood of full or partial repayment of debt. Thus heightened liability under existing U.S. law for non-issuer actors at the time of the public offering of securities will create a managerial bias toward choosing debt offerings over equity offerings. Since this bias is unrelated to the relative social costs of the choice, it creates an inefficient distortion. Because debt gives rise to agency costs, most financial economists believe that a firm has an optimal debt/equity ratio.[78] This bias tilts the firm toward exceeding this optimal ratio. The resulting additional agency costs are unnecessary social costs.

IV. THE PROPOSED CIVIL LIABILITY SYSTEM

Disclosure rules are meaningless without incentives for compliance. Civil liability is one method of providing these incentives. The starting assumption of this Article is that a country has decided to have a set of governmentally generated disclosure rules and to use civil liability as at least one means to encourage compliance. This assumption is a political reality in the United States. Mandatory disclosure backed by civil liability is a well established institution. The existence of both a substantial body of principled supporters and significant entrenched interests that prosper from its continued existence strongly suggests that the institution is likely to be retained in some form for a long time to come. Abroad, as outlined in Part I, with the growing concern for transparency, enforcement is being taken more seriously. Civil liability, whatever its problems, has sufficient attractions that it is likely to be increasingly employed by some other countries as well.

Parts II and III develop the principle that the system of civil liability should be structured in such a way that corporate decisionmakers have equally strong incentives for disclosure regulation compliance whether or not the firm is publicly offering its equity. This Part considers what this structure should look like. The proposal here provides an example of what a system of civil liability structured in this

[78] *See supra* note 57 and accompanying text.

way could look like. The exercise helps us help think through the larger question of how to approach designing a civil liability system that reflects a modern understanding of financial economics and the role of mandatory disclosure.

The proposal would provide incentives for compliance at all times that are as strong as they traditionally were only at the times when an issuer engaged in a U.S. Securities Act registered public offering. The key to the design, however, is not that the level of incentives be equal to that at the time of a traditional U.S. Securities Act registered public offerings; it is that whatever level of incentives is chosen, they be equally strong at all times. The choice of a level of strength equal to that existing with a traditional Securities Act registered offering simply provides an illustrative baseline. A different level could be easily achieved with minor adjustments.

While there are clear social benefits with having the incentives for compliance at this level, there are obviously substantial social costs as well, including significant resources devoted to both due diligence and litigation. For the United States, a cost benefit analysis might suggest that the level of incentive strength should be lower or higher than the baseline example used here. And even if the level suggested here is right for the United States, a cost benefit analysis might suggest a different level of incentive strength would be appropriate for another country.[79]

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[79] The ownership pattern of the typical publicly traded corporation in the United States is dispersed, with no single controlling shareholder. Raphael La Porta, et al. *Corporate Ownership Around the World*, 54 J. FIN. 471, 491—95 (1999). With such a corporation, the primary corporate governance problem is the divergence of interests between management and shareholders, i.e., the agency costs of management. *See supra* note 35 and accompanying text. As discussed, disclosure can be very helpful in ameliorating this problem. *Id.* In a substantial majority of other countries, most corporations are controlled by families or the state. La Porta et al., at 496. As a consequence, the corporate governance problems are different. These differences may affect disclosure's usefulness for improving corporate governance and hence disclosure's level of social benefits. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 16—17 (2001); COFFEE, GATEKEEPERS, *supra* note 16 at 78—83 (explaining that dispersed ownership creates managerial incentives to exaggerate reported income while concentrated ownership tends to lead to the extraction of private benefits of control). If, because of these corporate governance differences, the social benefits from disclosure in such a country are less, then the optimal level of incentives for compliance would likely be less as well, because providing stronger incentives tends to be more socially costly. Fox, *Disclosure in a Globalizing Market* , *supra* note 32, at 757—60.

A. Substantive Rules Governing the Disclosure Process

1. Timing.

The liability scheme proposed here contemplates that issuers are required to provide periodic disclosure. The U.S. system, with its extensive annual report on Form 10-K, its quarterly updates of a selected subset of disclosures on Form 10-Q and its "current report" for major new developments on Form 8-K, is an example of such requirements. In addition, any time that an issuer offers to sell a substantial number of additional securities, it would need to disclose any material changes since its last annual report that are not disclosed in a

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Comparing the social benefits from disclosure in different countries is, however, tricky. On the one hand, the agency problems associated with management are lower in countries where most corporations are controlled by families or banks. This is because managers can be more easily supervised by persons with control than by dispersed shareholders. Thus a high level of disclosure is not as necessary to keep managers in line. On the other hand, the persons with control may, at the expense of the non-control shareholders, seek to maximize their own private benefits or those of non shareholder stakeholders of the corporation, such as labor or the communities in which the corporation is located. Disclosure can be helpful in discouraging such behavior, but the extent of its effectiveness depends greatly on the specific situation. News of such behavior may depress share prices, but if those in control directly or indirectly determine the votes of a majority of the shares, such a decrease in price will not lead to a fear of being replaced by a hostile takeover. Whether disclosure has some other kind of deterring effect depends both on the overall social and business mores of the country and the extent to which such behavior can be meaningfully challenged in court. Also, to the extent that the share value depressing behavior involves decisions that benefit other stakeholders at the expense of shareholders, there is a debate as to whether such behavior is socially undesirable in the first place. While there is a broad, though not universal, consensus among commentators in the United States that share value diminishing decisions are generally socially undesirable, *see, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 453--56 (2007) and ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 2, 130—31 (1993) (describing the objective of American corporate law as the maximization of share value and criticizing other systems that take other constituencies into account), this view is far from fully accepted abroad. *See* Michael Gruson & Wienand Meilicke, *The New Co-Determination Law in Germany*, 32 BUS. LAW. 571 (1977); Detlev F.Vagts, *Reforming the "Modern" Corporation: Perspectives from the German,* 80 HARV. L. REV. 23, 38—43 (1966) (the corporate purpose of German corporations extends beyond maximizing shareholder value).

subsequent quarterly or current report.[80] Under this scheme, the price of the issuer's shares in the secondary market will, assuming compliance, reflect up to date information concerning all of the subjects of the mandatory disclosure rules. This secondary market price will be the main determinant of the price at which the new primary market offering

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[80] Without such an updating requirement, issuers will have an incentive to offer securities immediately after they become aware of bad news and prior to the time at which they would be required to disclose it in their periodic reports. Such an updating requirement is included in the automatic shelf registration procedure that was introduced as part of the SEC's 2005 offering reforms and that brings the United States closer to a company registration type mandatory disclosure regime for large established issuers (WKSIs), see *supra* note 9. The updating works as follows. Issuers filing an automatic shelf registration statement may incorporate by reference all reports filed under the Exchange Act. Form S-3, 17 C.F.R. § 239.13, at Item 12. At the time of registration, the issuer need only describe any "material changes" that have occurred since its most recent Exchange Act filing, either by describing these material changes directly in its Form S-3 automatic shelf registration statement or by describing them in a Form 8-K that the issuer then files and incorporates by reference in the Form S-3. Form S-3, 17 C.F.R. § 239.13, at Item 11, 12. After the effective date of the registration statement, Item 512(a) of Regulation S-K requires the issuer, during any period when an offering is actually being made, to file a post-effective amendment to reflect any facts or events which represent a "fundamental change" in the information set forth in the registration statement. 17 C.F.R. § 229.512.

Additional updating at the time of the offering should probably be waived if the issuer is making a de minimis offering or offerings, perhaps something like in aggregate less than a few percent of its shares within a three month period. The waiver is appropriate because the gain that the issuer could achieve by selling the shares at a possibly higher price because of bad news that it is not yet required to disclose under the periodic disclosure regime is not sufficiently large, given the relatively small number of shares offered, to create much of a special incentive to make an offering. Freeing such small offerings from the updating requirement would facilitate a "just in time" method of "at the market" equity financing. Facilitating such offerings is desirable because they involve lower social costs due to their not requiring the real resources that would otherwise go into marketing. The 2005 offering reforms do not provide this kind of a waiver. See note *supra* 9.

At the other extreme, if an offering is sufficiently large - perhaps equal to 30% or 40% of outstanding equity - the disclosure and liability regime proposed here should not be applicable. *Id.* The issuer should instead be treated in the same fashion as an initial public offering (IPO). There are two reasons. First, an offering of this size is likely to be accompanying a transformative event in the history of the firm and so the fact that the secondary market price prior to the offering was efficient provides much less assurance that the offering price will be efficient. Second, like an IPO, there will need to be significant marketing efforts to find new persons willing to hold the many new shares being offered and so again an efficient secondary market in the issuer's shares provides less assurance that the offering price is efficient. Under the 2005 offering reform's amended Rule 415, however, there is no limitation on the amount of securities that may be offered by a WKSI pursuant to its automatic shelf procedure.

would be made since the newly offered shares and the already outstanding ones are perfect substitutes for each other.[81]

2. External Certification.

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[81]This is not to say that the price of the offering will necessarily be the same as it would have been in the secondary market if the new primary market offering had not been made. In fact, there a number of reasons, discussed below, why the decision by an established issuer to raise cash through a new primary market offering might affect the secondary market price of the issuer's shares. The important point for this discussion, however, is that none of these reasons undermines the company registration logic of relying on secondary market prices to assure that the price of the primary offering reflects up to date information.

One reason that the decision to offer the securities could have an effect on the secondary price is signaling. Even with mandatory disclosure, managers inevitably know more than outsiders and outsiders may assume that the decision to offer equity means that managers, based on their private information, think the stock is worth less than its secondary market price. The announcement of the offering will therefore cause the price to drop. Stewart C. Meyers & Nicholas S. Majljuf, *Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have*, 13 J. FIN. Econ. 223 (1984); BREALEY, MYERS & ALLEN, *supra* note 52, at 490-93. Presumably, though, the better the periodic mandatory disclosure regime, the smaller the signaling effect.

A second and third reason why the decision to offer the securities could have an effect on the secondary market price each relate to the increased supply of the issuer's shares. This effect might be long run or only short run. The possible long run effect relates to the much debated question of whether there is a downward sloping demand curve for each individual issuer's shares. The capital asset pricing model would suggest that there is not because there is a vast reservoir of other stocks with the same beta that are perfect substitutes for the issuer's shares. Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VIR. LAW REV. 549, 570, n.67 (1984). For empirical findings purporting to support this theory, *see* Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972). For contrary views *see* Saul Levmore, *Efficient Markets and Puzzling Intermediaries*, 70 VA. L. REV. 645, 653-654 (1984). (reviewing alternative explanations of Scholes findings); Paul Asquith & David W. Mullins, *Equity Issuers and Offerings Dilution*, 15 J. FIN. ECON. 61 (1986) (empirical findings purporting to show a downward sloping curve).

Alternatively, the increased supply might have only a temporary effect of on the secondary market price if investors would need to adjust their portfolios for the new supply to be absorbed by the market. These adjustments entail transaction costs that must be compensated for by a decrease in price. Once the absorption occurs, however, price should return to the level dictated by fundamentals. Michael J. Barclay & Robert H. Litzenberger, *Announcement Effects of New Equity Issues and the Use of Intraday Price Data*, 21 J. FIN. ECON. 71, 75, 94, 96-98 (1998)(empirical findings purportedly consistent with this theory).

The annual report, in addition to being signed by the top executives and a majority of directors, would be signed by a certifying, financially sound, investment bank or other well capitalized entity with financial expertise (the "external certifier"). At the same time, the external certifier would also certify, subject to any corrections set out in the annual report, the truthfulness of all the issuer's other SEC filings during the preceding year as of their respective filing dates. The certifier would thus associate itself with the annual report in the same way as would an underwriter in a traditional registered offering. As described below, the external certifier, in order to maintain a defense to liability if any of these filings contained a material misstatement, would need to conduct the same kind of due diligence investigation concerning the truthfulness and completeness of the annual report and the earlier filings as an investment bank traditionally conducted as an underwriter in a registered public offering. In return for providing this gatekeeping function, the certifier would obviously charge a fee. The object of imposing liability coupled with a due diligence defense is to motivate the external certifier to assure that the annual report would contain the same high quality disclosure as typically did traditional U.S. registration statements in a public offering.[82] The prospect that the earlier filings would need subsequent certification or correction by the external certifier would provide an incentive for the issuer and its officers and directors to make them accurate as well.

Investment banks are unusually well situated to play this vital gatekeeper role. To start, unlike lawyers or accountants, their skill set

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[82] See *supra* notes 4, 8 and 9 for a discussion of the traditional role played by underwriters enhancing the quality of disclosure at the time of a securities offering and how the movement toward company registration, with its greatly reduced time to bring an offering to market, has undermined this function. *See also* COFFEE, GATEKEEPERS, *supra* note 16, at 206, 348—49; Coffee, *Re-engineering*, *supra* note 9, at 1184 (1995) (noting underpricing in the market for equity shelves); David J. Denis, *Shelf Registration and the Market for Seasoned Equity Offerings*, 64 J. BUS. 189, 197—98 (1991). For a description of the more leisurely process by which the traditional registration statement was drafted, which involved the active participation of the underwriters and their counsel, and citations to a variety of commentators who stated that this process generated significant additional disclosure beyond what was in an issuer's periodic filings, see Fox, *Shelf Registration*, *supra* note 10, at 1025—26. An external certifier certifying an issuer's annual report would have the time that the underwriter had in a traditional offering and so could play a role similar to the underwriter of an established issuer offering in the past. Because the external certifier would be faced with the same liability as the underwriter in the traditional offering, it would be motivated to perform this role similarly well.

includes projecting future cash flows. Modern U.S. mandatory disclosure involves much more than providing accounting numbers that relate to past performance. Particularly important is the Management's Discussion and Analysis ("MD&A") in which the issuer must disclose any trends or uncertainties known to management that could result in past earnings being not necessarily indicative of future earnings.[83] Information useful for projecting future cash flows is the information that is most useful to persons trading in the market and their advisers. Analysts and speculative traders strive to make their projections of an issuer's cash flow as accurate as possible. This is because future cash flows determine share value and it serves their personal interests to identify issuers whose share values are above or below current market price. For the reasons discussed in Part II, trading behavior based on more accurate projections, by moving share price towards share value, promotes the interests of society as well. To the extent that legal or accounting expertise is needed in the revisions of the annual report, investment banks are well positioned to take responsibility for delegating such work in a sound manner.

Investment banks also have experience because they currently perform this same exact role in connection with IPOs. This experience not only means that they are already prepared to perform this task well, it also suggests that they would be interested in getting into the business of providing certifications as a way of extracting additional rents from an already established skill set.[84]

Finally, investment banks have the virtue of being highly capitalized and so there is little chance that their motivation to provide needed due diligence will be compromised by the prospect of being judgment proof.

Other kinds of entities with a staff of persons with high financial expertise, such as major consulting firms, could also perform this

[83] 17 C.F.R. § 229.303. There is empirical evidence that adoption in the late 1970s of the revisions to MD&A that prompted these disclosures resulted in a significant improvement in share price accuracy. See Fox, *Share Price Accuracy*, *supra* note 34 at 376.

[84] Investment banks are currently primarily oriented toward selling financial products and arranging transactions. This orientation might suggest an organizational disinclination to developing a certification business, despite the synergies involved. There are other areas, however, where investment banks have chosen to exploit existing skills for new, non-sales applications, for example the provision of "fairness opinions" in corporate control and financial restructuring transactions.

certifying role well. While they would not start with the advantages of an organization that is already performing the same task in the context of IPOs, as they gained experience, they would not be at any cost disadvantage. It is in fact desirable to open the opportunity of being an external certifier as broadly as possible, consistent with the maintenance of quality and adequate capitalization, because competition will keep prices down and encourage efficiency and innovation. It would be necessary, however, for the SEC, or its equivalent abroad, to approve entities to be external cerfitiers so as to assure their financial capacity to pay liabilities and their competency to do the job.[85]

B. Issuer Liability

1. A Disclosure Violation with No Offer of Securities.

Under the proposal here, unlike U.S. law today, the issuer would not be liable for civil damages if it commits a disclosure violation but offers no securities. Thus Rule 10b-5 fraud-on-the-market suits against issuers based on their misstatements in mandatory disclosure filings would be eliminated. Liability for issuer statements made outside of issuer filings would also be eliminated if substantially the same statement were previously or simultaneously made in a filing. The object of such a rule would be to funnel all significant statements through the official filing process and thus subject them to the truth inducing effects of the external certification and of the prospect of liability outlined below for the relevant non-issuer actors. Should the statement made outside the filing turn out to be false, the damage would have already been done when it appeared in the filing. No further damage occurs from the simultaneous or subsequent retelling unless the

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[85] Established major investment banks are highly capitalized because that is what is needed to perform their ordinary range of businesses. A survey of banks with major investment banking and underwriting operations - Bank of America, J.P. Morgan, Citigroup, Goldman Sachs, UBS, Deutsche Bank, Credit Suisse, Merrill Lynch, Morgan Stanley and Lehman Brothers - revealed that as of February 12, 2008, their total stock market capitalization ranged, respectively, from about $190 billion to $30 billion. Source: Yahoo Finance. Their latest reported total book equity ranged, in minor variation from this respective order, from about $188 billion to $22 billion. *Id.*

To prevent the entry of poorly capitalized "fly by night" investment banks or other entities into the certification business, the SEC or its equivalent abroad would, like a state insurance examiner, need to maintain some kind of supervision to assure the capital adequacy of the entities whose certifications it would accept, as well as their competency to do an effective job at due diligence.

retelling appears to have an updating quality to it.

Freeing the issuer from liability but maintaining liability for other actors may at first glance seem backwards. A corporate entity, the issuer, is the entity required to produce the disclosures. The standard law and economics wisdom is that if there is civil liability for a corporate violation, the corporate entity should be primarily liable.[86] According to this view, the open question would be whether secondary liability should also be imposed on the issuer's directors, officers and professional agents, with the presumption being that it should not be absent a showing that issuer liability alone will fail.[87]

This conventional wisdom does not fit disclosure violations very well, however. When managers of a corporation make decisions that result in the corporation's violation of the typical regulation, for example a rule limiting the emission of toxic pollutants, the victims are third parties. In contrast, when the managers make decisions that result in the corporation's violation of a disclosure rule, the corporation is the primary victim of the violation, just as it is the party hurt by a director or officer's breach of a fiduciary duty. This is because, as demonstrated in Part II, disclosure's primary role is to improve corporate governance and to lower the corporation's cost of capital by increasing the expected level of liquidity. The corporation's shareholders are thus the persons ultimately damaged by the violation because of the resulting reduction in the value of the shares due to poor management and reduced liquidity.

What, though, about the persons who purchased or sold in the secondary market at an unfavorable price during the period of the violation? Are they not victims? The answer is no. When the issuer is not offering securities, buyers and sellers in the secondary market are, in terms of the prices that they pay or receive, no better off on an expected basis with a disclosure regulation complying corporation than with a non-complying one. If a falsely positive disclosure violation increases an issuer's share price by $5, every buyer pays $5 more per share than if there had been no violation. But every seller receives $5 more per share. For every share traded, the buyer's loss because of the violation is exactly counterbalanced by the seller's gain. More generally, the overall effect of a disclosure violation on investors trading in the secondary

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[86] Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 858 (1984).

[87] *Id.* at 867; STEVEN SHAVELL, AN ECONOMIC ANALYSIS OF ACCIDENTS 170—72 (1987).

market is a zero-sum game: the winners' winnings just equal the losers' losses. Each winner and loser is in that position by reason of chance and is just as likely to be in the opposite position as the result of disclosure violations by other issuers. For the typical diversified investor, and even for the non-diversified investor who buys and sells different stocks over time, her aggregate experience with disclosure violations is likely to be a wash.

If the losers have a cause of action against the issuer, it will ultimately be paid for by the shareholders at the time the suit is brought, thereby passing on the losses from one chance group to another, neither of which should be any less able to bear the risk than the other, at least for any investor within either group who is diversified.[88] As has been widely recognized for some time, this means that if a regime is in place by which the losers are compensated by issuers that make the false statements, the damages are in some sense "circular," as many critics of fraud-on-the-market class action suits have noted.[89]

In sum, as these critics have argued, the compensation justification for a cause of action against the issuer for a misstatement in a disclosure filing is very weak, particularly given the high transactions costs associated with securities litigation. Such a cause of action does have deterrence value, however. Managers will be motivated to avoid

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[88] Between an undiversified loser and an undiversified shareholder at the time suit is brought, a damage action would probably permit some loss spreading. At the time suit is brought, some of the issuer's shareholders have held their shares since prior to the issuer's misstatement and so suffered no trading loss as a result of the misstatement, because they neither bought nor sold at a price influenced by the misstatement. Thus, not all of the issuers shares were traded at a disadvantageous price due to the misstatement. As a result, providing damages will spread the losses from the persons who did engage in such disadvantageous trades across the holders of all the outstanding shares, which is larger in number than the number of shares traded at a disadvantageous price. This loss spreading comes at the very high price of the substantial real resources consumed by securities litigation, however. *See supra* note 15. Diversification is a more effective, and far less expensive, alternative way to reduce the risks associated with issuer misstatements. Thus risk reduction is an unconvincing rationale for imposing civil liability on issuers in order to provide damages to those who lose by trading at disadvantageous prices due to issuer misstatements.

[89]*See, e.g.*, Paul Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets,* 78 VA. L. REV. 623, 632 (1992); Coffee, *Reforming, supra* note 15, at 1556—66 (2006); *See* Thakor, *supra* note 17. All these authors express skepticism concerning the compensation rationale for civil liability imposed on issuers to provide damages to those who trade in the secondary market at disadvantageous prices due to issuer misstatements.

disclosure violations in order to avoid the issuer losses involved in paying damages, just like they are motivated to avoid any other large cost to the firm. But, as developed in Part IV.E. *infra*, the same level of deterrence can be achieved more effectively and at less cost by imposing liability on the managers directly.[90]

2. A Disclosure Violation When Securities Are Being Offered Publicly.

The issuer's public offer of securities at the time that a disclosure violation exists should, like U.S. law today, make the issuer absolutely liable to investors.[91] The aggregate amount of issuer liability should be

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[90] Professors Arlen and Carney reach the same conclusion. They analyze the problem in terms of the three traditional rationales in the accident law context for favoring enterprise liability over agent liability: enterprise liability deters more effectively, enterprise liability better spreads risk between the firm and its agents, and enterprise liability better allocates losses between the firm and the victims of the violation. They find that none of these rationales apply persuasively in the case of fraud on the market violations of the securities law. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud or Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 700—20. While there is a great deal of overlap between my reasoning and theirs, their analysis differs from mine in one important respect. They do not identify that from the appropriate *ex ante* perspective, secondary market investors are not damaged in terms of their trading profits by the prospect of buying and selling in the shares of corporations that engage in frequent misstatements rather than few or none. Recognizing this makes crystal clear that the only kind of damage, if any, that should give rise to liability is to the corporation itself. This saves a number of steps in the analysis and eliminates the need for unrealistic assumptions such as that there is no possibility of over deterrence in the case of misstatements. Given, for example, the possibility of legal error and the discretion that management has in the fullness of its answers to the questions required by its periodic disclosure filings (to say nothing of voluntary disclosure beyond the requirements of these filings), we need to recognize that management can be deterred from making what it believes is truthful disclosure by the risk of liability. Similarly, we can, through the level of care required in order to maintain a due diligence defense available to directors, officers and the external certifier, affect the level of care that an issuer devotes to the accuracy of its disclosures. This care is costly and so there is some optimal level above which is socially wasteful. *See* note 79 *supra* and IV.C.1 *infra*.

[91] In this context, the term "absolute liability" sounds more draconian than it really is. To give rise to liability, a statement of historical fact must be false or misleading at the time it is made. This suggests that whatever the state of mind of the issuer's agents, the true state of affairs must be knowable at the time, something that the plaintiff would have to show to establish falsity. *See, e.g., In re* Navarre Corp. Sec. Litig., 299 F.3d 735, 742—43 (8th Cir. 2002) (stating that plaintiff's complaint fails under the heightened pleading standard of the PSLRA because it did not indicate why

equal to the increase in the issuer's sale price resulting from the violation multiplied by the number of the shares sold.

Imposing liability on the issuer for a disclosure violation when the issuer offers securities and not otherwise may seem contradictory as part of a liability scheme that is intended to provide corporate decisionmakers with equally strong incentives for regulatory compliance whether or not the issuer is selling securities. Such issuer liability when the issuer is offering its equities for sale, however, simply returns what would otherwise be the special gain for committing a price inflating disclosure violation. Thus, issuer liability does not create an incentive for managers and directors to provide higher than usual compliance at the time of such a sale; it is an antidote for what would otherwise be an incentive to provide lower than usual compliance. This incentive for lower than usual compliance arises because of the derivative gains that such corporate decisionmakers enjoy when an issuer does better financially, which will happen if it sells shares for more than they are worth.

Exactly to whom this aggregate amount of liability should run is a complicated question. The prospect of this liability will be equally effective in deterring disclosure violations whether liability runs to the investors or someone else, for example, the government. Arguably, also, it is not necessary from a fairness point of view for the payments to go to investors. If liability were imposed, but the proceeds went elsewhere and so compensation was not paid to the purchasers, the market price of all firms that offer securities would be discounted to reflect the fact that deterrence will fail in a certain percentage of cases with the resulting disclosure violations making the issuers involved look more valuable

defendant's statements would have been false or misleading at the time they were made). With respect to a forward looking statement, which by definition cannot be a statement of fact, calling it "false" or "misleading" has to go to how reasonable a basis the forward looking statement has and the issuer's degree of conviction as to its accuracy. The specification of what constitutes an actionable forward looking statement under U.S. securities law has undergone considerable development over the last 40 years. The current law on actionable forward looking statements comprises a mix of statutory and common law rules. Rule 175 and Rule 36-b, promulgated, respectively, under the Securities Act and the Exchange Act, provide a safe harbor for projections made with a reasonable basis and good faith. 17 C.F.R. §§ 230.175, 240.3b-6 (2007). For reporting issuers, the PSLRA amended the Securities Act and Exchange Act to provide additional safe harbors for certain projections. 15 U.S.C. §§ 77z-2, 78u-5 (2005). Courts have also developed the "bespeaks caution doctrine", which protects projections if accompanied by meaningful cautionary statements. *E.g.*, Romani v. Shearson Lehman Hutton, 929 F.2d 875 (1st Cir. 1991).

than they really are. So, even without the prospect of compensation, the price ex ante is fair, even though some investors will be unlucky and ex post suffer a loss.

Paying investors the damages collected from issuers may matter, however, for allocative efficiency, if the "institutional" view of finance is correct so that share price directly affects established firm real investment.[92] Without the prospect of compensation, investors will discount what they are willing to pay for the shares of all issuers that offer securities because they do not know for which issuers deterrence will fail. Consider the honest issuers that in the ideal world, where there are no misstatements and hence no discount, would have received a high enough price for their shares to find equity financing worthwhile. With the discount, equity finance will no longer be worthwhile for some and positive net present value projects will not be implemented. Full compensation would eliminate the discount and so assure implementation of these projects.[93]

Moreover, providing a purchaser with a right to compensation creates a pool of interested private persons on whose behalf the civil suits, necessary for liability to provide its deterrence function, can be brought.

The total damages paid by the issuer should, as noted, equal the number of shares that it sells in the offering multiplied by the amount by which the disclosure violation inflated the price at which the shares were sold. The total damages collected presumably should be divided up among all persons who purchased the issuer's shares during the period that their price was inflated by the misstatement, whether they purchased in the primary market at the start of the offering or later in the secondary market. For purchases in the secondary market, it should not matter whether the share purchased was one sold in the primary offering or one that was already outstanding. The total damages paid by the issuer should be divided among these claimants pro rata in proportion, for each investor for each share that she purchased during this period, to the amount by which the price was inflated by the misstatement at the time of purchase (less, if it were sold prior to the bringing of the suit, the

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[92]*See supra* Part II.C.2

[93]The allocative efficiency effects of compensating investors are not free from ambiguity, however. With the discount being eliminated by compensation, more issuers that *are* making misstatements may also find it worthwhile to make offerings.

amount, if any, it was still inflated at the time of sale).[94]

C. Liability of Other Actors

Whether or not a securities offering is occurring, a disclosure violation should trigger imposition of liability on the directors, officers and external certifier. These actors' liability would be absolute, subject to a due diligence defense, which is the U.S. rule today only when the issuer is offering securities. Damages should be in a limited amount that is unrelated to whether there is an offering. The damages should be payable to the issuer, not to investors who engaged in losing trades as a result of the misstatement.

1. The Object of Placing Liability on the Non-issuer Actors.

The object of the proposed liability system is to give the directors, officers and, most importantly, the external certifier the same civil liability incentives to make an established issuer comply with its *periodic* disclosure requirements as they traditionally had to make the issuer comply with the Securities Act registration statement disclosure requirements for a public offering (and that they continue to have in the case of an IPO). These incentives worked well in the past to produce high quality disclosure, before short form and shelf registration made impractical serious underwriter due diligence for offerings by established issuers.[95] Each of these non-issuer actors will be exposed to the same risk of liability, in roughly comparable amounts, as they would have faced in a traditional registered offering and each will be provided with

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[94]There are serious problems with the two alternative approaches to compensation. One approach allows secondary market purchasers to sue, but only if they purchased the specific shares originally sold in the offering. Secondary market purchaser compensation would be largely a chimaera because, as a practical matter, in this market the shares from the offering are usually indistinguishable from those that were already outstanding. Even if the distinction could be made, it would be incompatible with a single secondary market for the issuer's shares because each type would have different rights and hence a different value. The alternative approach is to confine the cause of action only to primary market purchasers. This reduces the liquidity of the offered securities because they would lose their rights to damages when sold and hence, all else being equal, be worth less to the purchaser than to the seller.

[95] *See supra* notes 6, 9, 10 and 82 and accompanying text.

the same due diligence defense.[96] With such incentives in place, established issuers can be expected to provide on an ongoing basis the same high level of disclosure that they provided in a previous era at those times when they were engaging in public offerings.[97]

2. The Non-issuer Actor's Liabilities as Their Contribution Obligations to "Total Liability"

a. Certification by the external certifier and directors and officers. The external certifier and the directors and top officers of the issuer would each sign the issuer's periodic disclosure annual report filing (the 10-K in the U.S. system). The signature would constitute a certification of the truthfulness of the annual report and of each of the issuer's periodic disclosure filings during the preceding year (except to the extent that any misstatement in the earlier filing was properly corrected in the annual report).

b. The concept of"Total Liability". The concept of Total Liability is the starting point for calculating the amount of liability for each non-issuer actor if the annual report contains a disclosure violation and the actor does not meet its due diligence defense. To determine Total Liability, treat the annual report as if it were a registration statement for a share offering in an amount, call it I, equal to the issuer's total amount

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[96] Greater accuracy in firm disclosures requires a greater level of care by the firm's officers and directors and by the external certifier. Greater care involves greater costs. Therefore, there is some optimal level of care. As discussed at the beginning of Part IV, this proposal assumes that the optimal level of care is what was required in the traditional registered public offering. If analysis for either the United States or another country suggests that a different level of care is optimal, the level of care required of the officers, directors and certifying investment bank, in order that each be able to maintain their due diligence defense, should be adjusted accordingly.

[97]This Article does not specifically deal with the liability of accountants for misstatements in the audited financials contained in the annual report. Accountants are obviously vital gatekeepers. They too will have greater incentives to exercise care if subject to some kind of civil liability. It may be appropriate to subject accountants to an approach similar to what is recommended here for other non-issuer defendants, freeing them from fraud-on-the-market liability and substituting some kind of other measured liability that depends in part on to the size of the issuer's annual investment rather than trading volume during the period of the misstatement. But the issues relating to the tradeoffs between achieving any given level of care and the costs of doing so, as well as the history of the applicable rules of liability to date, are sufficiently different that they call for a separate inquiry.

of real investment and increase in non-liquid assets during the preceding year. The phantom number of shares offered in this hypothetical offering would be I/P, where P is the issuer's share price immediately after the filing. The Total Liability would be the amount by which the share price was increased as a result of the disclosure violation times I/P (the phantom number of shares in the hypothetical offering). [98]

c. Liability of each non-issuer actor. Each non-issuer actor's individual potential liability would be the amount the actor would be required under U.S. law to pay in an action against it for contribution, if as described above, the annual report were a registration statement for an offering of $I in shares (with the external certifier being the underwriter) and the Total Liability had been paid in full by some other defendant who then brings the contribution action against the actor in question. Each of these actors can free herself of this potential liability by engaging in acts that would enable her to show, if a suit should arise after the disclosure filing, that at the time of the filing, after reasonable investigation, she had reason to believe and did believe the annual report

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[98] For each phantom share offered, this measure is roughly equivalent to the aggregate amount of damages owed under Section 11(e) of the Securities Act to the one or more purchasers of the share in the period between the time of the offering and the time suit is brought. Under § 11(e), subject to certain caps, the person holding this share at the time suit is brought has a prime facie case for damages equal to the difference between the price he paid and its "value" at the time of suit. Value, in the case of an established issuer trading in an efficient market is typically the price at time of suit. *See In re* Fortune Systems Sec. Litig., 680 F. Supp. 1360, 1370 (N.D. Cal. 1987) ("The 'value' of a security may be found to be different from the actual price of the security, but this is an unusual and rare situation. In general, price and value are used interchangeably, and the courts have not often found the 'true value' of a stock to differ from its market value"). If this holder purchased the share in the secondary market rather than in the offering itself so that the share had one or more prior holders, each prior holder's prime facie came for damages equals the difference between price paid and price sold. Thus, except to the extent that certain caps alter the calculation, the potential aggregate prima facie case for damages associated with each share in the offering is the difference between the offering price and the price at the time suit is brought. The defendant is allowed under §11(e) an affirmative defense to the extent that it can show that the decline was due to any other cause besides the misstatement. Each secondary market purchaser must also show that the share purchased was one sold in the offering. *See* Rosenzweig v. Azurix Corp., 332 F.3d 854, 871—73 (5th Cir. 2003) ("all four courts of appeals to address the question have held that, even after *Gustafson*, aftermarket purchasers have standing to sue under § 11"); *see also* Gibb v. Delta Drilling Co., 104 F.R.D. 59, 69—70 (N.D. Tex. 1984) ("to recover under Section 11 a party need only show that he purchased securities that are the direct subject of the prospectus and registration statement").

contained no disclosure violations. Thus each of these actors would have the same incentive to make the issuer's annual report disclosure violation free as they traditionally had with respect to an issuer's Securities Act registration statement.

d. Interim reports. If any the of issuer's quarterly or other updating filings (in the U.S. system, 10-Qs and 8-Ks) contained a material misstatement that was not corrected in the annual report, each of the non-issuer actors would be liable as if the misstatement had been repeated in the annual report. If it was corrected in the annual report, the external certifier would not be liable. Each of the officers and directors, assuming she was in office at the time of the earlier filing, would be liable, but damages would be reduced so that they would be in proportion to the fraction of the year between date of the earlier filing and the date of the annual report (or, if unambiguously corrected earlier, the date of the earlier correction).

e. Underwriter liability eliminated. Unlike U.S. law today, no liability would be imposed on any underwriter associated with a public offering for any disclosure violation relating to the issuer involved.[99] Under the proposal, the underwriter's traditional information forcing function would be taken over by the external certifier.

f. Varying the level of damage exposure. There is nothing sacred about the specific levels of damage exposure traditionally imposed under the Securities Act on the underwriting investment bank or the other non-issuer actors associated with a public offering. Indeed, these levels have themselves been in flux to some extent over time. As part of the PSLRA, for example, the Securities Act was amended in 1995 to reduce the exposure of outside directors.[100] A cost benefit analysis might well

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[99] This refers to underwriter liability akin to existing liability for false or misleading statements in the registration statement pursuant to §11 of the 1933 Act. The underwriter should still be liable to purchasers in the offering for its own statements pursuant to a Rule 10b-5 anti-fraud standard. If the external certifier was also the investment bank that was acting as the underwriter, it would, of course, be liable as the external certifier just as if it were not the underwriter.

[100] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. The PSLRA amended Section 11(f) of the Securities Act to limit the liability of outside directors to proportionate liability, except in the case of a knowing violation, to which joint and several liability would still attach. 15 U.S.C. §§ 77k(f), 78u-4(f).

suggest the desirability of further tinkering with respect to some or all kinds of non-issuer defendants who are individuals, for example imposing income or wealth based damage caps of some kind. Nor is there anything sacred about the current standards of what constitutes due diligence with respect to any of the non-issuer defendants. Again, a cost benefit analysis might suggest that safe harbors be available to certain classes of non-issuer defendants such as outside directors, if, for example, they undertake specified procedures such as reasonable reliance on outside disclosure counsel.[101] The key point is that each of these non-issuer defendants face some diminishment in their wealth if the annual report contains a material misstatement unless it can establish a due diligence defense appropriately designed to reflect what would likely be discovered given what would be a reasonable amount of investigation for a person in its position.[102]

g. Indemnification and insurance. Indemnification of the non-issuer actors, at least beyond perhaps paying officer and director legal fees, would make no sense because the damages are being paid to the issuer and so it would just be taking money out of one pocket and putting

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[101] See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004) (Coffee argues that in order to relieve the tension between the lawyer as gatekeeper and the lawyer as advocate, corporations should use two separate law firms, with one acting as outside disclosure counsel. Disclosure counsel would review the issuer's filings. *id* at 355. With this sort of procedure, if the disclosure counsel's opinion stated that no information had come to its attention that would suggest any disclosure violation, outside directors who reasonably relied on the opinion would have a very strong argument that they should be free from liability. The SEC could provide a safe harbor for such a director under its exemptive authority pursuant to its authority under Exchange Act §§ 3(f) and 36. Some prominent commentators have even argued that outside directors should not be liable at all. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability: A Policy Analysis*, 16 J. INSTITUTIONAL & THEORETICAL ECON. 5, 6, 17 (2006).

[102] Imposing on the gatekeeper the task of proving non-negligence has a number of advantages over putting the burden on the plaintiff. There is less chance of legal error because the gatekeeper has most of the information as to whether it met its standard of care. Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 Mich. L. Rev. 1677, 1693 (2007). Moreover, the social resources consumed by the plaintiffs' lawyers, and the fee needed to be paid to them to induce them to bring actions where they are socially warranted, would be substantially less than in fraud-on-the market suits since they would simply need to show the existence of a material misstatement and of a loss caused by the misstatement. This is often not difficult, for example in the case of an earnings restatement immediately followed by a sharp price drop.

it back in the other. Given that the primary function of civil liability under this plan is deterrence, insurance should also probably be prohibited, at least in the case of officers and directors.

At first glance, the case for prohibiting the external certifier from obtaining insurance might appear to be the stronger one, since the certifier's only function in this scheme is to investigate the truthfulness and adequacy of the issuer's annual report. Closer analysis, though, shows that it might not seriously undermine the system to allow the external certifier to obtain insurance, because the insurance provider would have strong incentives to monitor the adequacy of the external certifier's due diligence practices and any certifier seeking such insurance would have a strong incentive to minimize its premiums.

Any analysis of denying insurance for officers and directors must start with the recognition that, unlike the external certifier, officers and directors have important functions beyond assuring the quality of their company's securities disclosures. The normal justification for the issuer purchasing directors and officers (D&O) insurance is that it is necessary to attract qualified people to do these other tasks. Such a person, the argument goes, would be unwilling to serve without insurance because of the risk of a large judgment being erroneously imposed upon him.[103] The whole point of putting liability on directors and officers, however, is deterrence, not compensation. If deterrence is to be maintained, allowing issuer paid D&O insurance for disclosure violations is highly problematic. One reason is that, unlike the external certifier, it would be the issuer, not the insured, who would be paying for the policy. The officers and directors might be able to prompt the issuer, in a non-transparent transaction, to buy a policy that, in return for being expensive, involves little scrutiny of the history and procedures of the officers and directors who are covered. Shareholders would end up paying the bill for this low scrutiny policy. A second reason is that the available empirical evidence suggests that D&O insurance providers do little to monitor issuers in order to prevent misrepresentations and that their risk assessment and pricing policies send only a weak deterrence

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[103] R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 9 (1987) ("[m]any directors have resigned from their positions or have declined to seek to renew their terms as such when liability insurance is unavailable, and many qualified individuals have refused to accept directorships initially").

signal.[104] The more appropriate solution to maintaining deterrence, while still allowing issuers to attract qualified directors and officers, is to limit the impact of the risk associated with the possibility of an erroneous judgment by providing for damage caps (related, perhaps, to an individual's compensation from the firm or the individual's total wealth)[105] and by providing, ex ante, a sufficient boost in salary or fees to compensate for the remaining risk. It should also be noted that the risk of an erroneous judgment against an officer or director is reduced where she, rather than the plaintiff, is the one who has the evidentiary burden with respect to the standard of care, since most of the information relevant to that determination is within her possession.[106]

3. Rationale for Damages Being Proportional to the Issuer's Annual Total Investment.

Why choose the firm's total investment for a year, I, as the amount of the phantom offering from which officer, director and external certifier liability is calculated? The answer is that whether a firm uses external or internal funds to finance its investments, it ought to expose itself to the scrutiny of the mandatory disclosure process in proportion to the total amount of such investments, especially given the poor investment record of firms that rely primarily on internally generated funds.[107] Also, total investment is usually a reasonable proxy for firm size. The absolute value of the social gains from a given degree of improvement in the alignment of the interests of management and shareholders should be roughly proportional to firm size. The larger the firm, the larger is the social gain from the realignment. The same is true

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[104] Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO.L. J. 1795, 1798—99 (2007).

[105] In 2005, the government of Ontario, Canada, amended the Ontario Securities Act to provide for civil liability for secondary market disclosure violations. See *supra* note 24. For a liable director or officer of a responsible issuer, damages are limited to the greater of C$25,000 or fifty percent of the aggregate of the director's or officer's annual compensation from the responsible issuer and its affiliates. Notice of Amendments to the Securities Act and Regulation, and to the Commodity Futures Act, 28 Ontario Securities Commission Bulletin 6555 (Aug. 5, 2005).

[106] Hamdani & Kraakman, *supra* note 102, at 1693.

[107] *See supra* notes 71-73 and accompanying text.

of the reduction in cost of capital from disclosure induced increased liquidity. These observations in turn socially justify a proportionally greater amount of resources devoted to due diligence for larger firms. The prospect of a larger expected damage award if the due diligence performed fails to avert a misstatement will prompt this greater amount of resources devoted to due diligence.

To the extent that the ratio of a firm's total investment to firm size deviates from the average (making total investment a less reliable proxy for firm size), the deviation in turn reflects the rate at which the firm is changing. A higher than average ratio would suggest that the firm is changing faster than the average firm. For any given size of firm, a faster rate of change would call for more thorough periodic disclosure and hence, again, a greater amount of resources devoted to due diligence. The opposite conclusion would follow from a lower than average ratio.

This use of a firm's total investment as a scalar for determining damages should be contrasted with the current U.S. liability system's volume-of-trade scalar implicit in fraud-on-the-market action damages. The "out of pocket" measure used to determine damages in such suits is, for each purchaser of a share inflated in price by a falsely positive misstatement, the amount by which share price was inflated at the time of purchase (less, if it was sold prior to full revelation of the truth, the amount it was inflated at the time of sale).[108] Thus, the total damages owed by the defendants is a sum equal to (x) the number of shares that were purchased at least once during the period that the price was inflated, times (y) the amount by which each such share was inflated at the time of its first purchase during such period.[109] For issuers of any given size, the volume trading varies considerably from one issuer to the next and from one period to the next. These variations have no obvious connection with the gains in corporate governance and reduced cost of capital arising from better disclosure and thus would appear not to be appropriate factors to be considered in the calculation of damages.

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[108]Randall v. Loftsgaarden, 478 U.S. 647, 662 (1986); Estate Counseling Service, Inc. v. Merrill Lynch, 303 F. 2d 527, 532 (10th Cir. 1962); LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4413-14; Green v. Occidental, 541 F.2d 1335, 1341—46 (9th Cir. 1976) (concurring opinion of Judge Sneed).

[109] For any share that was purchased more than once during the period that the price was inflated, the total damages of all its purchasers under the out-of-pocket measure would equal the amount by which the misstatement inflated price at the time of the initial purchase.

4. Procedures for Recovery.

A suit against an officer, director or the external certifier could be brought under this system by any shareholder on behalf of the corporation in much the same fashion that a shareholder can now bring a suit to recover short swing profits under Section 16(b) of the Exchange Act. Attorney's fees would be available for successful plaintiffs, as they are under Section 16(b).[110]

Given these proposed procedures, civil liability actions against non-issuer defendants for disclosure violations would obviously continue to be driven by entrpreneurial plaintiffs' lawyers, since, except when there has been a radical change of management, current directors and officers will not induce an issuer to sue either themselves or recently departed directors and officers with whom they served. The central role of the entrepreneurial plaintiffs' lawyer should be explicitly recognized, not treated like an awkward embarrassment. Thus there is no place in this proposed scheme for the contemporaneous ownership rule from corporate law requiring that the plaintiff bringing a derivative suit be a person who was a shareholder at the time of the misdeed.[111] If any shareholding is required, a law firm wishing to bring a suit on behalf of an issuer should be able to qualify simply by buying a share at the time of filing.[112] There remains the problem of how to choose among competing plaintiffs' firms, each of which wants to bring the case on behalf of an issuer. Perhaps preference should be given to a firm that has the approval of one of the issuer's large non-control shareholders, akin to the lead plaintiff system under the Private Securities Litigation Reform

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[110] *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

[111] 19 AM. JUR. 2D *Corporations* § 2010 (2007). The Federal Rules of Civil Procedure also impose a contemporaneous ownership requirement on shareholders bringing derivative suits. FED. R. CIV. P. 23.1.

[112] A suit to recover short swing profits under Section 16(b) of the Exchange Act may be brought by the "owner of any security of the issuer." 15 U.S.C. § 78p(b). Courts have consistently held that the plaintiff in a 16(b) action need not have held the issuer's securities at the time of the alleged short swing transaction. William E. Aiken, Jr., Annotation, *Who is "issuer" or "owner of any security of the issuer" for purposes of enforcing short-swing profits provisions of § 16(b) of the Securities Exchange Act of 1934*, 51 A.L.R. Fed. 785 (1981).

Act of 1995 ("PSLRA").[113]

D. Class Action and Derivative Suit Litigation Concerns

The agency problems associated with plaintiff lawyer representation in securities class actions and corporate derivative suits in the United States have given rise to considerable concern in both a portion of the scholarly literature and in more general discussion over the last couple of decades.[114] Two concerns in particular have been raised. First, many commentators say that the United States has experienced too many "strike suits": meritless securities law claims brought by plaintiff's class action lawyers to obtain attorney's fees based on settlements extracted from defendants wishing to avoid the nuisance of continuing litigation and the risk of an erroneous negative judgment.[115] Second, there is a widespread feeling that for those suits that should be brought, plaintiff's lawyers are overpaid relative to the work they do.[116] The PSLRA was in large part a legislative response to

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[113] The PSLRA provides that the presumptive lead plaintiff in a securities class action is the plaintiff with the largest financial interest in the relief sought and otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure. 15 U.S.C. § 77z-1(a)(3)(B).

[114] *See, e.g.,* John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 677 (1986). Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 B.Y.U. L. REV. 1239, 1259-1275.

[115] *See,* e.g., Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 524 – 54 (1991). A conceptually very similar problem occurs in the case of a highly marginal suit where, for the same reasons, plaintiffs' lawyers are able to obtain a settlement that is much larger than the expected value of the judgment, if any, that would result if the suit were fully litigated.

[116]*Id.* at 541 – 542; *In re Quantum Health Res., Inc.*, 962 F. Supp. 1254 (E.D. Cal. 1997) (stating that experience has shown that the risk that justifies large contingency fees in securities class actions simply does not really exist); Richard W. Painter, *The New American Rule: A First Amendment to the Client's Bill of Rights*, in Manhattan Institute, 2000 Civil Justice Report 1, 2 (2000) (stating that the market for contingency fee lawyers is not competitive leading to inefficiencies and overcompensation).

these two concerns.[117]

The claim might be made that implementing in the United States the liability scheme proposed here would aggravate these problems because at times when the issuer is not offering securities, the non-issuer actors would be more open to liability than is the case today. In fact, however, I believe that the overall scheme moves in the direction of reducing these problems. The proposed scheme would eliminate fraud-on-the-market suits against issuers not offering securities that are based on misstatements in a mandatory disclosure filing. It would also eliminate all such suits based on any statement made outside of such a filing if substantially the same statement were made in such a filing prior to, or at the same time as, the statement made outside. The substantial majority of all payments made by issuers today in connection with settlements or judgments relating to securities litigation arise precisely

[117] Private Securities Litigation Reform Act of 1995, 104 S. Rep. No. 98, 99 (1995). It is unclear, however, whether the PSLRA makes it more difficult to bring meritless fraud-on-the-market suits relative to the difficulty of bringing suits with merit, or whether it simply makes it more difficult to bring all fraud-on-the-market suits. The distinction is important. If all the weight of the PSLRA's restrictions falls on non-meritorious actions, then it helps solve the problems of class actions without lessening deterrence. To the extent that it also makes it more difficult to bring actions with merit, however, any reduction in the class action problems comes at the cost of reduced deterrence. Overall, the evidence suggests that the PSLRA does in fact impose this tradeoff, though it does not resolve whether any reduction in the social costs associated with non-meritorious suits is greater than any social losses associated with a reduced number of successful meritorious suits. Professors Johnson, Nelson & Pritchard concluded that case quality may have improved post-PSLRA, finding a closer empirical relation between factors indicating fraud (restatements and abnormal insider stock sales) and securities class action filings. Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627 (2007). Stephen Choi argued that although the PSLRA deters some frivolous suits, it has also deterred certain meritorious suits. Choi found that the PSLRA probably deters non-frivolous securities lawsuits in two situations: situations involving smaller companies with small offerings or low secondary market turnover and situations where companies engage in fraud but there is a lack of pre-filing hard evidence of that fraud. Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598 (2007). See also, Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913 (2003); Eric Talley & Gudrun Johnsen, *Corporate Governance, Executive Compensation and Securities Litigation*, USC Law School, Olin Research Paper No. 04-7; and USC CLEO Research Paper No. C04-4 (2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=536963.

out of these kinds of actions.[118] For a number of reasons, these problems would occur less frequently under the new substitute causes of action proposed here than under the eliminated fraud-on-the-market actions.

1. Reduced Frequency of Occasions to Sue

The proposed scheme should reduce the frequency of disclosure violations and hence the frequency of the occasions that give rise to the new substitute causes of action. Today, outside of the certified

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[118] Because of the difficulty of meeting the traditional reliance requirements in a class action, most Rule 10b-5 class actions are fraud-on-the-market suits, see *supra* note 14. Through the years 1997-2004, Rule 10b-5 claims have been involved in over 95% of the settlements, while Section 11 or Section 12(a)(2) claims have only been involved in 20% of the settlements. *See* Securities Class Action Settlements, at http://securities.cornerstone.com/pdfs/Settlements_2004.pdf (last accessed Aug. 15, 2007) (providing securities class action settlement statistics for the years 1997-2004). Section 11 and Section 12(a)(2) claims continue to be involved in only 20% of securities class actions settlements through the year 2006. *See* Securities Class Action Settlements 2006 Review and Analysis, at http://securities.cornerstone.com/pdfs/Settlements_2006.pdf (last accessed Aug. 15, 2007).

Two features make fraud-on-the-market class actions particularly vulnerable to strike suits and to highly marginal suits that extract disproportionately large settlements relative to the expected value of a fully litigated judgment. First, the typical issuer does not expect to have such suits brought against it frequently. According to one study, the average public corporation has only a 1.9% probability that it will face a shareholder class action lawsuit in a given year. RONALD I. MILLER, TODD FOSTER, AND ELAINE BUCKBERG, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: BEYOND THE MEGA-SETTLEMENTS, IS STABILIZATION AHEAD? 3 (NERA Economic Consulting 2006), *available at* http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf. Thus, for an issuer, there is little reward in fighting such an action simply to develop a reputation that it will resist meritless and highly marginal actions in the future. Instead, a rational issuer will compare the cost of settlement with the expected cost of continuing to litigate the action, which, once a case survives a motion to dismiss and so discovery begins, is very substantial. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1469 (2004) (describing the high costs that pressure companies to settle even frivolous securities suits); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 5 (1990) (describing and modeling the incentives facing plaintiffs and defendants with respect to settlement of frivolous lawsuits). Second, if a meritless case is fully litigated, there is always the possibility of legal error. The potential damages associated with an adverse fraud-on-the-market judgment make this risk of legal error hard to take. These damages can be huge relative to the size of the company, at least in the situation where the misstatement inflates price for a significant period of time and trading has been heavy. Rather than "bet the company," the issuer settles for a substantial amount.

financials, the persons making disclosure decisions - corporate managers - are not subjected to any kind of outside review. And while they face the possibility that a disclosure violation will result in the issuer needing to make a payout in response to a fraud-on-the-market suit which in turn could hurt the managers derivatively, there is only a slight chance that they will have to make a payout personally as a result of the action.[119]

The scheme proposed here changes things by introducing a prophylactic procedure that should reduce the number of disclosure violations in the first instance. Managers would need the approval of an external certifier that would face liability directly if the certifier certified a filing containing a disclosure violation that could have been caught by reasonable investigation. If there were no requirement for certification, a manager who knows some negative information that the rules call for disclosing may, out of dread of the sharp share price drop that would result from disclosure, decide not to comply. The external certifier is not in the same position. An unhappy customer is the worst that can happen to the certifier if it insists on compliance. Moreover, managers are likely to rationalize and downplay the importance of any bad news for which their actions are at least partly responsible. External certifier personnel, who have had no such connection, are more likely to be objective.

2. Smaller Judgments and Settlements Yield Smaller Fees

The judgments rendered under these substitute causes of action, and the settlements in their shadow, are likely to involve considerably smaller amounts in damages. The amount of liability imposed on the officers, directors and the external certifier under the scheme proposed here will be much less than the typical aggregate recovery in a Securities Act Section 11 suit where the issuer is still solvent. In the phantom Section 11 case that forms the model for non-issuer liability under the proposed scheme, after the settling up that would occur through contribution actions (or more typically in their shadow), the issuer would end up bearing the bulk of what would be owed in the phantom case

[119]Coffee, *Reforming*, *supra* note 15 at 1550. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059-60, 1080 (2006).

(which I termed the "Total Liability").[120] The amount borne by the non-issuer defendants in the phantom case, which determines what they owe under the proposed scheme, would only be the remainder. Moreover, the Total Liability itself will be smaller than the typical recovery in a fraud-on-the-market suit. Turnover in the shares of large, established issuers is rapid enough that typically the aggregate value of an issuer's shares that have been traded at least once in the secondary market during the period that a misstatement inflates the issuer's share price[121] is greater than the amount a firm typically invests in a year.[122]

The aggregate liability imposed on the officers, directors and the external certifier under the scheme proposed here, therefore, will be considerably smaller than it would be under a conventional securities class action today for a comparable misstatement by a comparably sized firm. So, therefore, will be any set percentage of this aggregate liability. If plaintiffs' lawyers are awarded the 20% to 30% (which is typical of all but the very large settlements and judgments)[123] of this

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[120]Black, Cheffins & Klausner found that actual payments of damages for securities lawsuits and state corporate lawsuits are almost always paid by the company. In a Section 11 case, the company is the most attractive defendant because it is held to a strict liability standard. Black, Cheffins & Klausner, *supra* note 119.

[121] Since the 1980s, the average annual turnover rate has continued to approach 100% annually. *See* LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 66—68 (1988) (the annual turnover rate for major exchange listed stock in 1986 was approximately 87 percent). ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 39 (2000) (in 1999, the average annual turnover rate for stocks listed on the NYSE was 78%, while the average annual turnover rate for stocks on NASDAQ was 221%). Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 902 (2003) (finding the average turnover rate to be approximately 100%). Casual empiricism suggests that the typical period of price inflation alleged in planitffs' class action complaints ranges from a few months to a few years.

[122]As of January 2007, for the average publicly traded company with a market capitalization of at least $1 billion, capital expenditures as a fraction of the firm's total market value was approximately 5.7%. This figure is the author's own calculation using data from the Value Line Database, which provides accounting and market data for approximately 7,000 public companies on a monthly basis. (Capital expenditures data was reported in the most recent 10K as of January 2007; market capitalization data was the market value of equity on the last trading day of 2006).

[123]See *supra* note 15.

smaller aggregate liability, there is less incentive for them to bring a frivolous suit. For the same reason overpayments of plaintiffs' lawyers will occur less often in the case of meritorious actions.

3. Fewer Settlements Driven by Fear of Legal Error

Risk averse issuer managers may settle meritless fraud-on-the-market suits against the issuer because of fear of legal error and the resulting potential for damages that are substantial portion of the total value of the company. The causes of action that the proposal here would substitute in the place of fraud-on-the-market actions are less vulnerable to this problem. To start, as noted above, the risk of an erroneous judgment against the defendant is less because the evidence relating to standard of care - the steps taken to perform due diligence - are within the possession of the defendant.

Also, as just discussed, the amount of damages in absolute terms will also be much lower. For the external certifier, this lower absolute amount should be, by the very design of the proposed system, a relatively small fraction of the certifier's total net worth. Thus, for it, litigating to the point of judgment should not involve a "bet the company" type risk, the way fraud-on-the-market suits against issuers can. For the officers and directors, the lower absolute amount of damages may be more than counterbalanced by the fact that it is individuals who will be paying these damages. But if sensible caps are put in place related either to an individual's net worth or the income or fees that the individual earns from the issuer, then they too should not be driven to settle a meritless claim out of fear of being devastated should legal error occur.

Because external certifiers and officers and directors are less likely to be driven to settle meritless claims out of fear of legal error, plaintiffs' lawyers are less likely to bring such actions. If they do so, they run a large risk of expending all the resources necessary to take a case to trial without obtaining anything in return.

4. The Person Making the Decision Will Pay the Settlement and the Issuer Will Receive It.

Fraud-on-the-market strike suits are attracted by the fact that the prospective settlements that give rise to them will be agreed to from the defense side by the firm's officers and directors. The officers and directors are typically defendants themselves, but in almost all cases, another person - the issuer (together possibly with the issuer's insurer) - pays all, or nearly all, the cost of the settlement.[124] Under the scheme proposed here, at least in the case of directors and officers, the persons making the decision to enter into the settlement would be paying the money out of their own pockets and therefore can be expected to drive a harder bargain and to be less likely to settle just to make a nuisance go away.[125] Again, if defendants are less likely to settle meritless claims for a significant amount of money, plaintiff's lawyers will be less likely to bring them because of the risk of incurring substantial expense with no return.

Under the proposed scheme, the directors' and officers' settlement decision is changed in another way as well, related to the fact that the issuer, not former shareholders, is paid the settlement. This has important consequences with regard to the concern that plaintiffs' lawyers are paid too much when they bring actions that do have merit. When an issuer's officers and directors approve the settlement of a fraud-on-the-market suit involving falsely positive information, their main concern is with the size of the gross settlement. They are relatively indifferent between the portion of that gross amount that goes to the fees of the plaintiffs' lawyers and the portion that goes to the members of the class. This is because the class consists of persons who sold the issuer's stock and therefore typically are no longer shareholders. Because of this and the fact that class members do not effectively control their lawyer representatives, the size of the plaintiffs' lawyer's fee in a class action case is subject to judicial supervision and class members are allowed to

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[124]Coffee, *Reforming, supra* note 15, at 1550.

[125]Even for the external certifier, its managers would probably be less inclined to agree to extra dollars in settlement than issuer managers in a fraud-on-the-market suit. To start, the payout would reduce the net operating revenues for the certifier, which is in the business of covering such litigation risks, whereas it would be an extraordinary item for the issuer. A decline in earnings to lower net operating revenues is generally regarded by investors as more serious than a decline due to an extraordinary item because it has more predictive power in terms of a company's future cash flow. Also, compared to the issuer, the external certifier is more likely to be a repeat defendant since, at any one time, it will presumably be the certifier of a number of issuers. Potential repeat defendants have a greater incentive to establish a reputation of not being willing to settle meritless claims just to get rid of the nuisance.

object to the court about a proposed fee award.[126] This procedure, however, is generally regarded as a relatively ineffective procedure for controlling the size of the fees.[127] Under the scheme proposed here, every dollar that goes to the plaintiffs' lawyers is a dollar less that goes to the company. While a defendant's primary concern is going to be with the dollars she is paying out, she still is better off if the money goes to her company than to the lawyers on the other side.

5. Problem May Be That the Fees Are Too Low

The problem may in fact run in the opposite direction. The percentage of recovery awarded as a contingent fee may actually need to be increased to assure that suits with a reasonable prospect of recovery will be brought. This need, though, is tempered by the fact that the actions contemplated in the scheme proposed here involve less work for the plaintiffs' lawyer than in a fraud-on-the-market suit. Whereas in the fraud-on-the-market suit, the plaintiff must establish scienter, under the scheme proposed here, the defendant has the burden with respect to his standard of culpability.

V. THE CURRENT DISCUSSION ON LIABILITY

The liability scheme proposed above can be elucidated, and perhaps refined, by considering it in terms of other scholarly commentary on the subject over the last decade. I will consider issues raised by three prominent securities law scholars who have discussed securities law liability in recent years, in each case prompted at least in

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[126]The Federal Rules of Civil Procedure provide for judicial supervision of attorney fees in a class action. The court must approve any settlement and may propose terms for attorney fees and hold a hearing on an attorney fees award. FED. R. CIV. P. 23(g), (h).

[127] Many commentators argue that judicial supervision of class action settlements and attorney fees is largely ineffective, due to information problems, judicial misinterpretation of, or apathy toward, class members' input, and the judge's vested interest in settling a case. Alon Harel & Alex Stein, *Auctioning for Loyalty: Selection and Monitoring of Class Counsel*, 22 YALE L. & POL'Y REV. 69, 90—91 (2004); Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 FLA. L. REV. 71, 72, 107—08 (2007); William B. Rubenstein, *The Fairness Hearing: Adversarial and Regulatory Approaches*, 53 UCLA L. REV. 1435, 1444—45 (2006).

part by the movement in the United States toward company registration or by concerns about problems with class actions. Each commentator has struck a somewhat different theme. Stephen Choi has suggested that the very firms that would qualify for company registration and that are the subject of this inquiry – established firms whose shares trade in efficient markets – should not be subject to as stringent a liability scheme as is currently the case because of the costly nature of the frivolous litigation that it generates. He suggests that for such firms, greater reliance on the market mechanisms that help assure the availability of adequate information about firms would be more cost effective.[128] Donald Langevoort expresses concern with the inadequate quality of periodic disclosure, particularly since it is becoming the central source of information about issuers even when they are offering securities.[129] Like me, he favors some kind of outside certification of periodic disclosure as a partial response. But he also feels that because of the difficulty of conducting due diligence in the new world of rapid offerings, non-issuer actors should not be subject to any more liability at the time of a public offering than they currently are when there is no offering, i.e., they should be liable only when they are shown to have scienter. He suggests improving periodic disclosure through some kind of internal compliance program. John Coffee expresses a similar concern with the existing quality of periodic disclosure, but he too, for reasons similar to those of Langevoort, would favor reducing the stringency of liability for non-issuer actors when the issuer is offering securities.[130] He has suggested a system of certification of annual reports by outside disclosure counsel, which he argues is a superior approach to the external certifier suggested here.[131] He also favors a liability system that would continue to exempt all issuers from liability absent a showing of scienter if a disclosure violation occurs during a private placement because of the due diligence that the financial

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[128] Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime, 64* U. CHI. L.REV. 568, 573, 628, 649—50 (1997).

[129]Donald C. Langevoort, *The Future Content of the U.S. Securities Law: Deconstructing Section 11: Offering Liability in a Continuous Disclosure Environment*, 63 LAW AND CONTEMP. PROBS. 45, 47, 52—55, 62 (2000).

[130]John C. Coffee, Jr., *Re-engineering, supra* note 9.

[131]COFFEE, GATEKEEPERS, *supra* note 16, at 347—53.

intermediaries purchasing the securities can provide.[132] The views of these commentators raise a number of points worthy of comparison with the approach presented here.

A. The Relationship of Size and Stringency of Issuer Liability

Is the liability system proposed here moving us in the wrong direction by increasing the currently prevailing stringency of liability imposed on non-issuer actors in cases where an issuer is not offering securities, instead of reducing the currently prevailing stringency of liability on all actors in cases where such an issuer is offering securities?

Professor Choi suggests that we should move in this other direction and reduce the liability imposed on larger, more established firms when they offer securities.[133] One basis for his suggestion is that larger firms attract more frivolous litigation because they have more money. This is undoubtedly true. But for the same reasons, such firms also attract more non-frivolous litigation. Indeed, Choi's own research indicates that small firms attract little of either.[134] Choi makes no showing that large size contributes more to Type I error – more money paid out in settlement of frivolous claims – than it reduces Type II error – fewer disclosure violations that fail to generate civil liability or settlement payments in its shadow. Absent such a showing, there seems no reason why the tendency of size to attract frivolous litigation justifies a reduction in the stringency of liability imposed on larger, more established firms. It should also be noted that larger size in one sense already makes it harder for a plaintiff to establish liability. This is because for a disclosure violation of a larger firm to be considered material and hence actionable, it must have a larger absolute effect on investors and hence on the economy.

A second basis for Choi's suggestion that disclosure liability in connection with large firms be reduced is the idea that the market mechanisms for assuring the market has adequate information about an issuer work more effectively with larger firms.[135] One factor cited by

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[132]Coffee, *Re-engineering*, *supra* note 9 at 1147, 1182—85, 1187.

[133] Choi, *supra* note 128, at 588.

[134] *Id.* at 599.

[135]*Id.* at 581—83.

Choi is the greater availability of contra information because larger publicly traded issuers are followed more closely by analysts.[136] This may again be true, but it ignores the fact that the issuer is generally by far the least cost provider of the information required by mandatory disclosure. Moreover, an important function of mandatory disclosure is to correct a market failure by prompting issuers to provide information when the private benefits to managers are less than the costs to them and where the social benefits are greater than the social costs.[137] Without regulation, an issuer will often be disinclined to disclose such information even though there is a net social gain from it doing so.

Choi also suggests that the officers and directors of established issuers have more to lose reputationally from not complying with disclosure regulations and that the same is true of the investment banks underwriting the offerings of such issuers.[138] These factors, however, would appear to be counterbalanced by the fact that compliance of a larger firm is more socially important since the resulting improvement in disclosure improves the efficiency with which more of society's scarce resources are allocated.

B. Standard of Liability of Non-Issuer Actors

Professors Langevoort and Coffee express concern that imposing absolute liability subject to a due diligence defense on officers, directors and underwriters, as is done under Section 11, is unfair because the speed with which public offerings now go forward in this near-company-registration world makes such diligence impractical.[139] Their reluctance to deal with the problem by instead imposing this kind of stringent liability on disclosure violations in periodic disclosure reports – a setting where such diligence is practical – may arise from a failure to recognize the equal social value of periodic disclosure whether or not the issuer is offering securities. It should also be noted that issuer and non-issuer actor liability can be separated in this situation with the non-issuer

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[136] *Id.* at 581.

[137] Coffee, *Market Failure*, *supra* note 31; Easterbrook & Fischel, *supra* note 68, at 684 – 85.

[138] *Id*. at 583—84.

[139] In my proposal, I would eliminate underwriter liability altogether for this very reason. *See supra* Part IV.C.1.

liability confined within sensible limits, unrelated, unlike current fraud-on-the-market suits, to the amount of trading that occurs in the secondary market during the period of the violation.

Choi also states that if gatekeepers are worthwhile, issuer managers will have incentives to provide them voluntarily.[140] This statement again ignores the market failure justification for mandatory disclosure and, where the choice of the disclosure regime is voluntary, the need for some kind of civil liability system to help bond management to any commitments it makes at the time of sale of securities to provide ongoing periodic disclosure in the future. Because of the divergence between the private and social costs of issuer disclosure, it may be in an issuer's best interests not to hire a gatekeeper that would prompt greater disclosure even though it is in society's interest that it do so.

Finally, Professor Choi again suggests that because market mechanisms are more effective with larger issuers, the need for non-issuer actor liability is less.[141] This suggestion is subject to the same critique as was provided above.

C. Critiques of the External Certifier

Professor Coffee has commented on the idea of using a certifying investment bank- the most obvious kind of external certifier- as a way of taking the investment banker's traditional gatekeeping function in the context of underwritten public offering and recreating it to assure the quality of periodic disclosure.[142] He finds the idea "feasible."[143] Coffee has three critiques, however. First, he suggests that it will be costly because an investment bank would demand a high fee before it would accept the accompanying liability.[144] It is not clear, however, why in a competitive market the cost of an investment bank or other external certifier would not equal the social cost of the proposal, i.e., the opportunity cost of the personnel necessary to conduct the due diligence

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[140]Choi, *supra* note 128, at 584—87.

[141] *Id.* at 587

[142]See Fox, *Shelf Registration*, *supra* note 10 at 1034, for the first proposal of this idea, at the time that integrated disclosure was introduced.

[143]COFFEE, GATEKEEPERS, *supra* note 16, at 353.

[144]*Id.*

plus the expected value of the residual costs of litigation judgments, settlements and legal fees. This cost was traditionally deemed worthwhile to assure quality disclosure at the time of a public offering. It is the argument of this Article that high quality periodic disclosure is equally valuable socially, and hence also worth this cost. Moreover, the costs of the proposed scheme, which aims at prophylactically preventing poor disclosure, must be compared with the cost of our current periodic disclosure violation deterrence system, the fraud-on-the-market suit.

Second, Coffee suggests that the idea has already been tried on the AIM market in London.[145] He claims that it has been shown to have the disadvantage of tying issuers closely to a single investment bank with the result that there is little competition among bankers for the issuer's business. The bank can therefore extract monopoly rents from its situation.[146] It is not clear that this would be a serious problem under the proposed scheme, however. It is true that if the external certifier were an investment bank, there would be synergies in the certifying bank being a lead underwriter in a subsequent public offering because the certifying bank has done the research necessary to assure itself that it wishes to associate its name and reputational capital with the issuer. This is the limit of the tie, however, and any rents extracted cannot be greater in any event than the rents extracted by someone for the amount of due diligence that should properly be done at some point close to the time of the offering. Importantly, the proposed scheme would not impose liability on the underwriter at the time of an offering for issuer misstatements and so competing underwriters would not be at a competitive disadvantage relative to the certifying bank in terms of fear of legal liability.

Coffee's third critique of the proposed scheme is that his own proposal of outside counsel certification of annual reports is a superior substitute.[147] He suggests that counsel certification would be less expensive and just as effective. As discussed more extensively above, however, an external certifier of the kind I propose is better situated to play this gatekeeper role for several reasons.[148] Unlike a lawyer, the skill set of an investment bank or other qualified external certifier

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[145] *Id.* at 338-340, 353-355

[146] *Id.* at 353-354.

[147] *Id*. at 356.

[148]*See supra* IV.A.2

includes projecting future cash flows. The certifier is fully capable of delegating responsibility for those portions of the work that lawyers or accountants could do better. An investment bank, in particular, is already experienced at doing this kind of due diligence. For an entity, whether or not an investment bank, to qualify as an external certifier, it must be sufficiently capitalized that its incentives will not to be compromised by the possibility of being judgment proof. Law firms, even large ones, are not highly capitalized because of the nature of their business and because limitations imposed on their methods of financing imposed by professional regulations. Thus, law firms do run the risk of being so compromised. Finally, if lawyers really could perform the same kind of due diligence and face similar liabilities when they fail, it is not obvious why they would in fact be less costly.

D. Private Placements

Some full-fledged proposals for company registration impose the same liability system on all sales of securities, whether private or public. This, for example, appears to have been the position of a majority of the members of the SEC's Advisory Committee chaired by former Commissioner Steven Wallman.[149] The Committee's report suggests several benefits that would arise from the abolition of the private placement exemption. These include elimination of the legally complex distinction between private and public offerings and some of the accompanying concepts such as integration and gun jumping, [150] the elimination of restrictions on resales by affiliates and statutory underwriters that were developed to prevent evasion of the registration

[149] In the Wallman Report, the Advisory Committee on the Capital Formation and Regulatory Process explored what a full fledged company registration system would look like and recommended a voluntary pilot program. See *supra* note 9. The report suggested a number of benefits from eliminating the exemption. *Id.* at 9. Professor Coffee has stated that this was the preferred position of some members of the Committee. Coffee, *Re-engineering, supra* note 9, at 1180. The Advisory Committee, however, decided that in its proposed pilot program, each issuer accepting the SEC's invitation to join a company registration system should have, at the time it joins, the option of a system with or without a private placement exemption. It gave as its reason a concern that "at this initial stage and until issuers become comfortable with the company registration concept, the loss of the ability to conduct exempt private placement and offshore offerings could be a deterrent to the voluntary use of the company registration system." Wallman Report at 24-25.

[150] *Id.* at 24.

rules by means of an initial private sale followed by the purchaser engaging in a public offering,[151] the claimed "merging" of private and public markets for securities,[152] and the problems with Regulation S foreign offerings of shares often flowing rapidly back and being traded in the United States in a way that appears to be an evasion of the registration provisions.[153]

Professor Coffee, on the other hand, has argued for retention of the private placement exemption.[154] He has two rationales. First, an issuer may be in possession of material non-public information that is not required to be disclosed absent a sale. It may be contrary to the issuer's interest to disclose the information publicly, but the issuer can trust a private buyer to keep the information confidential.[155] Second, institutional purchasers in private transactions, will, if they are forced to hold onto securities for a period before reselling to the public, perform a due diligence role that substitutes for the due diligence done by underwriters in a public offering. The argument is strengthened by the fact, Coffee suggests, that underwriter due diligence - the source of comparison - will be weakened in its effectiveness by the smaller size of many of the deals that are likely to be done under company registration ("just in time capital") and the greater speed with which all deals, big or small, will be done.[156]

Ultimately the SEC, when it moved further toward company registration by adopting the new offering regulations in late 2005, did not go as far as the majority of the Advisory Committee recommended. Because, as a formal matter, the issuer chooses whether the shares involved in any given offer and sale are registered pursuant to the issuer's automatic shelf registration statement or not, they effectively retained the need for a private offering exemption. The discussion below suggests that this was the right choice and that, in accord with Professor Coffee, the company registration concept would not be

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[151] *Id.*

[152] *Id.* at A-38.

[153] *Id.* at A43-A45.

[154] Coffee, *Re-engineering, supra* note 9, at 1180.

[155] *Id.*

[156] *Id*. at 1182—85.

advanced by revisiting the decision.

At first glance, the question of whether to retain the private offering exemption would appear to attack a non-problem: what possible need is there for an exemption for transactions involving the private offering of securities when company registration would remove the need to register securities offerings in the first place? When one considers civil liability, however, the question does not disappear so easily. Assume, as I propose and as would be the case under the Advisory Committee's proposal, that an issuer faces a higher level of civil liability when a violation of the system's disclosure regulations is accompanied by a *public* sale of securities than when it is accompanied by *no* sale of securities. In that event, we need to decide whether the issuer should also face this higher level of civil liability when the violation is accompanied by a *private* sale of securities.[157] Because the question of whether a company registration system should include a private placement exemption arises specifically due to this concern with liability, it can only be answered in the context of the larger issue of what, overall, civil liability in a company registration system should look like. Thus the analysis above of this larger issue, with its focus on the social value of disclosure and the desirability of avoiding a distortion of choices among sources of finance, forms a useful framework for analyzing the desirability of a private placement exemption.

Consider first the preceding discussion of the social value of disclosure. It was established that public disclosure is equally valuable whether or not the issuer is selling equity at the time. Therefore, as long as the legal regime governing issuer disclosure is adequate for periods when the issuer is not selling its securities, it should, subject to the qualifications set out below, be adequate as well at the time that the issuer is selling securities.

When the issuer is not selling securities, the liability system proposed above imposes civil liability sanctions only on *non-issuer* actors. I have argued that this should be sufficient in terms of civil liability to guarantee the quality of public disclosure at such times. The only recommended modifications to this regime when a public sale of securities occurs is the filing of updating information and the imposition of absolute liability on the issuer for any inflation in price due to a

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[157] Under the Securities Act, the private placement exemption is an exemption from the requirement in Section 5 that securities, to be legally offered, must be registered. Registration carries with it potential Section 11 liability. An exempted transaction is not subject to such potential liability.

disclosure violation. The rationale for requiring updating disclosure is to prevent a special incentive for sales during the period between the issuer becoming aware of bad news and when it must disclose the news in a periodic filing. The rationale for imposing liability on the issuer is to be an antidote for the extra incentive not to comply with disclosure regulations at time of offering.

A consideration of these rationales for the modifications in the regime when a public sale of securities occurs shows that the modifications are not needed in the case of a private sale to one or a few large institutional purchasers. In other words, a private placement exemption is appropriate in the case of such a sale. The key concern should be with the ability of the buyer or buyers to negotiate a due diligence process and a contractual liability scheme that would satisfy the concerns that led to the modifications recommended here in the disclosure regime at the time of public sales. As long as private parties cannot turn around and sell to the public before all undisclosed material information is likely to come out, a private institutional purchaser has the needed incentives to seek updating information and to set up its own liability scheme.[158] Indeed, the solution reached by the issuer and the private purchasers may, for these particular parties, be less costly or more effective than the one-size-fits-all regime imposed on public offers in terms of its meeting the concerns that generated the recommended modifications to the civil liability regime when a public offering occurs.

Granting an exemption for private sales to institutional investors would also promote the goal of avoiding distortions in issuer choice among sources of finance. It avoids the no exemption approach's tilt toward internal funding when the public release of material information would be untimely, one of Professor Coffee's concerns. It also avoids any liability based distortion to an issuer's choice among sources of external finance. Any gain to the issuer from choosing a private sale over a public one reflects an issuer calculation that the sum of the cost of the private approach to issuer liability and the costs of the source of finance chosen are less than the sum of the cost of the public liability regime and the costs of finance through a public offering. These private costs mirror the social costs and so the issuer's undistorted choice should be socially optimal.

The Advisory Committee majority's concerns about the legal costs of maintaining a private placement exemption seem misplaced. It

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[158] The contractual regime might impose absolute liability, for example, but use a different standard of materiality or a different measure of damages.

is true that having an exemption would preserve the need for legal resources to advise as to, and police, the border between private and public transactions as well as rules concerning when resales are allowed. But in any legal regime, an attempt to tailor the regime to adjust to particular situations in ways that more precisely meet its objectives are subject to this kind of objection. At least as far as the private costs are concerned, if the parties find them too burdensome, they need not avail themselves of the exemption. Moreover, the exemption and the resale rules can be much more focused and simple than they are today since the reasons for treating issuers differently when they engage in public offerings are narrowed.

VI. IMPLEMENTATION

A. Politics

For established public corporations, the proposed scheme involves a “grand bargain.” Corporations gain by being freed from fraud-on-the-market suits. Also public equity finance will be less expensive because the corporation will no longer have to pay the expected costs of underwriter liability that is currently passed on to them. In return, corporations must take on the cost and inconvenience of the external certifier and must provide the additional compensation necessary to compensate officers and directors for the risks of legal error associated with their new potential liabilities. Since the reforms lead to cost effective improvements in corporate governance, the aggregate valuations of U.S. should increase. Corporations, however, are represented by real individuals, their managers. In terms of their personal interests, increased transparency’s reduction in the agency costs of management might diminish the aggregate rents received by U.S. issuer managers. Its more important effect probably would be redistributive, with more effective managers earning higher rents from their skills, and less effective ones earning lower rents. Natural conservatism is still likely to lead to broad managerial opposition.

Investment banks are freed from underwriter liability and, as a result of this cost saving that with competition will lower their prices, should enjoy an increase in the amount of underwriter services demanded of them. The external certifier requirement also gives them the opportunity to extract greater rents out of their already established due diligence skills. Other potential external certifiers should also be supportive.

Institutional investors are an important group politically that should be solidly in favor of the reform. The increases in efficiency should translate into an increase in value in their huge existing holdings of established publicly traded issuers.

Plaintiffs' lawyers will likely see this reform negatively. While the liabilities of officers, directors and external certifiers for misstatements in periodic disclosures opens up new opportunities, the damages that these actions will generate are low compared to the those associated with the eliminated fraud-on-the-market suits. Even if a higher fee percentage were introduced, their total volume of fees is likely to be substantially lower. The "defense bar," while personally identifying with their corporate management clients' frustration with fraud-on-the-market suits, may be sufficiently self-interested not to forcefully advocate for the elimination of a cause of action that derivatively generates so much business for them. On the other hand, these lawyers typically work for the same firms who could benefit from the increase in due diligence work that the external certifiers would undoubtedly send to them, as well as from increased work on behalf of officers and directors seeking some kind of safe harbor from liability.

It is unclear how the influence of these important organized groups, pro and con, would come out in the balance. The important point here is that the proposed reform is not just another good idea without a constituency. Powerful groups would benefit from its adoption and, if properly educated as to its potential benefits, might lead the fight.

B. Procedures

Under the proposed scheme, underwriters would be relieved of their Securities Act Section 11 liability. Issuers and their officers and directors would be relieved of their fraud-on-the-market Rule 10b-5 liability for misstatements in periodic disclosure filings. Absolute liability, subject to a due diligence defense, would be imposed on issuer officers and directors and on external certifiers for misstatements in periodic disclosure filings.

The cleanest approach to implementation would be new legislation. The problem with legislation is that the wide variety of persons who need to cooperate to make it happen make it more vulnerable to a de facto veto by organized interest groups in opposition. The alternative to legislation is administrative rule-making by the SEC. The SEC clearly has broad powers of exemption from the impact of both statutory provisions and its own rules under Section 28A of the Securities Act, and its cognate Section 36 of the Exchange Act. Under this authority, it could eliminate underwriter Section 11 liability and issuer, officer and director fraud-on-the-market liability for misstatements in periodic disclosure filings. Finding a source of SEC authority affirmatively to impose absolute liability, subject to a due diligence defense, on all issuer officers and directors and on external certifiers is more difficult, however.

The SEC could, however, condition issuer receipt of the exemptions contemplated by the scheme on the acceptance of the contemplated liabilities by the issuer, its officers and directors, and its external certifier. Thus participation in the grand bargain would be voluntary, firm by firm. The SEC could sweeten the attraction of the program by appropriately redeploying its staff so that the SEC level of review of the periodic filings of participants is lower than it is now, and the level of review of the filings of non-participants be higher than it is now.

There would be significant pressures on issuers to participate. To start, if they were the target of a fraud-on-the-market suit, it would make their public protests about the large expenses involved seem rather hollow, since they had a transparency enhancing way of obtaining protection from such suits. Also, institutional investors, which have become very corporate governance oriented, could create substantial pressure for change. Finally, the managers that have the least to fear from greater transparency may sign their issuers on as a way of differentiating themselves from other issuers. This combination of pressures should over time build the number of participating issuers to a critical mass, where non-participation may appear a deviation from "best practices" and an embarrassment. If there are significantly fewer scandals among the participating group, it may also lay the groundwork for legislation that might not have been possible at the beginning.

VII. CONCLUSION

The primary social benefits of disclosure by established issuers trading in efficient markets are the improved selection of proposed new investment projects in the economy and the improved operation of existing ones, as well as the reduction in capital market illiquidity and other costs of secondary market trading. Disclosure is, in general, equally important in terms of promoting these benefits whether an issuer is offering securities at the time or not. This suggests that, unlike today in the United States, the mandatory disclosure civil liability system should create an environment for corporate decisionmakers where they have equally strong incentives to comply at all times, not one like today where the incentives are weaker when, as is the case most of the time, the issuer is not currently offering any securities. Such an approach would also eliminate the current system's tendency to distort, in ways unrelated to considerations of social benefit and social cost, issuer management's choices between internal and external finance and among sources of external finance. The proposal in this Article is an example of a structure that meets these tests and helps us think through the larger question of designing a system of civil liability that reflects a modern understanding of financial economics and the role of mandatory disclosure.

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