RETHINKING DISCLOSURE LIABILITY IN THE MODERN ERA

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The state of issuer disclosure in 1997 is like the proverbial half-filled glass. On one hand, as Dean Seligman has amply demonstrated in his contribution to this symposium,[1] the glass is half empty in the sense that the legal incentives for established issuers to engage in high quality disclosure at the time that they sell new securities have decreased in recent decades. Due to the more liberal exemptions available under Regulation S, Rule 144A, Regulation D and Regulation A, a much smaller portion of such sales is even subject to the formal disclosure oriented registration process under Section 5 of the Securities Act of 1933 (the "Securities Act").[2] For the portion that is, the resulting amount of disclosure has been reduced in many cases because short form and shelf registration has weakened underwriter due diligence.[3]

On the other hand, the glass is half full in the sense that some of these same reforms have improved the quality of disclosure at times when such issuers are not selling new securities. Under the Securities Exchange Act of 1934 (the "Exchange Act"), publicly traded issuers are required to file periodic disclosure reports with the SEC—10-K's, 10-Q's and 8-K's—whether or not they are selling new securities. Traditionally, before short

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Financial support for this project as provided by the Cook Fund of the University of Michigan.

1. Joel Seligman, *Götterdämmerung for the Securities Act?*, 75 Wash. U. L.Q. 887, 889-96 (1997).

2. *Id.* at 890-96. The disclosure, if any, that does accompany these sales is also not subject to the strict liability provisions of Securities Act section 11.

3. Underwriter due diligence is the underwriter's investigation into the truthfulness and completeness of a registration statement conducted in order to be able to establish an affirmative defense if an action against it for damages under Section 11 of the Securities Act should subsequently arise. The weakening occurs under the reforms because of, among other things, the greatly abbreviated period between when an issuer indicates its intent to make an offering and the time the offering commences. *See* Report of The Advisory Committee on the Capital Formation and Regulatory Process pt. 4, at 53-66 (SEC 1996) [hereinafter Wallman Report] (separate statement of John C. Coffee, Jr., Edward F. Greene, and Lawrence W. Sonsini); Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1025-28 (1984). For other commentators who agree that the reforms will reduce underwriter due diligence, but who are less impressed by its value, see Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984); David M. Green, *Due Diligence Under Rule 415: Is the Insurance Worth the Premium?*, 38 EMORY L.J. 793 (1989). These commentators, however, do not consider the value of issuer disclosure discussed *infra* in Part I.

form and shelf registration, issuers provided much lower quality disclosure in these periodic filings than in their section 5 Securities Act registration statements. Although both sets of documents were supposed to answer essentially the same questions, the periodic filings provided lower quality disclosure because they were subject to a less severe liability regime[4] and were not given a due diligence review by an investment bank.[5] Today, issuers have an incentive to improve the quality of their periodic filings. Improved quality puts an issuer in a better position to utilize short form registration and shelf registration should it decide subsequently to sell new securities. The attraction of each of these reforms is based on the ability it gives an issuer to incorporate by reference disclosures set out in its Exchange Act filings. This would be of no use to an issuer with low quality periodic filings because material incorporated by reference in this fashion is subject to the much stricter Securities Act liability regime.[6] These new incentives, however, take us only half way. For a variety of reasons, an issuer preparing a periodic filing that it might in the future want to incorporate by reference is still not going to feel the same pressures to be accurate and complete as it would have felt preparing a traditional Securities Act registration statement prior to short form and shelf registration.[7]

One way to make ourselves happy with the current half-filled glass is to look at it with an optimistic attitude. Another, better way is to make the glass all full. To do so, we should establish a system of liability that creates incentives for established public issuers to provide disclosure in their periodic

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4. If an Exchange Act filing has a material misstatement or omission, a plaintiff seeking to recover damages must sue under either the Exchange Act's Rule 10b-5 (which requires the plaintiff to show scienter and often reaches only the issuer) or section 18 (which has been interpreted as requiring the plaintiff to show actual "eyeball" reliance on the filed document). *See* Ross v. A.H. Robbins Co., 607 F.2d 545 (2d Cir. 1979)). She thus has much less chance of success than if the same statement appears in a registration statement under the Securities Act, which, among other things, imposes, pursuant to section 11, absolute liability on the issuer and, subject to an affirmative due diligence defense, on the issuer's directors, top officers and underwriters as well.

5. Nothing under the liability scheme traditionally applicable to Exchange Act filings would prompt such a review.

6. *See supra* note 4 and accompanying text.

7. In many, if not most cases, no underwriter will participate in the drafting of an issuer's periodic filing. An investment bank, not knowing whether it will subsequently be an underwriter in a public offering of the issuer, would generally consider participating in such drafting sessions not worth the effort. When one does, it will not, for the same reasons as well as for fear of antagonizing a potential client, be as aggressive in preventing disclosure violations as it would be in a traditional registered public offering where it would already know it had the deal. See Fox, *supra* note 3, at 1027-28.

filings that is as high quality as they traditionally provided at the time of a registered public offering prior to short form and shelf registration.

I. THE INEVITABLE COMING PRIMACY OF PERIODIC DISCLOSURE AND THE NEED TO REDEFINE LIABILITY

The moment is ripe for pressing this proposal.[8] The concept of "company registration" has again become the focus of debate,[9] due in part to the technological forces that are the subject of this symposium.[10] Under company registration, an issuer would register just once and thereafter provide updating information on a continuing basis. Unlike the traditional scheme, the issuer could then offer and sell securities whenever it wished without the need to register the securities themselves. We are already moving in the direction of company registration. Short form and shelf registration, by enabling established issuers to incorporate by reference disclosures contained in their periodic filings, make the statement registering the securities a relatively simple document. The step from less onerous registration to no registration is not a large one.

Proposals for company registration rest on the relatively limited premise

8. I have been arguing this position for over a decade. *See* Fox, *supra* note 3, at 1033-34; MERRITT B. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY 358-67 (1987).

9. *See generally*, Wallman Report, *supra* note 3. The idea of company registration traces its origins back at least as far as a 1966 article by Milton Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966), in which he argues that the combined disclosure requirements of the Securities Act and the Exchange Act would have been quite different if they had been enacted in reverse order. Cohen argues that the base of the disclosure system should be Exchange Act periodic disclosure. *Id.* at 1366-67. The American Law Institute's proposed Federal Securities Code represented an early effort to implement the idea of company disclosure. Federal Securities Code (Am. Law Inst.) (1980). See also Statement Concerning Codification of Federal Securities Laws, Securities Act Rel. 6377 (Jan. 21, 1982).

10. As Professor Cox points out, the technological forces that are the subject of this symposium are leading issuers to engage in more frequent, smaller share offerings instead of in occasional large offerings. James D. Cox, *The Fundamentals of an Electronically-Based Federal Securities Act*, 75 Wash. U. L.Q. 857, 859 (1997). These forces raise the possibility that, absent current regulation, the efficient way to raise capital would be almost continuous sales. Established issuers not in need of the reputational validation of a quality underwriter might be able to do without an underwriter's marketing services as well. They might be able to post on the Internet daily offerings of stock in amounts very small relative to a traditional public offering. There are other reasons as well why company registration has come to the forefront, the same ones that Dean Seligman cites as the reasons for the occurrence of the reforms that have resulted in the decline in the quality of new issue disclosure. Seligman, *supra* note 1, at 896-98. These include the incorporation of some basic principles of modern financial economics into the conventional understanding of persons concerned with securities law issues and the politics of deregulation generally.

that the market is "informationally" efficient with respect to the kinds of information contained in periodic disclosure filings. As soon as the filing occurs, the issuer's security price "fully reflects" the filed information as if everyone in the market knows it.[11] Given this widely accepted premise, company rather than security registration is just plain common sense, at least in the case of a new issue offering of an existing class of securities already actively trading in the secondary market.[12] The actual giving of information to each prospective investor, which is at the heart of securities registration, will not influence the price at which the shares can be sold.

The difficult issue is not whether we should move to company

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11. There is a large body of financial economics literature that evaluates the market reaction to the affirmative public announcement of various kinds of important events affecting particular issuers. For a classic review, see KENNETH GARBADE, SECURITIES MARKETS 249-59 (1982). The typical such "event study" involves a large number of issuers, each of which has experienced at one time or another the announcement of a particular kind of important event, for example, a stock split. The studies show that the shares of the affected firms as a group experience statistically significant abnormal returns at the time of the announcement and, starting almost immediately thereafter, normal returns for the duration of the study, which is sometimes as long as several years. Thus, while some issuers' share prices go up in the periods following the announcement (compared to the market as a whole) and others go down, the average change is near zero. This suggests that as information diffuses out to a larger and larger number of investors, the price on average does not change. Thus the initial price reaction is on average the same "as if" this larger group of investors also knew the information from the beginning. The announcements of events tested in this fashion are similar in kind to the types of information contained in Exchange Act filings.

This limited claim of market efficiency is all that is necessary for company registration to make sense because it suggests that actually giving information to each prospective investor will not influence the price at which investors buy. Thus the case for company registration does not require the stronger claim that a publicly traded security's price is "fundamental value" efficient in the sense that it is the best estimate, based on publicly available information, of the discounted present value of the cash flow that will accrue to the security's holder. There is greater skepticism about the fundamental value efficiency of share prices. *See* FOX, *supra* note 8, at 57-59; Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761 (1985); Donald Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992); Andrei Schliefer & Lawrence Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990); William K.S. Wang, *The "Contemperaneous" Traders Who Can Sue an Insider Trader*, 38 HASTINGS L.J. 1175 (1987).

Professor Cox is concerned that this skepticism undermines arguments for company registration based on market efficiency. He instead rests his support for company registration on the capacity of the Internet and the World Wide Web to permit the implications of an issuer's Exchange Act filings to reach investors through a process of "filtration" involving securities professionals and the advice of individual brokers. Cox, *supra* note 10, at 13-26. The analysis above suggests that his concerns about reliance on an efficient market based justification for company registration are exaggerated and unnecessarily force him to a justification that is in fact more problematic.

12. This paper concerns only the liability rules for this kind of offering. The efficient market hypothesis does not justify, for example, a company registration system for an initial public offering because there is no preexisting secondary market for a security conferring the same rights.

registration. We should and we will. It is how to structure liability for materially false, misleading or incomplete disclosures in a company's periodic filings: who should pay whom under what circumstances. In particular, should such a disclosure violation give rise to greater liability if the issuer sells new securities prior to the time that the market becomes informed of the true situation than if the issuer does not sell any securities. Commentators have only begun to think seriously about the liability issue,[13] which makes Professor Cox's contribution to this symposium at the "cutting edge."[14] Our thinking can be improved, however, by revisiting the question of what are the social gains from issuer disclosure. Therefore, I am going to consider first why these gains are as important when an issuer is not offering securities as when it is. I then provide a preliminary sketch of what, in light of the answer to this question, would be the best structure of liability.

II. BAD AND GOOD REASONS WHY HIGH QUALITY DISCLOSURE IS AS IMPORTANT WHEN AN ISSUER IS NOT OFFERING SECURITIES AS WHEN IT IS

A. *The need for investor protection in the secondary market is not a good reason*

A common argument for improving the quality of periodic disclosure is that buyers in the secondary market are in just as much need of the protection from such disclosure as buyers in the primary market. In fact, the argument goes, the traditional emphasis on primary market disclosure is particularly misplaced because far more trades occur each year in the secondary market than in the primary market.[15] This is not a good argument. Investor protection, while a worthy goal of securities legislation in its regulation of many kinds of behavior, is not a persuasive justification for the affirmative regulation of issuer disclosure.[16] Disclosure is not necessary to protect investors against either unfair prices or risk.

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13. Wallman Report, *supra* note 3, at 39-47; Letter from the American Bar Association Section on Business Law Committee on Federal Regulation of Securities 8, 29-30 (Dec. 11, 1996) (responding to the SEC request for comments pursuant to Release 33-7314) (copy on file with the author).

14. *See generally* Cox, *supra* note 10.

15. Cox, *supra* note 10, at 13-26.

16. I have discussed this point in considerably more detail elsewhere. Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. ___ (forthcoming 1997) (Part IIA1).

To see why, first consider unfair prices. Under the efficient market hypothesis, securities prices are unbiased whether there is a great deal of information available about an issuer or very little.[17] In other words, share prices will on average equal the actual value of the shares involved whether issuers are required to produce a lot of disclosure or only a little. Thus, greater disclosure is not necessary to protect investors from buying their shares at prices that are, on average, unfair, i.e., greater than their actual values.[18]

Now consider risk. It is true that with less information available about an issuer, share price, while still unbiased, is less accurate, i.e., it is more likely to be significantly off one way or the other from the share's actual value. If an investor has a less than fully diversified portfolio, greater share price inaccuracy can make the portfolio more risky. High quality disclosure would, to some extent, protect such an investor by reducing this risk. The investor, however, can protect himself much more effectively and at less social cost by simply diversifying more.[19]

B. Efficiency Enhancement is a Good Reason

A second, much stronger argument for high quality periodic disclosure is that it improves how proposed new investment projects in the economy are selected for implementation and the way existing projects are operated.[20] This improvement occurs through disclosure's effects on three of the economy's

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17. Empirical work showing unbiased reactions to announcements of corporate information, *see supra* note 11, suggests that the market is unbiased as well to issuer absences of comment about certain matters.

18. For an analysis of why the noise theory critique of the efficient market hypothesis still does not create a strong fairness justification for mandatory disclosure, see Fox, *supra* note 16, at Part II.A.1.

19. In portfolio theory terms, issuer disclosure reduces firm specific ("unsystematic") risk. Firm specific risk can be completely eliminated by sufficient diversification. *See generally* Banoff, *supra* note 3.

20. I have discussed this point in more detail elsewhere. *See* Fox, *supra* note 3, at 1017-25. *See also* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992). For other perspectives on the efficiency enhancing features of securities disclosure, see Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995) (arguing that while regulators chase the goal of accuracy enhancement, the laws enacted under this banner actually work to reduce the flow of information relevant to accurate pricing of securities); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995) (arguing that the goal of disclosure should be focused on and limited to helping investors uncover breaches of contractual or fiduciary obligations); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988) (disputing the premise that an efficient market is able to monitor or structure the allocation of scarce resources in the economy).

key control mechanisms: the market for corporate control, share price based managerial compensation and the cost of capital. It occurs whether or not the issuer is offering new securities for sale.

1. The Market for Corporate Control

The market for corporate control is a well recognized device for limiting the agency costs of management where ownership is separated from control, as in the typical publicly held corporation. More information and the resulting increase in price accuracy improves the control market's effectiveness in performing this role. A potential acquiror, in deciding whether it is worth paying what it would need to pay to acquire a target it feels is mismanaged, must make an assessment of what the target would be worth in the acquiror's hands. This assessment is inherently risky and acquiror management is likely to be risk averse. Greater disclosure, however, reduces the riskiness of this assessment. Hence, with greater disclosure, a smaller apparent deviation between incumbent management decisionmaking and what would maximize share value is needed to propel a potential acquiror into action.

Also, when share price is inaccurately high, even the potential acquiror who believes for sure that it can run the target better than incumbent management may find the target not worth paying for. The increase in share price accuracy that results from greater disclosure reduces the chance that this will happen.

Thus, greater disclosure makes the hostile takeover threat more real. Incumbent managers will be less tempted to implement negative net present value projects that maintain or enlarge their empires or to operate existing projects in ways that sacrifice profits to satisfy their personal aims. And those that do do these things are more likely to be replaced.

2. Share Price Based Managerial Compensation

Greater disclosure can reduce the agency cost of management in a second way: by increasing the use of share price based managerial compensation.[21]

21. Share price based compensation is an affirmative way to better align the interests of management with those of shareholders. *See, e.g.*, Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138. A critical review of the literature advocating greater share price based compensation for management can be found in Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2096-106 (1994).

The problem with share price based compensation is risk.[22] Managers, being risk averse, will not want all of their compensation in share price based form.[23] More accurate share prices make such compensation less risky, however. As a result, managers, when offered a total compensation package with a given expected value, will be willing to take a larger portion in share price based form.

3. Capital Allocation

Finally, increased share price accuracy can improve the selection of proposed new investment projects in the economy as well through a more direct effect on the investment behavior of individual firms than the forces discussed above. This is obvious when the project under consideration would be financed with a stock sale. What is important here, however, is that share price can have similar effect even when the firm would finance the project some other way. On the supply side, share price can affect the cost of a project by affecting the terms at which intermediaries are willing to extend the firm alternative forms of external financing.[24] On the demand side, share price can affect management's willingness to use funds to implement a new project. Share price can affect management's willingness to use debt financing because the firm may feel the need to counterbalance any new debt with a subsequent new equity financing in order to maintain its optimal debt/equity ratio.[25] More generally, because of concern with public

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22. Job compensation is a large part of the typical manager's annual income. Therefore the risk associated from receiving part or all of it in share price based form, though firm specific, cannot be diversified away.

23. There is empirical evidence to support the proposition that a reduction in the riskiness of an issuer's stock will increase the proportion of compensation a manager will be willing to take in stock price based form. Randall Kroszner compares the percentage of shares owned by officers and directors in a representative sample of exchange-listed U.S. firms in 1935 and one in 1995 and finds that it increased from 13% to 22%. He finds that the relationship between ownership and performance is very similar in the two periods and that the most promising explanation of the change is the reduction in stock price volatility between the first and second periods. Randall Kroszner, *Were the Good Old Days that Good?: Evolution of Managerial Stock Ownership and Corporate Governance Since the Great Depression* (Oct. 8, 1996) (unpublished paper presented at the University of Michigan Department of Economics History Seminar) (on file with author).

24. HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 123 (1979).

25. Some financial theorists, of course, suggest that there is no optimal debt/equity ratio. For the classic statement of this view, see Franco Modilgiani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). The more orthodox view today is, however, that there are factors weighing against both too little debt and too

perceptions, low share price can constrain use of both external and internal funds.[26] Putting these supply and demand factors together, if share price is inaccurately low, management may decide not to pursue relatively promising proposed investment projects. Alternatively, if it is inaccurately high, it may implement relatively unpromising proposed projects. Greater disclosure, through its enhancement of price accuracy, limits this problem.

C. *Avoiding Financing Distortions is a Good Reason*

A third, also much stronger argument for raising the quality of periodic disclosure to that required when new securities are issued is that doing so will eliminate existing distortions in the choice of funding sources. The higher quality disclosure prompted by a new securities offering involves producing information that managers would rather not produce. This is the reason disclosure needs to be mandated. Managers can avoid this displeasure (as well as registration's out of pocket costs for the legal assistance and document printing) by raising funds for investment in a way that does not require registration.

Professor Cox points out one of these distortions: if external finance is used, there is an incentive to choose a form that does not require registration, for example, a private placement, a sale into the Rule 144A market or a sale abroad under Regulation S. The firm (and society) pay a cost for these "back alley" forms of financing, however, because the sale price the firm receives reflects a discount for the fact that these securities typically have restrictions on resale and trade in markets with inferior liquidity.[27] Accompanying social costs of a system requiring securities registration but providing exemptions are the legal resources devoted to determining whether the issuer is entitled to an exemption and the administrative resources devoted to assuring compliance with necessary procedures.[28]

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much. Too little debt deprives a firm of its tax deductible interest payments. Too much debt leads to increased agency costs because of the resulting increased divergence between the interests of debt and equity. It also increases the likelihood of bankruptcy, which would involve real costs. For an overview of these points and the responses of the adherents of financial structure irrelevance, see RICHARD A. BREALEY & STEWART C. MEYERS, PRINCIPLES OF CORPORATE FINANCE, 447-66 (5th ed. 1996).

26. *See* FOX, *supra* note 8, at 282-87.

27. Cox, *supra* note 10.

28. Letter from the American Bar Association Sections on Business Law Committee on Federal Regulation of Securities, *supra* note 13.

A second, less recognized distortion from transaction triggered disclosure is the incentive it creates for using internal rather than external finance. By using internal funds, management can avoid unwanted disclosure without enduring illiquidity discounts associated with non-registered external finance. This is an unfortunate distortion because by avoiding outside finance, managers avoid subjecting their real investment choices to the discipline and scrutiny of the market.[29] There is evidence that the investment projects chosen by firms relying predominantly on internal finance are considerably inferior to those chosen by other firms, an inefficiency which significantly damages the economy's growth in productivity.[30]

The hostile takeover activity of the late 1980s can be seen as a reaction to this problem. This activity was concentrated in industries where firms had large "free cash flows."[31] In such cases, often the acquiror's objective was to undertake a leveraged financial restructuring of the target in order to increase the payout of cash flow to the market. Alternatively, the acquiror sought to "bust up" the target by separating into different corporations operations producing high cash flows from operations into which these cash flows were being inadvisedly poured.[32] The hostile takeover boom may have partially corrected the problem of suboptimal projects funded by internal funds, but it entailed enormous transaction costs. Furthermore, with the subsequent spate of state anti-takeover statutes, hostile takeovers may be less effective at continuing to play this role today. Removing one of the incentives for internal finance by eliminating the difference between the disclosure level entailed in using internal finance and that entailed in using external finance could help reduce the problem and would be less expensive than hostile takeovers.

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29. *See* FOX, *supra* note 8, at 132-40; Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (Sept. 1984).

30. *See, e.g.*, GORDON DONALDSON, CORPORATE DEBT CAPACITY (1961); William J. Baumol et al., *Earnings Retention, New Capital and the Growth of the Firm*, 52 REV. ECON. & STAT. 345 (1970). For a critical review of these and several other studies, as well as an estimate of the magnitude of the effects on the economy, see FOX, *supra* note 8, at 233-37.

31. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (May 1986).

32. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993); Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988).

III. A LIABILITY SYSTEM TO ASSURE THAT WHEN AN ISSUER IS NOT OFFERING SECURITIES, ITS DISCLOSURE IS AS HIGH QUALITY AS IT WAS TRADITIONALLY WHEN AN ISSUER WAS OFFERING SECURITIES

The liability scheme that I am proposing would apply to established, publicly traded issuers of the kind that now qualify to use Form S-3. It contemplates a company registration type system of disclosure filings. The issuers would continue to provide periodic disclosure on the annual Form 10-K, the quarterly form 10-Q, and the "current report" form 8-K. Any time an issuer offers some additional securities, it would need to file with the SEC, twenty-four hours in advance of the offering, a notice of its intent to make the offer (a "notice of offer") that discloses any material changes since its last 10-K not disclosed in a subsequent 10-Q or 8-K.[33]

The 10-K, in addition to being signed by the top executives and a majority of directors, would be signed by a "certifying," financially sound investment bank. In doing so, the bank would associate itself with the filing in the same way as an underwriter in a traditional registered offering.[34] To avoid liability should the 10-K turn out to contain a disclosure violation, the investment bank would need to conduct the same kind of due diligence investigation concerning the truthfulness and completeness of the 10-K as it traditionally conducted as an underwriter in a registered public offering. In return, the bank would obviously expect to receive a fee. With this type of investment banker motivation, the 10-K would typically contain the same high quality disclosure as did the traditional registration statements.

The question of who would be liable, and for how much, if disclosure violations occurred in any of the issuer's disclosure documents—the 10-K, 10-Q, 8-Q and the notice of offer—is obviously quite complicated. What is set out below is a brief, first cut at this question.

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33. This requirement would require disclosure of the same updating information that currently must be disclosed in a shelf registration prospectus. *See* Adoption on Integrated Disclosure Systems, Securities Act Release No. 6383, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982).

34. For the top few hundred largest corporations, there might be a requirement that a certifying investment bank sign the quarterly 10-Q's as well. The argument for such a requirement would be that disclosure involves economies of scale. The benefits grow proportionally with the size of the issuer making the disclosures, but the costs rise more slowly with size. If this special requirement for the largest issuers were adopted, the same kinds of liability that would be imposed on the certifying bank for a disclosure violation in a 10-K of an ordinary issuer would be imposed for disclosure violations in these largest issuer's 10-Q's as well.

A. A Disclosure Violation When A Sale of Securities Occurs

In the reformed liability system of the new era, the issuer's sale of securities at the time that an uncorrected "disclosure violation"[35] exists should, as under Section 11, make the issuer absolutely liable in an amount equal to the increase in the offering price resulting from the violation.[36] The fact that a sale occurred should not affect the directors', officers' or certifying investment banker's liability for the violation, which is discussed in the next section.

Imposing liability on the issuer in this fashion is contrary to the recommendations of Professor Cox in his contribution to this symposium.[37] And it may seem contradictory as part of a larger plan to reform the old system's special emphasis on disclosure at the time securities are issued. Closer consideration of the point, however, reveals that there is no such contradiction. Issuer liability in this situation simply returns what would otherwise be a special gain for issuing securities while the price is inflated due to a disclosure violation. It does not create an incentive to provide higher than usual quality disclosure at the time of such a sale; it is an antidote for what would otherwise be an incentive to provide lower than usual quality disclosure at such a time.

From this, it should be clear that continuing to impose liability on the issuer will not distort the choice between internal and external finance. As long as all issuer sales of securities are subject to liability, issuer liability also will not distort the choice among potential offerees and methods of offering. Offerings to just a few investors, only to institutional investors or only abroad

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35. A "disclosure violation" would exist if the issuer's most recent 10-K, its most recent subsequent 10-Q or 8-K (if either were required) or its updating notice of offering contains, as of the notice's filing date, an uncorrected materially false or misleading statement or omission of a material fact required to be stated therein.

36. The measure of damages under Section 11(e) appears to be an attempt to achieve an easily administrable approximation of this amount. For a security purchased at the time of offering and retained until the time of judgment, the plaintiff, by submitting into evidence the offering price and the price the day the suit was brought, establishes a prima facie case for damages of that amount. The defendant can rebut this by showing that the market price of the security at the time the suit is less than its actual value (the actual language of the statute refers to "the value thereof at the time the suit was brought") or by affirmatively showing that some or all decline in price was due to factors other than the disclosure violation. In essence, the drop in price between the time of offering and the time of suit (when the truth would be out), is a crude market measure of the amount by which the disclosure violation inflated the offering price, which the defendant can refine if it can introduce convincing evidence of other factors responsible for part or all of the decline.

37. Cox, *supra* note 10.

would rest on their own economic merits, not on their ability to provide a means to avoid quality disclosure. Inclusion of such transactions is clearly called for once it is understood that the function of mandatory disclosure is efficiency—improved selection of the proposed new investment projects in the economy and improved operation of existing ones—not investor protection.[38]

While, as discussed below, directors, officers and certifying investment bankers should be exposed to a certain amount of liability when a disclosure violation occurs, the amount should not be affected by whether the issuer sold securities or not.[39] Admittedly, these actors might receive a derivative advantage from the inflated price the issuer enjoys when a disclosure violation exists at the time it is selling securities. This is not a strong reason to impose liability on these actors when absent a sale we would not, however, because the issuer would still have to give up its gains under my proposal. Beyond this derivative advantage, for which my proposal corrects, these other actors have no more incentive to countenance an issuer disclosure violation at the time the issuer is selling securities than at any other time.

B. A Disclosure Violation When No Sale of Securities Occurs

As just noted, a disclosure violation, whether or not a sale of securities occurs, should trigger imposition of liability on the directors, officers and certifying investment bankers. The liability would be subject to a due diligence defense. It should be limited in amount and should be payable to the issuer. The issuer should not be liable to anyone for a violation if it has sold no securities.

The object of the proposed liability system is to make directors, officers and, most importantly, the certifying investment bank feel the same legal incentives to make the issuer's 10-K free of disclosure violations as they traditionally felt with respect to an issuer's registration statement. This can be accomplished by exposing each of them to the same risk of liability in the same amount as they would have faced in a traditional registered

38. The Wallman Report's recommendations would impose section 11 on these previously exempt transactions also. Because the Report leaves unexamined the orthodox, but flawed investor protection rationale for mandatory disclosure, however, it has trouble explaining why transactions where that protection is not really needed should still give rise to issuer liability. *See generally* Wallman Report, *supra* note 3.

39. This statement applies only to liability under the mandatory disclosure regime, not the antifraud rules.

underwriting if they had exercised the same amount of due diligence.

More specifically, the 10-K can be treated as if it were a registration statement for an offering on the date of filing in an amount, call it I, equal to the issuer's total amount of real investment and increase in non-liquid assets during the preceeding year. To establish what each individual actor's liability would be, we need to establish a concept of "total liability," which would be the total amount of damages under section 11(e) of the Securities Act if the 10-K were a registration statement to sell $I in shares. In that case, a plaintiff suing on behalf of all purchasers in this imaginary offering who could establish a disclosure violation would establish a prima facie case for damages equal to

$$I \times [(P_o - P_1)/P_o]$$

where P_o is the market price of the issuer's shares on the 10-K's filing date and P_1 is the market price at the time the suit is brought. The bulk of these damages in the case of a real registration statement would be borne by the issuer. Each director, signing officer and certifying investment bank in such a case would only have liability to the extent of their required contributions. Under my reform proposal these persons' potential liabilities for a disclosure violation in the 10-K would be the same as their required contributions in the case of a real registration statement. They could free themsevles of this potential liability by engaging in acts that would enable them to show, if a suit should arise after the filing, that after reasonable investigation at the time of the filing, they had reason to believe and did believe the 10-K contained no disclosure violations.

A suit against an officer, director or certifying investment bank could be brought under these provisions by any shareholder on behalf of the corporation in much the same fashion that a shareholder can now bring a suit to recover short swing profits under section 16(b) of the Exchange Act. Attorney's fees would be available for successful plaintiffs, as under section 16(b).[40]

Two questions may stand out in the reader's mind after reviewing this proposal. The first is why choose the firm's total investment for a year, I, as the amount of the phantom offering from which officer, director and underwriter liability is calculated. The answer is that whether a firm uses external or internal funds to finance its investments, it ought to expose itself

40. *See* Smowlowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943).

to the scrutiny of the mandatory disclosure process in proportion to the total amount of such investments. This is especially so given the poor investment record of firms that rely primarily on internally generated funds. Also, total investment is a rough measure of firm size and the absolute value of the gains from a given improvement in the alignment of the interests of management and shareholders should also be roughly proportional to firm size. The larger the firm, the larger the gain from a realignment. That in turn justifies a proportionally greater amount of resources devoted to due diligence. Larger potential liability will prompt that greater amount of due diligence.

The other question is why should the issuer not be liable for a disclosure violation if it sells no securities. In this situation, the effect of the violation on investors trading in the secondary market is a zero-sum game. There are winners as well as losers and the winners' winnings just equal the losers' losses. Each winner and loser is in that position by reason of chance and is just as likely to be in the opposite position as the result of disclosure violations by other issuers. For the typical diversified investor, and even for the non-diversified investor who buys and sells different stocks over time, her aggregate experience with disclosure violations is likely to be a wash. If the losers have a cause of action against the issuer, it will be paid for by the shareholders at the time the suit is brought, passing on the losses from one chance group to another. There seems little justification for such a redistribution, particularly given the high transaction costs associated with securities litigation, other than its deterrence value in motivating management to be more careful in preventing disclosure violations. The proposed liability scheme already does that far more effectively.

IV. CONCLUSION

We are moving toward a world in which periodic disclosure will be the primary focus of the system and little or no additional disclosure will be required of issuers at the time securities are offered and sold. This should prompt us to rethink our system of liability for disclosure violations, which is based on our historical disclosure system with its opposite emphasis.

Rethinking liability intelligently requires us to reexamine what are the social benefits from mandatory issuer disclosure when an issuer is not selling securities. Modern financial economics provides a guide not available to an earlier generation. Contrary to popular belief, protecting investors against unfair prices or against risk are not persuasive reasons for mandatory disclosure. Improving how proposed new investment projects in the economy are selected for implementation and the way existing projects are operated is a persuasive reason. Another persuasive reason is eliminating distortions that otherwise occur in the choice between internal and external finance and in the choice among sources of external finance.

High quality issuer disclosure has substantial value all of the time, whether or not the issuer is selling securities. The current movement toward company disclosure results in lower quality periodic disclosure than traditionally was provided in registration statements. To raise the quality of periodic disclosure to that benchmark requires putting new pressures on issuers to avoid disclosure violations when they make their periodic filings. This can be accomplished by involving an investment bank and the officers and directors of the issuer in the drafting of the annual 10-K periodic disclosure filings. Liability would be imposed on each of these actors to give them the same incentives as they had in the traditional registered offering to make the filing free from disclosure violations.