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Civil Liability and Mandatory Disclosure

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ARTICLE

CIVIL LIABILITY AND MANDATORY DISCLOSURE

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This Article explores the efficient design of civil liability for mandatory securities disclosure violations by established issuers. An issuer not publicly offering securities at the time of a violation should have no liability. Its 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 should face measured liability. Officers and directors should face similar liability, capped relative to their compensation but with no indemnification or insurance allowed. Damages should be payable to the issuer, not traders in its shares, because the true social harm from issuer misstatements is poor corporate governance and reduced liquidity. A trader is as likely to be a gainer by selling, as a loser by buying, at the misstatement-inflated price.

An issuer publicly offering securities at the time of a violation should be liable to purchasers for the resulting inflation in price. Such liability is an antidote to what otherwise would be an extra incentive not to comply.

This design would increase incentives for U.S. issuers to comply with periodic disclosure rules. At the same time, litigation-expensive fraud-on-the-market class actions would be eliminated. So would underwriter liability for lack of due diligence, a sharply diminishing spur for disclosure given the speed of modern offerings. For countries considering implementation of securities disclosure civil liability systems for the first time, this design helps them get it right from the start.

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INTRODUCTION

Corporate transparency has been increasingly recognized as a key element in financial market development and in economic growth more generally. Mandatory disclosure regimes seek 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 the optimal design of such a system of civil damages 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 Article 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 the issuer is selling securities at the time of the violation? A central thesis of this Article is that the answers to these questions should reflect the more modern understanding that the primary way that 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 new set of insights into 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 or not an issuer is offering securities. 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 securities offering. 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 to 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.

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. Resolving their contending claims requires a conceptual framework that reflects the realities of contemporary markets and a modern understanding of corporate governance and financial economics. Countries abroad 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 seventy-five 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 enormously: A field that was once an intellectual backwater is now a fertile source for Nobel prizes.[4] 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 the civil liability system that a modern understanding suggests would most effectively and efficiently support our current system of mandatory disclosure.

1. *The Traditional Approach.* — Traditionally, the U.S. mandatory disclosure regime focused primarily on an issuer's disclosure at the time 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.[5] Absolute liability subject to a "due diligence" defense was im-

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1. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

2. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78*lll*).

3. Jeffrey N. 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 development of modern U.S. corporations' orientation toward share value maximization and prevalence of independent director-dominated monitoring boards to increase in informedness of share prices and liquidity of capital markets).

4. Winners whose work was primarily in financial economics include George Stigler (1982), Franco Modigliani (1985), Harry Markowitz (1990), Merton Miller (1990), William Sharpe (1990), Robert Merton (1997), and Myron Scholes (1997). See All Laureates in Economics, at http://nobelprize.org/nobel_prizes/economics/laureates/ (last visited Jan. 14, 2009) (on file with the *Columbia Law Review*).

5. 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 omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading" may bring an action for damages against, among others, the

posed on the issuer's top officers and directors and on the investment banks underwriting the offering.[6] This imposition of absolute liability subject to a due diligence defense was intended to motivate each of the nonissuer actors, particularly the lead underwriter, to do an independent investigation of the issuer and to participate actively in the drafting of the registration statement.[7]

In contrast, although 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.[8]

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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).

6. Section 11(a), as just noted, imposes absolute liability on each of these actors. See id. 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. Id. § 77k(b)(3)(A).

7. See Edward F. Greene, Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System, 56 Notre Dame L. Rev. 755, 767–70 (1981) (noting that full disclosure was key goal in drafting of section 11 of Securities Act); see also Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971) ("'Only the underwriter and the accountant are free to assume an adverse role, have little incentive to accept the risk of liability, and possess the facilities and competence to undertake an independent investigation. They may therefore reasonably be required to share the burden of verification.'" (quoting Comment, *BarChris*: Due Diligence Redefined, 68 Colum. L. Rev. 1411, 1421 (1968))); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 696–97 (S.D.N.Y. 1968) (discussing responsibility of underwriters to protect investors by verifying information). 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. 171, 173 (1933) (asserting that civil liabilities were "set high to guarantee that the risk of their invocation will be effective in assuring that the 'truth about securities' will be told"); Felix Frankfurter, The Securities Act: II, Fortune, Aug. 1933, at 53, 108 ("The scope of the liability is carefully defined. Untruth in a material fact or its omission—the means whereby investors are misled—makes all who are chargeable with the duty of knowing and revealing the truth liable to an investor in ignorance of the truth.").

8. As a formal matter, a material misstatement in any of these Exchange Act periodic filings is subject to liability pursuant to section 18(a) of the Exchange Act. 15 U.S.C. § 78r. Court decisions, however, have concluded that to succeed, the plaintiff must establish "eyeball reliance" on the misstatement in the filed document. See, e.g., Ross v. A.H. Robins Co., 607 F.2d 545, 552–53 (2d Cir. 1979) ("'Reliance on the actual [filed] report is an essential prerequisite for a Section 18 action and constructive reliance is not sufficient.'" (quoting Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir. 1968))). 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

2. *Modern Developments.* — 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.[9] 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 wished without the need to register the securities themselves.[10] The U.S. movement toward company registration, though still not complete, has switched the regime's primary regulatory focus for these issuers to their ongoing periodic disclosures.[11] Such issuers, as a

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claims are not worth the costs of pursuing. As a result of these factors, section 18(a) has largely been considered a "dead letter." 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), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008), at least as a practical matter, until the issuance of court decisions, discussed infra note 16, 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.

9. See Richard A. Brealey, Stewart C. Myers & Franklin Allen, Principles of Corporate Finance 358–59 (9th ed. 2008) (summarizing EMH).

10. 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 registering new offerings and that no useful purpose is served in requiring the questions 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 can be traced to 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 Fed. Sec. Code, at xx–xxi (1980) (citing Cohen, supra, as an impetus for codification project). 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 11.

11. This shift began in the 1970s with the SEC's adoption of Regulation S-K, 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. See 17 C.F.R. § 229. This development was followed in the early 1980s by the

adoption of Rule 415 "shelf registration," id. § 230.415, and S-3 "short form" registration, id. § 239.13. Rule 415 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 that would incorporate subsequent periodic disclosure filings by reference as amendments to the original "shelf" registration statement. Shelf Registration, Securities Act Release No. 6499, Exchange Act Release No. 20,384, 48 Fed. Reg. 52,889, 52,894–95 (Nov. 23, 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 section 6(a) of the Securities Act, 15 U.S.C. § 77f(a), 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, 113 (1941) (describing section 6(a) policy to "assure investors that the registration statements . . . on which they rely, so far as is reasonably possible, provide current information").

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. See Adoption of Integrated Disclosure System, Securities Act Release No. 6383, Exchange Act Release No. 18,524, Investment Company Act Release No. 12,264, 47 Fed. Reg. 11,380, 11,382–85 (Mar. 16, 1982) (announcing adoption of Form S-3). Form S-3 allows a 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. Id.

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 prefiling 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 Coffee, Re-Engineering] (describing SEC changes during this period). 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 Report of the Advisory Committee on the Capital Formation and Regulatory Processes, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834, at 88,403 (July 24, 1996), available at http://www.sec.gov/news/studies/capform.htm (on file with the *Columbia Law Review*) [hereinafter Wallman Report]. The SEC's initial response, in November 1998, was the release of its "Aircraft Carrier" proposal, so named because of its sheer physical size. See The Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40,632A, Investment Company Act Release No. 23,519A, 63 Fed. Reg. 67,174, 67,174 (proposed Nov. 3, 1998) (to be codified in scattered sections of 17 C.F.R.) (announcing proposed SEC revisions).

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. See Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,722 (Aug. 3, 2005) (codified in scattered sections of 17 C.F.R.) (announcing securities offering reforms). While not fully abandoning the traditional transactional basis of disclosure regulation, the reforms took 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

practical matter, can offer their shares at any time they wish, 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.[12] Yet these offerings still need to be registered and, as the recent *In re Worldcom, Inc. Securities Litigation* decision makes clear, the standard of liability imposed on the underwriter has not significantly changed.[13] Thus underwriters have moved from being a force to promote disclosure to being merely an insurer for disclosure failure.[14] Underwriters

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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 expected to be thickly traded and followed by analysts in the market. 17 C.F.R. § 230.405; Securities Offering Reform, 70 Fed. Reg. at 44,726–27 (describing WKSIs). WKSIs are permitted under the amended Rule 415 to register "for the shelf" an unlimited number of shares to be offered (subject to 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. Under this "automatic shelf registration" procedure, payment of registration fees is allowed on a "pay as you go" basis, rather than at the time of registration, as was required previously. Id. § 230.456. Immediate "takedowns" of securities so registered can occur without any delay for possible SEC review of updating filings. Id. § 230.415(a)(5). 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).

12. In theory, since the underwriter continues to face section 11 liability, it could insist that the offering be held up pending completion of a proper due diligence investigation. Delays, however, are costly for issuers. 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 Disclosure, and Underwriter Due Diligence: An Economic Analysis, 70 Va. L. Rev. 1005, 1025–30 (1984) [hereinafter Fox, Shelf Registration].

13. See In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662–64 (S.D.N.Y. 2004) (noting requirement that underwriter's behavior be "reasonable").

14. 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*, N.Y.L.J., Jan. 20, 2005, at 5.

argue that this role serves little social purpose and should be eliminated.[15]

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. 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.[16]

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15. See Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, Exchange Act Release No. 18,011, Investment Company Act Release No. 11,889, 46 Fed. Reg. 42,015, 42,017 (proposed Aug. 18, 1981) (to be codified at 17 C.F.R. pt. 230) ("[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 . . . . [I]ssuers may be reluctant to wait for responsible underwriters to finish their inquiry . . . ."); see also Comm'n on Fed. Regulation of Sec., 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 Comm'n on Fed. Regulation of Sec., Bus. Law Section, to David B.H. Martin, Dir., Div. of Corp. Fin., SEC (Aug. 22, 2001), available at http://www.abanet.org/buslaw/committees/CL410000pub/comments/20010822010000.pdf (on file with the *Columbia Law Review*) ("[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."); Letter from The Bond Mkt. Ass'n to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) (on file with the *Columbia Law Review*) (urging relaxation of underwriter liability on shelf registration); Letter from Davis Polk & Wardwell to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) (on file with the *Columbia Law Review*) (same); Letter from Merrill Lynch to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) (on file with the *Columbia Law Review*) (same); Letter from Sec. Indus. Ass'n to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) (on file with the *Columbia Law Review*) (same); Letter from Sullivan & Cromwell LLP to Jonathan G. Katz, Sec'y, SEC (Jan. 31, 2005) (on file with the *Columbia Law Review*) (same).

16. The starting point for the development of fraud-on-the-market class actions against an issuer for damages suffered as a result of an issuer misstatement goes back forty years. In *SEC v. Texas Gulf Sulphur Co.*, 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. 401 F.2d 833, 860–62 (2d Cir. 1968). 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. See Basic Inc. v Levinson, 485 U.S. 224, 247 (1988). A material public misstatement by an official of an issuer whose shares trade in an efficient market will, under the efficient market hypothesis, affect the issuer's share price. This effect provides a plaintiff a way to establish "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." Id. at 243.

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.[17] 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 come at great social expense.[18] As the scandals of the early 2000s and the huge number of recent accounting restatements suggest, they are also far from totally

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This is an alternative to establishing this connection through a showing of traditional reliance, which involves demonstrating that the misstatement induced the plaintiff to purchase or sell the security. In the case of a falsely positive statement, for example, allowing the plaintiff to show reliance by establishing that the 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.

17. See Todd Foster et al., NERA Econ. Consulting, Recent Trends in Shareholder Class Action Litigation: Filings Stay Low and Average Settlements Stay High—But Are These Trends Reversing? 1 (2007), available at http://www.nera.com/image/PUB_RecentTrends_Sep2007-FINAL.pdf (on file with the *Columbia Law Review*) (noting average settlement values were at all-time high in first half of 2007, and "[f]or the first time, all of the top ten shareholder class action settlements exceed $1 billion"); see also infra note 18 (discussing large amounts that issuers paid out annually in connection with such suits in prior years).

18. See, e.g., John C. Coffee, Jr., Reforming the Class Action, 106 Colum. L. Rev. 1534, 1562–63 (2006) [hereinafter Coffee, Reforming] (describing argument that fraud-on-the-market class actions may shift costs to shareholders, who may themselves be victims of securities fraud). For the years 2000 through 2005, total annual securities class action settlements have averaged about $4.1 billion. See Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Post-Reform Act Securities Settlements: 2005 Review and Analysis 1 fig.1 (2006), available at http://securities.cornerstone.com/pdfs/settlements_2005.pdf (on file with the *Columbia Law Review*) (reaching $4.1 billion figure by averaging total settlement dollars each year from 2000 to 2005). Studies suggest that contingent fee awards to plaintiffs' lawyers in securities class actions average around thirty percent. See Frederick C. Dunbar & Vinita M. Juneja, Nat'l Econ. Research Assocs., Recent Trends II: What Explains Settlements in Shareholder Class Actions? tbl.4 (1993) (finding that attorneys' fees averaged 31.32% of settlements in sample of 135 cases from July 1991 through June 1993); Frederick C. Dunbar et al., Nat'l Econ. Research Assocs., Recent Trends III: What Explains Settlements in Shareholder Class Actions? ii (1995) (finding that although average settlements fell between 1993 and 1994, plaintiffs' attorneys' fees remained constant, averaging one-third of settlement awards, or $1.96 million in 1993 and $2.03 million in 1994). If we assume that defendants' lawyers are paid comparable fees, this would suggest that the total annual legal expenses associated with these actions averaged about $2.46 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 the investors who claim to be injured. The issuer defendants' expenses are ultimately borne by

effective.[19] Such shortcomings have led some to call for eliminating, or substantially curtailing, fraud-on-the-market class actions.[20] These calls have gained momentum as prominent persons have expressed concern about the competitiveness of U.S. capital markets versus those abroad and have suggested that securities class actions are part of the problem.[21]

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 a funda-

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their shareholders at the time suit is brought. Other social costs include use of the judicial system and the time and attention the issuers' executives devoted to the litigation.

19. See John C. Coffee, Jr., Gatekeepers: The Role of the Professions and Corporate Governance 15 (2006) [hereinafter Coffee, Gatekeepers] (describing rash of financial scandals, including those involving Enron and Worldcom, whereby issuers attempted to maximize market price of their securities by creating misimpressions as to what their future cash flows were likely to be, and hundreds of resulting restatements).

20. See 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 4–6 (2005), available at http://www.instituteforlegalreform.org/issues/docload.cfm?docID=855 (on file with the *Columbia Law Review*) (concluding that class action securities litigation often overcompensates institutional investors); Anjan V. Thakor, U.S. Chamber Inst. for Legal Reform, The Unintended Consequences of Securities Litigation 14 (2005), available at http://www.instituteforlegalreform.org/issues/docload.cfm?docID=857 (on file with the *Columbia Law Review*) [hereinafter Thakor, Unintended Consequences] (arguing that litigation destroys shareholder wealth, creates deadweight loss, and lowers firms' capital investment); see also Coffee, Reforming, supra note 18, at 1585–86 (concluding that securities class action does not benefit shareholders and should be reconfigured into "mechanism for deterrence"); Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 646–47 (1996) (finding that "direct net harm" of fraud may be zero and that litigation overcompensates investors); Amanda M. Rose, Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5, 108 Colum. L. Rev. 1301, 1304–05 (2008) (arguing that litigation can lead to overcompensation and stymie governmental efforts to set effective enforcement policy).

21. The Committee on Capital Markets Regulation, also known as the "Paulson Committee," claims, for example, that there has been a reduction in the competitiveness of U.S. capital markets versus markets abroad due in part to 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. See Interim Report of the Committee on Capital Markets Regulation 81–82 (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (on file with the *Columbia Law Review*) (calling for adoption of In re PolyMedica Corp. Securities Litigation, 432 F.3d 1, 26 (1st Cir. 2005), rule that plaintiffs must prove market price fully reflects *all* publicly available information). 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 to court. Such claims would instead be heard in arbitration. If the charter amendment so provided, the claims could be brought only individually by each shareholder, not by a class action. Id. at 109–11. As noted supra note 16, 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.

mentally redesigned system of civil liability that creates in their place new, more efficient and effective incentives for periodic disclosure compliance.[22]

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 growing recognition of the value of deep, vibrant equity markets and of the dispersed pattern of corporate ownership that they permit.[23] 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.[24] By giving venture capitalists an option to exit start-ups through the sale of their interests in an IPO, such markets promote innovation.[25] 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 make decisions based on more accurate cash flow projections.

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22. See infra Part IV.

23. See Bernard S. Black, The Legal and Institutional Preconditions for Strong Securities Markets, 48 UCLA L. Rev. 781, 832–38 (2001) [hereinafter Black, Legal and Institutional Preconditions] (discussing qualitative advantages of strong securities markets and collecting studies showing relationship between strong securities markets and economic growth); Ross Levine, Financial Development and Economic Growth: Views and Agenda, 35 J. Econ. Lit. 688, 703–20 (1997) (compiling evidence indicating "strong, positive link between financial development 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 & Luigi Zingales, Financial Dependence and Growth, 88 Am. Econ. Rev. 559, 584 (1998). For further discussion of the advantages of dispersed ownership, see Erik Berglöf & Stijn Claessens, Enforcement and Corporate Governance 3 (World Bank Policy Research, Working Paper No. 3409, 2004), available at http://ssrn.com/abstract=625286 (on file with the *Columbia Law Review*) (finding that consolidated ownership leads to "entrenchment of the manager and owner, poor performance of firms, limited risk diversification, liquidity costs as the owner cannot sell its stake easily, and minority rights expropriation").

24. See infra Part II.D (arguing that greater disclosure increases liquidity and reduces cost of capital, leading to more efficient allocation of scarce resources).

25. See Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. Fin. Econ. 243, 257–64 (1998) (showing that venture capitalists' successful exits take place disproportionately through IPOs).

Vibrant, deep equity markets and dispersed ownership structures in turn appear to be possible only with a high level of corporate transparency.[26] Transparency has also been heralded as necessary for good corporate governance more generally.[27]

Several countries have implemented, or are considering implementing, laws that would promote civil liability for disclosure violations. In Canada, where securities regulation is primarily a provincial responsibility, Ontario, the leading financial province, recently enacted new legislation making it easier for investors to sue in the event of issuer misstatements.[28] Korea has provided for securities class actions for the first time.[29] 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.[30] The governments in Ireland and

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26. See Coffee, Gatekeepers, supra note 19, at 109 (describing impossibility of dispersed ownership and separation of ownership from control without reliable, audited financial statements); Erik Berglöf & A. Pajuste, Emerging Owners, Eclipsing Markets: Corporate Governance in Central and Eastern Europe, *in* Corporate Governance and Capital Flows in a Global Economy 267, 267–68 (Peter K. Cornelius & Bruce Kogut eds., 2003) (explaining how countries with poor transparency were quickly transformed, after initial privatization auctions created dispersed ownership, to concentrated ownership economies); Black, Legal and Institutional Preconditions, supra note 23, at 783, 834–35 (collecting empirical studies showing relationship between transparency and depth of equity markets measured by indicators such as ratio of stock market capitalization to GDP); John C. Coffee, Privatization and Corporate Governance: The Lessons from Securities Market Failure, *in* Corporate Governance Lessons from Transition Economy Reforms 265, 274–81 (Merritt B. Fox & Michael A. Heller eds., 2006) (comparing disappearance of market trading for most of nearly 1,500 Czech issuers created by privatization in early 1990s with better performance of Polish capital markets and attributing difference in part to very poor issuer disclosure in Czech Republic versus relatively high quality issuer disclosure in Poland); Frank B. Cross & Robert A. Prentice, The Economic Value of Securities Regulation, 28 Cardozo L. Rev. 333, 376–89 (2006) (collecting empirical studies showing relationship between transparency and depth of equity markets measured by indicators such as ratio of stock market capitalization to GDP); Hazem Daouk et al., Capital Market Governance: How Do Security Laws Affect Market Performance? 25 (Feb. 16, 2006) (unpublished manuscript, on file with the *Columbia Law Review*), available at http://ssrn.com/abstract=702682 (linking "increased enforcement of insider trading laws, improved accounting standards . . . and a relaxation of short selling" to market performance).

27. See, e.g., OECD Principles of Corporate Governance 49–57 (2004), available at http://www.oecd.org/DATAOECD/32/18/31557724.pdf (on file with the *Columbia Law Review*) (detailing importance of transparency in business); Mark J. Roe, Corporate Law's Limits, 31 J. Legal Stud. 233, 243–44 (2002) (arguing that corporate law is ineffective without transparency).

28. Bill 198 to the Ontario Securities Act, which effectively eliminated the need for plaintiffs to establish reliance or loss causation, became effective on December 31, 2005. Canada Introduces Securities Disclosure Liability, Can. Int'l Fin. L. Rev., Jan. 1, 2006, at 28, 28; see also Bradley Davis, Bill 198 Will Bring a New Era in Class Action Litigation in 2006, Law. Wkly., Oct. 14, 2005, at 9.

29. Ryu Jin, Assembly Passes Watered-Down Class Action Bill, Korea Times, Dec. 23, 2003, at 2.

30. See Stefano M. Grace, Strengthening Investor Confidence in Europe: U.S.-Style Securities Class Actions and the *Acquis Communautaire*, 15 J. Transnat'l. L. & Pol'y 281,

Finland are considering such reforms as well.[31] And the Parmalat scandal has led prominent academics to call for such reforms in Italy.[32]

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 contingent fees for plaintiffs lawyers, the existence of a "loser pays" 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 claims that can be brought collectively.[33] 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 importance because it comes against the background of a recent body of scholarly literature arguing that private damage suits play a special role in the enforcement of securities disclosure laws.[34]

290–300 (2006) (noting effects of different political economies on allowing class action litigation); Peter Geier, A Wary Europe Moves a Step Closer to Class Actions, Nat'l L.J., Dec. 5, 2006, at http://www.law.com/jsp/article.jsp?id=1165244464820# (on file with the *Columbia Law Review*) (commenting on change in five years since Europe allowed plaintiffs to bring increased class action securities suits); Press Release, German Fed. Ministry of Justice, The German "Capital Markets Model Case Act" (Jan. 12, 2006), available at http://www.bmj.bund.de/media/archive/1056.pdf (on file with the *Columbia Law Review*) (discussing similarities and differences between U.S. and new German class action systems).

31. Geier, supra note 30.

32. Guido Ferrarini & Paolo Giudici, Financial Scandals and the Role of Private Enforcement: The Parmalat Case 3 (European Corporate Governance Inst., Law Working Paper No. 40/2005, 2005), available at http://ssrn.com/abstract=730403 (on file with the *Columbia Law Review*) (noting influence of media on quickly formed class action system in Italian courts after *Parmalat*).

33. For recent overviews of "collective action" reforms in Europe, see Heather Smith, Is America Exporting Class Actions to Europe?, Law.com In-House Counsel, Feb. 28, 2006, available at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1141047298349 (on file with the *Columbia Law Review*) (documenting first product liability class action court case in Europe); see also Linklaters, Global Dispute Resolution: Class Action (2008), available at http://linklaters.com/pdfs/publications/Litigation/Classactions.pdf (on file with the *Columbia Law Review*) (describing increasingly stringent U.S. class certification standards designed to increase viability of similar systems in Europe).

34. See, e.g., Black, Legal and Institutional Preconditions, supra note 23, at 796 (explaining historical success of stock market listing standards requiring corporate disclosure in increasing dispersed ownership); Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, What Works In Securities Laws?, 61 J. Fin. 1, 19 (2006) (studying empirical relationship between availability of private enforcement of securities laws and capital market development); Katharina Pistor, Martin Raiser & Stanislaw Gelfer, Law & Finance in Transition Economies, 8 Econ. Transition 325, 348 (2000) (noting that effective laws rather than rapidly changing laws are most likely to influence external financial situations positively); Jennifer Arlen, Public Versus Private Enforcement of Securities Fraud 12–19 (2007) (unpublished manuscript, on file with the *Columbia Law Review*) (examining best allocation of public and private enforcement authority); Berglöf & Claessens, supra note 23, at 15, 22 (distinguishing effects of private versus public enforcement mechanisms).

II. The Social Value of Disclosure and the Irrelevance of Whether an Issuer Is Offering Securities

What is the social interest in the level of an issuer's disclosure? 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 regardless of whether it is offering securities. 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,[35] 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.[36] These benefits generally arise equally whether or not the issuer is offering securities at any given moment.

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35. Good corporate governance encourages firm managers to select more accurately the most promising from among all the proposed investment projects in the economy and to better operate their existing projects.

36. The importance of economic efficiency as a goal for disclosure regulation has gained increasing recognition over the last twenty-five years. 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 Coffee, Market Failure]; see also Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L.J. 711, 713 (2006) ("[T]he ultimate goal of securities regulation is to attain efficient financial markets and thereby improve the allocation of resources in the economy."); Steven A. Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory, *in* Issues in Financial Regulation 177, 191 (Franklin Edwards ed., 1979) (discussing costs of compliance with disclosure requirements). 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) (linking disclosure rules to accurate stock pricing and efficient resource allocation); Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047, 1048, 1050 (1995) (arguing that 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 (codified as amended in scattered sections of 15 U.S.C.), which amended the Securities Act to add section 2(b) providing that:

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.[37] 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—meaning it is as likely to be below the share's actual value as above—whether there is a lot of or very little information publicly available about the issuer. In other words, greater disclosure is not necessary to protect investors from buying 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 it reduces only *unsystematic* risk. Simply being diversified can protect investors from this unsystematic risk much more effectively and at less social cost than increasing issuer disclosure. The weakness of the investor protection rationale for mandatory disclosure is important because, as will be discussed in Part IV, it 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 similarly weak.[38]

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.[39] The starting point in establishing this proposition is to note that it is in the best interest of public shareholders that management make these decisions in a way that maximizes share value, i.e., maximizes the future expected cash flows for the rest of the life of

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> 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.*

Id. § 106(a), 110 Stat. at 3424 (codified as amended at 15 U.S.C. § 77b(b)(2006)) (emphasis added). The 1996 Act made an essentially identical amendment to the Securities Exchange Act by the addition of section 3(f). See id. § 106(b), 110 Stat. at 3424–25 (codified as amended at 15 U.S.C. § 78c(f)).

37. 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 Fox, Disclosure in a Globalizing Market] (rejecting fairness as compelling reason for disclosure and examining risk reduction strategies other than disclosure).

38. See infra Part IV.B.1.

39. 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., Law, Share Price Accuracy, and Economic Performance: The New Evidence, 102 Mich. L. Rev. 331, 338–41 (2003) [hereinafter Fox et al., Share Price Accuracy] (examining empirical evidence suggesting disclosure can increase economic efficiency).

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 the price at which it sells its output 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, however, 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 monitor management closely. The deviations between the decisions that maximize managerial utility and the ones that maximize share value are 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 cost-effectively minimizes these agency costs of management.[40]

A higher level of disclosure reduces the agency costs of management by two routes. First, disclosure enhances the effectiveness of the *legal* mechanisms for assuring good corporate governance by making the exercise of the shareholder franchise more effective and assisting shareholder enforcement of management's fiduciary duties. Second, disclosure enhances the effectiveness of the *market* mechanisms for aligning 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

40. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976) ("The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent."). 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 96 and accompanying text.

information.[41] 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 prices. 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 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 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 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, in an election for directors, to vote for 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.[42] Unlike the typical small individual shareholder, the larger

41. 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. Analysts J. 54, 54 (2000).

42. Jay C. Hartzell & Laura T. Starks, Institutional Investors and Executive Compensation 7 (Sept. 2002) (unpublished manuscript, on file with the *Columbia Law Review*), available at http://ssrn.com/abstract=468800 (finding, in sample including all firms in the S&P 500 Index, the S&P Midcap Index, and the S&P Smallcap Index, average aggregate institutional holdings to be 53.1% of shares outstanding and average holdings of top five institutional investors in a firm to be 22% of outstanding shares and 44% of aggregate institutional holdings); accord Anthony Saunders et al., The Impact of Institutional Ownership on Corporate Operating Performance 14 (NYU Stern Finance, Working Paper No. 03-033, 2003), available at http://ssrn.com/abstract=468800 (on file with the *Columbia Law Review*) (finding, in sample of firms in the S&P 100, that 59.3% of shares outstanding were held by institutions and average holdings of top five institutional investors in a firm is 20.1% of outstanding shares).

shareholder has a big enough stake to make the kind of information provided 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.[43]

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 Institutional Shareholder Services (ISS), which, while creating their own agency problems, help mitigate the shareholder voting collective action problem.[44] 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.[45] Substantial evidence indicates, however, that activist hedge funds have been able to target individual firms[46] and accomplish changes in management, managerial policy, and corporate governance in ways that appear to be share value enhancing.[47] The

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43. 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 Fox, 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.

44. See Frank P. VanderPloeg, Legal Standards for Adoption of Executive Compensation Programs and Contracts, *in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2008, at 167, 169 (PLI Tax Law & Estate Planning, Course Handbook Series No. 833, 2008).

45. Id.

46. 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, at i (Univ. of Pa. Inst. for Law & Econ. Research, Working Paper No. 06-16, 2006), available at http://ssrn.com/abstract=919881 (on file with the *Columbia Law Review*) ("[H]edge fund activism differs from activism by traditional institutions in several ways: it is directed at significant changes in individual companies (rather than small, systemic changes), it entails higher costs, and it is strategic and ex ante (rather than intermittent and ex post)."). But see Lucian Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 676 (2007) (arguing that shareholders generally have little influence through their franchise).

47. William W. Bratton, Hedge Funds and Governance Targets 11 (European Corporate Governance Inst., Working Paper No. 80/2007, 2007), available at http://ssrn.com/abstract=928689 (on file with the *Columbia Law Review*) (describing hedge funds' high record of success in using proxy system to achieve corporate change); Alon Brav et al., Hedge Fund Activism, Corporate Performance, and Firm Performance 1 (Sept. 22, 2006) (unpublished manuscript, on file with the *Columbia Law Review*), available at http://www.fdic.gov/bank/analytical/cfr/2006/oct/hedge_fund.pdf (concluding that activists are at

more firm-specific information 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, recent years have seen 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;[48] corporations on their own adopting requirements that directors can be elected only upon the vote of an absolute majority of their shareholders;[49] and reforms to permit internet proxy voting.[50]

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least partially successful at achieving corporate change two-thirds of the time and that there are statistically significant abnormal returns in the range of five to seven percent around time of announcement that hedge fund has become active with respect to particular issuer).

48. 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 directors of public companies. See Shareholder Proposals, Exchange Act Release No. 56,160, Investment Company Act Release No. 27,913, 72 Fed. Reg. 43,466, 43,469 (proposed Aug. 3, 2007) (to be codified at 17 C.F.R. pt. 240); Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,785 (proposed Oct. 23, 2003) (to be codified at 17 C.F.R. pts. 240, 249 & 274). Ultimately, however, it decided to maintain the Rule 14a-8(i)(8) exclusion of election-related shareholder proposals from company proxy materials and to 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, Exchange Act Release No. 56,914, Investment Company Act Release No. 28,075, 72 Fed. Reg. 70,450, 70,453 (Dec. 11, 2007) (codified at 17 C.F.R. pt. 240.14a-8(i)(8)) (2008).

49. Notwithstanding the retrenchment at the SEC, increasingly corporations have adopted on their own a majority voting standard for director elections. See AT&T Inc.: Majority Voting Standard Is Adopted for Some Elections, Wall St. J., Nov. 21, 2006, at A11 (announcing amendment to AT&T bylaws to adopt majority voting standard for director nominees in uncontested elections); Neal E. Brunette & John D. Stoll, GM Board Declines to Discuss Meeting on Alliance, Turnaround, Wall St. J., Oct. 4, 2006, at A2 (noting that GM's board amended company bylaws "to allow majority voting in the election of directors"); Jared A. Favole, Delaware Lets Firms Enact Rule on Majority Vote, Wall St. J. Online, Oct. 4, 2006, available at LexisNexis, WSJNL file (citing Clorox, Co., Agilent Technologies Inc., Martek Biosciences Corp., and Wal-Mart Stores Inc. as recent examples of Delaware-incorporated companies "to enact majority-vote standards with teeth"); McDonald's Corp.: Bylaws Are Amended to Address Uncontested Director Elections, Wall St. J., Nov. 15, 2006, at B12 (noting that McDonald's Corp. amended bylaws to adopt majority voting standard for directors in uncontested elections); Kara Scannell, SEC Proxy Plan May Spur Debate—Agency Takes up Issues of Shareholders' Access, Directors' Accountability, Wall St. J., July 25, 2007, at A3 (announcing SEC vote on whether to allow shareholders to amend election-related bylaws).

50. See Internet Availability of Proxy Materials, Exchange Act Release No. 52,926, Investment Company Act Release No. 74,598, 80 Fed. Reg. 74,598, 74,598 (proposed Dec. 15, 2005) (to be codified at 17 C.F.R. pts. 240, 249 & 274) ("We are proposing amendments to the proxy rules . . . to furnish proxy materials to shareholders by posting

b. *Fiduciary Duties.* — A high disclosure regime enhances the effective enforcement of management's fiduciary duties because managers are not otherwise likely to provide information voluntarily about their breaches of fiduciary duty.[51] A rule requiring the issuer to report all material transactions 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 such a transaction exists, this fiduciary breach-reducing burden placed on management by corporate law is meaningless.[52]

Arguably, a manager willing to engage in a transaction that is unfair to the corporation would also be willing to violate disclosure rules in order to cover up the transaction, in which case disclosure regulations would have no deterrent effect. This argument, however, ignores that the transaction itself, or its effects, may ultimately become visible, at which time it may be easier, from a factfinding perspective, for a court to conclude that there has been a disclosure violation than that unfairness has occurred. 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 lawyers.[53]

2. *Market Mechanisms.* — A high level of disclosure also reduces the agency costs of management through its beneficial effects on two market

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them on an Internet Web site and providing shareholders with notice of the availability of proxy materials.").

51. See Mahoney, supra note 36, at 1089–95 (conducting efficiency analysis of mandatory disclosure regime).

52. For a more detailed discussion of these points, see Fox, Required Disclosure, supra note 43, at 118–20 ("Absent required disclosure, managers are not inclined to provide information that might suggest the existence of a breach of fiduciary duty. Without that information, it is often impossible for shareholders to know about the potential breach."); see also Roe, supra note 27, at 269–71 (discussing value of corporate law in "protecting distant shareholders").

53. 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 rarity of adjudicated breaches of 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 immediately below. See Goshen & Parchomovsky, supra note 36, at 741–42.

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, with 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 the costs necessary to acquire the target. To make this determination, the potential acquirer must assess 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.[54]

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 (NPV) 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 disclosure can likewise reduce the agency costs of management by increasing the use of share price-based managerial compensation. The problem for managers with share price-based compensation, compared with 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.[55]

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54. See, e.g., Merritt B. Fox, Finance and Industrial Performance in a Dynamic Economy: Theory, Practice, and Policy 84–91 (1987) [hereinafter Fox, Finance and Industrial Performance] (analyzing managerial decisionmaking based on return/risk ratio); Fox, Disclosure in a Globalizing Market, supra note 37, at 2546–48 ("[F]ear of a takeover will motivate incumbent management to make decisions more in accord with the best interests of shareholders than it might otherwise make."); Aaron S. Edlin & Joseph E. Stiglitz, Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiencies 1302 (Nat'l Bureau of Econ. Research, Working Paper No. W4145, 1997), available at http://ssrn.com/abstract=227981 (on file with the *Columbia Law Review*) ("[M]anagerial rent-seeking affects not only the *level* of investment, but also the *form*.").

55. Empirical evidence demonstrates 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. See Clifford G. Holderness, Randall S. Kroszner & Dennis P. Sheehan, Were the Good Old Days That Good? Changes in Managerial Stock Ownership Since the Great

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 NPV projects in order to maintain or enlarge their empires.

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,[56] arguably illustrate that share price compensation is more effective at promoting disclosure violations than good management. There are two responses. First, these problems arose largely from the design of the compensation packages, which had insufficient emphasis on longer-run share performance.[57] Long-run share performance is much harder to manipulate through earnings management.[58] Second, the scandals 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 debatable. 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 to undertake a proposed investment project. Under this second view, however, share price will usually have this effect regardless of the source of the funds tapped to implement the project,

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Depression, 54 J. Fin. 435, 437 (1999) ("[R]eduction in costs and increase in benefits of managerial ownership provide an explanation for the increase in managerial ownership . . . .").

56. Coffee, Gatekeepers, supra note 19, at 55–56, 62–64.

57. Id. at 55.

58. 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 manipulate earnings to increase their personal rewards if the share price-based compensation plan emphasizes the longer run and hence captures this later depression in price.

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 more socially important when the issuer is offering new securities to the market than it is at other times. 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 regardless of whether a share offering is the source of finance.

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 Modigliani and Miller tenet that investment and financing decisions should be separate.[59] 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 NPV, i.e., that the expected future net revenues from the project discounted to present value exceed or equal the project's cost.[60] 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.[61] Thus the two factors needed to make the NPV 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 NPVs allow the firm to earn a higher risk-adjusted expected return on the amount needed to fund the project than investors can receive by investing these same funds in the market. Thus only positive NPV projects add to the value of holding a share.[62]

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 the 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.[63] 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 not to the real investment decision of whether to implement any par-

59. See Merton H. Miller & Franco Modigliani, Dividend Policy, Growth, and the Valuation of Shares, 34 J. Bus. 411, 413–14 (1961) ("Having established that [a firm's current market value] is unaffected by the current dividend decision it is easy to go on to show that [it] must also be unaffected by any future dividend decisions as well.").

60. Brealey, Myers & Allen, supra note 9, at 17.

61. Id. at 215–17.

62. By the same logic, implementing projects with a zero NPV has no effect on share value and implementing negative NPV projects decreases share value.

63. See, e.g., Daniel R. Fischel, The Law and Economics of Dividend Policy, 67 Va. L. Rev. 699, 701–02 (1981) (describing "irrelevance" of dividend policy on share value).

ticular project.[64] Only the investment decision 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 whether 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 NPV. 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 NPV 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 equity finance would be 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 has only a negative NPV 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.[65] 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 socially undesirable projects.

The institutional finance theory account so far might appear to suggest that share price accuracy, and hence disclosure, matters more when an issuer is considering a public offering of shares. But there is more to the story. Even where the firm has sufficient internal funds or a public

64. The importance of these rationales for separating the finance and investment decisions emerges in the case of a firm that has overpriced shares, but has only a negative NPV investment project under consideration, i.e., the expected rate of return 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. Id.

65. Such a distribution would signal that the issuer sold its immediately preceding new issue of shares simply because it believed they were overpriced in the market. This signal might complicate shareholder relations and future sales of equity.

equity offering is not the least-cost method, share price may affect whether the project is implemented. On the supply side, share price can affect the cost of financing a project by influencing the terms demanded by the intermediaries constituting the other available external sources of funds.[66] 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 NPV project because of the prospect that the counterbalancing equity financing may, through dilution, become too costly to current shareholders.[67] 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

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66. See Homer Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 123 (1979) (discussing importance of "market price of shares" for "the company's borrowing power, the interest rate it pays on its borrowings, and the value of its 'paper' in mergers and acquisitions").

67. Brealey, Myers & Allen, supra note 9, at 488–90. In the situation where top management is reasonably confident that the share price is too low because it has information 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 it is not subject to rigorous mandatory disclosure regulations and does not otherwise have a 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 top management's awareness because top management is not forced to answer the questions that would be asked as part of a high disclosure regime. See Fox, Required Disclosure, supra note 43, at 123–25 (discussing role of disclosure requirements in raising managerial consciousness); Louis Lowenstein, Financial Transparency and Corporate Governance: You Manage What You Measure, 96 Colum. L. Rev. 1335, 1342 (1996) (describing benefits of disclosure requirements).

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 the understanding of managers and hence of which they are not aware.

have an amount of undiversifiable risk comparable to that of the proposed project. Because companies with similar 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 NPV 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, an inverse relationship develops between the discount rate they use to calculate the project's NPV and the issuer's share price. This leads to more projects appearing to have positive NPV than is actually the case when share price is inaccurately high and the opposite when it is inaccurately low.[68]

Finally, because of concern with public perceptions, low share price can more generally constrain the use of both external and internal funds.[69] 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 that they invest in negative NPV projects,[70] a low share price may put management on the defensive even when in fact it has positive NPV 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 cost effectively, 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 nonpublic information. Market makers and specialists, who ordinarily do not know the identity of the person placing a buy or sell order, 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

68. Again, if management knows that the share price is too high or too low because of information it possesses, the inaccurate price may not have this effect. But the managers of lower disclosure issuers are likely to be less aware of price inaccuracies. See supra note 67.

69. See Fox, Finance and Industrial Performance, supra note 54, at 282–87 (noting that "a company with a good image will have a good chance of making a success out of a new investment" and describing factors that contribute to image).

70. See infra notes 87–89 and accompanying text.

seller orders.[71] The bigger the spread, the less liquid the issuer's shares, and the less valuable they are to hold. When an issuer offers shares in the primary market, the larger 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.[72] By reducing the amount of nonpublic information and hence the opportunities for insiders and tippees to engage in such trades, ongoing periodic disclosure should therefore reduce bid/ask spreads, increase liquidity, and, consequently, reduce the cost of capital.[73]

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.[74] 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.[75] Foreign issuers experience a price jump when undertaking such cross-listings.

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71. Larry Harris, Trading & Exchanges: Market Microstructure for Practitioners 287–88, 299–302 (2003) (describing "bid/ask" spreads); Lawrence R. Glosten & Paul R. Milgrom, Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders, 14 J. Fin. Econ. 71, 72 (1985) (same).

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

73. For models working out these points more rigorously, see Robert E. Verrecchia, Essays on Disclosure, 32 J. Acct. & Econ. 97, 164–72 (2001) (finding that disclosure reduces information asymmetries and lowers cost of capital); David Easley & Maureen O'Hara, Information and the Cost of Capital 32–33 (Nov. 2001) (unpublished manuscript, on file with the *Columbia Law Review*), available at http://ssrn.com/abstract=300715 (same).

74. See Luzi Hail & Christian Leuz, Cost of Capital Effects and Changes in Growth Expectations Around U.S. Cross Listings 40 (European Corporate Governance Inst., Fin Research Paper No. 46/2004, 2008), available at http://ssrn.com/abstract=938230 (on file with the *Columbia Law Review*) [hereinafter Hail & Leuz, U.S. Cross Listings]; see also Luzi Hail & Christian Leuz, International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?, 44 J. Acct. Res. 485, 524 (2006) (finding, from cross-country comparison, inverse relationship between effectiveness of securities regimes and cost of capital). For other empirical studies showing that greater disclosure leads to increased liquidity and a lower cost of capital, see Christine A. Botosan, Disclosure Level and the Cost of Equity Capital, 72 Acct. Rev. 323, 325 (1997) (presenting empirical findings that for firms that attract low analyst following, greater disclosure is associated with lower cost of equity capital); Christian Leuz & Robert E. Verrecchia, The Economic Consequences of Increased Disclosure, 38 J. Acct. Res. 91, 113 (Supp. 2000) (presenting empirical findings, from study of German firms, that increased disclosure leads to lower cost of capital); Michael Welker, Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets, 11 Contemp. Acct. Res. 801, 801 (1995) (presenting empirical findings "that a well-regarded disclosure policy reduces information asymmetry and hence increases liquidity in equity markets").

75. Hail & Leuz, U.S. Cross Listings, supra note 74, at 1.

Hail and Leuz 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.[76] The market's anticipation of greater ongoing disclosure 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 increase 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 change firm behavior in ways that will increase *actual* future cash flows.[77] 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 reduced the rate at which future expected cash flows are discounted and hence the firm's cost of capital decreases. Hail and Leuz attribute this lower cost of capital to the increase in the expected level of disclosure that accompanies a U.S. cross-listing.[78] They find no comparable results for a foreign firm's over-the-counter (OTC) cross-listing in the United States (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[79]), neither of which triggers the need to comply with the U.S. periodic disclosure requirements.[80]

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. In return, these issuers and entrepreneurs receive 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 fall in the future (relative to a future price that reflects the market expected

76. Id. at 2 (explaining model that analyzes "ex-ante estimates of firms' cost of equity capital implied by market prices and analyst forecasts" in order to isolate issue of cash flow).

77. Id. at 7–8 (explaining effects of bonding on companies under increased U.S. disclosure requirements and threats of SEC enforcement and shareholder suits).

78. Id. at 1.

79. See 17 C.F.R. § 230.144A (2008).

80. See Hail & Leuz, supra note 74, at 40.

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 markets are the counterparts of the sellers in the secondary market. They give up current dollars to obtain claims on future dollars for one of three reasons: to have a place to store the savings generated by their current consumption being less than their current income, to readjust their financial portfolios, or to speculate that the share price will rise in the future (again relative to a future price that reflects the expected market return). Whichever reason 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 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.[81] 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.[82]

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

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81. See William J. Baumol, Economic Theory and Operations Analysis 517 (4th ed. 1977) (describing market imperfections from welfare economics perspective).

82. See Harris, supra note 71, at 214–15 (describing public benefits of liquid markets). 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. It therefore 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 Parts II.B and II.C.

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 because the knowledge discovered is impounded in share price through trading and adds to its accuracy. As we have seen, more accurate share prices 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.[83] This is very likely to be the case where the information either is 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.[84]

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 (from a stock exchange, for example); 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 precautionary checking are no greater at the particular moment that an issuer is offering shares than at any other point in time.

F. *Implications for Mandatory Disclosure Design*

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

83. See Jack Hirshleifer, The Private and Social Value of Information and the Reward to Inventive Activity, 61 Am. Econ. Rev. 561, 573 (1971) (stating that gains from obtaining information must be offset by costs of acquisition and dissemination).

84. See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 681–82 (1984) (arguing that mandatory disclosure reduces duplicative information searches).

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 regardless of whether the issuer is selling securities. For established, publicly traded issuers, this is largely true as a formal matter today in the United States. Indeed, this has been the guiding principle of the movement over the last twenty-five years away from a transactionally based system of disclosure regulation toward a system of company registration.[85] Second, and a key point of this Article, civil liability should be structured to give corporate decisionmakers 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 note 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.

III. Avoiding Financing Source Distortions

Efficiency requires management choices between internal and external finance and among sources of external finance to 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 finance source 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 over 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 should avoid such distortions. It imposes a significantly heightened risk of liability on managers and other nonissuer actors if a violation occurs when 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 nonissuer actors is not counterbalanced by

85. See supra notes 10–11 and accompanying text (examining logic and history of mandatory registration).

greater private gains from the violation.[86] 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*

Internally generated funds represent one alternative to funds raised by a public offering of equity. Consider, however, the position of the managers of a firm with insufficient internal funds to finance all its positive NPV projects. Given the heightened liability that a public offering of equity imposes on nonissuer 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.

Two kinds of social losses may flow from this decision. First, some of the issuer's positive NPV 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 NPV projects not worthwhile.

Second, when some firms leave positive NPV 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 firms have more internally generated funds than they have positive and zero net value projects and are using these surplus internal funds to finance negative NPV 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 investing in negative net value projects. This signal blurs, however, when firms with unimplemented positive NPV 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 NPV 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 NPV investment opportunities are likely to find it in their personal interests to

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

implement negative NPV projects in addition.[87] The chance that their share value-diminishing 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.[88] Substantial empirical evidence indicates that the investment projects chosen by firms relying predominantly on internal finance are considerably inferior to projects chosen by other firms, an inefficiency that has significantly damaged the economy's growth in productivity.[89]

Since the late 1980s, hostile takeovers may have reduced the scale of this problem. The high transaction costs associated with such takeovers,

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87. 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. See Fox, Finance and Industrial Performance, supra note 54, at 121–27. The greater the 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). Id. The idea that managers gain utility simply from the size of the firm they run has a long history. See, e.g., Robert A. Gordon, Business Leadership in the Large Corporation *passim* (1945) (examining incentives of managers to run large companies); Frank Knight, Risk, Uncertainty, and Profit 291-312 (1921) (examining role of salaried corporate managers); Joseph A. Schumpeter, The Theory of Economic Development 128–56 (Redvers Opie trans., Harvard Univ. Press 1949) (1911) (discussing "entrepreneurial profit"). 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. See Oliver Williamson, Markets and Hierarchies 120 (1975) (arguing that "dispute settling characteristics" lead to creation of specialized roles). The idea that managers of public corporations will under many circumstances have an interest in investing in negative NPV projects is also behind Jensen's so-called "free cash flow" hypothesis. See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 Am. Econ. Rev. 323, 323 (1986) (explaining management incentives to grow firms beyond optimal size).

88. See Fox, Finance and Industrial Performance, supra note 54, at 132–40 (discussing management techniques for reading external scrutiny); Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650, 654 (1984) (noting monitoring problem of managers who are not subject to outside scrutiny).

89. See, e.g., Gordon Donaldson, Corporate Debt Capacity 3–26 (1961) (introducing analysis of "the choice between debt and equity as the source of . . . long-term capital"); William J. Baumol et al., Earnings Retention, New Capital and the Growth of the Firm, 52 Rev. Econ. & Stat. 345, 354 (1970) (studying effect of source funding on investment projects). 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 54, at 233–37; see also Jensen, supra note 87, at 326–27 (reviewing empirical effects in oil industry); Reinier Kraakman, Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive, 88 Colum. L. Rev. 891, 898 (1988) (critiquing misinvestment and alternative discount hypotheses).

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 NPV 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 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),[90] and public offerings of equity restricted to foreign investors (in the United States, Regulation S).[91] 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 NPV 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 such sales generate are discounted substantially.[92] 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.[93] Greater use of nonpublic external finance also causes firms to devote more legal and administrative resources to determining whether a method of raising funds is in fact not a domestic public offering (and hence exempt from registration), as well as to determining 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 also be registered under the

90. A publicly traded U.S. issuer is not permitted, however, to use Rule 144A to avoid Securities Act registration of an offering of its common stock. See 17 C.F.R. § 230.144A (2008).

91. See id. §§ 230.901–.905. 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.

92. 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 seven percent and twenty percent. Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, Securities Act Release No. 8813, 72 Fed. Reg. 36,822, 36,838 n.175 (proposed July 5, 2007) (to be codified at 17 C.F.R. pts. 230, 239) (citing studies estimating illiquidity discount excluding other price-discounting factors of restricted stocks).

93. See supra Part II.D.3.

Securities Act[94] and hence it too leads to heightened liability for nonissuer actors. But a misstatement as to the assets of, or likely future underlying cash flows generated by, a firm at the time of a public debt offering would, under many circumstances, be less likely to be considered material than the same misstatement at a public equity offering. Even if a misstatement does lead to liability, it would generally result in smaller damages. Public debt offerings provide a lower chance of liability and smaller potential damages because debt is paid back first in preference to distributions to equity. As a result, a misstatement will typically create a larger misperception concerning the size of the residual available for distributions to equity than concerning the likelihood of the repayment of debt. Thus heightened liability under existing U.S. law for nonissuer 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.[95] 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 endure in some form for a long time to come. As outlined in Part I, governments abroad are taking enforcement more seriously with the growing concern for transparency. Civil liability, whatever its problems, has sufficient attractions that other countries are increasingly likely to employ the remedy.

Parts II and III developed 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 such a civil liability structure should look like. The exercise helps us think through the larger question of how to design a civil liability system that

94. Securities Act of 1933 § 5a, 15 U.S.C. § 77e (2006) (prohibiting sale of any security without registration).

95. See supra note 67 and accompanying text.

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 chosen be equal to that at the time of a traditional U.S. Securities Act registered public offering; 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 to having the incentives for compliance at the level in my proposal, 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. Even if the level suggested here is right for the United States, a cost-benefit analysis might indicate a different level of incentive strength for another country.[96]

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96. 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, 491–94 (1999) (noting that "16 out of 20 [firms] in the United States fit the widely held description"). 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 40 and accompanying text. As discussed, disclosure can ameliorate this problem. Supra note 40 and accompanying text.

In a substantial majority of other countries, most corporations are controlled by families or the state. La Porta et al., supra, at 496 ("[O]nly 24 percent of the large companies in rich countries are widely held, compared to 35 percent that are family-controlled, [and] 20 percent are State-controlled . . . ."). As a consequence, the corporate governance problems differ from those in the United States. These differences may affect disclosure's usefulness for improving corporate governance and hence disclosure's level of social benefits. Coffee, Gatekeepers, supra note 19, at 78–82 (explaining that dispersed ownership creates managerial incentives to exaggerate reported income whereas concentrated ownership tends to lead to extraction of private benefits of control); John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L.J. 1, 16–17 (2001) (discussing dispersed versus concentrated ownership). 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 37, at 2580 (detailing optimal apportionment of regulatory authority).

But comparing the social benefits from disclosure in different countries is tricky. On one hand, the agency problems associated with management are lower in countries where most corporations are controlled by families or banks because persons with control can supervise managers more easily than can 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 noncontrol shareholders, seek to maximize their

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 a system with such requirements. In addition, any time 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 subsequent quarterly or current report.[97] Under this scheme, the price of the

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own private benefits or those of nonshareholder stakeholders of the corporation, such as labor or the communities where 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 a broad, though not universal, consensus exists among commentators in the United States that share value-diminishing decisions are generally socially undesirable, this view is far from fully accepted abroad. Compare Richard A. Posner, Economic Analysis of Law 453–56 (2007), and Roberta Romano, The Genius of American Corporate Law 2, 130–31 (1993) (describing objective of American corporate law as maximization of share value and criticizing other systems that take other constituencies into account), with Michael Gruson & Wienand Meilicke, The New Co-Determination Law in Germany, 32 Bus. Law. 571, 571–73 (1977), and Detlev F. Vagts, Reforming the "Modern" Corporation: Perspectives from the German, 80 Harv. L. Rev. 23, 38–43 (1966) (describing corporate purpose of German corporations as extending beyond maximizing shareholder value).

97. Without such an updating requirement, issuers will have an incentive to offer securities immediately after they become aware of bad news and before 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 11. The updating works as follows: Issuers filing an automatic shelf registration statement may incorporate by reference all reports filed under the Exchange Act. See Registration Statement Under the Securities Act of 1933 (Form S-3), at 11–12 (2008). At the time of registration, the issuer need describe only "material changes" 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. See id. 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 that represent a "fundamental change" in the information set forth in the registration statement. See 17 C.F.R. § 229.512(a)(1) (2008).

Additional updating at the time of the offering should probably be waived if the issuer is making a de minimis offering or offerings—such as, say, an offering in aggregate less than a few percent of its shares within a three-month period. The waiver is appropriate because the gain the issuer could achieve by selling the shares at a possibly higher price

issuer's shares in the secondary market will, assuming compliance, reflect up-to-date information concerning every subject of the mandatory disclosure rules. This secondary market price will be the main determinant of the price at which the new primary market offering would be made since the newly offered shares and the already outstanding ones are perfect substitutes for each other.[98]

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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 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 by not requiring the real resources that would otherwise go into marketing, they involve lower social costs. The 2005 offering reforms do not provide this kind of a waiver. See supra note 11 (discussing 2005 offering reforms).

At the other extreme, if an offering is sufficiently large—perhaps equal to thirty or forty percent of outstanding equity—the disclosure and liability regime proposed here should not be applicable. See supra note 11. For two reasons, the issuer should instead be treated in the same fashion as an IPO. First, an offering of this size is likely to accompany a transformative event in the history of the firm, and so the efficiency of the secondary market price before the offering provides much less assurance that the offering price will be efficient. Second, as with an IPO, significant marketing efforts will be necessary 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. The 2005 offering reform's amended Rule 415, however, places no limit on the number of securities that may be offered by a WKSI pursuant to its automatic shelf procedure. See supra note 11.

98. 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 are 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 the decision to offer the securities could affect 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. Brealey, Myers & Allen, supra note 9, at 490–93 (observing that rational investors will believe "[t]he *attempt* to sell stock shows that it must be worth less"); Stewart C. Myers & Nicholas S. Majluf, Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have, 13 J. Fin. Econ. 187, 188 (1984) (noting that investors will reason that "[t]he news conveyed by an issue is bad"). Presumably, though, the better the periodic mandatory disclosure regime, the smaller the signaling effect.

The second and third reason offering the securities could affect the secondary market price both relate to the increased supply of the issuer's shares. The increased supply of shares could create a long-run or only short-run effect. 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 a vast reservoir of other stocks with the same beta could substitute for the issuer's shares. Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 570 n.67 (1984). For empirical findings purporting to

2. *External Certification.* — 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 infra Part IV.C, 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 of disclosure as traditional U.S. registration statements in a public offering typically did.[99] The prospect that the earlier filings would need

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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, 191–206 (1972). But see Paul Asquith & David W. Mullins, Equity Issuers and Offering Dilution, 15 J. Fin. Econ. 61, 70–85 (1986) (presenting empirical research purporting to show downward-sloping curve); Saul Levmore, Efficient Markets and Puzzling Intermediaries, 70 Va. L. Rev. 645, 653–54 (1984) (reviewing alternative explanations for Scholes's findings).

Alternatively, the increased supply might have only a temporary effect 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, 97 (1988) (summarizing empirical findings purportedly consistent with this theory).

99. See supra notes 5, 10, 11 (discussing traditional role played by underwriters in enhancing quality of disclosure at time of securities offering and how 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 19, at 206, 348–49 (discussing attorneys' traditional gatekeeping role); Coffee, Re-Engineering, supra note 11, at 1157 (same); David J. Denis, Shelf Registration and the Market for Seasoned Equity Offerings, 64 J. Bus. 189, 197–98 (1991) (discussing price of underwriting under shelf procedure). For a description of the traditional registration statement's more leisurely drafting processes, 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 12, at 1025–26. An external certifier certifying an issuer's annual report would have as much time as the underwriter had in a traditional offering and so could play a similar role. Because the external certifier would face the same liability as the underwriter in the traditional offering, it would be motivated to perform this role similarly well.

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 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.[100] Information useful for projecting future cash flows is the information 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 toward share value, promotes societal interests as well. To the extent that the revisions of the annual report instead require legal or accounting expertise, investment banks are well positioned to take responsibility for delegating such work.

Investment banks also have experience because they currently perform this same role in connection with IPOs. This experience not only means that they are prepared to perform this task well, but also suggests that they would be interested in providing certifications as a way to extract additional rents from an already established skill set.[101]

Finally, investment banks have the virtue of being highly capitalized, minimizing the chance that the prospect of being made judgment proof will compromise their motivation to provide needed due diligence.

Other kinds of entities with a staff of persons with high financial expertise, such as major consulting firms, could also perform this certifying role well. Although they would not start with the advantages of an organization that is already performing the same task in the context of IPOs, they would not be at any cost disadvantage as they gained experience. It is in fact desirable to open the opportunity of being an external certifier

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100. See 17 C.F.R. § 229.303. There is empirical evidence that the late-1970s adoption of the revisions to the MD&A that prompted these disclosures resulted in a significant improvement in share price accuracy. See Fox et al., Share Price Accuracy, supra note 39, at 376.

101. Investment banks are currently oriented primarily toward selling financial products, trading on their own accounts, 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, nonsales applications—for example the provision of "fairness opinions" in corporate control and financial restructuring transactions.

as broadly as possible, consistent with maintaining 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 certifiers so as to assure their financial capacity to pay liabilities and their competency to do the job.[102]

B. *Issuer Liability*

1. *A Disclosure Violation with No Offer of Securities.* — This Article's proposal, unlike U.S. law today, would not hold the issuer liable for civil damages if it commits a disclosure violation but offers no securities. This eliminates Rule 10b-5 fraud-on-the-market suits against issuers based on their misstatements in mandatory disclosure filings. Liability for issuer statements made outside 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 nonissuer actors. Should the statement made outside the filing 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 retelling appears to have an updating quality.

Freeing the issuer from liability but maintaining liability for other actors may at first glance seem backward. A corporate entity, the issuer, is the entity required to produce the disclosures. The standard law and economics wisdom is that if civil liability for a corporate violation exists, the corporate entity should be primarily liable.[103] According to this view, the open question would be whether the law should impose secondary liability on the issuer's directors, officers, and professional agents, with the

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102. 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—J.P. Morgan, Bank of America, UBS, Goldman Sachs, Citigroup, Credit Suisse, and Morgan Stanley—revealed that as of January 26, 2009, their total stock market capitalization ranged, respectively, from about $90 billion to $18 billion. Their latest reported total book equity ranged, in minor variation from this respective order, from about $147 billion to $28 billion. These figures were reflected in the data at Yahoo! Finance, http://finance.yahoo.com, on January 26, 2009. Copies of each relevant page are on file with the *Columbia Law Review*.

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 perform due diligence.

103. Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 858 (1984).

presumption being that it should not absent a showing that issuer liability alone will fail.[104]

But this conventional wisdom does not fit disclosure violations very well. 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[105] and to lower the corporation's cost of capital by increasing the expected level of liquidity.[106] The corporation's shareholders are thus the persons ultimately damaged by the violation because poor management and reduced liquidity reduce the value of shares.

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-compliant corporation than with a noncompliant one. If a falsely positive disclosure violation increases an issuer's share price by five dollars, every buyer pays five dollars more per share than if there had been no violation. But every seller receives five dollars 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 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 nondiversified 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 diversified investor within either group.[107] As has been widely recognized

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104. Id. at 867–68; see also Steven Shavell, Economic Analysis of Accidents 170–72 (1987).

105. See supra Part II.B.

106. See supra Part II.D.

107. 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 before the issuer's

for some time, this means that under a regime by which the losers are compensated by issuers that make the false statements, the damages are in some sense "circular."[108]

In sum, as critics of fraud-on-the-market class action suits 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 transaction costs associated with securities litigation. Such a cause of action does have deterrence value, however. Managers will be motivated to avoid disclosure violations in order to avoid the issuer losses involved in paying damages, just as 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.[109]

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misstatement and so suffered no trading loss as a result because they neither bought nor sold at a price influenced by the misstatement. Thus, not all of the issuer's 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. But this loss spreading comes at the very high price of the substantial real resources consumed by securities litigation. See supra note 18 and accompanying text. Diversification offers a more effective, and far less expensive, 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.

108. For authors expressing skepticism toward 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, see, e.g., Coffee, Reforming, supra note 18, at 1556–66; Paul G. Mahoney, Precaution Costs and the Law of Fraud in Impersonal Markets, 78 Va. L. Rev. 623, 632 (1992); Thakor, Unintended Consequences, supra note 20, at 6–8.

109. 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, better spreads risk between the firm and its agents, and 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 securities law. Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 700–20. While my reasoning and theirs overlap a great deal, our analyses differ 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 shares of corporations that engage in frequent misstatements rather than few or none. See supra Part IV.B.1. Recognizing this fact makes crystal clear that the only kind of damage, if any, that should give rise to liability is damage to the corporation itself. See supra note 88 and accompanying text. This insight saves steps in the analysis and eliminates the need for unrealistic assumptions, such as that there is no possibility of overdeterrence in the case of misstatements. See supra Part II.B–D. Given, for example, the possibility of legal error and the discretion that management has in fully answering questions required by its periodic disclosure filings (to say nothing of voluntary disclosure beyond the requirements of these filings), we need to recognize that the risk of liability can deter management from making what it believes is truthful disclosure. See infra Part IV.C.1. Similarly, through the

2. *A Disclosure Violation When Securities Are Being Offered Publicly.* — The issuer's public offer of securities at the time a disclosure violation exists should, as under U.S. law today, make the issuer absolutely liable to investors.[110] The aggregate amount of issuer liability should be 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 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 effec-

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level of care required to maintain a due diligence defense available to directors, officers, and the external certifier, we can 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 the care becomes socially wasteful. See supra note 96; infra Part IV.C.1.

110. 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. See, e.g., In re Navarre Corp. Sec. Litig., 299 F.3d 735, 742–43 (8th Cir. 2002) (stating plaintiff's complaint fails under heightened pleading standard of Private Securities Litigation Reform Act ("PSLRA") because it did not indicate why defendant's statements would have been false or misleading at time they were 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. Id. 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 forty years. The current law on actionable forward-looking statements comprises a mix of statutory and common law rules. Rule 175 and Rule 3b-6, promulgated under the Securities Act and the Exchange Act, respectively, provide a safe harbor for projections made with a reasonable basis and in good faith. Pub. L. No. 104-67, §§ 27A(g), 21E(g), 109 Stat. 737, 751–755 (codified at 15 U.S.C. §§ 77z-2, 78u-5 (2006)). For reporting issuers, the PSLRA amended the Securities Act and Exchange Act to provide additional safe harbors for certain projections. Id. Courts have also developed the "bespeaks caution doctrine," which protects projections if accompanied by meaningful cautionary statements. See, e.g., Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 (1st Cir. 1991) ("Documents such as this, which, 'clearly "bespeak caution,"' are not the stuff of which securities fraud claims are made." (quoting Luce v. Edelstein, 802 F.2d 49, 56 (2d Cir. 1986))).

tive in deterring disclosure violations whether liability runs to the investors or someone else—the government, for example. Also, it is arguably 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 were not paid to the purchasers, the market price of all firms that offer securities would be discounted to reflect deterrence's failure in a certain percentage of cases, with the resulting disclosure violations making the issuers involved look more valuable than they really are. So, even without the prospect of compensation, the price is fair ex ante, even though some investors will be unlucky and suffer a loss ex post.

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.[111] 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 cannot identify the issuers for which deterrence will fail. Consider the honest issuers that in the ideal world, with 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 NPV projects will not be implemented. Full compensation would eliminate the discount and so assure implementation of these projects.[112] 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 serve 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 should presumably be divided 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, 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 amount, if any, it was still inflated at the time of sale).[113]

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111. See supra Part II.C.2.

112. 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.

113. Each of the two alternative approaches to compensation creates serious problems. One approach allows secondary market purchasers to sue, but only if they

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 current U.S. rule only when the issuer is offering securities. Damages should be in a limited amount and 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 Nonissuer Actor.* — 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 the incentives that used to exist (and still exist in the case of an IPO) to make the issuer comply with the Securities Act registration statement disclosure requirements for a public offering.[114] These incentives worked well in the past to produce high-quality disclosure, before short form and shelf registration made serious underwriter due diligence for offerings by established issuers impractical.[115] Each of these nonissuer 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 the same due diligence defense.[116] 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, when they were engaging in public offerings.[117]

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purchased the specific shares originally sold in the offering. Secondary market purchaser compensation would be largely a chimera 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.

114. Securities Act of 1933 § 11, 15 U.S.C. 77(k); see also supra Part I.A.2.

115. See supra notes 7, 11–12, 99 and accompanying text.

116. Greater accuracy in firm disclosures requires a greater level of care by the firm's officers, directors, and 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. See supra Part IV.A. If analysis for either the United States or another country suggests that a different level of care is optimal, then the level of care required of the officers, directors, and certifying investment bank, in order that each can maintain its due diligence defense, should be adjusted accordingly.

117. This Article does not deal specifically 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 nonissuer defendants, freeing them from

2. *The Nonissuer 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 nonissuer 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 of real investment and increase in nonliquid 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).[118]

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fraud-on-the-market liability and substituting some other kind of measured liability that depends in part on the size of the issuer's annual investment rather than on 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.

118. 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 section 11(e), subject to certain caps, the person holding this share at the time suit is brought has a prima facie case for damages equal to the difference between the price he paid and its "value" at the time of suit. Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e). 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 Sys. 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 . . . , 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 prima facie case 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. Section 11(e) allows the defendant an affirmative defense to the extent that it can show that the decline was caused by something besides the misstatement. § 11(e), 15 U.S.C. § 77k(e). 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) ("[A]ll four courts of appeals to address the question have held that . . . aftermarket purchasers

c. *Liability of Each Nonissuer Actor.* — Each nonissuer 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* dollars 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. If a suit should arise after the disclosure filing, each actor can free herself of this potential liability by engaging in acts that would enable her to show that at the time of the filing, after reasonable investigation, she had reason to believe and did believe the annual report contained no disclosure violations. Thus each actor would have the same incentive to make the issuer's annual report disclosure violation free as she traditionally had with respect to an issuer's Securities Act registration statement.

d. *Interim Reports.* — If any of the 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 nonissuer 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 officer and director 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 the 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 under 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.[119] 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 nonissuer actors associated with a public offering. Indeed, these levels have themselves been somewhat in flux over time. As part of the Private Securities Litigation Reform Act ("PSLRA"), for example, the Securities

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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.").

119. This refers to underwriter liability akin to existing liability for false or misleading statements in the registration statement pursuant to section 11 of the 1933 Act. See § 11, 15 U.S.C. § 77(k). The underwriter should still be liable to purchasers in the offering for its own statements pursuant to a Rule 10b-5 antifraud standard. 17 C.F.R. § 240.10b-5 (2008). If the external certifier were 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.

Act was amended in 1995 to reduce the exposure of outside directors.[120] A cost-benefit analysis might suggest the desirability of further tinkering with respect to some or all kinds of nonissuer defendants who are individuals, for example imposing income- or wealth-based damage caps. Nor is there anything sacred about the current standards of what constitutes due diligence with respect to any of the nonissuer defendants. Again, a cost-benefit analysis might suggest that safe harbors be available to certain classes of nonissuer defendants such as outside directors, if, for example, they undertake specified procedures such as reasonable reliance on outside disclosure counsel.[121] The key point is that each of these nonissuer defendants faces some diminishment in 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 from a reasonable investigation for a person in that actor's position.[122]

g. *Indemnification and Insurance.* — Indemnifying nonissuer 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 it back in the other.

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120. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 201, 109 Stat. 737, 758–62 (codified as amended at 15 U.S.C. §§ 77k(f), 78u-4(f)) (amending section 11(f) of Securities Act to limit liability of outside directors to proportionate liability, except in case of a knowing violation, to which joint and several liability would still attach).

121. See John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. Rev. 301, 355 (2004) (arguing that in order to relieve tension between lawyer as gatekeeper and lawyer as advocate, corporations should use two separate law firms, with one acting as outside disclosure counsel, where disclosure counsel would review issuer's filings). 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 sections 3(f) and 36. 15 U.S.C. §§ 78c(f)15, 78mm. Some prominent commentators have even argued that outside directors should not be liable at all. See Bernard S. Black, Brian R. Cheffins & Michael Klausner, Outside Director Liability: A Policy Analysis, 162 J. Institutional & Theoretical Econ. 5, 6, 17 (2006) (suggesting liability for outside directors would "discourag[e] good candidates from serving, caus[e] counterproductive risk-avoidance among those who do serve, and induc[e] directors to focus unduly on taking procedural precautions designed to protect against liability").

122. Imposing on the gatekeeper the task of proving nonnegligence 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 about whether it met its standard of care. Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 Mich. L. Rev. 1677, 1693 (2007) (explaining benefits of "reverse negligence" regime). 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 not need to show that the defendant had scienter, simply the existence of a material misstatement and 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.

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 having the issuer purchase directors and officers (D&O) insurance is that it is necessary to attract qualified people to do these other tasks. The risk of a large judgment being imposed erroneously, the argument goes, would make such a person unwilling to serve without insurance.[123] The 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 becomes highly problematic. Unlike the external certifier, it would be the issuer, not the insured, who would pay for the policy. The officers and directors might be able to prompt the issuer, in a nontransparent transaction, to buy a policy that, in return for being expensive, involves little scrutiny of the history and procedures of the covered officers and directors. Shareholders would end up paying for this low-scrutiny policy. Furthermore, 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 signal.[124] 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)[125] and by providing, ex ante, a suffi-

123. See R. Franklin Balotti & Mark J. Gentile, Commentary from the Bar, Elimination or Limitation of Director Liability for Delaware Corporations, 12 Del. J. Corp. L. 5, 9 (1987) ("Many 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.").

124. Tom Baker & Sean J. Griffith, The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer, 95 Geo. L.J. 1795, 1798–99 (2007).

125. 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 28. For a liable director or officer of a responsible issuer, damages are limited to the

cient 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, has the evidentiary burden with respect to the standard of care, since most of the information relevant to that determination is within her possession.[126]

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.[127] 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 the social gain from the realignment. The same is true of the reduction in cost of capital from disclosure-induced increased liquidity. These observations socially justify a proportionally greater amount of resources being devoted to due diligence for larger firms. The prospect of a larger expected damage award if the due diligence fails to avert a misstatement will prompt this increase in resources.

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 firm size, a faster rate of change would call for more thorough periodic disclosure and hence, again, greater resources devoted to due diligence. The opposite conclusion would follow from a below-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).[128] Thus, the total damages owed by the de-

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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. Ontario Securities Act, Part XXIII.1, R.S.O., ch. S.5, § 138.3 (1990).

126. Hamdani & Kraakman, supra note 122, at 1693.

127. See supra notes 71–73 and accompanying text.

128. Randall v. Loftsgaarden, 478 U.S. 647, 661–62 (1986); Green v. Occidental Petrol. Corp., 541 F.2d 1335, 1341–46 (9th Cir. 1976) (Sneed, J., concurring); Estate

fendants 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.[129] For issuers of any given size, the volume of trading varies considerably from one issuer to the next and from one period to the next. These variations have no obvious connection to 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 calculating damages.

4. *Procedures for Recovery.* — Under this Article's proposal, any shareholder could bring a suit on behalf of the corporation against an officer, director, or external certifier in much the same fashion as 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).[130]

Given these proposed procedures, entrepreneurial plaintiffs' lawyers would obviously continue to drive civil liability actions against nonissuer defendants for disclosure violations since, except when there has been a radical change of management, current directors and officers will not induce an issuer to sue 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 corporate law contemporaneous ownership rule requiring the plaintiff bringing a derivative suit to have been a shareholder at the time of the misdeed.[131] 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.[132] 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

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Counseling Serv., Inc. v. Merrill Lynch, 303 F.2d 527, 533 (10th Cir. 1962); Loss et al., supra note 11, at 4413–14.

129. For any share purchased more than once during the period when 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.

130. See Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2006); Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir. 1943).

131. See 19 Am. Jur. 2d Corporations § 2010 (2004). The Federal Rules of Civil Procedure also impose a contemporaneous ownership requirement on shareholders bringing derivative suits. See Fed. R. Civ. P. 23.1.

132. 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, 789–90 (1981).

given to a firm that has the approval of one of the issuer's large noncontrolling shareholders, akin to the lead plaintiff system under the PSLRA.[133]

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 the scholarly literature and in general discussion over the last couple of decades.[134] Two concerns in particular have been raised. First, some commentators say that the United States has experienced too many "strike suits": meritless securities law claims brought by plaintiffs' class action lawyers to obtain attorney's fees based on settlements extracted from defendants who wish to avoid the nuisance of continuing litigation and the risk of an erroneous negative judgment.[135] Second, there is a widespread feeling that for those suits that should be brought, plaintiffs' lawyers are overpaid relative to the work they do.[136] The PSLRA was in large part a legislative response to these two concerns.[137]

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133. 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 who otherwise satisfies the requirements of Rule 23 of the Federal Rules of Civil Procedure. 15 U.S.C. § 77z-1(a)(3)(B).

134. See, e.g., Lisa L. Casey, Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging, 2003 BYU L. Rev. 1239, 1259–75 ("Agency theory posits that the nature of the private enforcement model itself, coupled with counsel's sizeable financial incentives, tempts plaintiffs' lawyers to engage in opportunistic behavior."); John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L. Rev. 669, 677–98 (1986) (discussing plaintiffs' attorneys' incentives to litigate class and derivative suits).

135. 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) (arguing that "structural characteristics of the legal system" result in settlements "without regard to the merits"). A conceptually similar problem occurs in the case of a highly marginal suit where, for the same reasons, plaintiffs' lawyers are able to obtain a settlement much larger than the expected value of the judgment, if any, that would result if the suit were fully litigated.

136. See id. at 541–42 (discussing incentives created by lodestar compensation of plaintiffs' attorneys); see also In re Quantum Health Res., Inc. Sec. Litig., 962 F. Supp. 1254, 1257–58 (C.D. Cal. 1997) (stating that experience has shown that risk justifying large contingency fees in securities class actions does not 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, 1–2 (2000), available at http://www.manhattaninstitute.org/html/cjr_1.htm (on file with the *Columbia Law Review*) (stating that market for contingency fee lawyers is not competitive, thus leading to inefficiencies and overcompensation).

137. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). 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 nonmeritorious actions, then it helps solve the

The claim might be made that implementing the liability scheme proposed here in the United States would aggravate these problems because when the issuer is not offering securities, the nonissuer 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 such a filing if a similar 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 out of these kinds of actions.[138] For a

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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 nonmeritorious suits is greater than any social losses associated with a reduced number of successful meritorious suits. Professors Johnson, Nelson, and 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. See 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, 648–49 (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 nonfrivolous securities lawsuits in two situations: those involving smaller companies with small offerings or low secondary market turnover and those where companies engage in fraud but there is a lack of prefiling hard evidence of that fraud. See Stephen J. Choi, Do the Merits Matter *Less* After the Private Securities Litigation Reform Act?, 23 J.L. Econ. & Org. 598, 622–23 (2007); see also Michael A. Perino, Did the Private Securities Litigation Reform Act Work?, 2003 U. Ill. L. Rev. 913, 969 (arguing that PSLRA did not reduce nonmeritorious filings); Eric Talley & Gudrun Johnsen, Corporate Governance, Executive Compensation and Securities Litigation 26 (Univ. of S. Cal. Law Sch., Olin Research Paper No. 04-7, 2004), available at http://ssrn.com/abstract=536963 (on file with the *Columbia Law Review*) ("Our results appear inconsistent with the claims of the statute's proponents that the PSLRA systematically discouraged frivolous litigation without burdening meritorious claims.").

138. 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 16. From 1997 to 2004, Rule 10b-5 claims were involved in over ninety-five percent of the settlements, while section 11 or section 12(a)(2) claims were involved in only twenty percent of the settlements. Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Post-Reform Act Securities Settlements: Updated Through December 2004, at 17 (2005), available at http://securities.cornerstone.com/pdfs/Settlements_2004.pdf (on file with the *Columbia Law Review*) (providing securities class action settlement statistics from 1997 to 2004). Section 11 and section 12(a)(2) claims continued to be involved in only twenty percent of securities class actions settlements through 2006. Laura E. Simmons & Ellen M. Ryan, Cornerstone Research, Securities Class Action Settlements: 2006 Review and Analysis 9 (2007), available at http://securities.cornerstone.com/pdfs/Settlements_2006.pdf (on file with the *Columbia Law Review*).

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

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 the certified 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 that in turn could hurt the managers derivatively, only a slight chance exists that they will have to make a payout personally as a result of the action.[139]

The scheme proposed here introduces 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. Without the certification requirement, a manager who knows negative information that should be disclosed may, out of dread of the sharp share price drop that disclosure would cause, 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. Moreo-

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to the expected value of a fully litigated judgment. First, the typical issuer does not expect to encounter such suits frequently. According to one study, the average public corporation has only a 1.9% probability of facing a shareholder class action lawsuit in a given year. Ronald I. Miller, Todd Foster & Elaine Buckberg, NERA Consulting, Recent Trends in Shareholder Class Action Litigation: Beyond the Mega-Settlements, Is Stabilization Ahead? 3 (2006), available at http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (on file with the *Columbia Law Review*). Thus, for an issuer, there is little reward in fighting such action simply to develop a reputation that the issuer 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 discovery begins, is very substantial. See Stephen J. Choi, The Evidence on Securities Class Actions, 57 Vand. L. Rev. 1465, 1469 (2004) (describing 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 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 hard to take. Damages can be huge relative to the size of the company, at least in the situation where the misstatement inflates price for a long time and trading has been heavy. Rather than "bet the company," the issuer settles for a substantial amount.

139. See Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055, 1059–60, 1080 (2006) [hereinafter Black, Cheffins & Klausner, Director Liability] (noting that outside directors rarely contribute to securities class action settlements); Coffee, Reforming, supra note 18, at 1550 (noting that corporate managers rarely contribute to securities class action settlements).

ver, 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 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 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 nonissuer liability under the proposed scheme, after the settling up that would occur through contribution actions (or more typically in their shadow), the issuer would bear the bulk of what would be owed (which I termed the "Total Liability").[140] The amount borne by the nonissuer defendants in the phantom case, which determines what they owe under the proposed scheme, would be only 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[141] is greater than the amount a firm typically invests in a year.[142]

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140. See supra Part IV.C.2.b. Black, Cheffins, and Klausner found that actual payments of damages for securities lawsuits and state corporate lawsuits "are nearly always made by the companies involved—either directly or pursuant to directors' rights to indemnification—or by a D&O insurer, a major shareholder, or another third party." Black, Cheffins & Klausner, Director Liability, supra note 139, at 1059–60. In a section 11 case, the company is the most attractive defendant because it is held strictly liable. Id. at 1080.

141. 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) (noting that annual turnover rate for major exchange listed stock in 1986 was approximately eighty-seven percent); Robert J. Shiller, Irrational Exuberance 39 (2000) (noting that in 1999, average annual turnover rate for NYSE-listed stocks was seventy-eight percent, while 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 average turnover rate to be approximately 100%). Casual empiricism suggests that the typical period of price inflation alleged in plaintiffs' class action complaints ranges from a few months to a few years.

142. As of January 2007, for the average publicly traded company with a market capitalization of at least one billion dollars, capital expenditures as a fraction of the firm's total market value were 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 10-K as of January 2007; market capitalization data was the market value of equity on the last trading day of 2006.)

The aggregate liability imposed on officers, directors, and the external certifier will be considerably smaller under the scheme proposed here than it would be under a conventional securities class action today for a comparable misstatement by a comparably sized firm. Accordingly, any set percentage of this aggregate liability will also be smaller. If plaintiffs' lawyers are awarded twenty percent to thirty percent (which is typical of all but the very large settlements and judgments)[143] of this 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 due to fear of legal error and the resulting potential for damages that are a substantial portion of the total value of the company. The causes of action that the proposal here would substitute for 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—rests in the defendant's possession.

Also, as discussed, the amount of damages in absolute terms will be much lower. For the external certifier, this lower absolute amount should, by the very design of the proposed system, be a relatively small fraction of the certifier's total net worth. Thus, unlike fraud-on-the-market suits against issuers, litigating to the point of judgment should not involve a "bet the company" type risk. 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.[144] Under the scheme

143. See supra note 18.

144. Coffee, Reforming, supra note 18, at 1550.

proposed here, at least in the case of directors and officers, the persons deciding to enter into the settlement would pay 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.[145] Again, if defendants are less likely to settle meritless claims for a significant amount of money, plaintiffs' 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 because the issuer, not former shareholders, is paid the settlement. This has important consequences for the concern that plaintiffs' lawyers are paid too much when they bring actions with actual 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 toward the portion of that gross amount that goes to plaintiffs' lawyers' fees and the portion that goes to the members of the class. This is because the class consists of many persons who sold the issuer's stock and therefore typically are no longer shareholders. This and the fact that class members lack control over their lawyer representatives makes the size of the plaintiffs' lawyer's fee in a class action case subject to judicial supervision and allows class members to object to the court about a proposed fee award.[146] This procedure, however, is generally regarded as a relatively ineffective means for controlling the size of the fees.[147]

Under the scheme proposed here, every dollar that goes to the plaintiffs' lawyers is a dollar that does not go to the company. While a defen-

145. 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. 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 due 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 nuisances.

146. 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(e), (h).

147. 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. See, e.g., 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, 107–10 (2007); William B. Rubenstein, The Fairness Hearing: Adversarial and Regulatory Approaches, 53 UCLA L. Rev. 1435, 1444–45 (2006).

dant'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 ensure 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 do fraud-on-the-market suits. Whereas the plaintiff must establish scienter in the fraud-on-the-market suit, the defendant has the burden with respect to his standard of culpability in the scheme proposed here.[148]

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 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 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 a liability scheme as stringent as is currently the case because the current scheme generates frivolous, costly litigation.[149] He suggests that for such firms, greater reliance on market mechanisms that help assure the availability of adequate information about firms would be more cost effective.[150] 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.[151] Like me, he favors some kind of outside certification of pe-

148. See supra note 122.

149. See Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. Chi. L. Rev. 567, 588–91 (1997) [hereinafter Choi, Company Registration] (arguing that antifraud liability should be reduced for larger, more highly capitalized companies because those companies attract more frivolous litigation).

150. See id. at 573, 628, 649–50 ("Where companies trade in an efficient market . . . a company registration system could rely heavily on the market to transmit information on the company to all investors.").

151. See Donald C. Langevoort, Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment, Law & Contemp. Probs., Summer 2000, at 45, 47, 52–55, 62 [hereinafter Langevoort, Deconstructing] (arguing that current disclosure regime is "largely satisfactory as a conceptual matter, although public resources for enforcing that regime are woefully lacking").

riodic disclosure as a partial response.[152] But he also feels that because of the difficulty of conducting due diligence in the new world of rapid offerings, nonissuer 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.[153] He suggests improving periodic disclosure through some kind of internal compliance program.[154] John Coffee expresses a similar concern with the existing quality of periodic disclosure, but he too, for reasons similar to Langevoort's, favors reducing the stringency of liability for nonissuer actors when the issuer is offering securities.[155] 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.[156] 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 intermediaries purchasing the securities can provide.[157] 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 nonissuer 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.[158] One basis for his suggestion is that larger firms attract more frivolous litigation because they have more money.[159] This is undoubtedly true. But for the same reasons, such firms also attract more nonfrivolous litigation. Indeed, Choi's own research indicates that

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152. See id. at 47 (calling for creation of "a much more determinate obligation on the part of seasoned issuers to implement an efficient disclosure monitoring system").

153. See id. (suggesting negligence-based liability for insiders, and scienter-based liability for others).

154. See id. at 62 (suggesting that "boards take reasonable systemic steps to assure compliance with periodic disclosure obligations").

155. See Coffee, Re-Engineering, supra note 11, at 1166–68 (suggesting that arguments for increased disclosure to investors require only "modest adjustment in the company registration scheme").

156. See Coffee, Gatekeepers, supra note 19, at 347–52.

157. See Coffee, Re-Engineering, supra note 11, at 1147, 1182–85, 1187 (finding institutional investors to be adequate gatekeepers).

158. See Choi, Company Registration, supra note 149, at 588 (arguing in favor of tailoring market-based antifraud mechanisms).

159. See id. at 589 (attributing such targeting to plaintiffs' lawyers seeking large settlements from large companies due to increased monetary incentives).

small firms attract little of either.[160] 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 to be 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, consequently, 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.[161] Choi cites the greater availability of contra information stemming from analysts' closer scrutiny of larger publicly traded issuers.[162] This, again, may be true, but it ignores that the issuer is generally the least cost provider of the information mandatory disclosure requires. 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.[163] Without regulation, an issuer will often be disinclined to disclose such information even when doing so would trigger a net social gain.

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.[164] 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 Nonissuer Actors*

Professors Langevoort and Coffee express concern that imposing absolute liability subject to a due diligence defense on officers, directors, and underwriters, as section 11 does, is unfair because the speed with which public offerings now go forward in this near-company-registration

160. See id. at 599.

161. See id. at 581–83.

162. See id. at 581.

163. See Coffee, Market Failure, supra note 36, at 722 (arguing that validity for this theory is limited); Easterbrook & Fischel, supra note 84, at 684–85, 687 (advocating for, but noting limits on, self-induced disclosure).

164. See Choi, Company Registration, supra note 149, at 583–84.

world makes such diligence impractical.[165] 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 nonissuer actor liability can be separated in this situation with the nonissuer 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.[166] 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 interest 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, there is less need for nonissuer actor liability.[167] This suggestion is subject to the same critique as was provided above.[168]

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 offerings and recreating it to assure the quality of periodic disclosure.[169] He finds the idea "feasible,"[170] but offers three critiques. First, he suggests that it will be costly because an investment bank would demand a high fee before it would accept the accompanying liability.[171] 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

165. See Coffee, Re-Engineering, supra note 11, at 1147-49; Langevoort, Deconstructing, supra note 151, at 46. My proposal would eliminate underwriter liability altogether for this very reason. See supra Part IV.C.2.e.

166. See Choi, Company Registration, supra note 149, at 584–87.

167. See id. at 587.

168. See supra Part V.A.

169. See Coffee, Gatekeepers, supra note 19, at 352–53. For the first proposal of this idea, at the time that integrated disclosure was introduced, see Fox, Shelf Registration, supra note 12, at 1034.

170. Coffee, Gatekeepers, supra note 19, at 353.

171. See id.

personnel necessary to conduct the due diligence 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. This Article argues that high-quality periodic disclosure is equally valuable socially, and hence also worth this cost.[172] Moreover, the costs of the proposed scheme, which aims to prophylactically prevent 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.[173] 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.[174] It is not clear, however, that this would be a serious problem under the proposed scheme. 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 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 other 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.[175] He suggests that counsel certification would be less expensive and equally 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.[176] Unlike a law firm, the skill set of an investment bank or other qualified external certifier 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, investment bank or otherwise, to qualify as an external certifier, it must be sufficiently capitalized that its incentives will not be compromised by the possibility of being judgment proof. Law firms, even large ones, are not highly capitalized because of

172. See supra Part II.
173. See Coffee, Gatekeepers, supra note 19, at 338–40, 353–55.
174. See id. at 353–54.
175. See id. at 356.
176. See supra Part IV.A.2.

the nature of their business and the limitations imposed on their methods of financing by professional regulations. Thus, law firms 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.[177] 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,[178] the elimination of restrictions on resales by affiliates and statutory underwriters that were developed to prevent evasion of the registration rules by means of an initial private sale followed by the purchaser engaging in a public offering,[179] the claimed "merging" of private and public markets for securities,[180] 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 suggests that the offering abroad was simply an effort to try to evade U.S. registration provisions.[181]

Professor Coffee, on the other hand, has argued for retention of the private placement exemption.[182] He has two rationales. First, an issuer may possess material nonpublic information that is not required to be disclosed absent a sale.[183] It may be contrary to the issuer's interest to

177. 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 Wallman Report, supra note 11, at i–xvi (summarizing committee's findings). The report suggested a number of benefits from eliminating the exemption for private placements. Id. at 19. Professor Coffee has stated that this was the preferred position of some members of the Committee. Coffee, Re-Engineering, supra note 11, 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, supra, at 34–35.

178. See Wallman Report, supra note 11, at 33.

179. Id. at 34.

180. Id. at A-48.

181. Id. at A-55; see also supra note 91 and accompanying text (describing Regulation S).

182. See Coffee, Re-Engineering, supra note 11, at 1180–82.

183. Id. at 1180.

disclose the information publicly, but the issuer can trust a private buyer to keep the information confidential.[184] Second, institutional purchasers in private transactions, if forced to hold onto securities for a period before reselling to the public, will perform a due diligence role that substitutes for the due diligence done by underwriters in a public offering.[185] Coffee suggests that the argument is strengthened by the fact that underwriter due diligence—the source of comparison—will be weakened by the smaller size of many of the deals 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.[186]

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.[187] 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, the SEC 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,[188] revisiting the decision would not advance the company registration concept.

At first glance, the question of whether to retain the private offering exemption appears to attack a nonproblem: Why exempt 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.[189] 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 be answered only in the context of the larger issue of what, overall, civil liability

184. Id. at 1183.

185. Id.

186. See id. at 1182–85.

187. See Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,722 (Aug. 3, 2005) (codified in scattered sections of 17 C.F.R.) (announcing securities offering reforms).

188. See supra notes 182–186 and accompanying text.

189. Under the Securities Act of 1933, the private placement exemption, 15 U.S.C. § 77d(2) (2006), 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. Securities Act of 1933 § 11, 15 U.S.C. § 77k. An exempted transaction is not subject to such potential liability. § 5, 15 U.S.C. § 77e.

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.[190] 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 similarly adequate when the issuer is selling securities.

When the issuer is not selling securities, the liability system proposed above imposes civil liability sanctions only on *nonissuer* 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 updated information and imposing of absolute liability on the issuer for any inflation in price due to a disclosure violation. The rationale for requiring updated disclosure is to prevent a special incentive for sales during the period between when the issuer learns of bad news and when it must disclose the news in a periodic filing. The rationale for imposing liability on the issuer is to counteract the extra incentive not to comply with disclosure regulations at the time of offering.

It appears, then, that a private placement exemption is appropriate 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 sale. 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 updated information and to set up its own liability scheme.[191] 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 to-

190. See supra Part II.

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

ward internal funding when the public release of material information would be untimely, one of Professor Coffee's concerns.[192] 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's 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 is true that an exemption would preserve the need for legal resources to identify, 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. Public equity finance will be less expensive because corporations will no longer have to pay the expected costs of underwriter liability currently being passed on to them. In return, corporations must take on the cost and inconvenience of the external certifier and must provide the additional income 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. issuers 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.

192. See Coffee, Re-Engineering, supra note 11, at 1183.

Investment banks are freed from underwriter liability and, as a result of this cost saving, which along 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 a politically important group that should solidly favor 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 create new opportunities, the damages that these actions will generate are low compared with 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 advocate forcefully 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 that 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 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 about 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 rulemaking 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.[193] 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. But finding a source of SEC authority to impose absolute liability affirmatively, subject to a due diligence defense, on all issuer officers and directors and on external certifiers is more difficult.

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 make the program more attractive 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 nonparticipants is higher than it is now.

There would be significant pressures on issuers to participate. If they were the target of a fraud-on-the-market suit, it would make their public protests about the large expenses involved seem hollow, since they had a transparency-enhancing way to obtain protection from such suits. Also, institutional investors, which have increasingly become corporate governance-oriented,[194] 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 build the number of participating issuers to a critical mass over time, where nonparticipation may appear to be 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.

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 U.S. law today—where the incentives are weaker when, as is the case most of the time, the issuer

193. Securities Act of 1933 § 28A, 15 U.S.C. § 77z(3) ("The Commission . . . may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter . . . ."); Securities Exchange Act of 1934, 15 U.S.C. § 78mm (same).

194. See, e.g., Brian J. Bushee et al., Institutional Investor Preferences for Corporate Governance Mechanisms 41 tbl.4 (Dec. 2007) (unpublished manuscript, on file with the *Columbia Law Review*), available at http://ssrn.com/abstract=1070168 (measuring firms' preference for corporate governance from 1997 through 2004).

is not currently offering any securities—the mandatory disclosure civil liability system should create an environment for corporate decisionmakers where they have equally strong incentives to comply at all times. 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.