

THE FUNDAMENTALS OF AN ELECTRONIC-BASED FEDERAL SECURITIES ACT

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What if among his other important accomplishments, Theodore Roosevelt had invented the transistor and thereby unleashed the rapid pace of computer technology fifty years earlier than it occurred? By making very bold assumptions about the pace of related technological developments—fiber optics, software, imaging—we could envision that investors in 1930 were not only grappling with the Great Depression, but also were connected by the Internet and had vast information retrieval opportunities on the World Wide Web. This Article examines what the structure of an electronic-based securities act would be if technological conditions that prevail today existed as well in 1933.

To assume what did not occur, namely the dawn of the computer age at the turn of the 20th Century, may strike many as unnecessary and an awkward setting to discuss the impact of technology on the Securities Act of 1933 (“Securities Act” or “the Act”).¹ The assumption does, however, simplify the discussion of what ought to be the focus and operation of the Securities Act in the age of the World Wide Web; the assumption, bold as it is, removes the troubling inertial forces of the regulatory culture that has developed in the administration and practice of the Securities Act.² Any broad re-examination of the securities laws must necessarily address the many practices, and even theologies, that have developed over the years, both within the Securities Exchange Commission (“SEC”) and among securities professionals that trace their roots to the regulatory commitment made in 1933. For example, in retrospect, we may question whether there would be an obligation to deliver a final prospectus to investors or even if there would be a prospectus requirement at all.³ However, because this was a key feature to the

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1. 15 U.S.C. §§ 77a-77bbbb (1994).

2. On the capacity of the SEC’s culture to nurture or otherwise embrace wholesale regulatory changes, see Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formation*, 47 WASH. & LEE L. REV. 527 (1990). There is, of course, the additional retarding force of inertia, as well as the private sector “investment” in the existing regulatory mechanisms. See Gregg A. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273 (1984); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

3. 17 C.F.R. §§ 230.420-434 (1996).

Securities Act's overall scheme of "filtering" information to investors, and the practice has become expected among investors and market professionals, any proposal to dispense with this practice must deal with the expectations that have evolved over nearly seventy years among investors who have grown accustomed to a the more paternalistic delivery of prospectus requirement.⁴

I. THE BAGGAGE OF THE SECURITIES ACT'S TRANSACTION ORIENTATION

The most troubling issues posed by the Securities Act trace their cause to the Act's transactional focus. Under the Securities Act, the public offering of securities, whether by their issuer or a control person, sets in motion a regulatory process that assumes an information void surrounds the issuer and the offering. Though the assumption has great practical and, therefore, regulatory appeal in the case of the initial public offering, it has long been recognized that the regulatory process should not be blind to the substantial body of information available to investors regarding companies that are publicly traded.⁵ Certainly there is cause to question why the regulatory framework that is acceptable for equity trading markets that are nearly thirty-five times the dollar volume of the amount of equity offerings registered with the SEC⁶ should not be equally sufficient for most public companies offering their securities for sale.

The integrated disclosure system the SEC introduced in 1983⁷ did not overcome the Securities Act's transactional focus. For example, available data reflects that registrants qualified to use the integrated disclosure system

4. On this point, consider the SEC's and industry's support for a process of accommodating both the requirements that a "final prospectus" be delivered and that the settlement date must occur within three days of the trade. *See* Prospectus Delivery, Securities Act Release No. 7168, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,601, at 86,311 (May 11, 1995). Because the T+3 rule, 17 C.F.R. § 240.15c6-1 (1996), effectively prevents the preparation and delivery of a prospectus containing the materials in an effective registration statement. New Rule 434 departs from past practices by allowing the final prospectus to be contained in a series of prescribed communications, including a preliminary prospectus (which formerly was used only prior to the registration statement becoming effective). 17 C.F.R. § 230.434 (1996). The regulatory response to the practical problem posed by Rule 15c6-1's requirement for settlements within three days of the trade was defining a document that could meet both the shortened requirements and the received model of a culminating disclosure statement.

5. For the most sweeping consideration of this matter, see Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, Part I (November 3, 1977).

6. *See* Report of the Advisory Committee on the Capital Formation and Regulatory Processes, app. A at 45-46 (SEC 1996) [hereinafter Report of the Advisory Committee].

7. *See* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 47 Fed. Reg. 11380 (Mar. 16, 1982).

continue to incur nontrivial delays and costs in complying with that system.⁸ This occurs not because of the need for new disclosures to be filed with the SEC—by definition, most of the important financial information about the issuer under integrated disclosure has previously been filed with the SEC under the Exchange Act, so that only the more benign transaction specific information need be created—but because of the greater liability the issuer and others incur for omissions and misstatements in report information submitted under the Securities Exchange Act of 1934 (“Exchange Act”)⁹ when that information becomes part of the Securities Act registration statement. As discussed later, the Securities Act’s transactional focus finds its source and continued vitality because of section 11’s demanding liability standards. And, it is not likely that the burdensome effects of this transactional focus will subside so long as the issuer, and others such as underwriters, accountants and directors who have burdensome due diligence requirements, remain liable under section 11 for omissions and misstatements when the registration statement becomes effective.

The Securities Act’s present transaction orientation has all the appeal of a suit advertised as “one size fits all.” The burdens of this transaction orientation transcend the significant liability burdens faced by those subject to section 11. For example, the transaction focus is the hallmark of the operation of the Securities Act’s exemptions. At the core of the exemptive process is the need to define the offering, which in turn implicates the doctrine that interdependent offerings of the same class of securities are for regulatory purposes integrated so that collectively they must either be registered or meet the criteria for *an* exemption from registration.¹⁰ The offering concept was natural within the 1933-vintage paradigm whereby small start-up companies

8. See Report of the Advisory Committee, *supra* note 6, app. A., tbl. 2, at 48 (average time at the SEC in 1994 & 1995 of registration materials for Form S-2 and Form S-3 registrants was 15.6 days and 9.3 days, respectively).

9. 15 U.S.C. §§ 78a-78ll (1994).

10. Securities Act exemptions promulgated by the SEC provide much needed certainty against integration by providing distinct time periods during which offerings will not be integrated. See, e.g., Securities Act Rule 251(c)(1), 17 C.F.R. § 230.251(c)(1) (1996) (Regulation A offerings will not be integrated with *earlier* offers or sales); Securities Act Rule 502(a), 17 C.F.R. § 230.502(a) (1996) (Regulation D offerings beyond six months of another offering will not be integrated.). Absent such a safe harbor, the issuer must depend on the uncertainties inherent in the traditional factor analysis. See Non-Public Offering Exemption, Securities Act Release No. 4552, 27 Fed. Reg. 11316 (Nov. 16, 1962); Exemption for Local Offerings from Registration, Securities Act Release No. 4434, 26 Fed. Reg. 11896 (Dec. 13, 1962). See generally Committee on Federal Regulation of Securities, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595 (1986).

and established corporations each raised capital episodically through public offers aimed at individual investors. The Securities Act's offering concept, and related integration doctrine, are symptomatic of the Act's transactional orientation in which the disclosure mechanism is aimed at the episodic event of the issuer raising money through a broad public solicitation of investors. Many issuers still do this, but the more seasoned issuers today have far more options than they had in 1933, or even 1990, to meet their capital needs by the sale of securities. It was practicable in 1933 to envision registration as occurring only episodically. Today, because of technology and the institutionalization of all facets of securities markets, capital raising increasingly is a continuous process for rapidly growing publicly-traded firms. Further electronic linkages among market professionals and their clients will further render the offering concept as outdated and inappropriate for today's capital markets.

Issuers today can privately place securities with an investment bank who thereupon syndicates that offering pursuant to Rule 144A to qualified institutional buyers ("QIBs") through the Private Offering, Resale and Trading through Automated Linkages system ("PORTAL").¹¹ But this approach is not without its own regulatory web. The burdens of this method of financing is that the distributed security cannot be fungible with the issuer's publicly traded security.¹² This nonfungibility requirement essentially is a limitation on resale and has a negative impact on the price at which the distributed securities are sold by the issuer. Similarly, issuers who seek to avoid registration under the Securities Act by offering their securities abroad pursuant to Regulation S¹³ can expect those securities to be issued at a substantial discount from the price at which the same security is traded in U.S. capital markets. Again, there is a discount in the pricing of the shares because of this minimal restriction on resales. The source of the discount is Regulation S's resale restrictions which require that the foreign-offered security remain "off shore" for at least 40 days.¹⁴ Because most U.S. issuers

11. 17 C.F.R. § 230.144A (1996).

12. Securities Act Rule 144A(d)(3), 17 C.F.R. § 230.144A(d)(3) (1996).

13. Securities Act Rules 901-904, 17 C.F.R. §§ 230.901-904 (1996).

14. See Securities Act Rule 903(c)(2)(iii) & (c)(3)(ii), 17 C.F.R. §§ 230.903(c)(2)(iii) & (c)(3)(ii) (1996). The resale restriction extends to one year for equity offerings by companies for which there is a substantial U.S. investor interest, but which are not subject to the Exchange Act's continuous reporting system. Securities Act Rule 903(c)(3)(iii)(A), 17 C.F.R. § 230.903(c)(3)(iii)(A) (1996). On the problems posed by the resulting share discounts, see Bevis Longstreth & Joel B. Prager, "Gum Jumping" Revisited: A Proposal to Prevent False Starts in Private Offerings, 21 SEC. REG. L.J. 235

using either Rule 144A or relying on Regulation S for their offshore offerings are reporting companies, the major source of information to their QIBs or for U.S. investors when the foreign offered securities flow back to the United States is the information provided by the continuous reporting provisions of the Exchange Act. The issuer, however, is not permitted to rely on such information for conducting a public offering in the United States without section 11 liability and must resort to exemptions, such as those embodied in Rule 144A or Regulation S which impose their own costs in terms of the resulting share discount incurred by the issuer.

Further evidence of the outmoded offering concept is the practical blurring between public and private offerings.¹⁵ Rule 144A effectively does more than establish an institutional trading market. Its important impact is that by assuring liquidity to privately placed securities it greatly facilitates the ability of issuers to raise capital privately. We should question whether, given the ability of purchasers of privately placed securities to offer those securities to thousands of institutions via the PORTAL system, should such a transaction continue to be viewed as truly private? Moreover, consider the effect of the so-called A/B exchange, whereby the issuer agrees at some future date to exchange newly registered securities for the formerly issued restricted securities.¹⁶ The A/B exchange effectively allows the issuer to disconnect its interface with the Securities Act's registration process from its entrance to capital markets. Though we may herald the A/B exchange as an illustration of how creative lawyering can overcome the Securities Act's regulatory burdens, and thereby free the hand of capitalism, it should also be realized that the issuer incurs nontrivial costs in doing so, and that those costs largely are the result of the Securities Act's transactional focus.

Another feature of the Securities Act's transactional approach is its preoccupation with public solicitation of investors. Exemptions such as

(1993).

15. More generally on this point, see Report of the Advisory Committee, *supra* note 6.

16. The SEC's no-action letters authorize A/B exchanges. See, e.g., Shearman & Sterling, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶76,704, at 78,039 (July 2, 1993). The important issue in such no-action letter requests is whether the selling security holder will be an underwriter and, among other burdens, be subject to section 11 liability in connection with its sales of the registered security. Cf. *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303 (2d Cir. 1977) (sellers of registered securities received in exchange for unregistered securities violated section 5 by failing to deliver a prospectus to their buyer). See generally Jennifer O'Hare, *Institutional Investors, Registration Rights and the Specter of Liability Under Section 11 of the Securities Act of 1933*, 1996 Wis. L. REV. 217.

Regulation D¹⁷ are not available if the offering is accompanied by general advertisements and solicitations. And, such promotions are anathema to the private offering exemption provided in section 4(2). Solicitation is interpreted broadly so that communications that operate to condition the market constitute impermissible “gun jumping.”¹⁸ Yet, the unwavering obeisance to fears of “conditioning the market” collides with the managers’ responsibility to inform their shareholders and the market of financially significant events affecting the corporation. Though the SEC, through its safe harbor provisions in Rule 135¹⁹ and Rule 135c,²⁰ has permitted limited disclosures regarding an upcoming public offering or private placement of securities,²¹ the disclosures so permitted are narrowly circumscribed so that concern continues whether the appropriate regulatory balance between “conditioning the market” and informing trading markets has been struck. Against this preoccupation with general solicitations and, more generally, conditioning the market, we may once again question whether the “one size fits all” orientation makes sense. For example, is it practicable or even desirable to discourage Chrysler corporation from conditioning the market for securities it will soon offer for sale? In a well publicized case, a public offering of Chrysler Financial securities was scuttled and a much smaller amount was privately placed after one of its proposed underwriters had circulated information about the offering among some of its institutional clients.²² The result reached here is all the more problematic when one considers that the Securities Act condones the same underwriter making cold calls to unsophisticated investors without

17. Securities Act Rules 501-508, 17 C.F.R. §§ 230.501-508 (1996).

18. See generally Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989); Joseph P. Richards & Joseph E. Reece, *Gun Jumping*, 26 REV. SEC. & COMMODITIES REG. 1 (1993).

19. 17 C.F.R. § 230.135 (1996).

20. 17 C.F.R. § 230.135c (1996).

21. The SEC has proposed further relaxing its stance regarding pre-offering promotional efforts to permit issuers and their underwriters to “test the waters.” See Commission Records and Information, Securities Act Release No. 7188, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) (proposing Rule 135d). However the rule as proposed will be limited to companies that are not subject to the Exchange Act’s continuous reporting provisions. Because of this focus, Professor Coffee has suggested that proposed Rule 135d is ill-conceived because, among other faults, it does not complement either the technology or market structure for such issuers of public offerings of securities. See John C. Coffee Jr., *SEC Deregulation: Sense and Nonsense*, N.Y. L.J., Sept. 28, 1995, at 5. Professor Coffee’s criticisms of proposed Rule 135d are consistent with this Article’s thesis that technology and market institutionalization for publicly traded firms reject continuing the Securities Act’s transaction orientation for such firms.

22. See Michael Siconolfi, *Bear Stearns Muffs Chrysler Financial \$1 Billion Offering*, WALL ST. J., Feb. 4, 1992, at C13.

providing any written materials, so long as a registration statement for the offered securities has been filed with the SEC. It is difficult to understand why, in an informationally rich environment such as that for Chrysler, the public solicitation of investors should depend on the coincidence of filing essentially the same documents with the SEC that embodies information that is already on file with the SEC.

A final feature of the Securities Act's transactional approach is its treatment of secondary distributions. Congress, in enacting the Securities Act, believed distributions by a control person posed the same needs for disclosure as distributions by issuers.²³ It accomplished this objective by expanding the definition of underwriter so that it includes those who facilitate a distribution of the control person's securities.²⁴ The Securities Act identifies yet another transaction for which disclosure and its allied burdens, such as potential section 11 liability and prospectus delivery requirements, apply. These results follow regardless of the richness of the information environment for the issuer's security. Once again, the approach is that of one size fitting all. Moreover, the regulatory burdens for such transactions are greater than are those facing the issuer. First, there are fewer exemptions from registration available for the control person's resales than are available for the security's issuer. This occurs because the control person technically is not the *issuer*²⁵ and most Securities Act exemptions are *issuer*-based exemptions.²⁶ Second, a good deal of ambiguity surrounds the meaning of "control person" when defining the scope of secondary distributions. Though the reports accompanying the Securities Act's enactment appear to apply a test of whether an individual had the power to compel the issuer to file a registration statement, the SEC continues to adhere to a broader test dependent on one's

23. See H.R. REP. NO. 73-85, at 14 (1933) ("Such a public offering may possess all the dangers attendant upon a new offering of securities.").

24. Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994).

25. Issuer is defined in section 2(4), 15 U.S.C. § 77b(4) (1994), so that it is the entity in which the investment is made through the security. The control person is an issuer only for the limited purpose of defining whether the actions of another are those of an underwriter. Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994).

26. Notable exceptions to this are that the intrastate exemption provided by section 3(a)(11), 15 U.S.C. § 77c(a)(11) (1994), also includes resales by control persons, and Regulation A's abbreviated disclosure under Rule 251(b) is also available to control persons. 17 C.F.R. § 230.251(b) (1996). By contrast, Rule 147, 17 C.F.R. § 230.147(a) (1996), provides an exemption only for the issuer's intrastate offerings, and section 4(2)'s private offering exemption, 15 U.S.C. § 77d(2) (1994), applies only for issuers, as do the Regulation D exemptions, 17 C.F.R. 230.501-.508 (1996).

power to influence the issuer's managerial policies.²⁷ Thus, those within the entity's managerial ranks are faced with the double concern of having a narrow band of regulatory freedom for resales by control persons while being uncertain whether this restricted environment applies to them.

Certainly the control person's disposition of shares merits regulation equal to that of the issuer where the control person is but a conduit for taking the corporation public. However, this occurs rarely and the more typical control person transaction is that of control person selling some of her holdings in the controlled entity rather than terminating her ownership in that entity. In either case investors are likely to view a control person reducing or terminating her ownership of the controlled firms as being material. Currently, the Securities Act meets this need by triggering registration requirements for the control person. An electronic-based securities act, on the other hand, could view the control person's disposition as a materiality issue that could be handled within its continuous reporting requirements. In this manner, the control person's disposition would not expose the issuer to section 11 liability or the accompanying needs to update its other SEC filings.

The above concerns played a dominant role in the call by the Advisory Committee on the Capital Formation and Regulatory Processes for a company registration system to be introduced on a voluntary basis for seasoned companies with a public float of at least \$75 million.²⁸

The effects of the merging of the public, private and offshore markets on the operation of the current Securities Act concepts and the protections are grounds for significant concern. It seems clear that these concepts are no longer capable of achieving their purpose of protecting investors, and are imposing substantial costs on insiders. In the case of seasoned issuers, the benefits of attempting to preserve these distinctions is unclear, given the significant costs and reduced investor protection that comes from them. Rather, with regard to seasoned issuers, the Committee concluded that investor protection would be better served by a regulatory model that no longer attempts to preserve any artificial distinctions among these markets. Instead, the new regulatory model would provide for Securities Act protections for all sales to purchasers in the United States (regardless of whether the

27. See Rutherford B. Campbell, Jr., *Defining Control in Secondary Distributions*, 18 B.C. INDUS. & COM. L. REV. 37, 40 (1976).

28. Report of the Advisory Committee, *supra* note 6, app. B, at 127.

securities were first offered abroad), and would extend the type of discipline and quality of disclosure traditionally enjoyed by the primary markets to the company's continuous reporting, for the benefit of all the markets for the seasoned issuer's securities.²⁹

The litany of the Securities Act's transactional focus reviewed above not only supports the Advisory Committee's recommendations, but suggests that those recommendations did not go far enough. The Advisory Committee not only continues the transaction orientation for companies who do not meet the proposed eligibility standards for the pilot project, but more importantly continues to emphasize the role of section 11 liability for all public offerings. As examined in Part III, so long as section 11 continues to be triggered by the registration of securities, many of the ill effects of the Securities Act's transactional focus will continue. A true company registration system should not prescribe the applicable liability standard by the type of security transaction that the issuer undertakes. Indeed, the electronic-based securities act would not be one whose content is focused on the offering of securities but rather it would be on the mechanisms by which information becomes publicly available.

II. A THEORETICAL BASE FOR AN ELECTRONIC-BASED SECURITIES ACT

Congress enacted the Securities Act during the heady first hundred days of the New Deal. The Act's proscription reflected the popular belief that the collapse of the stock market was the result of fraudulent practices by promoters and "the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise."³⁰ Aside from the rhetoric that propelled the Securities Act into law, the Securities Act sought to achieve investor protection and enhance investor confidence in capital markets by imposing mandatory disclosure standards on issuers through a public offerings registration process and by actively engaging certain professionals in a certification process for registration statement disclosures. Because the Act became law some four decades before expressions such as "random walk" or "market efficiency" became popular, the important mechanism for distributing the registration statement's

29. *Id.* app. A, at 45.

30. H.R. REP. NO. 73-85, at 2 (1933).

information was through its filtration into the investment community via the Act's prospectus delivery requirements. Thus, a crucial feature for investor protection is not simply the Securities Act's requirements for the delivery of a preliminary and final prospectus,³¹ but also the Commission rules requiring that broker-dealers involved in the security's distribution have sufficient copies of the issuer's prospectus.³²

Though the Securities Act's prospectus delivery requirements are a wondrous illustration of technical precision being carried out in an important piece of social legislation, one's wonderment should not blind oneself to what is really taking place within the interweaving statutes and their accompanying regulations. After issuers have filed a registration statement, and before the registration statement becomes effective, written offers, with very few exceptions, may only occur within the context of a document, the preliminary prospectus, that embodies the materials then on file with the SEC. Oral solicitations, however, can and do occur and there is no requirement that those orally solicited receive a prospectus, final or preliminary, before they receive confirmation of their security purchases.³³ Overreaching in the context of such oral solicitations is policed through section 12(a)(2) which imposes liability on the soliciting broker who commits an omission or misstatement, unless "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."³⁴ Clearly a broker who solicits an investor's security purchase on the basis of representations that are inconsistent with the prospectus will have a very difficult time meeting section 12(a)(2)'s defense. Thus, the prospectus delivery requirements serve two highly complementary purposes in terms of investor protection: (1) at least among brokers and dealers, it sharpens section 12(a)(2)'s disciplinary

31. The prospectus delivery requirements originate from section 5(b), 15 U.S.C. § 77e(b) (1994), which applies to issuers, underwriters and dealers. *See* Securities Act of 1933 §§ 4(1), 4(3), 15 U.S.C. § 77d(1), (3) (1988).

32. *See* Securities Exchange Act Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (1996).

33. It is fraudulent practice for a broker to distribute a security for an issuer that is not a reporting company, without delivering a preliminary prospectus at least 48 hours in advance of any confirmation of sale to those to whom they expect to direct confirmations of sale. Securities Exchange Act Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (1996). Parallel requirements appear in the SEC's decision to accelerate the effective date of the registration statement. *See* Insurance Company Qualified Pension Plans Exemption, Securities Act Release No. 4968 [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,730, at 83,671 (Apr. 24, 1969). Even in the instance of such a mailing, however, if the prospectus arrived after the broker mailed the confirmation, the confirmation would be effective so that the prospectus could not thereafter be the basis for the investor withdrawing his offer to purchase.

34. Securities Exchange Act of 1933 § 12(a)(2), 15 U.S.C. § 77i (1994).

effects,³⁵ and (2) it disseminates information about the offering.

Neither of these objectives necessarily depends on the solicited investor actually reading the prospectus or understanding its contents. The Securities Act is, in view of the times of its enactment, surprisingly agnostic on whether the typical investor would actually understand the contents of the registration statement. The object of registration was to obtain truthful filings by registrants and the prospectus delivery requirements were designed to make that information publicly available.

As the culture changed from a paper-based to an electronic-based dissemination of information, the SEC and the Securities Act have each proven adaptable. Information previously circulated in the bulky prospectus can now be electronically transmitted.³⁶ But, the capacity of the Securities Act to accommodate modern technology for fulfilling the tasks envisioned in 1933, when technology did not include even the chain saw to clear the West to supply the East with prospectuses, does not address the question of whether those tasks would have been otherwise defined if such technology was anticipated.

Before the architecture of an electronic-based securities act can be considered, there needs to be some concurrence of opinion regarding the objective sought by a securities act—a theoretical basis needs to be developed. This inquiry essentially recasts the debate on the purpose of mandatory disclosure rules. While this discussion focuses on whom the objective of the disclosures is—sophisticated market professionals or widows, widowers and orphans³⁷—its outcome is dominated by the more sweeping consideration of whether the objective of disclosure is to seek price accuracy or merely facilitate comparisons among competing securities.³⁸

35. Professional obligations also discipline brokers by requiring brokers to know both their customer and the recommended security. JAMES D. COX ET AL., *SECURITIES REGULATIONS CASES AND MATERIALS* 1096-1109 (2d ed. 1997).

36. Thus far the SEC has proceeded cautiously and flexibly in its embrace of electronic delivery or prospectuses. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 60 SEC Docket (CCH) 1091 (Oct. 6, 1995); Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7234, [1995-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,702, at 87,112 (Oct. 6, 1995). On the need for SEC to further liberalize the prospectus delivery requirements so that Internet technology can be more fully accommodated, see Robertson, *Personal Investing in Cyberspace and the Federal Securities Laws*, 23 SEC. REG. L.J. 347, 381-97 (1996).

37. See generally COX ET AL., *supra* note 35, at 250-56.

38. For the view that SEC policies, apparently designed to assure accuracy in securities prices, exacerbate the burdens of SEC disclosure requirements, see Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763 (1995).

Questions regarding the relative accuracy of the stock prices and comparative investment choices are at the heart of the commentators' criticisms of the SEC's invocation of the efficient market hypothesis to support many of its deregulatory initiatives. For example, Professor Donald Langevoort has insightfully questioned the SEC's invocation of the efficient market hypothesis to justify its adoption of integrated disclosure and shelf registration procedures.³⁹ Professor Langevoort premises his criticism on the weight of recent empirical work supporting the view that capital markets are noisy markets such that market prices for publicly traded securities frequently vary from the security's intrinsic value.⁴⁰ He reasons that, regardless of whether a prospectus is delivered in its traditional format or in the more abbreviated format for issuers qualified to use either Forms S-2 or S-3 of the SEC's integrated disclosure system, the result is still the same—the investor's decision to purchase the security price will sometimes, perhaps even frequently, be irrational.⁴¹ Professor Langevoort, therefore, concludes that deregulatory initiatives, such as integrated disclosure or shelf registration, could, as a practical matter, have been supported independently of the efficient market hypothesis.⁴²

39. Donald C. Langevoort, *Theories, Assumptions, and Securities Regulations: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992).

40. *Id.* at 866-72.

41. *Id.* at 881.

42. Professor Langevoort offers many possible explanations for the SEC's invocation of market efficiency. He suggests that (1) the SEC somewhat overstated the role of the efficient market hypothesis in its decision, (2) the SEC misunderstood the tentativeness of the hypothesis in light of available empirical work, (3) the SEC's visible reliance on the efficient market hypothesis was a pretext to diminish investor protection by reducing the likelihood that the certification process under integrated disclosure could be carried out with the same degree of rigor as outside the integrated disclosure system, and (4) the SEC was garnering support with its external constituencies. *Id.* at 886-88.

This author has a very different reaction to driving force for integrated disclosure, and more particularly the shelf registration procedures. First, when integrated disclosure was being considered, the United States was undergoing several important social forces. It was in the grips of the worst recession since the Great Depression. More importantly, it was at the early stages of an important deregulation movement, a movement that started under President Carter and became more wide spread with President Reagan taking office in 1981. In addition, there was a great malaise regarding the United States' competitive position in world markets. This force introduced several deregulatory efforts by the SEC, like Regulation D, and Congress sought to propel further SEC deregulation by enacting the Small Business Issuers' Simplification Act of 1980, Pub. Law 96-477, 94 Stat. 2294. This Act, among other steps, raised the exemption provided by section 3(b), 15 U.S.C. § 77c(b) (1994), to \$5 million, and also approved an exemption in section 4(6), 15 U.S.C. § 77d(6) (1994), for accredited investors.

Second, the frequency of large issuers raising funds in Europe drove integrated disclosure. Integrated disclosure, and the shelf registration procedures, were competitive regulatory responses to

Similarly, Professor Lynn Stout has challenged the SEC's preoccupation with market efficiency in its formulation of regulatory policies regarding insider trading, program trading, and the disclosure of merger negotiations. She contends that there is weak theoretical support for the SEC's view that securities prices established in trading markets influence important resource allocation decisions.⁴³ Much like Professor Langevoort, important to her argument is whether securities prices reflect the underlying intrinsic value of the traded security.⁴⁴

Professors Langevoort and Stout have disrobed the SEC's use of the efficient market hypothesis so that regulatory initiatives taken in reliance on the hypothesis appear to lack a defensible theoretical basis. Any call for a new electronic-based securities act that builds upon these earlier SEC initiatives runs the risk of being subject to the same critical response as that raised by Professors Langevoort and Stout. Thus, the following discussion defends the SEC's reliance on the efficient market hypothesis for its deregulation of the offering process by permitting integrated disclosures and broadening the scope of shelf registrations. This defense is not made for the SEC's benefit, but for the purpose of providing a theoretical foundation for a true company registration system that would be at the heart of an electronic-based securities act.

For convenience, it is useful to divide market efficiency into its various possible meanings. At the most basic level, market efficiency refers to the informational efficiency of trading markets. This level of efficiency is strongly supported through classic event studies that measure the relative rapidity of stock prices to announcements of economically significant

place U.S. capital markets on a footing that could compete with London. *See generally* COX ET AL., *supra* note 35, at 217-18, 223-24, 272-74. In combination, these considerations support Professor Langevoort's more general description that the content of securities regulation, and more specifically, the SEC, are each responsive to political and social forces, especially when those forces bear the banner of "Let's get America moving again."

43. Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988).

44. *Id.* at 616. Professor Stout's focus, however, is not on disclosure mechanisms, but on SEC policy regarding insider trading, program trading and the disclosure of merger negotiations. One may well agree that the SEC's regulatory initiative may only marginally promote market efficiency. *Id.* at 638. However, the actual emphasis of her article is on the more important debunking that securities markets are *allocationally* efficient. *Id.* at 641-77. As will be developed later, even if one accepted Professor Stout's major thesis that securities markets fail in their function to facilitate the allocation of resources, this conclusion has no impact on the regulatory mechanisms for carrying out the most basic function of the securities laws, providing investors with an opportunity to make informed choices and discouraging fraudulent promotion practices.

information. A finding that markets are informationally efficient, however, says nothing about whether the stock prices formed in such a market reflect a security's "true" intrinsic value. The capacity of stock prices in securities markets to represent that security's intrinsic value refers to fundamental market efficiency. Whether markets are fundamentally efficient is a more difficult proposition to test; absent a supreme being who can testify regarding any given security's intrinsic value, a surrogate for value must be used against which observed stock price behavior is assessed. Any examination of observed stock prices against the surrogate price derived from a model designed to forecast the security's intrinsic value surely will meet with the double concerns regarding the accuracy of the observations and the reliability of the forecasted surrogate price. Though there is much debate over the relative reliability of the surrogates used in such studies, there is a great body of evidence that rejects the notion that securities markets are fundamentally efficient.⁴⁵ The final, and arguably most important, form of efficiency is allocational efficiency. This refers to the role securities prices established in trading markets have in the allocation of resources among competing investment opportunities. This level of efficiency is not likely to be documented or rejected empirically, though theorists provide support for the important social function trading markets play in the allocation of resources.⁴⁶ However, those theorists assume accurate measurements of risk and return in stock prices so that the capacity of trading markets to be allocationally efficient would appear to depend on an independent finding that capital markets were fundamentally efficient which, as seen above, is not supported by existing data.

Just as politics is the art of the possible, one can say the same for the design of a securities regulation system. A disclosure system that quests accuracy in securities prices is likely to prove disappointing, and any regulatory initiative founded on assuring that trading markets fulfill the goal of allocational efficiency will surely meet with strong criticism, if not skepticism. First, the quest for accuracy will elicit much larger amounts of

45. See generally Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994); Langevoort, *supra* note 39, at 857-72. For a more technical review on the empirical work examining market efficiency and the detracting theory that markets are noisy, see Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991).

46. See, e.g., Eugene F. Fama & Arthur B. Laffler, *Information and Capital Markets*, 44 J. BUS. 289 (1971); Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Incentive Activity*, 61 AM. ECON. REV. 561 (1971).

information from issuers; the cost of producing this information is not limited to the person hours required for its assembly, but the more important costs of giving away potential competitive advantages the firm may otherwise enjoy if such sensitive information remained proprietary information.⁴⁷ Second, if capital markets are noisy markets, as suggested by most of the empirical evidence, there is a phenomenon within the investor community that prevents fundamental market efficiency, such that the considerable costs of the heightened disclosure the SEC believes necessary for the accuracy of prices in securities may not be rewarded by the benefits of prices that are indeed accurate.⁴⁸ A third concern is whether a sufficient case has been made for an unannounced public goal that security prices be accurate when we do not have such a goal for most other components of our economy. Certainly the pricing mechanism for such important commodities as oil, soybeans, and treasury bills are no more "accurate" as the pricing mechanism for IBM shares. Just as the announced regulatory policies for basic commodities is that of facilitating market forces, rather than a policy of assuring the assets are traded at their intrinsic value, one would expect the same policy for securities markets.

It is quite likely that Professor Langevoort, and other critics of SEC regulatory initiatives,⁴⁹ overstate their criticism. For example, the important contribution of the integrated disclosure system and shelf registration initiatives was the substantial reduction in the amount of information that must be created and distributed *in the prospectus*. For example, the prospectus for registrants eligible to register securities on Form S-2 is the issuer's most recent Form 10-K supplemented by the new information pertinent to the offering.⁵⁰ And, for the larger registrant qualified to use Form S-3, the prospectus is leaner yet, as there is no need to circulate the information contained in Form 10-K.⁵¹ Integrated disclosure thus relies on the most basic form of market efficiency, the belief that markets are informationally efficient. The integrated disclosure initiative depends not at

47. See Kitch, *supra* note 38.

48. See Cunningham, *supra* note 45, at 592-93; Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965 (1995).

49. See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 813-23 (1985).

50. Form S-2, 1 Fed. Sec. L. Rep. (CCH) ¶ 8061, at 7173-75 (May 11, 1995) [hereinafter Form S-2].

51. Form S-3, 1 Fed. Sec. L. Rep. (CCH) ¶ 8061, at 7185-86 (May 11, 1995) [hereinafter Form S-3].

all on the capacity of securities markets to move the registered security's price to its intrinsic value in response to the registrant's filings with the SEC. Moreover, the abbreviated prospectus for Form S-3 qualified registrants merely reflects the conclusion that the bulk of the information for the offering is sufficiently public; this conclusion is not dependent on the price of the security reflecting the security's intrinsic value. The premise for integrated disclosure is that information for certain types of companies is as accessible if on file with the SEC as it would be if physically delivered to prospective investors.

Similarly, shelf registration relaxes the requirements that issuers can only register that quantity of shares they then intend to sell and permits issuers to sell their securities as market conditions warrant. The shelf rule implicates market efficiency because it is limited to issuers qualified to use Form S-3; hence, shelf registrants may use an abbreviated prospectus with markets being informed by the more comprehensive information about the registrant and the offering on file with the SEC. These initiatives did not require a finding that markets are fundamentally efficient, but rather a finding that for some issuers information filed with the SEC is as readily available as if the information were circulated through a prospectus in the traditional manner.

The most basic objective of an electronically-based securities act is that embraced in the Securities Act itself, namely arming investors with sufficient information to make a fair comparison among competing securities. Just as in 1933, a regulatory policy founded on this belief does not also require a belief that investors will rationally respond to the information made available to them, an electronic-based securities act would not have among its goals, or even considerations, whether investors respond rationally to the information when that information is disclosed. The act may well proceed on the assumption that securities prices are formed through a much longer time frame and with more chaos in that process than earlier research suggested. Though the SEC disclosure requirements are largely aimed at enhancing price accuracy and have greatly expanded since 1933, the bedrock of the Securities Act is enabling investors to make fair comparisons among securities.⁵² If this were the objective of the electronic-based securities act, the act would not require proof that capital markets are either fundamentally or allocationally efficient. The objective of the act should be investor protection with the

52. There is the related objective, discussed later, of reducing the incidence of fraudulent offerings through the attestation function implicit in section 11 liability standards.

correlative benefit that the act would reduce the amount of money devoted to nonproductive fraudulent activities. Such an approach would be consistent with our society's overall commitment to market-based, rather than regulation-based, solutions. The electronic-based securities act need not, however, depend entirely on the capital market being informationally efficient. Indeed, in a world linked by fiber much of this concern is moot.

It is paradoxical that technology can today, on the one hand, liberate the Securities Act from its transactional orientation and thereby dramatically alter its content, and, on the other hand, fulfill the vision of the seventy-third Congress. With respect to its goal of the broad dissemination of information bearing on the public offering of a security, regulation took a path dependent on the world as it was understood in 1933,⁵³ when the norm was that capital-raising occurred through a single transaction, the public offering of securities, and the medium for the distribution of information was paper based. The central objective of the Securities Act is the filtration process by which the most salient portions of the registration statement are circulated among investment professionals and investors via a prospectus. Integrated disclosure has partially brought this process into more modern times by recognizing that filtration occurs, in the case of some companies, as effectively through a filing with the SEC as with the physical circulation of the registration statement's contents among broker-dealers and investors. The recent recommendations for a company registration system by the Advisory Committee on Regulatory and Capital Formation Processes would carry the integrated disclosure system to the next level, at least for those companies deemed worthy of such beneficial treatment.⁵⁴ The suggestion here is that technology should permit continuous company registration to be the norm for the electronic-based securities act.⁵⁵ Just as the Securities Act fulfilled the national goal by relying on the filtration of the registration statement's contents through pervasive and elaborate prospectus delivery procedures, it would appear that resort to the Internet and, more precisely, the World Wide Web, could equally serve this purpose today. That is, at the heart of an electronic-based securities act will be an information dissemination requirement that casts aside the baggage of the paper-based system. Much like the Securities Act, a basic information package and transaction specific

53. See generally Mark A. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996).

54. Report of the Advisory Committee, *supra* note 6, at 127.

55. See *infra* text accompanying notes 84-88.

information will be delivered electronically to all those involved in the distribution. It should also be possible to require even wider circulation, including to the Internet addresses of investors likely to be offered the security, but to whom offers have not yet been made.

The SEC may also consider melding these prospectus delivery requirements with other regulatory initiatives. For example, one possible regulatory response to the problem of cold calls is to require the electronic delivery of a prospectus or information regarding companies to be recommended or being promoted prior to the broker's call. Somewhat related, questions of customer suitability can be coupled with exemptions that would limit canvassing investors to those within the broker's electronic files that have met certain eligibility requirements. Such customers may all be armed with a password that enables them to visit the broker's web page that displays information regarding promoted offerings.⁵⁶

A further consideration is including various rating agencies among those to whom the electronic prospectus is delivered, thus further facilitating a role of alternative information sources regarding offerings. The overall objective of all such initiatives is that technology permits not only rapid dissemination of information to discrete groups of investors but that technology also permits efficient discrimination among investor groups so that this power can be effectively harnessed in an electronic-based securities act to fulfill classic regulatory objectives.

The Securities Act seeks to fulfill two very different goals. In addition to the goal of facilitating investors to make meaningful comparisons among competing offerings, there is also the objective of reducing fraudulent offerings. But for the Exchange Act, the seventy-third Congress would have been accused of an acute case of myopia had it limited regulation to public offering of securities, because comparative assessments involve comparing securities sold through a public offering with those available in trading markets. We may conclude that but for a concern for deterring fraudulent offerings the disclosure process for public offerings should be indistinguishable from that for publicly traded securities. In the 1930s, and even through most of the 1980s, information dissemination processes were paper based so that the transaction orientation of the Securities Act was the

56. See IPONET, SEC No-Action Letter [1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252 (July 26, 1996) (providing a password to accredited investors for accessing the broker's web page information about on-going Regulation D offerings does not constitute a general solicitation in violation of Regulation D's anti-solicitation requirements).

most practicable means for assuring the wide distribution of information. But that was then and this is now. If the goal of the electronic-based securities act is simply to facilitate comparative assessments among securities—what to buy, what to sell—a wide adoption of a company registration system, built on the architecture of the World Wide Web (no doubt with special downloading and delivery requirements on broker-dealers with respect to their customers who do not enjoy direct access to the Web) would be the act's linchpin. As discussed earlier, there is little reason to believe such a system would be any the less effective than the paper-based filtration system that prevails under the Securities Act. Thus, if facilitating investor comparisons were the sole goal of the electronic-based age securities act that act would have continuous reporting requirements similar to those of the Exchange Act with modest requirements for providing paper bound copies to those investors who lack computer access. This, of course, invites difficult questions regarding the duty of registrants to update their periodic filings⁵⁷ and perhaps some concern for cooling off periods between such an update and the offering of the securities. But the larger concern, discussed in the next section, arises in fulfilling the Securities Act's second goal, the deterrence of fraudulent offerings.

III. WHERE TO PLACE THE SPEED BUMP

Informational efficiency, therefore, provides a useful framework to examine the mechanisms for carrying out the Securities Act's important information dissemination function. However, market efficiency provides no guidance regarding the other objective of the Securities Act, verifying the accuracy of the registrant's disclosures. The verification function arises through section 11 liability and section 12(a)(2)'s discipline of those who commit misrepresentations in promoting the security. The express liability provisions impose their own discipline on the offering process so that investors resorting to the registration statement for self-protection may only be of secondary importance.⁵⁸ To be sure, integrated disclosure does not

57. For an analysis of how the SEC's failure to establish clear guidelines for its registrants' obligations to update and correct information is related to the orderly development of a truly continuous reporting system, see Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753 (1997).

58. See Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences*, 27 VILL. L. REV. 1, 4 (1981) (registration statement and resulting prospectus have dual purpose of promoting security and shielding issuer, underwriters, and others involved in the security's distribution from liability for misrepresentation).

protect investors from following the herd blindly over the cliff, but neither does the Securities Act's traditional registration process. But if a misrepresentation was committed, sections 11 and 12(a)(2) can provide them with a softer landing once they take the plunge.

So viewed, it might be said that the Securities Act is a simple piece of legislation; the Act imposes disclosure obligations and enforces those obligations through its express liability provisions, primarily section 11. It is not just Regulations S-X and S-K that expand the typical registration statement's girth. The private right of investors to sue under section 11 and the general antifraud provision elicit not only defensive disclosures, but quite probably disclosures that are scrubbed by the registrant's attorneys to assure the right flavor of blandness—not too pessimistic and only qualifiedly optimistic. Section 11, together with the SEC's review of registration statements, are the bulwark against deceptive offerings. Though the registrant has a stake in the registration statement being free of material omissions and misstatements because its liability in such case is absolute, the true measure of protection comes by section 11's burdens on the issuer's senior officers and directors, as well as the offering's underwriters and accountants, whose due diligence obligations enlist their professional efforts for the protection of investors.⁵⁹ As among those burdened with section 11 liability, certainly none is more likely to discharge their public obligations with more independence and skill than the issuer's underwriters. Others involved in the security's distribution, though they bear no responsibilities under section 11, are subject to liability for any deception committed by them, either under section 12(a)(2) or the Exchange Act's antifraud provisions, section 10(b) and Rule 10b-5.⁶⁰ Neither of these provisions, however, carries the full protective force

59. Section 11(a) provides an exclusive list of defendants. Senior officers become subject to section 11 by signing the registration statement, and directors are expressly designated as defendants. *See* Securities Act of 1933 § 11(a)(1), (2), 15 U.S.C. § 77k(a)(1), (2) (1994). In 1933, this posed less of an burden on the directors than it does today because, by comparison to contemporary practices, most directors were also officers of the company and, hence, more familiar with the business. Today, section 11 burdens are significant for outside directors whose remoteness from the registrant underscores the need to consider how such directors fulfill their duty to conduct the "reasonable investigation" leg of section 11's due diligence requirement.

60. Before the Supreme Court, in *Lampf, Pleva, Lipkind Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), required that the limitations period for *implied* causes of action equal that for *express* causes of action, litigants could circumvent section 11's shorter limitations period by bringing suit under the Exchange Act's antifraud provision, section 10(b), and Rule 10b-5. *See, e.g.,* *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). After *Gilbertson*, the antifraud provision could expand liability beyond the more narrow group of defendants specified in section 11(a).

that section 11 does, because they do not require, for example, the underwriter to undertake a reasonable investigation or have a reasonable basis for believing the registration statement is free of omissions or misstatements of material fact.⁶¹

It is in section 11's broad protection of investors that we find the greatest impediment to reconfiguring the Securities Act's registration process.⁶² So long as section 11 liability continues to attach to public offerings, the securities registration process will continue to have a transactional focus. For example, though integrated disclosure and even the shelf registration procedures purported to join the registration of securities to the Exchange Act's continuous reporting provisions, data supports the view that registration, even for registrants qualified to use Form S-3, remains an episodic event.⁶³ This occurs because the issuer's, and more importantly its underwriters', section 11 liabilities are set when the Form S-3 registration statement becomes effective. All efforts focus on that moment to assure that materials incorporated by reference into that registration statement are free of material omissions and misstatements. Indeed, the proposals for a company registration system underscores that integrated disclosure remains anchored in a transactionally oriented system, as it has since the Great Depression. The proposed company registration system calls for the filing of an expanded Form 8-K when securities are to be offered to the public. The Advisory Committee's proposals preserve section 11 liability for all the registrant's filings that are connected to the offering, so that its officers', directors', accountants', and underwriters' due diligence obligations extend beyond the narrow confines of the Form 8-K filing.

The Advisory Committee found it useful to consider section 11's connection to the registration of securities as analogous to a speed bump; it is

61. *But see Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980) (underwriter of an unregistered offering held to have a duty under section 12(a)(2) to investigate the offering brochure's financial statements for material omissions and misstatements). *See Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.* 3 F.3d 208 (7th Cir. 1993) (questioning the dicta in *Sanders*). For the view that expanding section 12(a)(2) due care standard to impose a duty to investigate is inconsistent with Congress' intent in drafting section 11, see *John Nuveen & Co. v. Sanders*, 450 U.S. 1005 (1981) (dissent of Justice Powell to denial of cert petition).

62. This is the source of the separate statements by Messrs. Greene and Sonsini and Professor Coffee in the Report of the Advisory Committee on the Capital Formation and Regulatory Processes. *See Report of the Advisory Committee, supra* note 6, at 36-41.

63. *See Report of the Advisory Committee, supra* note 6, app. A, tbl. 2, at 48 (average times during 1994 and 1995 that a Form S-3 and Form S-2 are with the SEC before becoming effective are 9.3 days and 15.6 days, respectively.).

a moment of caution and focus as the issuer drives toward ravenous investors.⁶⁴ The Advisory Committee, following the approach the SEC took earlier with its integrated disclosure initiatives, saw the event of registration as an appropriate time for seasoned issuers to review closely their Exchange Act reports that would be integrated into their Securities Act registration statement. As discussed earlier, integrated disclosure thus had the impact of increasing the quality of an Exchange Act filing by subjecting it, in such transactions, to the due diligence obligations imposed on certain parties by section 11. The Advisory Committee's report affirms its commitment to preserving the speed bump before the public offering of securities, so that a good portion of its report is a discussion of how this can be accomplished in the context of an "evergreen" registration statement.⁶⁵

Three members of the Advisory Committee sounded a cautionary note that the steps to be applied for companies electing to participate in the pilot program would be more burdensome than if the companies carried out their public offerings under the standard integrated offering procedures.⁶⁶ This cautionary qualification no doubt understates the problem. The concern is not simply that optional systems, such as that recommended by the Advisory Committee, will be foregone by issuers that will register their securities under an approach that requires fewer burdens, but that issuers will forego entering the registration system at all because by doing so it incurs known and unknown costs imposed by section 11. As seen earlier, issuers can forego registration, but incur other costs, such as share discounts, by selling their securities in mechanisms that carry explicit or implicit resale restrictions. Thus, by locating the speed bump in the path of an issuer entering capital markets, the bump not only diverts traffic to a back street but fails to achieve the level of protection for those in the path of the speeding issuer. The issuer's successful resort to an exempt means of distributing its securities leaves U.S.-based investors dependent on Exchange Act information for their protection and information sources. This should cause one to wonder whether there is a means to reduce issuer regulatory costs of registering public offerings, enhance the quality of Exchange Act reports, and provide greater investor protection. The following suggest that an electronic-based securities act can make this possible by both redesigning and moving the speed bump.

64. *Id.* at 37 n.4.

65. *Id.* at 29-34.

66. *See* Separate Statement of John C. Coffee, Jr., Edward F. Greene, and Lawrence W. Sonsini., Report of the Advisory Committee, *supra* note 5, at 36.

It may well be that the benefits of section 11 liability are vastly overstated. To be sure, there is great intuitive appeal for the view that the quality of SEC filings policed by section 11 are more likely to be greater than those policed by the antifraud provision, which imposes the less demanding scienter standard for liability in connection with material omissions or misstatements.⁶⁷ Thus, one may reason that the SEC's earlier embrace of integrated disclosure was pro-regulatory and not deregulatory because the SEC's actions raise the quality of Exchange Act filings by raising the level of responsibility to assure that those filings did not include material omissions or misstatements.

In view that the underwriter is the most central figure in the protection section 11 offers for investors, it should be noted that in most cases there may be an even more powerful force protecting investors, namely the underwriter's reputation and its on-going relationship with the investors to whom the securities are offered.⁶⁸ With the increasing institutionalization of the public offering market, established and on-going relationships between underwriters and their institutional clients can be expected to pique the underwriter's interest to review closely the offering and its registrant before selling it to the institution. Section 11 may, of course, be seen as further bonding the underwriter's undertaking to its client; in this sense, section 11 may be rationalized as a convenient "off-the-rack" rule that the parties would have contracted for, if contracting were costless. At the same time, it is equally plausible that the institutional client will be sufficiently resourceful to consider the offering's risks and may well prefer that the registrant's offering costs not include a charge for implicit insurance that the registration statement is not defective.⁶⁹

67. The discontinuity between the liability standards that customarily police Exchange Act filings and the section 11 demands with respect to when such filings are incorporated into registration statements prepared on Forms S-2 and S-3 was a source of great concern when the integrated disclosure system was adopted. *See, e.g.*, Securities Act Release No. 6499, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,449, at 86,335 (Nov. 17, 1983); Edward F. Greene, *Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System*, 56 NOTRE DAME LAW. 755, 787-90 (1981).

68. *See* Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, 785-87 (1972).

69. *See* Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 183 (1984) (if given a choice, investors may prefer not to incur the imputed costs of underwriters' section 11 liability); Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 776-78 (1985) (Section 11 may well frustrate the development of alternative mechanisms by which underwriters provide verification or protection to investors.).

An additional consideration here is that in the process of underwriting, a social hierarchy exists in which higher quality registrants attach themselves to higher quality underwriters.⁷⁰ One would expect that the higher quality underwriters, in general, have a substantial interest in preserving their reputations, so that this provides an independent incentive for such underwriters to scrutinize the registrant and its proposed offering. At the same time, lower quality underwriters have a narrower range of underwritings and, generally, underwriter offerings of lower quality issuers. It may well be that section 11 liability should thus have its greatest role in steeling the resolve of the lower reputation underwriters to assure that full and fair disclosure occurs in connection with the offering. Theory suggests that section 11 liability, or more generally, the scope of liability, should follow a crude spectrum that turns on the reputational quality of the issuer and its underwriters.⁷¹

Setting aside the difficult measurement problem for such a spectrum, there is a need to chasten theory with evidence from the real world. In a recent study of securities fraud action arising from initial public offerings, Professors Bohn and Choi provide several interesting insights.⁷² First, serious underenforcement of section 11 occurs in the case of small public offerings. That is, Professors Bohn's and Choi's data reflect that, though one half of the 3,290 IPOs carried out from 1975 to 1986 were offerings below \$6.71 million, this group accounted for only fourteen of the total 122 liability suits experienced by the entire sample.⁷³ Securities class actions more frequently occur in connection with larger public offerings, no doubt reflecting the class action attorney's need that there be sufficient sums in dispute to provide reasonable compensation for her services. Related to this finding is that the amount raised in an offering is positively correlated to the quality of the issuer and its underwriters.⁷⁴ Consequently, there are few low quality issuers who raise sufficient sums to expose themselves to suit under section 11. More ominously, they found an eighty percent correlation between the reputation of

70. See, e.g., Glen A. Wolfe et. al., *An Analysis of the Underwriter Selection Process for Initial Public Offerings*, 17 J. FIN. RES. 77 (1994) (underwriter reputation positively correlated with issuer risk).

71. For a more sweeping consideration of how liability standards should be stratified depending on issuer quality and size, see Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567 (1997).

72. James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903 (1996).

73. *Id.* tbl. 2.5, at 936.

74. *Id.* tbl. 3.2, at 956.

an offering's underwriters and the suit.⁷⁵ Professors Bohn and Choi explain this finding in terms of the strike suit thesis, namely that high quality underwriters will settle baseless claims by paying a small amount in the suit's settlement, rather than prolong the litigation process which would soil their reputation.

Professors Bohn's and Choi's findings pose interesting policy dilemma regarding the future of section 11. To preserve the action may serve no greater function than to enable others to bludgeon high reputation underwriters to settle questionable private actions. On the other hand, to release high quality underwriters and their issuers from section 11 liability may render section 11 nugatory because lower quality issuers raising smaller amounts through a public offering are, as a practical matter, not an economically viable target for the entrepreneurial class action attorney so that the disciplinary effects of section 11 for such offerings are seriously weakened. This dilemma, however, may tell us less about section 11 than it does about the importance of review carried out by the SEC's staff.⁷⁶ Those subject to section 11's due diligence commands are not the exclusive gatekeepers in this process. Aside from SEC staff review, the current transaction orientation of the securities laws provides further investor protection through the professional services of the issuer's attorneys. And, even though the issuer's attorneys are not subject to section 11 liability, their obligations in the registration process are nevertheless considerable.⁷⁷ Those deeply involved in their client's fraud incur primary participant liability under Rule 10b-5,⁷⁸ the attorney can be disciplined under the SEC's rules of fair practice,⁷⁹ and the attorney may also be subject to SEC enforcement sanctions as the "cause" for her client's violation.⁸⁰ More generally, the attorney's

75. *Id.* at 957-58.

76. See generally Abba D. Poliakoff, *SEC Review: Comfort or Illusion?*, 17 U. BALT. L. REV. 40 (1987). The SEC review process is an important independent check on the quality of the issuer's disclosures. Not all registrants are subject to such review, and those that are reviewed do not receive it with the same intensity. However, the SEC has over the years targeted its attention on the types of registrants it believes are most likely to pose disclosure issues. Again, the larger, more seasoned issuers escape close review, or any review, whereas IPO's and small issuers receive the closest review.

77. See The Association of the Bar of the City of New York, *Report by Special Committee on Lawyers' Role in Securities Transactions*, 32 BUS. LAW. 1879 (1977); Schneider et. al., *supra* note 58.

78. See, e.g., *Molecular Technology Corp. v. Valentine*, 925 F.2d 910 (6th Cir. 1991).

79. Rules of Practice 102(e), 17 C.F.R. § 201.102 (1996).

80. Securities Act of 1933 § 8A, 15 U.S.C. § 77h-1 (1994) (for violations of section 17(a) of the Securities Act); Securities Exchange Act of 1934 § 21C, 15 U.S.C. 78u-3 (1994) (for violations of the antifraud provision of the Exchange Act).

reputational concerns rival those of underwriters, and those concerns are underscored by state professional standards that, in general, proscribe knowing involvement in the client's fraudulent actions. It should also be observed here that the stronger the law firm's reputation the more concerned it will be to preserve that reputation.

Line drawing is hard and, in the end, invariably the separation one makes will be somewhat arbitrary. Hence, the placement of the speed bump will always prove controversial. On this question, the Advisory Committee on the Regulatory and Capital Formation Processes essentially punted. The Advisory Committee recommended a "pilot program" for the proposed company registration system limited to those with an equity float of \$75 million. At the same time, the Advisory Committee believed there was no need to relieve such registrants of their section 11 liability. Instead, the Advisory Committee speculated that systems could be developed that would fulfill the demands of section 11 with respect to information contained in its Exchange Act filings.⁸¹

There appears little justification to adopt a far reaching registration procedure, such as that recommended by the Advisory Committee, while continuing a liability regime that is anchored in the 1933 transaction-oriented system, at least not without some profile of the companies whose registration statements are defective. On this point, consider the extensive data gathered by the Advisory Committee bearing on so many aspects of the registration process, including costs, review time and offering size.⁸² However, the Advisory Committee did not collect any empirical data bearing on the incidence or profile of companies whose registration statements were misleading. We may speculate what the regulatory response would be if it were determined that a very small percentage of reporting companies that undertake public offerings have misleading registration statements, whereas approximately ten percent of IPO offerings under \$15 million have misleading registration statements.⁸³ Data along these lines would greatly inform policy makers regarding the desirability of imposing section 11 liability on all registrants. Such data was apparently not before the Advisory

81. Among the "disclosure enhancements" called for by the Advisory Committee are top management certifications of the completeness of the registrant's Forms 10-K and 10-Q, expansive management reports to the registrant's audit committee, and expanded presentations of risk factors. See Report of the Advisory Committee, *supra* note 6, at 29-31.

82. See *id.* app. A.

83. See *supra* notes 62-65 and accompanying text for a summary of Bohn & Choi's data.

Committee.

IV. CONCLUSION: A PROPOSAL FOR REDESIGN

The benefits of the securities laws imposing speed bumps that require a close review of the registrant's public disclosures appear beyond dispute. What is in doubt is whether their costs exceed their benefits. The point of the preceding was to suggest that whatever the balance of this social equation the cost considerations are greatly exacerbated when the defining moment of the speed bump is the public offering of securities. When it is the public offering of securities that triggers section 11 liability concerns, and the attendant costs of internal and SEC review, the attraction of the Securities Act's exemptions are like the Sirens calling Ulysses to the shoals. Though the desirability of a speed bump for the unseasoned issuer is easy to justify, imposing a like burden in the path of every issuer that seeks additional capital is more questionable. The regulatory challenge, therefore, appears to be two-fold: identifying which issuers should be relieved of section 11 responsibilities as we know them today and defining what responsibilities this lucky group of issuers should have with respect to their public disclosures.

A truly continuous reporting system should provide for the periodic close review of filings made with the SEC. This process need not occur yearly, but should occur periodically, perhaps every third year. This approach would appear to fulfill the goals of the Advisory Committee of enhancing the quality of public disclosures by expanding section 11 standards to Exchange Act reports. And, a true continuous reporting system would liberate the capital-raising process from section 11 so that decisions on whether and how to raise capital would not be compounded by the vagaries of section 11 liability. However, it would be unwise to excuse all issuers from the scope of section 11. Even though section 11's burdens are probably heavier for this group of issuers than for their more seasoned counterparts, it is just such a group of issuers where we would expect the greatest disclosure problems may lurk in the shadows of documents that otherwise were subject to only a scienter-based standard of fault. The suggestion here is to preserve the section 11 liability for seasoned issuers, but not have that liability arise in connection with the registration of securities. Public offerings by untested or financially distressed issuers⁸⁴ should continue to be subjected to section 11.

84. The eligibility requirements of SEC Forms S-2 and S-3, conditioning eligibility to use the

It would appear reasonable that the electronic-based securities act would impose section 11 liability on offerings by companies that are *not* subject to the Exchange Act's continuous reporting requirements, as well as reporting companies that have been subject to financial distress within the past twelve months.⁸⁵ Admittedly, this treatment is founded solely on the intuitive belief that there are many fewer external mechanisms for unseasoned companies that exist which can protect investors from fraudulent or ill-conceived ventures and that the management of companies experiencing serious financial distress has powerful incentives to mislead investors.⁸⁶ Thus, the current regulatory system would hardly be changed for this group of registrants.

The more seasoned registrants, under an electronic-based securities act, could find the current section 11 responsibilities spread over an interval of time with only mild section 11 interest being piqued by the public offering of securities. Section 11's current liability standards for the issuer and its officers, directors, and underwriters would apply to the reconfigured transaction-specific information. "Due diligence" responsibilities would extend not only to information bearing on the offering's terms and arrangements with the underwriters, but more importantly, on the use of the proceeds and a description of unusual risks facing the issuer in its business. The preservation of section 11 for unusual risks facing the issuer is intended to identify generally the type of information that the underwriter is likely to consider in deciding whether to associate its reputation with the offering. That is, the all-important role of the underwriter's due diligence requirement is preserved for the type of inquiry the underwriters are likely to undertake in considering its involvement in the offering. Neither its due diligence obligation, nor that of others, will extend to many other areas that are

integrated disclosure system on having been a reporting company for at least 36 months, or 12 months with a public float above \$75 million, may offer guidance to issuers. Form S-2, *supra* note 50, General Instructions I.C., at 7172; Form S-3, *supra* note 51, General Instructions I.A.3. & I.B.1., at 7182-83. Each imposes its own financial distress requirements by limiting eligibility to firms that have not defaulted or failed with respect to lease payments, preferred dividend requirements, or interest on long-term debt. See Form S-2, *supra* note 50, General Instructions I.D., at 7172; Form S-3, *supra* note 51, General Instructions I.A.5., at 7182.

85. The Advisory Committee prescribed a two-year window which may well be desirable. The one-year window suggested here is currently required for companies to be eligible to use Form S-3.

86. See Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 725 (Two-thirds of fraud on the market cases in the 1975-90 sample involved managers purposely presenting a false impression of success during a period of extreme financial distress for the firm.).

included in the registration statements. Similarly, the due diligence obligation of accountants for their certified financial statements continues because this merely mirrors their professional obligations to the registrant. However, we propose that the accountants' responsibility is set when they issue their certification, and not, as presently is the case, when the registration statement becomes effective. This effectively places much more importance on management's intervening interim reports, for which the issuer's senior officers and directors will become liable only if they fail to meet the "had no reasonable ground to believe and did not believe" standard that currently applies for such person's responsibility with respect to expertised portions⁸⁷ of the registration statement.⁸⁸

The final component of this liability regime would be the triennial requirement that all reporting companies submit a Form 10-K, for which due diligence requirements for the registrant, as well as its senior officers and directors, would attach to most portions of the disclosed information. The exact portions of the triennial report that would be exempt from such due diligence are best left for extended discussion within and without the SEC. One could argue that those portions of the report that elicit forward-looking information, like the current Management Discussion and Analysis of Item 303 of Regulation S-K, should be immune from a due diligence standard, such as that presently embodied in section 11. However, both the "bespeaks caution" doctrine and the statutory safe harbor for forward-looking information would appear sufficiently broad to provide issuers protection so that the effective costs of including such statements are within a due diligence review. This would be justified by the view that section 11-like liability should attach only to those historical or factual representations that are more easily verifiable, thus enhancing the administrability of the new system. In addition, by lifting section 11 liability for such disclosures, an important subsidy is provided that will more likely elicit this type of information, albeit surrounded by cautionary language sufficient to meet prevailing safe-harbor standards. As for other areas that would be exempt, this should reflect the Commission's cautious judgment. However, the Commission must be

87. The issuer's liability would arise vicariously through either respondeat superior liability, *see, e.g.,* *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980), or as a control person of its officers and directors, Securities Act of 1933 § 15, 15 U.S.C. § 77o (1994). It would not have absolute liability for such material misrepresentations as it does now. *See* Securities Act of 1933 § 11(b), 15 U.S.C. § 77k(b) (1994).

88. Securities Act of 1933 § 11(b)(3)(C), 15 U.S.C. § 77k(b)(3)(C) (1994).

mindful that the effect of this proposal is to expand significantly the quality of section 11 policed information because the recommendation set forth calls for triennial review of all Exchange Act reports under section 11 standards.

With speed bumps recontoured and repositioned, regulation could then better complement the filtration of information about registrants through the electronic-based securities act. Dissemination would occur through the mediums that are sought by investors and market professionals. Of course, the above liability standards are not based nearly as much on whether the registrant is traded in an efficient market, but on more paternalistic concerns of whether the registrant falls within the profile of the type of company that poses a serious disclosure risk to investors, such as being unseasoned or recently suffering some observable financial distress. Thus, the computer, even if not invented by Theodore Roosevelt, is a mere messenger. The content of the message is very much shaped by close consideration of the reasonableness of the regulatory burdens to be imposed on registrants. Under an electronic-based securities act, the burdens will be greater, as all registrants will undergo periodic due diligence reviews of their SEC filings, but the cost of this additional burden will not be triggered by the the act of raising capital.