TOWARD DISCLOSURE CHOICE IN
SECURITIES OFFERINGS

Alan R. Palmier

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* Professor of Law, Wake Forest University School of Law. Feel
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I. INTRODUCTION

U.S. securities regulation is mandatory. So goes the refrain. But is it still true? Over the last two decades, a fundamental rethinking of the federal laws that govern securities offerings has eroded the mandatory nature of secu-

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rities regulation. The new reality is that firms, in burgeonning contexts, can raise investment capital without subjecting themselves to the Securities and Exchange Commission's ("SEC") full-blown disclosure requirements or the heightened antifraud standards of the Securities Act of 1933 (the "Securities Act"). Underlying this regulatory transformation has been a subtle, but powerful rethinking of the twin tenets that have animated securities regulation for more than half a century — namely, manager informational shirking and investor helplessness. No longer can managers, if they ever could, dictate the informational terms on which their firms raise capital. More important, the prototypical investor is no longer our helpless and guileless grandmother, but has become instead our connected and savvy rich uncle.

As the story of market failure recedes, deconstruction of mandatory disclosure in securities offerings proceeds apace — though without significant change to the essential structure or language of the enabling legislation. In the hands of the SEC and the federal courts; abetted by Congress, the Securities Act of 1933 has become a shadow of its original regulatory self. As a positive matter, this article asserts that federal regulation of securities offerings has come to accept party choice more than articulated regulatory policy and academic criticism acknowledge. The Securities Act, as deconstructed, turns out to be a malleable vessel into which a newly emerging deregulatory philosophy is being poured. Issuers can now choose from among a richly-layered set of disclosure levels and methods in offering their securities to

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2 Recently, the SEC has proposed sweeping reforms to its rules governing securities offerings. The Regulation of Securities Offerings, Securities Act Release No. 7606A, 63 Fed. Reg. 67,174 (Dec. 4, 1998), available at <http://www.sec.gov/rules/proposed/337606a1.txt> [hereinafter Aircraft Carrier Proposal]. The proposal would undertake the most significant reforms to the securities offering process since 1933. The SEC proposes to change disclosure requirements in its registration statement forms, prospectus delivery rules, rules governing pre-offering communications, rules governing the integration of private and public offerings, and periodic disclosure requirements.
public investors. And using devices fostered by an administrative, judicial and legislative revisionism, they can avoid the disclosure warranties of heightened antifraud liability. Yet not all is disclosure avoidance. Despite the availability of choice, there is strong evidence that investor informational demands often propel issuers to provide disclosure at levels beyond that mandated — as a private, contractual matter.

As a normative matter, this article proposes the adoption of an enabling legal structure in which issuers can choose the disclosure level appropriate for their securities offerings. (I limit my proposal to securities offerings, not ongoing disclosure by publicly-traded companies to trading markets.) Just as U.S. corporate law over the last century has become largely facilitative, enabling corporate managers with investor concurrence to tailor virtually all aspects of their state-based relationships, securities regulation of capital formation should be seen as a subset of the private ordering by capital users and providers. Intermediated by markets and securities professionals, the disclosure aspects of the issuer-investor relationship in securities offerings should be a matter of choice, giving issuers the latitude to supply the firm-specific information that investors demand and are willing to pay for.

This is not to say that securities regulation should be abandoned or turned over to the state-based corporate regime. Federal disclosure rules have a continuing and invaluable role, largely deriving from the bifurcation of U.S. corporate law and securities law 65 years ago. The path we have taken is relevant. SEC disclosure forms can and should continue to evolve as a set of options in which issuers choose the level of disclosure and liability sought by investors — ranging from full-fledged "SEC certified" mandatory disclosure with warranty-like antifraud liability to

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"non-certified" disclosure subject only to minimal antifraud liability.

Consider the advantages of a system of disclosure choice with the SEC as form-giver. For many issuers, particularly start-up companies with limited capital needs or that seek to target particular investors, disclosure choice would open a broader range of financing options. For example, an issuer able to attract investors with only Regulation D disclosure, but unable to meet all the exemptive conditions, could choose this optimal disclosure. Larger issuers seeking to raise money in offerings to public investors, where institutional participation signaled sufficient veracity, could opt out of SEC registration and thus minimize the offering costs. For many firms — and investors — the costs of one-size mandatory disclosure are unwarranted and often unwanted.

The case for disclosure choice in securities offerings finds support in the behavior of investors and issuers in primary markets. U.S. issuers have increasingly shunned public offerings in favor of private offerings to avoid the costs of mandatory disclosure and heightened liability. But

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5 Party choice exists in other regulated markets. For example, vehicle purchasers unwilling to pay for the government-mandated safety features required for passenger cars can purchase a truck. Yet sellers of minivans (classified as trucks) have found that in selling to safety-conscious minivan buyers, they must signal that their minivans meet or exceed government safety requirements for automobiles. Minivan manufacturers have opted into automobile safety standards, which function as a kind of "government certification" useful in signaling minivan safety to minivan purchasers.

6 According to Securities Data Company, the deal value of Rule 144A private placements in 1997 was $254.4 billion, approximately $83 billion of which was raised by foreign issuers. See Lisa Tibbitts, Private Placement Volume Explodes as Structured Deals Rule 144A Market, INVESTMENT DEALERS' DIGEST, at 12 (Feb. 2, 1998).

This movement to private markets has been particularly true for municipal securities. See Lynn Stevens Hume, SEC Disclosure Rule Evasions Described at MSRB Forum, THE BOND BUYER, at 1 (Nov. 13, 1998) (reporting an increase in the number of private placements in the municipal market); 1997 Logs Record Issuance of Municipal Privates, PRIVATE PLACEMENT REP., Mar. 30, 1998, at 1, available in 1998 WL
in making private offerings, many issuers disclose voluntarily at the same or higher levels compared to regulated registered offerings.\textsuperscript{7} Moreover, issuers in public offerings often disclose information voluntarily beyond that required so as to increase investor confidence.\textsuperscript{8} In short, the disclosure demands of investors and their intermediaries — not the distortions of mandatory disclosure — govern the supply of information in securities offerings.

Ultimately, though, a system of disclosure choice must rest on a mandatory informational floor. Whether the law of deceit reflects inefficiencies in contracting\textsuperscript{9} or merely embodies the non-negotiable terms that parties would have bargained for costlessly,\textsuperscript{10} investors seem universally willing to pay for some level of informational pledge. Although legal recourse may be expensive and infrequent, such pledges provide a tangible protection against issuer opportunism.\textsuperscript{11}

\footnotesize{5034722 (reporting that municipal issuers, as well as underwriters and insurers in municipal offerings, are not interested in the lengthy disclosure process of a public offering, and in "current age of disclosure" private placements are more prevalent compared to ten years ago).


\textsuperscript{8} See, e.g., Richard Frankel et al., \textit{Discretionary Disclosure and External Financing}, 70 ACCT. REV. 135 (1995) (finding that firms are significantly more likely to forecast earnings if they access capital markets over sample period).

\textsuperscript{9} See Ian Ayres, \textit{The Possibility of Inefficient Corporate Contracts}, 60 U. CIN. L. REV. 387, 390 (1991) [hereinafter Ayres, \textit{Inefficient Corporate Contracts}] ("[S]trategic interactions may lead to inefficient corporate contracting (a) even in a world where there are numerous shareholder/investors competing to make investments and (b) even when it is costless to contract around a given default.").

\textsuperscript{10} See Jeffrey N. Gordon, \textit{The Mandatory Structure of Corporate Law}, 89 COLUM. L. REV. 1549, 1556 (1989) (asserting that mandatory rules are what parties would not contract around given the unifying nature of mandatory terms, the credibility they offer when created by legislative mandate, and the protection they offer against opportunistic amendment).

\textsuperscript{11} Ronald Mann, \textit{Informational Technology and Institutions for Verifying Information} (working paper on file with author) (doubting "di-
This function, I assert, can be performed well by Rule 10b-5 fraud liability — the remarkably malleable set of *ex post* disclosure standards created by federal courts over the last fifty years. As recent judicial experience in Delaware with proxy fraud litigation demonstrates, it is possible to build an effective disclosure scheme based on *ex post* enforcement unaccompanied by *ex ante* line-item or review requirements.\(^\text{12}\)

This proposal for disclosure choice calls on the SEC to use its broad exemptive powers to permit issuers to choose "no-registration" status for any securities offering. As a condition of opting out, issuers making a public offering would be required to provide investors (and the SEC) a cover sheet with disclosure along the following lines:

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This offering has not been registered with the Securities and Exchange Commission. Instead, the issuer has elected to provide disclosure in accordance with the standards of...
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Such opt-out disclosure might be even more cautioning than that provided through the current registration scheme and its comforting (though impenetrable) prospectus. Investors rely on a rich variety of non-prospectus signaling devices — principally from securities professionals and markets — in making investment decisions. Disclosure choice would shine the spotlight, even more brightly, on those who provide securities intermediation.

The article proceeds in three stages. I first explore the regulatory tenets upon which federal regulation of securities offerings has been constructed. These tenets, question-

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able from the beginning, have become even more suspect with the maturation of securities investors and intermediaries, the increasing institutionalization of investor ownership, and the globalization of securities markets. The case for market failure in securities offerings, if ever valid, is today largely rhetorical.

Second, I describe the ongoing deconstruction of mandatory disclosure in securities offerings by the SEC, the federal courts, and Congress. At an administrative level, the SEC has undertaken to lessen the burden of mandatory disclosure by offering a variety of disclosure options to public issuers and exempting many smaller offerings from full-blown registration. The SEC's recent "aircraft carrier" proposal is the latest, though misguided, effort at increasing disclosure choice in securities offerings. A rethinking of investor informational needs, particularly as applied to foreign securities, has come to permeate the SEC's agenda. At a judicial level, federal courts have, perhaps, been even more deregulatory. The judicial privatization of antifraud litigation, exemplified by the "bespeaks caution" doctrine and the recognition of private waivers of liability rights, reflects deep doubts about the tenets of securities regulation. At a legislative level, Congress has confirmed some of this revisionism. Its reforms of the standards and procedures in securities-fraud class actions, as well as its recent assaults on state "blue sky" regulation, illustrate growing congressional doubts about mandatory regulation of securities offerings.

Third, I outline my proposal for disclosure choice in securities offerings. Issuers choosing "no-registration" status would be exempt from ex ante disclosure regulation, subject only to market forces that shape issuer disclosure incentives in securities offerings and ex post liability under the adaptable Rule 10b-5 antifraud scheme. I consider the suf-

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Aircraft Carrier Proposal, supra note 2, at 67,181-86 (proposing, among other things, that larger seasoned issuers would have discretion in choosing the level of disclosure in the selling document delivered to investors, given the particular offering and the market demands for information).
ficiency of these market-based incentives and the lessons for a regime of disclosure choice that can be gleaned from state charter competition and international securities regulatory competition. Finally, I consider the adequacy of Rule 10b-5 antifraud liability as a disclosure floor. I conclude that federal regulation of securities offerings is ready for the next step.

II. Tenets Of "Truth In Securities"

The Securities Act of 1933 regulates securities offerings to public investors by combining mandatory ex ante disclosure to investors and market intermediaries, administrative clearance, and heightened ex post fraud liability. This "truth in securities" regime assumes that without mandatory disclosure, issuers, driven by natural venality, will withhold or misrepresent critical information, public investors will be powerless to overcome their informational and bargaining disadvantages, and securities intermediaries will adhere to custom and align themselves with client-issuers to the disadvantage of customer-investors. Mandatory disclosure, buttressed by administrative review and potent judicial remedies, is seen as necessary to equalize an unequal issuer-investor relationship — a market failure.\footnote{See Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966).}

Even on cursory inspection, this regime is remarkable. No other investments — real estate, commodities, labor, education — are subject to the intensive disclosure rules and regulatory mechanisms imposed by federal law for securities offerings. We allow ourselves the freedom to buy swampland, to obsess on collectibles and precious metals, to fritter away our human capital on mendacious employers,\footnote{See Kent Greenfield, The Unjustified Absence of Federal Fraud Protection in the Labor Market, 107 YALE L.J. 715 (1997) (recommending federal antifraud regime for disclosure by employers to employees).} and to commit our children's future to the wrong university — all without federal oversight. Are securities offerings different? The story of market failure and the tenets used
to justify mandatory disclosure in securities offerings, perhaps once plausible, are today feeble.

A. Federal Regulation of Securities Offerings

The Securities Act — essentially unchanged over the last 65 years — mandates the chronology, content and liability implications for securities offerings to public investors.¹⁶

Submission of disclosure document. The issuer prepares and submits to the SEC for agency review a detailed document (registration statement) disclosing the terms of the offering, the nature of the issuer’s business (including management’s discussion of future trends), the issuer’s financial history (audited by an independent accountant), the terms of the offering, and the nature of any prior offerings.

Controlled dissemination of information. During an interim waiting period, the core of the registration statement (a preliminary prospectus) is distributed to prospective investors and securities intermediaries. The issuer during this period can "test the waters" of investor interest, but cannot yet sell; prior testing is prohibited.

Agency supervision and permission. SEC staff reviews the registration statement and, under agency practice grafted into the statute, the offering can proceed only after administrative clearance pursuant to the SEC's power to accelerate the registration's effectiveness. The SEC can comment and even stop an offering based on the adequacy of disclosure, but not on the merits of the offering.

Prompt distribution of securities. Upon effectiveness, the registered securities must be promptly distributed to all investors, accompanied by a final prospectus. During distribution, prospectus dissemination must be effected by the issuer, underwriters, and participating securities firms.

Heightened liability. Under the private liability scheme for registered offerings, the issuer warrants to investors the accuracy and completeness of material information in the disclosure document. This disclosure warranty is relaxed for non-issuer defendants — namely the issuer's directors, its principal officers, the offering's underwriters, and experts (such as accountants) — who can avoid liability by establishing their "due diligence." Liability may be imposed in private litigation by purchasers in the offering. The SEC can also seek to enjoin or impose penalties on false or misleading offerings, without a showing of culpability.

This regulatory scheme cannot be avoided by consent: any stipulation waiving compliance with the federal protections is void. Yet federal regulation applies only to public offerings. For offerings by an issuer "not involving a public offering," the federal regime imposes neither mandatory disclosure nor agency review nor even explicit heightened liability. The functioning of private issuer-investor markets and the ability of private investors to bargain for disclosure and informational assurances, Congress assumed, render mandatory disclosure and heightened liability superfluous. Those who can "fend for themselves," the Securities Act supposes, will replicate regulatory protections privately through the contracting process and reliance on background antifraud standards.

The costs of mandatory disclosure in securities offerings, borne ultimately by investors,\(^{21}\) are imposing. There are direct costs: the issuer pays for assembling mandatory information, retaining accountants to certify financial information, and hiring inside and outside lawyers to format and present it. There are indirect opportunity costs: compliance with mandatory disclosure diverts management attention from the issuer's business; protracted regulatory approval, typically in excess of two months, delays the issuer's access to capital and increases its capital costs. Regulatory compliance imposes competitive costs: public disclosure, ostensibly meant for investors, can harm the issuer's business when used by competitors, particularly privately-held competitors that do not make reciprocal public disclosures. And there are liability costs: public offerings expose issuers (and their shareholders) to fraud litigation that overreacts to misinformation, thus chilling public offerings and the beneficial disclosure of "soft" and other non-testable information; underwriters, accountants, and other participants pass on their liability costs to the issuer in the form of higher fees; mandated issuer warranties and "due diligence" verification in public offerings further chills the production of information.\(^{22}\)

The benefits of the Securities Act's registration system are less clear. Two well-known studies suggest that the introduction of mandatory disclosure in securities offerings may not have improved pricing accuracy, though it seemed to discourage smaller, more volatile offerings. In the first study, George Stigler looked at returns to investors in new issues before and after the 1933 Securities Act.\(^{23}\) Stigler's

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\(^{23}\) See George Stigler, Public Regulation of the Securities Market, 37 J. BUS. 117 (1964). A recent study by Carol Simon largely confirms Stigler's study, finding no significant return effects in most categories of pre-Securities Act and post-Securities Act issues. See Carol J. Simon, The Effect of the 1933 Securities Act on Investor Information and the
study, which was based on market prices for new issues, computed the performance over time of new issues compared to the market as a whole. The study compared new issues made during the period from 1923-1927 with new issues in 1949-1955. For both periods, investors in new issues lost money compared to the market, with no statistically significant difference in their losses. In addition, the standard deviation of investor profits was much lower for the 1949-1955 period compared to the 1923-1927 period, suggesting to Stigler that the effect of the securities laws had been to exclude some small firms from the market. In another study, Gregg Jarrell compared returns for the years immediately before and after the Securities Act.\(^2\) The study looked not only at returns compared to the market, but also adjusted the returns to take into account the issues' volatility (a measure of risk). Comparing the five-year period before the Securities Act with the five-year period after its enactment and holding risk constant, Jarrell found that issues in neither period were overpriced compared to the market, and issues in 1926-1933 were actually

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*Performance of New Issues*, 79 AM. ECON. REV. 295 (1989). Simon's study did, however, find improved pricing accuracy in one subset of post-Act offerings, namely offerings by unseasoned issuers (mostly IPOs) on regional exchanges. Post-Act offerings in this subset showed greater returns than had pre-Act offerings, suggesting that pre-Act offerings by smaller unseasoned issuers were relatively mispriced. The relevance of these data, however, is unclear. They may indicate merely that securities intermediation improved after 1933, a tribute probably more to Exchange Act regulation than Securities Act disclosure. The data might also reflect only that fewer high-risk issues by unseasoned issuers went to market after the Securities Act, resulting in relatively better returns for the post-Act issues as a group. Moreover, as Professor Romano has pointed out, issues by unseasoned issuers on regional exchanges both before and after the Securities Act performed significantly worse than other new issues. See Romano, *Empowering Investors*, supra note 4, at 2377 n.47. That is, even if mandatory disclosure had a positive effect on accurate pricing in this subgroup, it was hardly optimal. In the end, the data's relevance would seem particularly limited today given the changes in securities intermediation and institutional investment.

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underpriced compared to the market. His study, however, confirmed Stigler's finding of a substantial reduction in volatility after the passage of the Securities Act — a reduction in risk.

The studies are nonetheless inconclusive on the value of the Securities Act in enhancing pricing accuracy. They conflate the effects of regulation of offerings under the Securities Act and regulation under the Securities Exchange Act of 1934 (the "Exchange Act") of market intermediaries and ongoing corporate disclosure.\footnote{Compare Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. CORP. L. 1, 2-9 (1983) (using historical research to argue that mandatory disclosure has led to less concealment and misrepresentation, reduced underwriters' compensation, and increased public confidence in the securities markets by reducing volatility). The benefits that Dean Seligman identifies stem as much, if not more, from the Exchange Act's program of corporate transparency and federal antifraud liability than episodic Securities Act disclosures.} It is entirely possible, perhaps probable, that regulation of ongoing disclosure and industry practices in secondary markets promoted pricing accuracy in securities offerings more than mandatory disclosure in primary markets.\footnote{See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 711.} Yet the studies strongly suggest that from the beginning the Securities Act drove certain issuers out of public markets, the Act's regulatory costs exceeding its benefits. Significantly, the studies do not support a conclusion that mandatory disclosure in securities offerings conclusively produces more pricing accuracy than does disclosure choice buttressed by antifraud liability and securities industry regulation.

Aside from the market effects of the Securities Act, it is important to put the legislation in its historical context. The Securities Act, which deals narrowly with public securities offerings, left for another day the regulation of bargaining and informational asymmetries arising in securities trading markets and investor dealings with securities intermediaries. The Exchange Act added, with significant subsequent congressional accretions, regulation aimed at
securities trading. In addition, the Exchange Act, along with the Investment Company Act of 1940 and the Investment Advisers Act of 1940, addressed the particular structure and practices of securities intermediaries.

Although this later federal regulation proceeded on the same premise of issuer (or intermediary) overreaching and investor helplessness, Congress did not limit the regulatory antidote to disclosure. Market regulation from the beginning has been more substantive — prohibiting certain transactions, creating automatic liability for others, and imposing operating standards on securities intermediaries sometimes as a matter of self-regulation and sometimes by mandatory federal rule. Unlike the Securities Act which assumes that mandatory disclosure and heightened antifraud liability are largely sufficient for investor protection, federal regulation of market trading reflects the understanding that disclosure alone is inadequate against market abuses. For example, the Exchange Act regulates particular market practices by insiders (such as stock manipulation and short-swing insider trading) by prohibiting the behavior, imposing strict liability, or both — rather than through disclosure.27 Moreover, while the history of the Securities Act has been characterized by incremental deregulation, the history of the Exchange Act (and its regulation of securities markets and intermediaries) has been characterized by incremental regulatory extensions.

Subsequent federal securities legislation also addressed matters of issuer-investor relations in non-offering contexts. For issuers whose securities are publicly traded, the Exchange Act mandates that issuers provide ongoing, periodic disclosure to securities markets. This disclosure is not linked to any particular capital raising activity, such as the issuance of securities, and thus has the characteristics of a public good. Although valuable in reducing research costs, it is likely to be under- and over-produced by traders in the

27 See Palmiter, Securities Regulation, supra note 16, at 228-29 (discussing the regulation of market manipulation); see id. at 319-32 (discussing short-swing disgorgement for insider trading).
absence of disclosure mandates. The classic economic defense of mandatory disclosure focuses on the value of post-offering ongoing disclosure to securities analysts whose advice to institutional and individual investors drives stock pricing.

B. Tenets of Mandatory Disclosure: A Contemporary Appraisal

The value of a security, perhaps more than any other commodity, depends on information within the control of the commodity's producer. The avowed purpose of the Securities Act is to make available to investors the same company-specific information known to issuers' management. Built on the assumption of market failure in securities offerings, the syllogism for mandatory disclosure proceeds as follows:

Premises

1. Management knows more about the issuer and its prospects than do investors.

28 See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 681-82 (arguing that absent issuer disclosure, investors under-produce information if its collective value is less than its individual marginal cost, and investors over-produce information because of needless redundancy and trying to "beat the market").

29 See John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 729 (1984) [hereinafter Coffee, Mandatory Disclosure] (describing the importance of ongoing corporate disclosure to securities analysts and concluding it is "no surprise that the professional investment community has long supported the continuous disclosure system of the '34 Act: to them the system implies cost savings").

30 See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir.), cert. denied, 394 U.S. 976 (1969) ("The only regulatory objective is that access to material information be enjoyed equally, . . . so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.").

31 The literature is extensive. See, e.g., H. Nejat Seyhun, The Effectiveness of the Insider-Trading Sanctions, 35 J.L. & ECON. 149, 158-167 (1992) (documenting abnormal profits from trading by insiders); Bala
2. Disclosure by management enables investors to more accurately price expected returns and risks, and thus distinguish between good and bad investments.  

3. Disclosure cannot be left to private contracting since managers cannot be counted on to voluntarily disclose price-sensitive information, particularly bad news or revelations embarrassing to management; investors cannot be expected to demand the information they need.

Conclusion

Therefore, to ensure accurate pricing and proper capital allocation, disclosure must be compelled through a system of \textit{ex ante} government mandates and supervision, as well as heightened \textit{ex post} private liability and government enforcement.

This syllogism rests on flawed premises. It assumes that public investors are irrational and helpless, but will behave rationally once adequately informed, with the help of securities professionals. It assumes that without \textit{ex ante} disclosure mandates, issuers in public offerings will not voluntarily disclose at adequate levels. It assumes the SEC can balance, better than the process of issuer-investor bargaining, the costs and benefits of \textit{ex ante} disclosure levels. Finally, it assumes heightened \textit{ex post} fraud liability is necessary to create incentives for optimal disclosure by issuers and fair dealing by offering intermediaries.

\begin{itemize}
  \item Dharan \& David Ikenberry, \textit{The Long-Run Negative Drift of Post-Listing Stock Returns}, 50 J. FIN. 1547 (1995) (finding that stock returns are generally worse than the market after a firm moves trading of its stock to the American or New York Stock Exchange, apparently since managers time the listing prior to decline in performance).
  \item See Coffee, \textit{Mandatory Disclosure}, supra note 29, at 717-753.
\end{itemize}
1. Investor helplessness and the role of market intermediaries

The Securities Act assumption that public investors are gullible, helpless speculators\(^\text{34}\) transformed by the mandated prospectus into disciplined investors capable of accurate pricing and prudent judgment is remarkable, to say the least. The implausibility of this transformation was recognized early.\(^\text{35}\) Given that most public investors are unlikely to actually read and grasp the stylized prospectus, mandatory disclosure has been justified as a way for market intermediaries to receive standardized and certified information.\(^\text{36}\)

Intermediaries function at two levels. Those that sell the offering (underwriters and retail broker-dealers) use mandatory disclosure to price the offered securities, gauge their own commitment in the offering, and advise investors on risk and return suitability.\(^\text{37}\) If the disclosure proves

\(^{34}\) See William O. Douglas, Protecting the Investor, 23 YALE L.J. 508, 523-24 (1933) (concluding that typical investors lack "training or intelligence" to assimilate information in registration statement).


\(^{36}\) Even the SEC has acknowledged the discomfiting truth: [M]any investors never read a prospectus, even when . . . provided to them well in advance of an investment decision. Significantly, however, the prospectus was available if investors wanted it and many investors who did not read prospectuses relied upon their brokers and advisers, who had received and reviewed the disclosure documents and could therefore assist the investor in making informed judgments.


\(^{37}\) At the core of the selling intermediaries' role are securities analysts. The Securities Act, along with the other federal securities laws, has fulfilled its promise of fomenting the securities analyst as a buffer
false, the registration document then frames litigation whose effect in significant part deters these intermediaries from selling overly-risky or mispriced offerings. Other intermediaries (institutional investors such as pension funds, mutual funds, banks, and insurance companies) buy securities offerings. Mandated disclosure to institutional investors, when it happens as part of a public offering, replicates the disclosure that these investors demand and receive in private offerings. Non-institutional investors rely on the informational demands and vigilance of their institutional counterparts.

Intermediated investment, over time, has weakened the Securities Act syllogism. First, the growth of institutional investment has led to a relative decline in registered offerings. Individual investors, the object of Securities Act protection, have more intermediated investment choices and can delegate their investment decisions. Second, institutional investors have increased the efficiency of securities markets, allowing individual investors to rely on market pricing mechanisms. Whether an offering is by a seasoned company or one going public, the offered securities will be priced by (or the issuer will take into account) institutional investors whose investment decisions are informed by securities analysts. Third, those individual investors who have not turned to intermediated investment have proved increasingly sophisticated, in part because of the greater access to securities analysis generated by institutional in-

between issuers and investors. See Coffee, Mandatory Disclosure, supra note 29, at 723-24 (describing the advent and functions of securities analysis in obtaining and testing exogenous and endogenous information relevant to securities pricing).

See, e.g., Sources of Funds for Private Placements More Plentiful Than Ever, BUS. WIRE, available in WESTLAW, BWIRE database (Jan. 14, 1999) (according to Securities Data Co., the total capital raised for private equity investments rose from $6.6 billion in 1985 to $75.1 billion in 1997); Aaron Lucchetti, Firms Choose Private Funds Over IPOs, WALL ST. J., Oct 19, 1998, at C1.
vestment. Despite frequent hand-wringing by the SEC and others favoring securities regulation, there is no empirical evidence that individual investors, aided by professional advice and other sources of information, are systematically less capable of making well-priced, prudent investment choices compared to professional investors.

More important, intermediation exposes the fundamental anomaly of the mandatory disclosure syllogism. The syllogism assumes individual investors, armed with adequate information and professional advice, have both the sophistication and the discipline to make rational investment choices. Indeed, Congress rejected regulation that would have given government officials authority to decide the merits of particular investments. Yet, mandatory disclosure assumes that these same investors, capable of investing rationally once informed and advised, are too undisciplined to insist on adequate disclosure or informational warranties. That is, the Securities Act leaves to well-advised public investors the prerogative to move capital to its optimal uses, but not to discount or simply refuse securi-

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39 See Rebecca Buckman, Cyber-Sleuths: Dogged on-Line Investors Are SEC's Top Source in Internet Probes, WALL ST. J., Aug. 4, 1998, at C1 (reporting that individual investors often provide detailed and well-researched information on Internet frauds).

40 See Greg Ip, Keeping the Faith: This Market Comeback is Brought to You by Individual Investors, WALL ST. J., Feb. 10, 1998, at A1 (describing purchasing by individual investors after 7.2% drop in Dow Industrials on October 27, 1997); Jonathan Clements, Yes, Stockbrokers Can Be Oh-So-Smug, But There Are Still Times to Use a Pro, WALL ST. J., Nov. 11, 1997, at C1 ("Wall Street's derogatory comments about small investors just aren't justified. A lot of these people do fine on their own.")

41 See generally JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1982) [hereinafter SELIGMAN, TRANSFORMATION]. Congress has been far more sanguine with respect to investor choice in investment companies, whose management and financial structure are governed by the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (1994), on the assumption that mere disclosure of their organization and conflicts of interest would be inadequate.
ties not accompanied by sufficient information or verification.

2. Issuer opportunism and supply-side incentives

The Securities Act further assumes that issuers, unless compelled, will shirk in providing full and truthful information to investors. The regulatory solution is to compel all issuers in public offerings to provide investors specified line-item disclosure and certify their honesty through heightened fraud liability.\(^2\) Yet the premise that, absent *ex ante* disclosure mandates, issuers in public offerings will supply less information than investors seek is overstated, at least in today's intermediated securities markets. Today issuers not subject to the full-blown registration regime respond voluntarily to investor and market informational demands even in the absence of *ex ante* mandates.

The private placement market offers the most compelling case in point. Though not required by the Securities Act or any explicit exemptive condition, offering circulars for unregistered private placements generally mimic and sometimes go beyond the disclosures mandated in a registered offering.\(^3\) In fact, the institutional investment community has come to expect registration-like disclosure for new issues. Investor demand for information, coupled with underwriters' reputational motivations and issuers' fears of antifraud liability, supplies sufficient incentives for honest and complete disclosure in private placements.

\(^2\) See S. REP. NO. 73-47, at 1 (1933) ("The purpose of this bill is to protect the investing public and honest business.").

\(^3\) See Franklin R. Edwards, *Listing of Foreign Securities on U.S. Exchanges*, 5 J. APPLIED CORP. FIN., Winter 1993, at 28, 31 (arguing that even in the absence of requirements firms would voluntarily provide investors with adequate information and pointing to the voluntary disclosures in the private placement market, which is exempt from SEC requirements); see also William J. Baumol & Burton G. Malkiel, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, 5 J. APPLIED CORP. FIN., Winter 1993, at 19.
In addition, many issuers with securities traded on U.S. markets, not subject to full-blown registration requirements (particularly foreign issuers), have nonetheless chosen to disclose beyond what disclosure regulation requires. Some examples illustrate the point. Before over-the-counter issuers were compelled in 1964 to provide ongoing periodic disclosure on the same basis as issuers listed on stock exchanges, OTC issuers provided markets information similar to that provided by listed issuers.\footnote{See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 684.} In 1993 Daimler-Benz, the largest German industrial firm, chose to list its shares on the New York Stock Exchange and reconciled its financial statements to U.S. generally accepted accounting principles ("GAAP"). In the process, Daimler revealed a $592 million first-half loss which had previously been hidden in its German accounting as "silent" reserves.\footnote{See John Schmid, Daimler-Benz Reports First-Ever Loss, Reflecting New Accounting, Lower Sales, \textit{Wall St. J.}, Sept. 20, 1993, at A10.} Many international issuers, to increase their appeal to international investors and attract capital, have voluntarily adopted International Accounting Standards ("IAS"), even though not required by any listing or regulatory authority.\footnote{In developed countries, investor pressures have led issuers to adopt IAS standards to give them better access to capital. "Nearly 300 companies — including Swiss giants Nestle, Novartis, and Hoffmann-LaRoche, and such German ones as Deutsche Bank and Bayer — have already switched over to IAS standards." Dave Lindorff, \textit{One World, One GAAP? Not Yet!}, \textit{Global Fin.}, Dec. 1997-Jan. 1998, at 28-33 (describing interest among international issuers harmonizing financial reporting standards because of the "dampening effect multiple accounting standards have on global capital flows, as investors feel uneasy about investing in companies with unfamiliar or opaque accounting methods").} Issuers in emerging countries have discovered great value in distinguishing themselves by adopting transparent accounting standards.\footnote{"Even in countries not as well developed as Malaysia, the amount of money you can save and attract from abroad with good accounting standards is so large that it overwhelms all other considerations." Ingrid Tighe, \textit{Back Chat}, \textit{Acct. Int'l}, Jun. 1998, at 20-22.} Foreign issuers whose American Depositary Receipts ("ADRs") trade in the United States often take the
additional step of voluntarily listing their ADRs on U.S.
 exchanges and NASDAQ, opting in the process for higher
U.S. disclosure standards. In fact, these Level 2 listings
have kept pace with Level 1 listings on the OTC "pink
sheet" market for which home-country disclosure is suffi-
cient.\footnote{See Michael A. Schneider, Foreign Listings and the
Preeminence of U.S. Securities Exchanges: Should the SEC Recognize
Foreign Accounting Standards?, 3 MINN. J. GLOBAL TRADE 301, 324
(1994) (reporting similar growth in both tiers).} By accepting
higher disclosure responsibilities, these foreign issuers believe they move into a new capitalist
league.

Yet, as many recent commentators have persuasively
argued, managers of corporate issuers have a natural incli-
nation not to disclose fully — for a variety of reasons.\footnote{See
Donald C. Langevoort, Theories, Assumptions, and Securities
Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851
(1992).} Accepting that managers are predisposed to shirk does not,
however, compel the conclusion that issuers should be sub-
ject to \textit{ex ante} disclosure mandates. If incentives from mar-
ket pressures and fraud penalties are insufficient to induce
disclosure, it is unlikely that line-item disclosure require-
ments will.\footnote{See Easterbrook & Fischel, \textit{Mandatory Disclosure,}
supra note 20, at 683.} The apathetic and even hostile response to
line-item disclosure in such sensitive areas as management
compensation and management discussion of future trends
illustrates the porousness of \textit{ex ante} mandates. Experience
suggests that workable disclosure incentives come from
market pressures and balanced liability standards, not \textit{ex ante}
disclosure mandates.

3. SEC supervision and cost-benefit balancing

The Securities Act assigns the SEC the role of deter-
mining what information investors receive, both in regis-
tered offerings and exempt offerings subject to disclosure
conditions. In registered offerings, the agency establishes
line-item disclosure requirements based on its assessment
of what investors would view as material information; it
reviews filings (on a selective basis) for completeness and facial accuracy; and it investigates possible registration or disclosure violations. In offerings that meet SEC exemptive criteria, the SEC has modified line-item disclosure and has diluted its review procedures. For both public and private offerings, the SEC has left accounting standards and oversight of the distribution process to private regulatory institutions, namely the Financial Accounting Standards Board ("FASB") and the National Association of Securities Dealers ("NASD"), over which the SEC has supervisory authority.

Mandatory disclosure assumes the SEC, in its various roles, will properly balance the benefits and costs of regulatory compliance. This may be too hopeful. Over time, the agency has been mesmerized by the regulatory syllogism, accepting the premise that issuers (unless compelled) will not disclose at levels sufficient for accurate pricing. Spellbound, the SEC's recent proposal to revamp the regulatory scheme for securities offerings assumes, without explanation, that unseasoned issuers cannot be expected to disclose at adequate levels. But this adherence to "accuracy enhancement," as Professor Kitch has pointed out, obscures the importance of a "prudent investor" rationale for mandatory disclosure — "what buyers want and are willing to pay for." For example, compelling revelation of competitively-sensitive information may actually injure investors, outweighing the value of the disclosure to accurate pricing and constraints on agency costs.

In theory, the SEC might correct these anomalies by engaging in a more sensitive cost-benefit analysis, but the SEC has only mild institutional incentives to do this. The proposed "aircraft carrier" proposal is a glaring case in point. Regulatory capture by a securities industry that

51 See Aircraft Carrier Proposal, supra note 2, at 67,177.
52 Kitch, supra note 22, at 767.
53 See id. at 770-71; Easterbrook & Fischel, Mandatory Disclosure, supra note 20.
54 For example, the release proposes new limits and conditions in a number of areas without any empirical analysis or studies that suggest their value —
extracts profits from overly-regulated securities transactions is an inescapable problem.\textsuperscript{55} Mandated disclosure has failed to provide investors essential information relevant to

- new requirements for the delivery of term sheets and preliminary prospectuses to investors — but no empirical analysis of what securities/investment information investors actually use and want. \textit{See} Aircraft Carrier Proposal, \textit{supra} note 2, at 67,177-78.
- new market capitalization, public float and average daily trading volume ("ADTV") criteria for companies to use integrated disclosure, based on studies of their relation to the number of analysts who follow a company — but no analysis of the effect current capitalization, float, and trading criteria have had on securities pricing. \textit{See id.} at 67,185-86 & nn.80-82 (proposing to increase public float/ADTV criteria for seasoned Form B issuers).
- new limits on percentage of shares that can be sold annually through direct-sales programs to existing shareholders — but no studies that indicate these investors are inadequately informed. \textit{See id.} at 67,188-89.
- warranty-like liability for all "offering information" used during the offering period — but no studies that indicate investors need or expect warranties of non-prospectus information. \textit{Id.} at 67,198-99.
- increased thresholds to qualify as a "small business issuer" — but no studies that indicate current size thresholds have fostered mispricing or fraud. \textit{Id.} at 67,202-03.
- new prospectus delivery requirements, in "recognition of the importance of the prospectus to investors," so investors will have time to review the document — but no evidence that investors read the prospectus, even if written in plain English, or consider it important. \textit{Id.} at 67,202.
- new factors to measure underwriters' due-diligence efforts, based on the view that "investors require that [underwriters] test the quality of the issuer's disclosure" in registered offerings — but no evidence that investors are willing to pay for underwriters' liability exposure. \textit{Id.} at 67,231-32.

To the extent the SEC relies on actual empirical observation, the information that the agency cites suggests the irrelevance of the current registration system. For example, the SEC observes: "We have had six years of successful experience with the small business issuer disclosure system." \textit{Id.} at 67,202. Yet small business issuers disclose at lower levels than larger public issuers, have fewer large institutional shareholders, and are followed by fewer analysts.

accurate pricing and risk valuation. For example, the SEC currently accepts boilerplate disclosure of such fundamental matters as the method by which the issuer and underwriter priced the offering, the level of actual or anticipated investor interest, and litigation risk analysis. The agency's track record is no better — the SEC long clung to the view that information most relevant to valuing an investment (namely, forward-looking predictions by management) was too dangerous for investors to handle.

Perhaps these costs of sloppy regulation could be justified if the benefits of mandatory disclosure were compelling. The evidence, as we have seen, is at best inconclusive. Moreover, studies indicate that even under mandatory constraints managers systematically avoid releasing unfavorable forecasts, time public offerings (both initial and seasoned) to take advantage of information asymmetries, and delay releasing mandated competitively-sensitive good news to trading markets. Yet securities markets, despite

56 See Kitch, supra note 22, at 768.
59 See James D. Cox, Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition, 55 LAW & CONTEMP.
the failures of *ex ante* disclosure rules, have largely been up
to the task and take into account systematic misinformation. For example, issuers sued for issuing false press releases tend to have abnormal price declines during the period of greatest disclosure activity.\(^6^0\)

4. Agency costs and disclosure externalities

Mandatory disclosure, it is said, also goads and enforces management answerability\(^6^1\) and is thus an essential component of the transparency of U.S. capital markets.\(^6^2\) In fact, the federal regime of mandatory disclosure finds its roots not in investor activism, but rather in the reform movement to impose corporate accountability through shareholder control.\(^6^3\) The humbling act of disclosure serves to remind managers of investor primacy and to constrain manager misbehavior.\(^6^4\) Disclosure also complements market mechanisms, such as the market in corporate control

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\(^6^4\) Louis Brandeis's aphorism captures this aspect of mandatory disclosure: "It is said that sunlight is the best of disinfectants, the electric lamppost the best of policemen." LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT* 62 (1933). Or as Professor Louis Loss said: "People who are forced to undress in public will presumably pay some attention to their figures." See LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 33 (2d ed. 1988).
and stock-based executive compensation, which have a disciplinary effect on managerial opportunism. In addition, state fiduciary standards depend on mandatory disclosure for their enforcement. In short, the reduction of agency costs, through these informal and formal processes, continues to be a compelling reason for mandatory disclosure.\footnote{See Paul G. Mahoney, \textit{Mandatory Disclosure as a Solution to Agency Problems}, 62 U. CHI. L. REV. 1047 (1995); Coffee, \textit{Mandatory Disclosure}, supra note 29, at 742 (arguing that ongoing disclosure assures a market in corporate control and prevents managers from using strategic silence to gain an unfair advantage in a management buyout).}

But corporate transparency does not hinge on the episodic, transaction-based disclosure in securities offerings. Rather, for issuers with publicly-traded securities, reduction of agency costs through the pricing mechanism depends on post-issuance and ongoing disclosure to public trading markets.\footnote{See Fox, \textit{Political Economy}, supra note 61, at 752 (recognizing that disclosure as a tool to reduce agency costs is "primarily not about disclosure at the time of an initial public offering but about what is provided periodically thereafter"). Ongoing disclosure may also have an additional salutary effect by revealing manager misbehavior to credit markets. Lenders have various tools to rein in manager opportunism, such as withholding short-term credit or calling shaky loans, that may be even more potent than those available to shareholders.} For issuers that exist outside this regime — the most successful in the United States during the last several decades — reduction of agency costs comes through mechanisms not dependent on mandatory disclosure.

In summary, evidence is lacking that the federal mandatory disclosure regime for securities offerings produces marginal information and side benefits that exceed the regime's marginal costs. It is unclear whether investors in a public securities offering would uniformly be willing to pay for the current scheme of mandatory registration and heightened fraud liability. These investors rely significantly on sophisticated market intermediaries (securities firms and institutional investors) that in private offerings, exempt from mandatory disclosure, do not opt for SEC registration and heightened fraud liability. Yet these interme-
diaries demand and receive registration-type information as a matter of private contracting. Mandatory disclosure in securities offerings, far from fomenting capital formation, merely pressures the migration from public markets to private markets.

III. **REGULATORY DECONSTRUCTION OF "TRUTH IN SECURITIES"

The Securities Act is in its twilight. The last twenty years — without significantly revising its text — the SEC, the courts, and Congress have whittled away the Securities Act regime. Broad exemptive rules and liberalized disclosure forms have redrawn the scope of *ex ante* registration and disclosure. Federal courts, along with congressional legislative reforms that largely codify judicial initiatives, have diluted *ex post* heightened liability for securities offerings. As the twin tenets of issuer opportunism and investor helplessness have lost their grip on the regulatory imagination, the unmistakable trend has been toward disclosure choice. And the Securities Act, originally a vessel for intrusive regulatory mandates, has shown itself a capable tool of private empowerment.

What has prompted this deregulation? There are multiple sources: a general recognition of the importance of startup capital to the national economy; increasing institutional ownership and demand for securities; the spillover of periodic disclosure from trading markets into offering markets; and the rise of offshore alternatives to domestic markets. In each case, securities regulators have come to

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67 See Joel Seligman, *Gotterdammerung for the Securities Act?*, 75 WASH. U. L.Q. 887 (1997) (concluding "the significance of registration under the Securities Act has vastly dissipated").

doubt that mandatory disclosure in securities offerings is worth it.

A. SEC Revisionism: Private Choice in *Ex Ante* Disclosure

As securities markets and investors have matured, the SEC has sought to keep pace — in incremental fashion.\(^59\) Over the last two decades, the agency has undertaken significant initiatives to reduce the heavy-handed costs of mandatory disclosure in securities offerings. SEC exemptive rules and disclosure standards enable a variety of securities offerings to escape full-blown registration. As Professor Paul Mahoney has observed:

> The traditional registration model involving a one-shot offering and a lengthy, comprehensive prospectus is now the exception rather than the rule.... Despite the "full disclosure" rhetoric... the disclosure system already reflects an implicit bargain between issuers and investors regarding the allocation of firm-specific information. Those companies that require even greater secrecy and can convince investors that secrecy is wealth-maximizing can opt out of the mandatory disclosure system through the many exemptions the SEC has recognized.\(^70\)

Consider the current form choices for a first-time issuer: Form S-1 (for issuers that choose a registered public offer-

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ing); Form 1-A (for issuers that choose a smaller "mini registration" public offering); and Form SB-2 (for small-business issuers that choose to register their public offering). Under the SEC registration exemptions, the possibilities are even greater. Unsophisticated investors, if the offering is small, receive only bare-bones mandatory disclosure — even though such offerings are the least likely to be well intermediated. Wealthy investors, if the offering is directed to them, receive no mandatory disclosure — on the assumption they can purchase intermediation. Public investors who purchase from seasoned issuers receive limited actual disclosure — even though the assumptions of informationally efficient markets may be overblown as to many of these issuers. Investors who purchase foreign-traded securities repackaged as ADRs receive no disclosure and, unless the securities are traded on a U.S. exchange or on NASDAQ, the foreign issuer need only file with the SEC its foreign-based disclosure — even though it usually falls short of U.S. standards. In all, the disclosure options and exemptive sieve expose fundamental agency questioning of the Securities Act’s regulatory tenets.

Yet as trickling deregulation becomes a torrent, U.S. capital markets (public and private) remain strong and grow stronger. The many regulatory dispensations expose the truth that mandatory ex ante disclosure in securities offerings has become unwarranted, if not undesirable. As former SEC Commissioner Wallman has observed, "regulators increasingly need to ensure that it is the market that leads, not the regulators."

1. Private placements: reliance on intermediation

The Securities Act draws a tenuous, but dramatic boundary between public offerings and private offerings. As explained by the Supreme Court, no registration is needed for investors who are "able fend for themselves" and

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71 Wallman, supra note 69, at 348.
thus contract for informational and veracity commitments.\(^{72}\) The private-placement exemption excuses the issuer (and other participants in the offering) from SEC filing and clearance requirements, line-item disclosure mandates, and heightened antifraud liability. Although lower courts in the 1970s sought to introduce mandatory disclosure as a court-made exemption condition, the attempt was short-lived.\(^{73}\)

In expanding the private placement exemption beyond its judicial boundaries, the SEC has been explicitly cognizant of regulatory costs. The safe-harbor of Rule 506 (unlike the statutory exemption) permits offers to unqualified investors, so long as solicitations are not made widely and the unqualified investors do not purchase. The rule specifies categories of qualified investors and equates wealth with investment sophistication and insider status. Wealthy investors, whether individuals or institutions, are treated as having the sophistication of institutional investors and the information access of insiders — on the assumption that the diversified wealthy can absorb greater risk and buy sophisticated intermediation. Unsophisticated, nonwealthy investors can be qualified if they number fewer than 35 and are assisted by a sophisticated representative. In short, the SEC's safe harbor assumes that sophisticated intermediation can replicate the protections of full-blown registration.

As private equity placements begin to approximate public offerings in size, the SEC has further blurred the line between public and private offerings.\(^{74}\) The Rule 144A safe


\(^{73}\) See James D. Cox et al., Securities Regulation: Cases & Materials 378-90 (2d ed. 1997) (describing a line of Fifth Circuit cases, largely supplanted, that required provision of information to private investors equivalent to that included in a registration statement).

\(^{74}\) See James D. Cox, The Fundamentals of an Electronic-Based Federal Securities Act, 75 Wash. U. L.Q. 857 (1997) [hereinafter Cox, Electronic-Based Federal Securities Act] (identifying ways in which issuers can avoid registration, yet assure liquidity to investors: private offerings traded through PORTAL, offshore offerings exempt under Regulation S that may be resold after a 90-day holding period, and private offerings accompanied by promises to register the securities in the future).
harbor, adopted in 1990, permits trading markets (such as the PORTAL system) in securities placed with institutional investors.\textsuperscript{75} Moreover, the SEC has permitted issuers to issue securities in a private placement with a promise to exchange the restricted securities with new registered securities at a future date — so-called A/B exchanges.\textsuperscript{76} By permitting issuers to reduce illiquidity for private offerings, the SEC has exacerbated the movement away from full-blown registration toward private offerings and greater institutional ownership.

Further blurring the private-public boundary, the SEC has lately permitted issuers greater marketing flexibility in soliciting investors in non-public offerings. Despite its long-standing view that any "general solicitation" of investors removes an offering from the private category,\textsuperscript{77} the SEC has allowed issuers in private placements to use non-profit matching services to identify prequalified investors, so long as the service does not provide investors investment advice.\textsuperscript{78} Moreover, issuers contemplating a Regulation A


\textsuperscript{77} This view is codified in Regulation D. See 17 C.F.R. § 230.502(c) (1998) (prohibiting offerings under Rules 505 and 506 if they involve a general solicitation). For a history of the general solicitation prohibition and its criticism, see Donald C. Langevoort, Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities, 2 J. SMALL & EMERGING BUS. L. 1 (1998) (describing SEC interpretations of ban on general solicitations, which effectively compels issuers to retain a registered broker-dealer to prequalify investors or to use a non-profit matching service to find so-called angel investors).

"mini-registration" offering may seek expressions of interest (subject to specified cautionary disclosures) from potential investors even before the investors are qualified and the issuer commits to the offering.\textsuperscript{79} This marketing can be, and increasingly has been, accomplished on the Internet. As Professor Langevoort has noted, "We are on the verge of widespread Internet-based solicitations of potentially interested accredited (and maybe other sophisticated) investors with respect to unregistered offerings of securities by unseasoned issuers."\textsuperscript{80}

2. Small offerings: perplexing cost-benefit analysis

Further erosion of the Securities Act's registration scheme has come in the "small issue" exemptive rules. Acting pursuant to congressional command to reduce regulatory costs for small businesses,\textsuperscript{81} the SEC has exempted from registration small securities offerings —

**Small offerings under $1 million.** Rule 504 offerings are subject only to state "blue sky" regulation, if any.\textsuperscript{82} State registration exemptions for offerings to less than 10 (sometimes 25) investors often results in no \textit{ex ante} regulation.\textsuperscript{83}

**Small, limited offerings under $5 million.** Rule 505


\textsuperscript{80} Langevoort, \textit{supra} note 77, at 10.


\textsuperscript{82} See 17 C.F.R. § 230.504 (1996).

offerings, if sold to no more than 35 "unaccredited" investors, escape most registration-style regulation. There is no SEC clearance procedure, nor heightened fraud liability. Unaccredited investors must be provided a disclosure document, whose contents can be scaled back for smaller offerings. Unaccredited investors can purchase without professional advice or other intermediation.

**Small, unlimited offerings under $5 million.** Regulation A offerings, though subject to SEC clearance, may be sold to an unlimited number of investors. Issuers are not subject to the quiet period rules applicable to registered offerings and can "test the waters" prior to the formal offering. Investors must be provided a disclosure document, though with less financial disclosure than a full-blown registration statement. There is no heightened fraud liability for the issuer or any gatekeepers, nor any requirement that investors receive sophisticated intermediation.

**Small offerings pursuant to employee benefit plans.** Non-reporting issuers may offer securities to employees pursuant to a company compensatory benefit plan. Employees receive no disclosure, other than a copy of the benefit plan and the contract describing their compensation. Each year an employer may issue up to 15% of its outstanding securities to employees, subject to a $5 million cap.

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85 See Rule 502(b)(2)(B), 17 C.F.R. § 230.502(b)(2)(B) (1998) (for offerings less than $2 million the issuer's income and cash flow statements need not be audited, and the balance sheet need be of only the most recent fiscal year).
86 Broad offerings under Rule 505 may be difficult given the SEC requirement that the issuer (or its agent) has a preexisting relationship with investors. See Rule 502(c), 17 C.F.R. § 230.502(c) (1998). The effect of the requirement is that issuers must use securities firms, whose relationships with their customers create the requisite qualification. Interposing a securities firm triggers a host of broker-customer protections.
In the name of reducing regulatory costs, the SEC's exemptive rules have cut away significant layers of regulatory protection.\textsuperscript{89} Ironically, for those issuers with the least market following and investors with the least professional assistance, the SEC regulatory dispensation is the greatest.\textsuperscript{90} For example, the small issuer exemptions have been frequently used in Internet offerings, where intermediation is least likely.\textsuperscript{91} Yet far from being abused, these exemptions appear to attract fewer allegations of fraud compared to traditional public offerings.\textsuperscript{92} If there is abuse in small offerings, it is mainly by securities professionals,


\textsuperscript{90} See Stephen J. Choi, \textit{Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation}, 2 J. SMALL \& EMERGING BUS. L. 27 (1998) [hereinafter Choi, \textit{Gatekeepers and Internet}] (describing current regime of regulatory exemptions for small issuers and concluding "[p]aradoxically those companies where investors require the greatest protection — small, unknown businesses — are also those companies with the greatest ability to skirt securities regulatory protections").

\textsuperscript{91} See, e.g., John C. Coffee, Jr., \textit{Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation}, 52 BUS. LAW. 1195 (1997); Fisch, \textit{supra}, note 89, at 69-89 (describing regulatory reforms to facilitate Internet offerings, but concluding that to date small businesses have had limited success with Internet offerings).

\textsuperscript{92} In its Aircraft Carrier Proposal, the SEC commented, "We have had six years of successful experience with the small business issuer disclosure system. Our experience indicates that small business issuers have incurred less cost, time and burden in preparing disclosure documents . . . without reducing investor protection." Aircraft Carrier Proposal, \textit{supra} note 2, at 67,202. This observation is borne out by the experience for smaller public IPOs. See James Bohn & Stephen Choi, \textit{Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions}, 144 U. PA. L. REV. 903 (1996) (finding that of the 3290 IPOs between 1975 to 1986, the smaller half accounted for only 14 of the total 122 liability suits).

3. Offerings by seasoned issuers: wishful reliance on market efficiency

The Securities Act's registration regime contemplates transaction-based disclosure with separate registrations for each discrete offering.\footnote{See Cox, \textit{Electronic-Based Federal Securities Act}, supra note 74 (criticizing transactional focus as too inflexible).} The logic of unifying Securities Act offering disclosure with Exchange Act continuous company reporting has driven (and continues to drive) a variety of SEC disclosure reforms.\footnote{The Aircraft Carrier Proposal takes a further step toward integration by streamlining registration for larger, seasoned issuers making Exchange Act filings but retains the transactional focus of existing Securities Act regulation. As initially proposed, it does not adopt the "company registration" program advocated by the SEC's advisory Committee on the Capital Formation and Regulatory Processes. \textit{See Aircraft Carrier Proposal, supra note 2, at 67,179-86} (proposing streamlined registration for offerings by larger, seasoned issuers under Form B, which would incorporate by reference an issuer's Exchange Act filings). \textit{See also} Cohen, \textit{supra} note 14 (proposing relaxation of registration requirements under the Securities Act for issuers already subject to reporting requirements of the Exchange Act).} Relying on the information-processing mechanisms of securities trading markets, the SEC has streamlined disclosure, registration, distribution, and prospectus-dissemination for larger seasoned issuers. Yet the SEC's stated reliance on information-efficient markets may be administrative alchemy. The agency has eased regulation beyond the relatively small portion of public issuers actively followed by securities analysts.\footnote{See Coffee, \textit{Mandatory Disclosure}, supra note 29, at 731 (describing the SEC Advisory Committee's conclusion at the time integrated disclosure was adopted that only about 1,000 of the 10,000 "reporting" companies were regularly followed by securities analysts).} It has relied on efficient markets, even as it has accepted that issuers...
can find market inefficiencies or "windows" to bring securities to market. It has assumed that offerings by seasoned issuers are efficiently priced, even though data suggests that these offerings are as subject to mispricing as initial offerings. In the end, deregulation may have been necessary to keep larger issuers in the registration system — to keep it a viable disclosure choice.  

Integrated disclosure. In 1982, after hearing more than a decade of criticism, the SEC integrated its overlapping and sometimes inconsistent disclosure standards under the Securities Act and the Exchange Act to permit seasoned issuers to refer to previously-filed information when offering securities publicly. The SEC made two assumptions. First, investors seek the same kind of information in primary markets as in secondary markets. Second, information filed with the SEC and available to market professionals comes to be reflected in the price of widely-followed

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87 As Professor Donald Langevoort has pointed out, the SEC's invocation of the efficient market hypothesis to support its deregulatory initiatives was disingenuous. See Donald C. Langevoort, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited, 140 U. PA. L. REV. 851 (1992) (pointing to the extant empirical studies casting doubt on the existence and depth of efficiency markets). Instead, the desire to keep U.S. issuers from migrating to less-regulated foreign markets and to reduce U.S. capital-formation costs motivated the deregulatory agenda. See Cox, Electronic-Based Federal Securities Act, supra note 74, at 868-69 n.42 (explaining the driving force for integrated disclosure, shelf registration and expansion of the small-offering exemption as "Let's get America moving again").


securities, so that its dissemination to investors is point-
less.\footnote{100}{See Adoption of Integrated Disclosure System, Securities Act Re-
lease No. 6383, [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 72,993 n.9.}

Integrated disclosure relaxes many of the disclosure, ad-
ministrative review, and prospectus-dissemination re-
quirements that apply in a full-blown registration. Larger
seasoned companies (so-called S-3 issuers) need not in-
clude in the registration statement company-specific information,
if incorporated by reference to other SEC filings.\footnote{101}{To qualify for Form S-3, the issuer must have been an Exchange
Act reporting company for at least three years and (1) have voting stock
held by nonaffiliates worth at least $150 million, (2) have voting stock
held by nonaffiliates worth at least $100 million and a trading volume of
at least 3 million shares annually, or (3) are selling investment grade
debt securities or preferred stock. See Securities Act Form S-3, General
(CCH) ¶ 7152, at 6251-52 (1998).}

Instead, investors and market intermediaries receive only a cursory
prospectus describing the terms of the offering and any ma-
terial developments since the latest incorporated SEC fil-
ings; the bulk of company-specific operational and financial
information incorporated by reference to Exchange Act fil-
ings. (For offerings to employees, the disclosure require-
ments are relaxed even further.)\footnote{102}{See Securities Act Form S-8, General
(requiring only incorporation by reference of SEC filings and confirma-
tion of how many securities the employee purchased). In 1990 the SEC
undertook an extensive revision of Form S-8 to streamline its use, re-
duce its costs and expand its availability. See Revision to Form S-8,
(CCH) ¶ 84,605 (June 6, 1990). Ironically, the very investors who the
SEC had argued to the Supreme Court in \textit{SEC v. Ralston-Purina} could
not "fend for themselves" and deserved full-blown registration now re-
ceive the least disclosure protection.} The SEC staff reviews
S-3 filings only rarely, and underwriters in S-3 offerings
(particularly when brought to market off the "shelf") rarely
perform "due diligence" reviews of disclosures incorporated
by reference, apparently also trusting the market's fraud-ferreting abilities.\textsuperscript{103}

The SEC's reliance on market mechanisms to replicate full-blown registration was consciously over-inclusive. At the time it adopted integrated disclosure, the SEC calculated that approximately thirty percent (about 3,000) of all publicly-filing companies would qualify for the S-3 exemption from full-prospectus preparation, yet an SEC Advisory Committee had concluded that only 1,000 companies were actually closely followed by securities analysts.\textsuperscript{104}

\textbf{Shelf registration.} In 1982, the SEC adopted Rule 415 to permit certain issuers to register securities on a delayed or continuous basis.\textsuperscript{105} The rule expanded and codified agency practice that permitted issuers to register certain offerings, such as securities issued pursuant to employee retirement plans or dividend reinvestment plans, although

\textsuperscript{103} See John C. Coffee, Jr., \textit{Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration}, 52 WASH. & LEE L. REV. 1143, 170 (1995) (asserting that shelf registration has hurt the ability of underwriters and auditors to conduct their due diligence investigations). By comparison, underwriter practices in an initial public offering are more inquiring and fulsome. See John Seegal, \textit{Due Diligence Procedures in Initial Public Offerings}, in \textit{How to Prepare an Initial Public Offering} 251 (PLI Corporate Law & Practice Course Handbook Series No. B4-7043 1993).


actual sales would be delayed. Motivated by pressures to keep U.S. issuers from migrating to the Eurobond market, the SEC expanded the shelf registration procedure to primary offerings of both debt and equity securities. Under the rule, the issuer must qualify for S-3 registration, must expect to take the securities off the shelf within two years of registration, and must undertake to update publicly available information when it takes the securities off the shelf.

Shelf registration dilutes the disclosure normally mandated in a non-shelf, S-3 public offering. During the marketing period when securities are taken off the shelf, investors receive only a "stickered" prospectus that describes "fundamental" changes since registration, not necessarily all "material" developments. Delayed marketing also reduces gatekeeper "due diligence." At the time of initial registration, since no underwriters have been selected, potential underwriters have little incentive (much less access) to investigate the issuer or the offering. Once the issuer decides to bring the offering to market, underwriters (sometimes after competitive bidding) will be under pressure to sell the deal quickly, often without more than cursory investigation of current and previously-filed disclosure.

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106 These "traditional" shelf offerings, typically carried out without an underwriter, are thought to pose little investor risk. In offerings to employee benefit plans, the plan trustee is likely to have investment sophistication and access to company information; trustee conflicts of interest are regulated by ERISA, 29 U.S.C. § 1001 (1994). In offerings pursuant to dividend reinvestment plans, it has been argued that shareholders who opt to use dividends to acquire additional shares are no worse off than if the company had chosen not to declare dividends. See Barbara Ann Banoff, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135 (1984).

107 See LOSS & SELIGMAN, supra note 81, at 359.

108 Additional conditions apply to equity offerings. Securities sold at market prices on a stock exchange or through an over-the-counter market maker must be sold through underwriters named in the prospectus. If the shelf offering involves voting securities, the offered securities cannot exceed more than 10% of the issuer's publicly held voting stock. See Rule 415, 17 C.F.R. § 230.415 (1998).

109 SEC Commissioner Thomas commented in her dissent to the proposed rule:
Yet, shelf registration also gives issuers greater flexibility, to the benefit of investors.\textsuperscript{110} Issuers can obtain competitive bids from underwriters;\textsuperscript{111} they can "dribble out" securities without an underwriter; they can negotiate so-called bought deals — all financing tools available to issuers selling in private and international securities markets. This greater flexibility, as the SEC recognized and subsequent studies confirm, permits issuers to reduce offering costs and more accurately meet investor demand.\textsuperscript{112} The

\begin{quote}
[Shelf registration of equity offerings] encourag[es] greater concentration of underwriters, market-makers, and other financial intermediaries and ... discourag[es] individual investor participation in the capital markets thereby furthering the trend toward institutionalization of securities holders, and (2) reduces the quality and timeliness of disclosure available to investors when making their investment decisions. . . . [It] alters the traditional disclosure scheme set forth in the Act and runs counter to the Act's statutory objective of protecting investors.


\textsuperscript{110} Mandatory disclosure for securities offerings requires not only that disclosure be complete and accurate, but also timely. The Securities Act specifies that financial information in the prospectus must be recent. See Securities Act § 9, 15 U.S.C. § 77q (1994). To prevent the use of stale information, the SEC has long taken the view that issuers cannot delay the distribution of securities once registered. See Banoff, supra note 106, at 135-36.

\textsuperscript{111} In a competitive bid offering, the issuer receives bids from many underwriters each basing its bid on an appraisal of investor demand. In a traditional negotiated offering, on the other hand, the issuer deals with only one underwriter which has sole access to information about customer demand and can systematically underprice the issue. See Banoff, supra note 106, at 180-83.

\textsuperscript{112} The SEC listed the many benefits for issuers of timing flexibility: meeting "market windows" to obtain lower rates on debt and preferred stock, varying the structure and terms of securities on short notice to meet market conditions, simplifying the registration process, reducing legal, accounting, printing and other costs by filing one registration statement rather than multiple statements for a series of offerings, and increasing competition among underwriters with resultant innovation in finance products and lower underwriting spreads and offering yields. During the rule's eighteen-month trial period, a majority of all public
SEC concluded greater offering flexibility outweighed any harms from deregulation. The agency rejected the NASD argument that "bought deals" would drive smaller, regional investment banks out of the market for lucrative "blue chip" offerings, arguably making these firms less able to act as intermediaries for smaller "start-up" offerings. The SEC also doubted that shelf underwriters would be less able to assess the merits of a shelf offering or "fraud-proof" the offering documents. In fact, the SEC seemed to doubt the cost-effectiveness of full-fledged underwriter "due diligence," at least for S-3 issuers. Professor Banoff would later pick up the SEC's train of thought:

offerings were registered "for the shelf," with issuers reporting significant savings.

Empirical studies of debt and equity offerings before and after the rule's final adoption found lower issuance costs after the rule. See Shelf Registration, Securities Act Release No. 6499, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,449 at n.15 (citing Kidwell et al., SEC Rule 415 — the Ultimate Competitive Bid, University of Tennessee and Virginia Polytechnic Institute and State University Working Paper (1983) (indicating that debt issues sold under Rule 415 sell between 30 and 40 basis points less than comparable negotiated issues); Bhagat et al., The Rule 415 Experiment: Equity Markets, University of Utah and Virginia Polytechnic Institute and State University Working Paper (1983) (indicating that the issuing cost of equity securities sold under Rule 415 is about 29 percent less than that of comparable equity securities not sold under Rule 415).

Professor Banoff argued that in an efficient market, in which "the price of individual stocks reflects the effects of diversification . . . and the risk that management is lying is a company-specific risk," investors should be indifferent to company lying because the market price already accounts for this possibility. "[P]laying underwriters a premium to insure [investors] against fraud, or, more precisely, against the underwriter's negligence in failing to discover fraud" creates a contradiction between efficient markets and due diligence. Banoff, supra note 106, at 180-83 ("By reducing company-specific risk to zero, diversification permits risk-averse investors to behave as though they were risk neutral. People who are risk neutral do not buy insurance."). The argument may overstate the effect of diversification. Although particular companies' risk might be diversified away, systemic risks (such as corrupt securities intermediaries or a legal system without antifraud rules) cannot be diversified away. Investors will have an interest in the investment environ-
If underwriting costs were unbundled from issue costs, so that investors were given a choice, they would not pay underwriters a premium to insure them against company-specific risk. Due diligence, except perhaps for new issuers or novel securities, does not increase investor welfare by more than its cost, and diminished due diligence is not a valid argument against shelf registration.\(^{114}\)

In the end, the SEC's very reasons for adopting shelf registration — to give issuers the timing flexibility to meet "market windows" — implicitly discredits informationally efficient markets, the condition upon which the agency permits for shelf registration for primary offerings.\(^{115}\) Even though markets may not match the assumed benefits of regulation, the SEC implicitly accepted that its full-blown registration regime is not worth the candle.


Mandatory disclosure is most tested by the globalization of securities markets. As U.S. issuers seek capital in foreign securities markets and U.S. investors discover the benefits of international diversification, SEC disclosure policies must confront the international mobility of capital. If U.S. mandatory disclosure produces a cost-benefit imbalance compared to that of other markets' disclosure policies, U.S. issuers and investors will move offshore and avoid U.S. markets.\(^{116}\) Likewise, imbalanced U.S. disclosure policies

\(^{114}\) Banoff, supra note 106, at 183.

\(^{115}\) See id. at 188.

\(^{116}\) See Lowenstein, supra note 62, at 1337 ("American investors have for some time been buying foreign stocks in the companies' home markets or in London. These investments are largely in world-class companies--Nestle, Siemens, Ciba-Geigy and the like — whose stocks, we
will discourage foreign issuers and investors from coming to the United States.\textsuperscript{117} Faced with the realities of a market test of U.S. securities regulatory policy, mandatory disclosure must pass muster.

The SEC has been deftly pragmatic — mostly. To prevent the migration of U.S. investors to foreign markets and to not jeopardize U.S. markets' ability to attract foreign listings, the agency has reduced the disclosure burdens on foreign issuers.\textsuperscript{118} International pressures have forced the SEC incrementally to liberalize federal disclosure requirements.\textsuperscript{119}

**ADR registration.** Foreign issuers who participate with U.S. depositaries in the issuance of American Depositary Receipts ("ADRs") can essentially choose the level of U.S. disclosure according to the degree they choose to access U.S. trading markets.\textsuperscript{120} Although the SEC has adopted the


\textsuperscript{118} For example, while Rule 415 does not permit foreign government issuers to make delayed or continuous offerings, the SEC has permitted shelf registrations for these issuers since 1980. See *Interpretative Release Relating to Continuous and Delayed Offerings by Foreign Governments or Political Subdivisions Thereof*, Securities Act Release No. 6424, 47 Fed. Reg. 39,809 (September 2, 1982) (announcing revised staff interpretation, under which seasoned foreign governments are permitted to use shelf registration in a manner substantially similar to that specified in Rule 415); see also *Procedures for Use of Registration Statement for Delayed Offerings by Foreign Governments or Political Subdivision Thereof*, Securities Act Release No. 6240, 45 Fed. Reg. 61,609 (September 10, 1980) (announcing staff interpretive position). Despite this facilitation, some have argued the agency has not done enough. See Nicholas Demmo, *U.S. Securities Regulation: The Need For Modification to Keep Pace with Globalization*, 17 U. PA. J. INT'L ECON. L. 691, 708, 720 (1996).

\textsuperscript{119} See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 97 (1993) [hereinafter ROMANO, GENIUS OF AMERICAN CORPORATE LAW].

\textsuperscript{120} American depositary receipts are certificates issued by a depositary in the United States (usually a U.S. bank) that represent ordinary shares of a foreign issuer that have been deposited with a custodian in
understandable regulatory stance that ADRs are securities separate from the underlying deposited securities, it has streamlined U.S. regulation for ADRs issued to U.S. investors. If the foreign issuer does not issue new securities in connection with an ADR program and the issued ADRs trade only on brokers' "pink sheets" (a Level 1 program), neither the U.S. depository nor the foreign issuer is subject to any additional U.S. disclosure requirements. The ADRs are registered under the Securities Act pursuant to a perfunctory procedure (Form F-6) in which the ADR certificate serves as the disclosure document.\textsuperscript{121} The foreign issuer is exempt from the continuous disclosure requirements of the Exchange Act on the condition that it supply the SEC with its home country disclosures.\textsuperscript{122} If the ADRs are traded on a U.S. exchange or through NASDAQ (a Level 2 program), the foreign issuer becomes subject to Exchange Act registration. The SEC, however, permits the foreign issuer to provide home-country financials provided they include a

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\textsuperscript{121} \textit{See} Securities Act Form F-6, Item 1, \textit{reprinted in} 2 Fed. Sec. L. Rep. (CCH) \$ 7003, at 6112 (1998), \textit{referring to} Reg. S-K, Item 202(f), \textit{reprinted in} 7 Fed. Sec. L. Rep. (CCH) \$ 71,022, at 61,845-46 (1998) (specifying disclosure of the terms of deposit, including procedures for voting, dividend collection and distribution, transmission of notices, reports and proxy soliciting materials, and any restrictions upon the right to withdraw and deposit the underlying securities).

rectification of foreign disclosure discrepancies with U.S. accounting standards.  

Besides diluting the disclosure standards for foreign issuers with ADR programs, the SEC has also eliminated Section 11 fraud liability for them. The SEC, with apparent market acceptance, has taken the position that in a Level 1 or 2 program neither the U.S. depository nor the foreign issuer is an "issuer" of the ADRs, the result being that no person or entity is subject to meaningful Section 11 liability. Moreover, the SEC's enforcement activities in response to disclosure failures by foreign issuers has been desultory, at best. The SEC annually lists foreign issuers whose securities are subject to ADR programs, noting each time that the foreign issuer's filings with the SEC may be incomplete and broker-dealers should undertake to investigate foreign information sources. In 1991, the SEC noted (without apparent concern) that approximately forty-three percent of foreign issuers with securities represented by

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124 "This altogether laudable demonstration of administrative flexibility means that nobody has the liability of an 'issuer' under Section 11 so far as Form F-6 is concerned." LOSS & SELIGMAN, supra note 81, at 775.

125 See Walter Stahr & John Palenberg, Rule 12g3-2(b) under the Securities Exchange Act: A Primer for Foreign Companies, 27 INT'L LAW 963 (1993) (pointing out that jurisdictional and comity concerns may lead to agency caution, and most of the information required by Rule 12g3-2(b) is already available to U.S. investors through the media or their brokers, so enforcement would arguably achieve little for U.S. investors).

ADRs are not reporting or otherwise filing current information with the SEC.\textsuperscript{127} The SEC has never sued a foreign issuer that has not sold securities in the United States for failing to make filings under the Exchange Act.\textsuperscript{128}

The SEC's explanations for its remarkable regulatory dispensations to foreign issuers with ADR programs have been terse.\textsuperscript{129} At their heart, they reveal the essential emptiness of the mandatory disclosure syllogism. Originally, the SEC adopted the exemption for over-the-counter ADRs pursuant to an enabling provision in the 1964 legislation that unified the regulation of exchange-listed and over-the-counter securities. In adopting Rule 12g3-2(b), the SEC stated:

\begin{quote}
Congress recognized that it was imposing significant burdens and obligations on issuers, but indicated that it did not intend to impose these burdens on foreign issuers whose securities were imported into the U.S. and traded in the over-the-counter market without the issuer's approval, or, in some cases, knowledge.\textsuperscript{130}
\end{quote}

But the "innocent issuer" rationale for the exemption proved empty. As ADR programs increasingly came to be

\begin{footnotes}
\textsuperscript{127} See American Depositary Receipts, Exchange Act Release No. 29,226, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,740, at 81,599-600 n.80 (May 23, 1991). In addition, although the SEC in 1991 pointed out that only 20% of U.S. depositaries comply with their reporting requirements concerning registered ADR facilities, the agency showed no inclination to undertake any enforcement action against them. \textit{See id.} at 81,598 n.78. It is not for lack of enforcement tools. Since October 1990, the SEC can issue cease and desist orders and impose civil penalties for filing truancy, something it has done frequently in the domestic context. \textit{See} Stahr & Palenberg, \textit{supra} note 125, at 964.
\textsuperscript{128} See Stahr & Palenberg, \textit{supra} note 125.
\end{footnotes}
sponsored by foreign issuers seeking access to U.S. markets, the 12g3-2(b) exemption remained unchanged. Underlying the 12g3-2(b) dispensation was the SEC's recognition that imposing regulatory parity would drive foreign securities offshore, and with them U.S. investors.\footnote{See Fox, Political Economy, supra note 61, at 713 n.42.} The SEC assumed U.S. investors, whether investing in foreign or U.S. markets, could take appropriate precautions and discount for any foreign disclosure weaknesses. In addition, as the SEC has noted, approximately 80-85% of the ADR market is apparently composed of institutional investors and securities brokers.\footnote{See American Depositary Receipts, Exchange Act Release No. 29,226, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,740, at 81,591 n.38 (May 23, 1991).} Based on appearances, ADR investors have found foreign issuers' disclosure adequate. In a 1991 request for public comment on its ADR rules, the SEC asked whether it should require additional disclosure concerning the foreign issuer (beyond the filing, for "pink sheet" programs, with the SEC of home country disclosures), the underlying securities (voting rights, limitations on foreign ownership, foreign currency exchange controls), or the depositary (fees, pass-through voting, notification to ADR holders). After receiving widespread support for its hands-off approach, the SEC took no action.

Reconciliation with U.S. disclosure standards. Foreign issuers subject to U.S. disclosure standards, whether by virtue of a U.S. public offering or a Level 2 ADR program, are subject to reduced disclosure standards.\footnote{See Fanto & Karmel, supra note 117, at 56-57 (describing different disclosure standards applicable to foreign issuers whose securities trade in the United States).} Recognizing the burden of U.S. disclosure, the SEC waives full compliance with U.S. GAAP for foreign issuers, making exceptions for such items as cash flow statements, individual management compensation, interim reporting, and re-
porting of segment data. In addition, the SEC now accepts a two-year (instead of a five-year) reconciliation with U.S. standards, and permits foreign issuers to choose reporting financial results in U.S. dollars or local currency, adjusting results in hyperinflation economies, and reconciling financial information in business combinations. To facilitate the offer and sale of "blue chip" German securities in the United States, for example, the SEC has granted class exemptions from its trading rules for U.S. distributions of actively traded equity securities of German issuers (notably Daimler-Benz).

134 The SEC has adopted special registration forms exclusively for foreign issuers, containing numerous disclosure concessions and dispensations. For example, foreign issuers need not disclose line-of-business information, individual management compensation, or material insider transactions. Foreign issuers may prepare financial statements in accordance with their home-country's accounting principles, provided they specify how these principles materially vary from U.S. GAAP, and quantify the reconciliation between net income under home-country standards and U.S. principles. See Integrated Disclosure System for Foreign Private Issuers, Securities Act Release No. 6360, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,054, at 84,648 (Nov. 20, 1981). See also Lowenstein, supra note 62; Panto & Karmel, supra note 117, at 56-57.

135 See Lowenstein, supra note 62, at 1338.


Cross-border tender offers. Foreign bidders, fearful of being subjected to strict U.S. tender offer rules, often exclude U.S. investors from advantageous cross-border offers. The SEC has proposed several accommodations to such bidders. The SEC would permit foreign bidders to comply with U.S. disclosure obligations by satisfying foreign disclosure, procedural and accounting requirements — including any home country listing requirements. The SEC proposal would make cross-border tender offers available to U.S. investors, not because they are less needy of U.S. tender offer protection, but in recognition that regulatory parity would deprive U.S. investors of full access to foreign investment opportunities. In fact, when U.S. investors are in a decidedly minority position and have a greater need for the disclosure and procedural protections of the U.S. tender offer rules, the SEC exemptive relief is the fullest. In the face of global market realities, the SEC seems to concede that investor choice should trump regulatory protection.

Although the globalization of capital markets has created strong pressures for the SEC to relax U.S. disclosure standards, the SEC has wavered in accepting full disclosure flexibility for foreign issuers. In response to the phenomenon of offshore offerings on the Internet, for example, the SEC has recently announced it will view an unregistered offering targeted at U.S. investors as a violation of

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139 Exemption from the SEC tender offer rules — except to require the foreign issuer to provide the SEC and U.S. investors an English translation of bidding documents — would apply only if target shares held by U.S. investors comprised 10 percent or less than the shares being sought. See id. at 81,061 (describing Tier I exemptive relief).

140 See Fox, Political Economy, supra note 61, at 766 (describing how globalization increases political pressure to lower U.S. disclosure standards, given that current regulatory jurisdiction turns on investor residence or trading market location).
U.S. registration requirements.\textsuperscript{141} Offshore issuers, the SEC warns, must implement measures to prevent U.S. investors from participating in unregistered Internet offerings.\textsuperscript{142} But given the seamless and global nature of the Internet, the U.S. regulatory dike cannot be plugged fully or forever.\textsuperscript{143}

Moreover, tiered-disclosure for ADRs — though providing foreign issuers some disclosure choice — constrains issuance and listing flexibility. By compelling foreign issuers whose ADRs are listed on an exchange or NASDAQ to register and report under the Exchange Act, the SEC imposes on U.S. investors the inconvenience of buying directly in foreign markets. Many foreign issuers, who would otherwise seek and qualify for U.S. listings, stay away because of the perceived intrusiveness of U.S. disclosure standards in a number of sensitive areas, as well as their concerns about open-ended U.S. antifraud liability.\textsuperscript{144} Foreign issuers report that if they do raise capital in the United States, they prefer to do so through private placements that avoid mandatory U.S. disclosure standards.\textsuperscript{145} In addition, overly demanding U.S. disclosure standards also limit investment opportunities for U.S. investors abroad, as foreign issuers

\begin{itemize}
\item \textsuperscript{142} See id.
\item \textsuperscript{143} As Professor Stephen Choi argues, the Internet will make it possible for issuers and investors to pick and choose among both public and private sources of protection, leading to the best combination of protections for each particular securities offering. See Choi, Gatekeepers and Internet, supra note 90, at 50-54 (arguing that issuers will be able to use the Internet to choose one or more public or private certifiers on the basis of risk, capitalization and potential for fraud).
\item \textsuperscript{144} See Fanto & Karmel, supra note 117, at 51, 71. See also Michel Hurley, International Debt and Equity Markets, 8 EMORY INT'L L. REV. 701, 706-707 (1994) (pointing out that 64 percent of foreign registrations in the United States are by foreign governments as opposed to foreign business firms).
\item \textsuperscript{145} See Frederick Choi & Richard M. Levich, THE CAPITAL MARKET EFFECTS OF INTERNATIONAL ACCOUNTING DIVERSITY (1990) [hereinafter CHOI & LEVICH, INTERNATIONAL ACCOUNTING DIVERSITY].
\end{itemize}
are hesitant to deal with them for fear of becoming subject to U.S. securities laws.\footnote{See Cox, Rethinking in the Shadow, supra note 59, at 162.}

Nonetheless, the anomaly that U.S. mandatory disclosure imposes lower disclosure standards on higher-risk foreign securities has not escaped attention. Some have argued for equalization of treatment, so that U.S. and foreign disclosure approach an international standard.\footnote{See id. at 157.} Others argue that foreign issuers should be permitted to rely on home country disclosure under varying circumstances.\footnote{See Edward F. Greene et al., Hegemony or Deference: U.S. Disclosure Requirements in International Capital Markets, 50 BUS. LAW. 413, 416-18 (1995) (arguing for home country disclosure when the market in the relevant foreign securities is efficient, as measured by minimum disclosure, reporting and insider-trading standards, and the issuer satisfies minimum capitalization and trading volume thresholds); Michael Schneider, Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?, 3 MINN. J. GLOBAL TRADE 301, 302-03 (1994) (arguing that foreign companies should be exempt from U.S. GAAP standards).} Still others argue that U.S. disclosure regulation should be equalized for international and domestic transactions.\footnote{See Lowenstein, supra note 62, at 1358-62 (asserting the superiority of U.S. accounting and disclosure standards and arguing that internationalization should not be used "as a convenient excuse for accepting the significantly lesser standards of others").}

Whatever the merits of these various proposals, separate regulatory policy for U.S. issuers and foreign issuers powerfully demonstrates the fallacy of mandatory disclosure in securities offerings. Once one concedes that U.S. investors do not need mandatory protection from foreign issuers, it is a small logical step to the conclusion that no protection is needed from U.S. issuers. As Professor Louis Lowenstein has pointed out:

If we lower standards radically for foreign companies, American companies surely will cry foul and demand equal treatment. Disclosure has its costs, and if investors don't need all that much from the
newcomers, why demand it from U.S. companies?^{150}

Given the overlap in the markets for domestic and foreign securities, it is inappropriate to disaggregate international and domestic transactions in the formulation of regulatory policy.^{151}

5. Company registration: cautious SEC reform

From appearances, the SEC has recently accelerated its deregulation of the Securities Act regime. In a 1996 concept release, the SEC outlined its deregulatory agenda for securities offerings.

The Securities Act and the issuer disclosure provisions of the Exchange Act are premised on the view that investors are best protected in making investment decisions if they are presented with full and fair disclosure of all material information about the investments. . . . Faced with the following developments, among others: increasing institutionalization of the markets; advances in technology and communication media; continuing globalization of securities markets; and the erosion of distinctions between private and public transactions, the Commission is examining whether the existing investor protection mechanisms, such as registration of both offers and sales and physical delivery of final prospectuses to investors around the time of sale, remain the best methods for accomplishing this full disclosure objective. . . . [T]he Commission is considering . . . whether certain distinctions between public and private offerings of public companies remain necessary . . . .^{152}

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^{150} Id. at 1338.
^{151} See Cox, Rethinking in the Shadow, supra note 59, at 157.
The SEC's reexamination of Securities Act registration was prompted by a report of the SEC Task Force on Disclosure Simplification (the "Wallman Report"), which had urged more readable and informative disclosure documents and regulatory reforms to reduce costs for securities offerings and increase access of smaller companies to the securities markets.\footnote{153} The SEC has responded to the Wallman Report in stages. In March 1996, the agency rescinded a slew of rules thought to be little used or outdated.\footnote{154} In 1997, the SEC introduced a "plain English" pilot program, prompted by the Wallman Report's conclusion that prospectuses, written principally for market professionals, are often "turgid, opaque and unreadable."\footnote{155}

In 1996 another SEC-created group, the Advisory Committee on the Capital Formation and Regulatory Processes, recommended a company registration system meant to eliminate unnecessary regulatory costs and streamline the process of raising capital, to enhance ongoing disclosures to secondary trading, and to eliminate the complex distinctions between public and private, domestic and offshore,


and issuer and non-issuer transactions. The heart of the company registration system would involve eliminating the regulatory requirement of offering intermediaries, as well as permitting greater issuer choice in structuring offerings and communicating with shareholders.

After a long gestation, the SEC proposed massive changes to the registration system for public offerings. Dubbed the "aircraft carrier," the SEC proposal would adopt some of the changes advocated by the Advisory Committee for larger seasoned issuers and for greater company disclosure to trading markets but would largely continue the transactional focus of current Securities Act regulation. The proposal would consolidate disclosure requirements for public offerings in two registration statement forms (Form A and Form B), mandate pre-sale delivery of disclosure documents to coincide with investors' actual investment decision, ease restrictions on pre-offering communications so issuers could test the waters before choosing a public offering, permit moves from public to private offerings, and increase periodic disclosure requirements and responsibilities.

The "aircraft carrier" proposal, far from easing regulatory overhang for public offerings, threatens to add rigidity and costs to the offering process. If adopted in its current form, the proposal would create offering delays both for sea-

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166 See Committee on Capital Formation, supra note 68. Company registration, like the SEC's integrated disclosure initiatives, assumes informationally efficient markets in which information reported to the market will be reflected in the trading price. Once the company is registered, the issuer could tailor its prospectus disclosure to the nature of the transaction and the targeted investors. The Advisory Committee lists a number of the benefits of company registration. See id. Market considerations, rather than regulatory concerns, would govern market access. With lower transaction costs and less delay, issuers could go to market more often and in smaller amounts. Company registration would eliminate the market overhang from universal shelf registrations and facilitate stock-for-stock acquisitions. See id. Greater flexibility in marketing would mean the timing and content of prospectus disclosure would be governed by informational needs of investors, not the need to prepare and deliver after-the-fact compliance documents. See id.
soned and unseasoned issuers, increase liability risks for issuers using streamlined Form B registration, and reduce the availability of highly-popular sales methods, such as at-market offerings using delayed shelf registration and private Rule 144A offerings made pursuant to A/B exchanges.\footnote{See Aircraft Carrier Proposal, \textit{supra} note 2. The SEC's proposal is a minefield of unintended (or perhaps intended) consequences. In the name of reducing the costs, delays and uncertainties of the current registration scheme, the agency proposes to add significant new conditions and risks that would further burden the U.S. offering process — creating costs ultimately borne by investors:}

\textbf{Issuers.} Issuers would be required to take certain steps not now required —

\begin{itemize}
\item assure pre-sale delivery to all investors of term sheets or preliminary prospectuses (with additional 3- or 7-day delays for issuers using the all-purpose Form A);
\item risk Section 12(a)(1) rescission liability for offerings using Form B (available to larger, seasoned issuers) if the form was not available or did not include required information;
\item forego at-market sales from the shelf if the issuer cannot use Form B (approximately 1100 seasoned S-3 issuers that currently qualify for shelf registration would not qualify for new Form B);
\item risk "going concern" disqualification under Form B if the issuer disagrees with SEC staff comments about Exchange Act filing disclosures; and
\item forego private 144A offerings to institutional investors that permit later resale of the securities into public markets (so-called A-B exchanges).
\end{itemize}

\textbf{Underwriters.} Securities firms acting as underwriters would have new burdens —

\begin{itemize}
\item assure pre-sale delivery to all investors of terms sheets or preliminary prospectuses, including disclosure of any material changes at least 24 hours prior to pricing;
\item risk Section 12(a)(1) rescission liability for offerings using Form B (available to larger, seasoned issuers) if the form was not available or did not include required information;
\item forego proprietary communications with customers or disclose information under filing requirement for all free-writing communications;
\item risk greater "due diligence" exposure for offerings of investment-grade debt, which are not covered by six "positive facts" proposed to measure reasonableness of underwriters' investigation; and
\item agree to heightened liability under Section 11 and Section 12(a)(2), as a condition to participating in a private offering commenced after
lease proposing the new rules is empirical analysis of the likely benefits and costs of the various new rules. For example, while acknowledging that more than a third of recent IPOs have been pursuant to an A/B exchange (in which an issuer offers securities privately and shortly afterward registers substantially identical securities in exchange for those privately placed) and without citing to any abuses in these transactions, the SEC proposes to eliminate the flexibility of these offerings based on the agency's unsupported "views regarding . . . the need for additional protections for non-QIBs in offerings by these smaller issuers." In its cost-benefit analysis of the new registration scheme, the SEC estimates that affected parties would spend about $5.4 billion to comply with the proposal, compared to current compliance costs of about $5.6 billion. Nowhere does the agency ask whether investors consider this expensive protection, and its many indirect costs, to be worth it.

The proposal, though styled as one creating greater issuer speed and flexibility, seems to reverse the SEC's de-regulatory direction, which over the last twenty years has been to offer more registration formats and greater disclosure choices. Perhaps the "aircraft carrier" proposal, which at this writing is still open to comment, represents a regulator's "wish list" and will be revised to accommodate inevitable issuer and investor concerns of over-regulation. Perhaps the proposal is a measured capitulation to the regula-

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an abandoned public offering.


In fact, it appears the SEC seems to want to increase offering costs. For example, the agency states its hope to make 144A offerings more difficult so that issuers will channel into registered public offerings — this despite the great success of 144A offerings. *See id.* at 67,186-88.

138 The SEC points out only that overall direct compliance costs for the private sector will fall from $5.6 billion per year under the current regime to $5.4 billion under the new regime, without any discussion of how the many restrictions on private offerings will affect issuers' costs of capital. *See id.* at 67,251 & n.586.

139 *Id.* at 67,208.

160 *See id.* at 67,251 & n.586.
tory status quo — an attempt to assure the SEC and established securities firms a continuing role in public offerings.\textsuperscript{161} Perhaps it is the SEC's "swan song."

Wherever the "aircraft carrier" proposal eventually docks, the last several years of SEC initiatives reflect deep doubts about the Securities Act's current registration scheme.

B. Judicial Revisionism: Private Choice in \textit{Ex Post} Liability

Federal courts, even more than the SEC in its deregulation of \textit{ex ante} disclosure, have sought to balance the costs and benefits of mandatory disclosure. Judicial deregulation of \textit{ex post} liability has proceeded on multiple fronts. Federal courts have limited the coverage of heightened antifraud standards; they have permitted issuer-investor contracting on such matters as forum selection and fee-shifting in securities fraud actions; and they have accepted that disclosure disclaimers can shift to investors the risk that management predictions will go awry.\textsuperscript{162} Recognition of party choice, as might be expected, has been particularly powerful in the international context. And federal courts have accomplished this multi-faceted deregulation without

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\textsuperscript{162} Professor Douglas Branson has assembled an even more impressive list of items on the courts' deregulatory agenda. \textit{See} Douglas M. Branson, \textit{Running the Gauntlet: a Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions}, 65 U. CIN. L. REV. 3 (1996) (describing the federal courts' pro-defendant case law over the last twenty years, including the restrictions on the classes of Section 12(a)(2) and Rule 10b-5 defendants, the creation and implementation of a shorter Rule 10b-5 statute of limitations, the heightened pleading requirements in securities fraud actions, the sanctions against securities plaintiffs and their lawyers under Rule 11 of the Federal Rules of Civil Procedure, the "bespeaks caution" doctrine, and \textit{caveat emptor} contract substitution) [hereinafter Branson, \textit{Running the Gauntlet}].
\end{quotation}
any particular administrative or legislative guidance.\textsuperscript{163} On their own, federal judges have perceived a shift in market maturation and investor sophistication and have modified the scope and content of \textit{ex post} mandatory disclosure.

1. Shrinking coverage of heightened liability

Over the last ten years, the map of disclosure liability in securities offerings has been redrawn. What began the decade as a broad scheme of heightened liability for misinformation in both registered and unregistered offerings is now riddled with exceptions and caveats. In unregistered offerings, where heightened ("due care") liability was long thought to govern private and other exempt offerings, the Supreme Court has reshaped Securities Act liability to cover only "public offerings." In registered offerings, where courts regularly extended strict-liability protection to all purchasers of registered securities, including those in the post-offering aftermarket, lower federal courts now limit plaintiff standing to original, direct purchasers of the registered securities.

\textit{Gustafson} and private offerings. For more than 60 years, securities lawyers and courts held as an article of faith that securities offerings (registered and exempt) are subject to heightened antifraud protection under Section 12(a)(2) of the Securities Act.\textsuperscript{164} In registered securities offerings, it was assumed Section 12(a)(2) extended liability

\begin{footnotesize}
\textsuperscript{163} Some commentators have proposed that Congress modify liability standards according to issuer quality and size. \textit{See}, e.g., Stephen J. Choi, \textit{Company Registration: Toward a Status-Based Antifraud Regime}, 64 U. Chi. L. Rev. 567 (1997). Yet these proposals would place the responsibility for balancing the costs and benefits of securities fraud liability on the institution that has shown the least adaptability.

\end{footnotesize}
coverage to participants (principally retail broker-dealers) not on the Section 11 defendant list and for misrepresentations arising outside the registration statement, whether in writings beyond the "preliminary" or "statutory" prospectus or in oral communications. In unregistered offerings, Section 12(a)(2) was thought to create antifraud coverage for statutory sellers under a "due care" standard — that is, heightened liability for negligent misrepresentations. Among lower courts and commentators, there was widespread agreement that this heightened liability was appropriate in securities offerings, including private offerings, given the perceived market failure in securities offerings and the investor protection philosophy of the Securities Act.\(^{165}\) The costs of increased "due care" imposed on statutory sellers, it was assumed, was more than offset by the protections afforded investors.

In *Gustafson v. Alloyd Co.*, the Supreme Court brusquely unraveled these understandings, at least as they relate to unregistered offerings.\(^{166}\) The Court interpreted Section 12(a)(2) to apply only to misrepresentations in public (apparently registered) offerings. Reading the term "prospectus" in Section 12(a)(2) to refer only to the statutorily-mandated disclosure document used in a public offering, the Court's majority removed private offerings from Section 12(a)(2) coverage. In the case, a sophisticated venture capital firm had purchased 100% ownership of a privately-held company from a family control group. After lower-than-expected earnings, the purchaser chose to pursue a rescis-


For a sampling of cases applying Section 12(a)(2) to private transactions, see Pacific Dunlop Holdings Inc. v. Allen & Co., 993 F.2d 578 (7th Cir. 1993), cert. granted, 114 S. Ct. 907, cert. dismissed, 114 S. Ct. 1146 (1994); Metromedia Co. v. Fugazy, 983 F.2d 350 (2d Cir. 1992), cert. denied, 113 S. Ct. 2445 (1993).

sion claim under Section 12(a)(2) rather than its negotiated contract remedies, which provided for an adjustment to the purchase price. Although it seemed clear the purchaser could have negotiated (and paid for) contractual disclosure warranties, the purchaser sought to hold the sellers to the statutory Section 12(a)(2) warranty against negligent misrepresentations.

The Court's reasoning, which commentators have correctly criticized as technically flawed, reflected fundamental doubts that investors in private securities transactions deserve the heightened "due care" protection of Section 12(a)(2). In effect, the Court rewrote the Securities Act to exempt private transactions from heightened fraud liability, paralleling the congressional conclusion sixty years earlier that investors in private transactions "can fend for themselves" and need not be compelled to bear the costs of registration. Just as investors in private placements must negotiate for disclosure, *Gustafson* now leaves to negotiation *ex post* disclosure liability beyond the traditional fraud liability of Rule 10b-5. Securities purchasers after *Gustafson* willing to pay for protection against negligent misrepresentations must now demand contractual warranties from which the seller would be excused if the identified information could not have been ascertained with "due care" — a contractual version of Section 12(a)(2) negligence liability.

Much of the commentary about *Gustafson*'s redrawing of the liability map has been unfavorable, but some has not

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been.\textsuperscript{168} Agreeing with \textit{Gustafson}'s exclusion of exempt private placements from "due care" liability, Professor Letsou has persuasively argued that private investors do not uniformly need the protection of heightened "due care" liability.\textsuperscript{169} Letsou, however, concludes that \textit{Gustafson}'s redrawing of the liability map was blunderbuss in that it excluded aftermarket trading from "due care" liability, even though public investors suffer information asymmetries in the post-offering aftermarket.\textsuperscript{170} Letsou would have had \textit{Gustafson} retain coverage for market purchases by unsophisticated public investors while excluding from coverage exempt private placements.\textsuperscript{171} At one level, this criticism is attractive. Asymmetries in trading markets are more likely than in negotiated transactions. Yet, it is difficult to understand why market purchasers would want to pay for heightened Section 12(a)(2) "due care" liability, while market sellers would prefer Rule 10b-5 "fraud" liability. In the end, \textit{Gustafson} seems to have gotten it right. Issuers and investors in private offerings can negotiate (and price) any enhanced disclosure liability, and both purchasers and sellers in market trading transactions enjoy the same Rule 10b-5 antifraud protection.

**Post-\textit{Gustafson} revisionism.** Lower federal courts have taken up the \textit{Gustafson} gauntlet with enthusiasm, if not recklessness. Ignoring language in the Supreme Court's opinion suggesting that Section 12(a)(2)'s heightened fraud liability might continue to cover exempt public offerings — such as widely-distributed small offerings ex-

\textsuperscript{168} See Elliot J. Weiss, \textit{Some Further Thoughts on Gustafson v. Alloyd Co.}, 65 U. CIN. L. REV. 137, 141 (1996) (agreeing with Court's conclusion that Section 12(a)(2) applies only to public offerings, but disagreeing with Court's analysis that used Section 10 to define the term "prospectus"); Elliott J. Weiss, \textit{Securities Act Section 12(2) After Gustafson v. Alloyd Co.: What Questions Remain?}, 50 BUS. LAW. 1209, 1215-16 (1995).


\textsuperscript{170} See id. at 99.

\textsuperscript{171} See id. at 99-100.
emptied from registration by Section 3(b) or commercial paper placements exempted by Section 3(a)(3) — lower courts since Gustafson have uniformly concluded that Section 12(a)(2) applies only to registered public offerings.\(^{172}\) Some courts, continuing a semantic confusion introduced by the Supreme Court in Gustafson, have even said that Section 12(a)(2) applies only to initial public offerings.\(^{173}\) Suggestions that Gustafson retained "due care" liability for small, but exempt, offerings to public investors have proved misguided.

Judges' revisionist enthusiasm has not been limited to Section 12(a)(2). Accepting Gustafson's reading that the Securities Act concerns itself only with public offerings, not aftermarket trading, lower federal courts have denied Section 11 standing to plaintiffs who purchased their securities in the aftermarket of a registered offering.\(^{174}\) Lower courts

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\(^{173}\) See Sturm v. Marriott Marquis Corp., 26 F. Supp. 2d 1388 (N.D. Ga. 1998) (dismissing claim involving exchange offer to limited partners, since "case does not involve an initial public offering"); Glamorgan Coal Corp v. Ratner's Group PLC, No. 93 Civ. 7581 (RO), 1995 WL 406167, at *2 (S.D.N.Y. July 10, 1995) (collecting cases and stating "[e]very court since Gustafson, including this district, has held in light of Gustafson, that Section 12(2) applies only to initial public offerings").

have pointed to the Securities Act legislative history cited by the *Gustafson* Court, which states the Act governs only "new offerings" rather than "the ordinary redistribution[s] of securities."\(^{175}\) This denial of Section 11 standing to aftermarket plaintiffs flies in the face of the Section 11 damages scheme, which explicitly contemplates the possibility that Section 11 plaintiffs may have purchased (presumably in the market) at more than the public offering price.\(^{176}\) Moreover until *Gustafson*, lower courts had uniformly accepted that Section 11 plaintiffs had standing if they proved the pedigree of their securities by tracing them to a registered offering, thus accepting the standing of aftermarket purchasers.\(^{177}\) Not surprisingly, the post-*Gustafson* courts that have narrowed Section 11 standing make no mention either of the judicial "tracing" rule or the statutory damages formula applicable to aftermarket purchasers. Revisionism is sometimes an unsightly enterprise.

2. Securities arbitration: contractual forum choice

The Supreme Court's decisions upholding the arbitrability of federal securities claims represent a watershed in the judicial attitude toward party choice in securities transactions.\(^{178}\) In 1987, the Court concluded in *Shear-


\(^{176}\) See Securities Act § 11(e), 15 U.S.C. § 77k (1994). For such plaintiffs their recovery is based on the lower of the purchase price and the offering price.

\(^{177}\) See *Barnes v. Ososky*, 373 F.2d 269, 273 (2d Cir. 1967) (imposing a tracing rule that Section 11 plaintiffs must have purchased securities that are the direct subject of the prospectus or registration statement); see also *Harden v. Raffensperger*, Hughes & Co., 933 F. Supp. 763 (S.D. Ind. 1996); *Wolfson v. Solomon*, 54 F.R.D. 584, 588 (S.D.N.Y. 1972). The tracing rule finds solid support in the text of Section 11, which speaks of "purchasers of such securities," and the Section 11 damages formula which caps damages at the offering price. Securities Act § 11(a), (e), 15 U.S.C. §77k(a), (e) (1994).

\(^{178}\) The cases continue the attitudinal shift toward private contracting in securities transactions begun in *Scherk v. Alberto-Culver Co.*, 417
son/American Express, Inc. v. McMahon that Congress had not excepted Exchange Act claims from the pro-arbitration mandate of the Federal Arbitration Act of 1925 (the "FAA"), despite the broad personal jurisdiction and venue procedures of the Exchange Act meant to assure securities plaintiffs a federal judicial forum of their choosing. 179 Two years later in Rodriguez de Quijas v. Shearson/American Express, Inc. the Court reaffirmed this conclusion for investor claims brought under the Securities Act. 180 The decisions opened a new era of securities arbitration.

Both McMahon and Rodriguez de Quijas involved boilerplate arbitration clauses in customer-broker agreements signed by investors who later sued in court claiming their brokers had committed securities violations. Implicitly, the Court concluded that the benefits of permitting brokers to offer their customers take-it-or-leave-it securities arbitration clauses outweigh the costs of such clauses, thus rejecting a cost-benefit analysis the Court had attempted thirty years before in Wilko v. Swan. 181 There, the Court had relied on the traditional tenets of securities regulation to invalidate securities arbitration as contrary to the Securities Act's forum-choice provisions. Forum choice, Wilko explained, compensated for the inability of investors to "deal at arm's length and on equal terms with [securities] sellers." 182 Given the bargaining asymmetries, any purported investor consent to a non-judicial forum could not be respected. The Securities Act's antiwaiver provision, Wilko held, voided pre-dispute agreements that stipulated away forum-choice rights. As an interpretation of regulatory paternalism, Wilko is unassailable.

But times had changed since 1953. McMahon expressed grave doubts about Wilko's suspicion of arbitration, and

U.S. 506 (1974), which upheld an arbitration clause in an international stock purchase agreement.

182 Rodriguez de Quijas, 490 U.S. at 480 (quoting Wilko, 346 U.S. at 435).
Rodriguez de Quijas formally overruled the 1953 decision. What had happened? There had been no change in the relevant statutory text: both McMahon and Rodriguez de Quijas considered the same forum-choice and antiwaiver language at issue in Wilko. There had, however, been a change in the regulatory landscape. In 1975, Congress had strengthened the SEC's hand in reviewing rules (including arbitration rules) of the stock exchanges and the NASD. In McMahon, the Court declared confidently: "Even if Wilko's assumptions regarding arbitration were valid at the time Wilko was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority." Yet McMahon's broad validation of securities arbitration did not depend on SEC oversight, the Court acknowledging that not all securities arbitration is conducted under Self Regulatory Organization ("SRO") rules. Later in Rodriguez de Quijas, the Court gave only fleeting attention to the existence of SEC regulatory oversight and instead focused on the procedural nature of the forum-choice provisions:

To the extent that Wilko rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.  

According to Rodriguez de Quijas, securities arbitration agreements do not waive substantive protections since they "serve to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes."

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183 McMahon, 482 U.S. at 233.
184 Id. at 258 n.16 ("Some arbitration agreements permit arbitration before the American Arbitration Association, whose rules are similar to those in the [SRO] Codes.").
185 Rodriguez de Quijas, 409 U.S. at 481
186 Id. at 483
Ultimately, the Court’s endorsement of securities arbitration was part of a broader pro-arbitration agenda anchored in an emerging "party choice" philosophy and achieved by the Court’s 1980s revival of the Federal Arbitration Act of 1925. The FAA had received only desultory attention in Wilko, where the Court decided the private choice philosophy of the 1925 Act had been superseded by the regulatory philosophy of the Securities Act of 1933. But by the time of McMahon and Rodriguez de Quijas, the Court’s attitude toward private dispute resolution had changed. In upholding securities arbitration, the Court embraced the assumptions of party volition and consent endorsed by the FAA. The Court had come to assume that investors, like other commercial actors, can fend for themselves. It was not that the SEC had become more effective in assuring investor protection, but rather that investors and the markets in which they operate had filled the role of pervasive government supervision.\textsuperscript{187} Regulatory paternalism, whatever the statutory text, had become outdated.

After a decade of experience, the Court’s hopes for securities arbitration seem vindicated. From appearances, securities arbitration can reduce the costs of \textit{ex post} enforcement of disclosure promises and thus of securities inter-mediation.\textsuperscript{188} Arbitration offers many benefits over court litigation to brokers and investors, such as reduced pleading formalities, lower discovery costs, faster resolution of disputes, gains from expert decision making, and privacy in

\textsuperscript{187} Professor Sachs reads the embrace in Rodriguez de Quijas of contractual freedom as limited to arbitration agreements. She points out that the Court "prohibited waiver of any 1934 Act provision necessary to ‘place buyers of securities on an equal footing with sellers,’ and thereby subordinated contract law to investor protection." Margaret V. Sachs, \textit{Freedom of Contract: the Trojan Horse of Rule 10b-5}, 51 WASH. \& LEE L. REV. 879, 886 (1994).

the proceedings (not to mention the episodes they reveal).\textsuperscript{189} While these benefits have some costs, such as biases among industry arbitrators, asymmetric lawyering with litigation-trained customer lawyers pitted against arbitration-savvy broker lawyers, and lower settlement incentives since brokers' reputations are less at stake in nonpublic arbitration. In all, though, the benefits seem to outweigh the costs.\textsuperscript{190} The continuing prevalence of arbitration agreements suggests that brokerage firms find arbitration less costly than litigation, and studies suggest that investors in arbitration are not systematically disadvantaged.\textsuperscript{191} In fact, securities arbitration conducted beyond SEC jurisdiction before the American Arbitration Association may be more favorable to investors than arbitration under stock exchange or NASD rules.\textsuperscript{192}

Moreover, the securities industry has been recently moved (whether by SEC oversight or otherwise) to undertake a number of reforms, such as greater transparency in reporting arbitral awards and the appointment of arbitral panels with non-industry representatives.\textsuperscript{193} There has


\textsuperscript{190} See Constantine N. Katsoris, Should McMahon Be Revisited?, 59 BROOK. L. REV. 1113 (1993) (outlining efforts since McMahon to improve the arbitration process and concluding that public investors perceive securities arbitration as a level playing field).

\textsuperscript{191} See GAO Report, supra note 188, at 60. Although questions remain that warrant continuing empirical study, the early indications are that securities arbitration has worked. See Joel Seligman, The Quiet Revolution: Securities Arbitration Confronts the Hard Questions, 33 HOUS. L. REV. 327, 367 (1996) (noting that the GAO Report may have used narrow and stale data but commending Ruder Task Force for confronting hard questions "in a fashion that suggests no bias in favor of either side, but rather a good faith effort to grapple with the mechanics or process of arbitration itself").


even been some concern that securities arbitration has moved too far in adopting litigation-style procedures, a development that plays into the hands of investors.\textsuperscript{124} Perhaps most telling, a significant proportion of customer-broker agreements do not have arbitration clauses, reflecting a conclusion that the costs of such clauses (perhaps from diminished broker reputations or implicit encouragement of customers to initiate formal dispute resolution) are not worth the benefits. Even though one may doubt the equality of the customer-broker bargaining process and question the fullness of investors' consent to pre-dispute arbitration clauses, experience suggests that additional forces mold the outcome of customer-broker dealings.\textsuperscript{125} For example, securities firms demand arbitration agreements principally of customers who employ high-risk investment strategies and are thus high litigation risks.

The \textit{Wilko} assumption that investors, if permitted to waive their statutory forum rights, would systematically be at the mercy of securities professionals seems today both naive and misplaced.

\textsuperscript{124} \textit{See Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.} 6-11 (1996) (making recommendations for the future of securities arbitration and noting that some suggested procedural reforms threaten to move arbitration away from "a model of informal, expeditious, and inexpensive dispute resolution"). Judge Selya of the First Circuit has suggested that securities arbitration procedures may be tending toward a litigation model, undermining arbitration's benefits as an alternative to court adjudication. \textit{See} Bruce M. Selya, \textit{Arbitration Unbound? the Legacy of McMahon}, 62 BROOK. L. REV. 1433, 1434 (1996) (applauding duality between private arbitration and court adjudication, and urging that "securities arbitration \ldots return to its mission as an efficient alternative dispute resolving mechanism rather than recasting itself as a cheap copy of the courts").

\textsuperscript{125} \textit{See} Stempel, \textit{supra} note 189, at 1385 (questioning investor consent and legitimacy of dispute resolution that "begins to look less like the Anglo-American system we have been raised to revere and more like totalitarian or other systems which place little emphasis on individual rights").
3. Private disclaimers of disclosure warranties

Federal courts have also permitted issuers to avoid fraud liability both in securities offerings and market communications through disclosure caveats and other stipulations that limit litigation redress. These judicially-created doctrines reflect a rethinking of the "investor protection" imperative, casting a shadow on the continuing relevance of mandatory disclosure. If investors can be trusted to discount puffery and negotiate contractual inroads on ex post liability rights, the case for mandatory ex ante disclosure must be questioned.

"Bespeaks caution" doctrine. Federal courts in securities fraud cases have declared that disclosures must be read in their context and if forecasts, opinions, or projections are accompanied by sufficiently clear warnings so that no reasonable investor would rely on them, they are not actionable. The doctrine responds to concerns about the costs, and the chilling effects on issuer disclosure, of the statutory disclosure warranties that arise through disclosure liability. As Judge Henry Friendly commented in Texas Gulf Sulphur:

If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that slip of the pen or failure properly to amass or weigh the facts — all judged in the bright gleam of hind sight — will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

196 The definitive statement of the "bespeaks caution" doctrine comes in In re Donald J. Trump, 7 F.3d 357, 364 (3d Cir. 1993). See also Donald Langevoort, Disclosure that "Bespeaks Caution", 49 BUS. LAW. 481 (1994).

Implicit in the doctrine, which has gained wide judicial acceptance, is the conclusion that investors and the markets in which they operate will (or should) discount forward-looking puffery.\(^{198}\) As the Fourth Circuit has commented:

The role of the materiality requirement is not to attribute to investors a childlike simplicity but rather to determine whether a reasonable investor would have considered the omitted information significant at the time. . . . [S]oft puffing statements generally lack materiality because the market price of a share is not inflated by vague statements predicting growth. No reasonable investor would rely on these statements . . . .\(^{199}\)

Implicitly, the doctrine shifts the costs to investigate the basis for forward-looking predictions from issuers to investors. Rather than holding issuers to standards of due diligence, the costs of which are ultimately borne by investors, the "bespeaks caution" doctrine permits issuers to shift investigation costs to investors operating in markets.\(^{200}\)

Courts have extended the "bespeaks caution" doctrine not only to trading in informationally efficient markets,\(^{201}\)

\(^{198}\) See Parnes v. Gateway 2000, Inc., 122 F.3d 539, 548 (8th Cir. 1997) (finding omissions about sales tax exposure, product quality and inventory systems to be rendered immaterial, as a matter of law, by "specific" and "explicit" warnings that a "reasonable investor would not have ignored"); Grossman v. Novell Inc., 120 F.3d 1112 (10th Cir. 1997) (holding statements in press releases and interviews that Novell-WordPerfect merger presented "compelling opportunities" were not materially misleading given cautionary statements in detailed registration statement).

\(^{199}\) Hillson Partners Ltd. Partnership v. Adage, Inc., 42 F.3d 204, 211, 213 (4th Cir. 1994) (citations and quotations omitted).

\(^{200}\) See Branson, Running the Gauntlet, supra note 162, at 19 (criticizing the Private Securities Litigation Reform Act's codification of the "bespeaks caution" doctrine which "substitutes cautionary language (easy and cheap) for traditional due diligence (difficult and expensive)").

\(^{201}\) The informational efficiency of trading markets (an element of the "fraud on the market theory") means that market participants "who
but to private placements, initial public offerings (of debt and equity), mergers, and closed-end mutual funds. The judicial doctrine is thus significantly broader than the legislative safe harbor for forward-looking statements in developed markets. It supposes a new breed of reasonable investor, not the prototypical guileless speculator for whom fraud liability imposed by a sympathetic judge is the last line of protection, but rather a wary analyst alert to the temptation of issuers to overestimate the future.

at the margin make the market efficient by sophisticated analysis of available information” will discount management optimism and focus on cautionary disclosures. In re Westinghouse Securities Litigation, 832 F. Supp. 948, 976 (W.D. Pa. 1993) (dismissing claims concerning disclosure of future loan loss reserves on ground that market participants would not have “naively overlooked” issuer cautions) rev’d in part on other grounds 90 F.3d 696 (3d Cir. 1996).

202 Many of the cases have involved tax shelter limited partnership investments. See Luce v. Edelstein, 802 F.2d 49 (2d Cir. 1986) (finding that cautionary language rendered immaterial estimates of future business results).

203 See Lasker v. New York State Elec. & Gas Corp., 85 F.3d 55, 59 (2d Cir. 1996) (equity offering); Sears v. Glasser, 64 F.3d 1061, 1066 (7th Cir. 1995) (debt offering); In re Donald J. Trump Casino Sec. Litig., 7 F.3d 357, 371 (3d Cir. 1993) (debt offering).

204 See Grossman v. Novell, Inc., 120 F.3d 1112 (10th Cir. 1997).


207 Investor sophistication has been a recurring theme in "bespeaks caution" cases involving privately-placed tax shelter investments. See, e.g., Haggerty v. Comstock Gold Co., 770 F. Supp. 216 (S.D.N.Y. 1991) (applying "bespeaks caution" doctrine to limited partners, all wealthy professionals experienced in tax shelter investments); Adler v. Berg Harmon Assoc., 790 F. Supp. 1235 (S.D.N.Y. 1992) (finding that sophisticated investors could not have relied on optimistic forecasts in private placement memorandum "replete with warnings" of risks). See also Rodney v. KPMG Peat Marwick, 143 F.3d 1140, 1146 (8th Cir. 1998) (Gibson, J., dissenting) (arguing that "sophisticated" investors who made $25,000 minimum investments had been warned of specific risks).
Contract stipulations. Federal courts have also increasingly enforced private stipulations in securities fraud litigation, despite the anti-waiver provisions of the federal securities laws. In a perceptive review of this trend, Professor Margaret Sachs describes the rise, since the late 1980s, of contract freedom in private securities litigation.\textsuperscript{208} Reviving caveat emptor, federal courts in private Rule 10b-5 litigation have come to accept contract-based defenses based on merger clauses, attorneys' fees clauses, and statutes of frauds — despite arguments that these stipulations undermine investor protection and are thus void under the securities acts' anti-waiver provisions.\textsuperscript{209} As Professor Sachs pointed out,

Courts have also assumed investor sophistication in public offerings. \textit{See} Parnes v. Gateway 2000, Inc., 122 F.3d 539, 548 (8th Cir. 1997) (applying "bespeaks caution" doctrine to omissions in public offering to individual investors who should understand "risk of [computer] obsolescence" and puffery implicit in "vague predictions of growth"); Dodds v. Cigna Sec., Inc., 12 F.3d 346, 351 (2d Cir. 1993) (holding, investors whatever their actual level of sophistication, to a "reasonable investor" standard regarding whether they had been put on notice of investment risks); In re Painewebber Ltd. v. Geodyne Resources, 171 F.R.D. 104 (S.D.N.Y. 1997) (holding investors in investment trusts to a "reasonable investor" standard).

\textsuperscript{208} See Sachs, supra note 187. Although judicial attitudes changed perceptibly in the 1980s, federal courts from the beginning understood that investor protection is designed for the innocent. For example, an investor waives his securities claims if he learns of a misrepresentation, but waits to sue hoping the investment becomes profitable. \textit{See} Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213 (9th Cir. 1962) (denying claim of plaintiff who waited two years after learning of misrepresentations before suing, since "purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out").

\textsuperscript{209} See Sachs, supra note 187, at 888. The metamorphosis in judicial attitude is unmistakable:


\textbf{Merger clause.} \textit{Compare} Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 416 (1st Cir. 1989) (dismissing 10b-5 claim based on oral represen-
private rule 10b-5 litigation has become riddled with the vocabulary of traditional contract jurisprudence — the statute of frauds, merger clauses, attorneys' fees clauses, choice of law clauses, releases, and the formation of an agreement. Thus, today lower federal courts often derail rule 10b-5 actions in reliance on the same contract devices that earlier case law rejected as inimical to investor interests.210

What explains this attitudinal change from regulatory paternalism to private facilitation? Professor Sachs attributes it to a confusion about the meaning of the Supreme Court's securities arbitration decisions, arguing that courts should use contractual analysis in federal securities litigation only if the contractual device is demonstrably anchored

Section 8-113 (1994). The Official Comment to § 8-113 states that the statute of frauds had become unsuited to securities transactions in view of the increasing use of electronic means of communication, and whatever its benefits of filtering out bad claims are outweighed by the obstacles it created for developing commercial practices in the securities business. See Official Comment, U.C.C. § 8-113. As of September1998, forty-eight states had codified the change. See Hawkland UCC Series Local Code Variations, at vi-vii (1998).

210 Sachs, supra note 187, at 880.
in the language, history, or policies of the federal securities laws. But on inspection the phenomenon seems not to emanate from judicial confusion, as much as from a new deregulatory spirit. Despite cautionary language in Rodriguez de Quijas, lower federal courts continue regularly to use contractual analysis in securities litigation. Enforcing agreements (sometimes indefinite) against investors who claim they have been defrauded, courts have focused on investor sophistication and awareness of risk with only dismissive attention to the legislation's antiwaiver provisions. As some courts have perceptively noticed, to excuse

211 See id. at 888. Sachs derives this conclusion from her reading of Rodriguez de Quijas which accepted waivers of investor protection (whether or not statutory) only if the investor had not given up something necessary to "place buyers of securities on an equal footing with sellers." Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 481 (1989). Sachs also finds support in the Supreme Court's decision upholding a 10b-5 right of contribution among joint tortfeasors, in which the Court rejected the parties' law-and-economics arguments about the efficiency of the right of contribution and characterized its task as "not to assess the relative merits of the competing rules, but rather to infer how the 1934 Congress would have addressed the issue." Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 293 (1993).

Professor Douglas Branson, who has also decried the judicial acceptance of contractual defenses, attributes the changed judicial mindset to "conservative judges" who have concluded that investors should act at their peril. Branson, Running the Gauntlet, supra note 162, at 22. In particular, Branson criticizes the judicial acceptance of merger clauses, which he describes as boilerplate that permits salespersons to exaggerate an investment knowing any oral assurances will be rendered actionless by the merger clause. See id.

212 Sachs, supra note 187, at 894-919 (collecting post-Rodriguez de Quijas cases that uphold contract defenses). The trend continues. See Harsco Corp. v. Segui, 91 F.3d 337, 344 (2d Cir. 1996) (upholding merger clause which "weakened" plaintiff's 10b-5 claim by limiting disclosure liability to particular warranties, since parties were both "sophisticated business entities"); United Municipal Leasing Co. v. Lexington Corporate Properties, No. 95 C 3212, 1996 U.S. Dist. LEXIS 17121 (N.D. Ill. Nov. 18, 1996) (statute of frauds). But see In re Integrated Resources Real Estate Limited Partnerships Securities Litigation, 815 F. Supp. 620 (S.D.N.Y. 1993) (citing Rodriguez de Quijas to permit indemnification for attorney fees only if investor's claim is frivolous).

213 In the contract cases, investors are regularly cast not as innocent victims, but rather as mature actors responsible for their promises and
investors from the terms of their agreements would expose issuers to investor opportunism and thus increase investment costs.\textsuperscript{214} In short, the shifting judicial attitude derives from a reconception of investor vulnerability.

4. Party choice in international securities transactions

Just as greater globalization has led the SEC to ease mandatory disclosure for cross-border offerings, federal courts have accepted disclosure choice in international securities transactions. Faced with parties that have contracted to avoid the costs of U.S. securities regulation, federal courts have enforced the terms of their international contracts even though the effect is to dilute U.S. investor protection.

In 1974, more than a decade before domestic arbitration won judicial favor, the Supreme Court in Scherk v. Alberto-Culver Co. upheld an arbitration clause in an international stock purchase agreement that the U.S. investor claimed had been procured through fraud.\textsuperscript{215} The Court accepted the parties' forum-selection clause because of the uncertainty

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investment risks. See Zissu v. Bear, Stearns & Co., 627 F. Supp. 687 (S.D.N.Y. 1986) (enforcing indemnification and attorney's fees clauses against investor who had falsely represented that he was qualified to make private tax shelter investment, despite arguments that clauses served to waive investor's liability rights), rev'd in part on other grounds, 802 F.2d 75 (2d Cir. 1986) (finding indemnification clause too vague to enforce, but upholding attorney's fees clause); Barnebey v. E.F. Hutton, 715 F. Supp. 1512 (D. Fla. 1989) (enforcing indemnification clause against investor who misrepresented his sophistication); Abbott v. Equity Group, Inc., 2 F.3d 613 (5th Cir. 1993) (upholding indemnification promise by investors to surety company, which sought to collect when investors defaulted on payment obligations in real estate venture; rejecting antiwaiver argument by investor-indemnitors, whose subscription agreement emphasized "a high degree of risk and special risks").

\textsuperscript{214} "If this indemnification agreement is not enforceable, it would undermine the securities laws to the extent that investors would be free to make misrepresentations with impunity and issuers would be wholly unable to accurately assess the qualifications of potential investors in risky ventures such as this one." Zissu, 627 F. Supp. at 694.

that would be engendered by application of national law to a multinational transaction.\textsuperscript{216} The decision came at a time that pre-dispute securities arbitration agreements, at least in the domestic context, were widely assumed to violate the securities laws' antiwaiver provisions.

The recent *Lloyd's of London* cases continue this judicial acceptance of party choice in the international securities context. The cases arose out of heavy insurance claims against Lloyd's that necessitated for the first time calls on its member "Names" to underwrite the losses.\textsuperscript{217} When U.S. Names sought to avoid the calls by asserting securities fraud in connection with their investment, Lloyds argued the Names' agreements called for litigation in British courts under British law. Federal courts, relying on the rule of *M/S Bremen v. Zapata Off-Shore Co.*\textsuperscript{218} that forum-selection clauses are valid unless shown to be unreasonable, have uniformly enforced the agreements' forum-selection and choice-of-law clauses.\textsuperscript{219} Although the Names have claimed

\textsuperscript{216} See also Mitsubishi Motors v. Soler, 473 U.S. 614, 629 (1984) (upholding clause in international distributor agreement calling for arbitration before the Japanese chamber of commerce since enforcing the parties' agreement would promote "international comity ... and sensitivity to the need of the international commercial system for predictability").

\textsuperscript{217} The cases arose out of substantial environmental claims against Lloyd's in the early 1990s. These claims had been anticipated. In 1969, Lloyd's management became aware the firm might face massive liability arising from asbestos, pollution, and health hazard claims. To cover the anticipated claims, Lloyd's began recruiting U.S. investors, but did not disclose the full extent of Lloyd's potential liability. In the 1980s, Lloyd's successfully lobbied Parliament to grant it limited immunity from civil suits by investors in English courts, including for claims of misrepresentation absent a showing of bad faith and fraud claims in connection with securities transactions. Investors who refused to sign the forum-selection and choice-of-law clauses were forced to withdraw from Lloyd's. See Stamm v. Barclays Bank of New York, 960 F. Supp. 724 (S.D.N.Y. 1997).

\textsuperscript{218} 407 U.S. 1, 15 (1972).

\textsuperscript{219} To date, all the courts of appeals presented with the issue have upheld the Lloyd's choice-of-forum and law clauses. On four occasions the Supreme Court has refused certiorari, despite urgings by the SEC as amicus to invalidate the Lloyd's clauses as contrary to the antiwaiver provisions of the federal securities laws:
that they were misled when they agreed to litigate in Britain and that British law provides limited immunity from securities fraud claims against Lloyd's, the courts have rejected these arguments and have pointed to the Names' investment sophistication, the awareness and adequacy of


Seventh Circuit. Lipcon v. Underwriters at Lloyd's, London, 148 F.3d 1285 (7th Cir. 1998), cert. denied, 142 L. Ed. 2d 704 (1999); Bonny v. Society of Lloyd's, 3 F.3d 156 (7th Cir. 1993), cert. denied, 510 U.S. 1113 (1994).


220 Haynsworth v. The Corporation, 121 F.3d at 967-68 ("The sophisticated individuals entering into these agreements are hardly so naive as
the parties' choice of British law,\textsuperscript{221} and the international nature of the agreements.\textsuperscript{222}

The cases, as the SEC has recognized, have important regulatory implications. In spirited \textit{amicus} briefs to the Seventh and Ninth Circuits, the SEC has argued that the Lloyd's clauses effectively nullify the federal antiwaiver provisions, an essential component of investor protection.\textsuperscript{223} The SEC has warned that allowing foreign securities pro-

to believe that by choosing only a foreign forum and not the law to be applied therein, they thereby retain some inalienable privilege of litigating their disputes under American law."). The Fifth Circuit's conclusion about investor sophistication was typical: "The FS/COL clause was straightforward and was a prominent part of the one-and-one-half-page General Undertaking, and the plaintiffs are presumed to have known what it said. The plaintiffs were sophisticated parties contracting voluntarily; it is not for us to impose a duty upon one party to counsel the other as to the risks and benefits of a contract." \textit{Id.} at 965 (footnote omitted).

In an interesting juxtaposition of the \textit{ex ante} disclosure requirements of the Securities Act and the \textit{ex post} liability standards of the antifraud provisions, the Second Circuit pointed out that the SEC had consistently exempted Lloyd's from the registration requirement of the securities laws, apparently on the grounds that the Lloyd's means test satisfied the "accredited investor" standards of Regulation D. The Second Circuit said: "We are extremely reluctant to dispute the SEC's apparent judgment that the . . . Names are sophisticated enough that they do not need the disclosure protections of the securities laws." \textit{Roby}, 996 F.2d at 1366. In other words, an investor who does not need \textit{ex ante} disclosure can bargain away \textit{ex post} liability rights.

\textsuperscript{221} \textit{See Roby}, 996 F.2d at 1364 (determining that U.S. securities laws would not be compromised because English law was adequate to protect American investors); \textit{Bonny}, 3 F.3d at 156 (expressing confidence in the adequacy of British law).

\textsuperscript{222} As the Seventh Circuit said, "[t]o conclude that the antiwaiver provisions of the United States securities laws categorically preclude sophisticated parties from entering into international agreements — agreements that by definition involve parties and subject matter that would be subject to the laws of more than one nation if the parties did not contract \textit{ex ante} for provisions governing choice of forum and choice of law — would undermine both policies upon which \textit{Bremen} and \textit{Scherb} were based." \textit{Lipcon}, 148 F.3d at 1294-95. \textit{See also Riley}, 969 F.2d at 957-58 (concluding that agreement was truly international, reflecting numerous contacts with the foreign forum).

\textsuperscript{223} \textit{See Lipcon}, 148 F.3d at 1285; \textit{Richards}, 135 F.3d at 1289.
motors to avoid private liability by forcing U.S. investors to agree to resolve disputes in a foreign jurisdiction under foreign law would dilute their remedies. The SEC has admonished courts not to supplant U.S. securities laws on the view that foreign law, though less protective of investors, is nonetheless sufficient. But the SEC arguments have fallen on largely deaf judicial ears.

Joining the SEC, some commentators have criticized the Lloyd's of London cases, and rightly so, as violative of the regulatory spirit of the U.S. securities laws.224 They have pointed out that U.S. securities laws were enacted to "protect investors" and the acts' antiwaiver provisions are meant to prevent investors, sophisticated and unsophisticated, from contracting away their statutory protections.225 Foreign arbitration under foreign law, they have explained, undermines U.S. protections in a number of ways: it removes SEC oversight of arbitral procedures; it results in the application of non-U.S. legal standards; it denies a disappointed party the opportunity for U.S. judicial review for consistency with "public policy"; and it privatizes U.S. disclosure law and undermines the general integrity of U.S.

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224 See James D. Cox, Choice of Law Rules For International Securities?, 66 U. CIN. L. REV. 1179, 1186-88 (1998) [hereinafter Cox, Choice of Law]. Professor Cox criticizes the Lloyds cases as privatizing U.S. securities regulation, with two untoward consequences: (1) the unknowing waiver of federal securities protection undermines the protective philosophy of the federal legislation, and (2) an imbalance in the disclosure responsibilities of foreign and domestic issuers raises the capital costs for all. See id. See also Darrell Hall, Note, No Way Out: An Argument Against Permitting Parties To Opt Out of U.S. Securities Laws in International Transactions, 97 COLUM. L. REV. 57 (1997) (urging that Congress pass legislation preventing parties from displacing U.S. securities regulations). Hall criticizes these decisions for a number of reasons and then argues that either the courts must establish a more clearly defined standard for assessing the enforceability of such clauses or Congress should pass legislation preventing parties from displacing U.S. securities regulation.

225 See, e.g., Cox, Choice of Law, supra note 224, at 1186-87; Hall, supra note 224, at 60 (quoting S. REP. NO. 73-47, at 2 (1933); H.R. REP. NO. 73-85, at 1 (1933)).
securities markets.\footnote{226} Under the approach in the \textit{Lloyd's of London} cases, U.S. investors seeking U.S. securities protection are left to prove that foreign procedures or legal standards will undermine their U.S. rights to full and honest disclosure. In effect, the critics have asserted, federal courts have accepted that sophisticated U.S. investors can contract out of statutory protections that Congress intended to be mandatory. Private choice has supplanted public law.

In the end, the \textit{Lloyd's of London} cases reveal the strength of the judicial resolve to permit private choice in securities offerings, particularly when the parties' transaction may be subject to multiple regulatory regimes. The cases create an impressive body of U.S. securities jurisprudence reflecting deep doubts about the securities acts' anti-waiver provisions and their assumption of investor helplessness and market failure.

C. Congressional Revisionism: Expansion of Private Choice

Congress has long been sensitive to the costs of mandatory disclosure in securities offerings. The most significant legislative recognition is found in the private offering exemption of the Securities Act.\footnote{227} Others include the often-expanded small-offering exemption of Section 3(b) and the accredited investor exemption of Section 4(6).\footnote{228} Congress, however, has largely left to the SEC the task of giving content to congressional concerns about the cost-benefit balance in \textit{ex ante} disclosure.

\footnote{226} See Cox, Choice of Law, supra note 224, at 1187-88; Hall, supra note 224, at 79-80. See also Jennifer M. Eck, \textit{Turning Back the Clock: A Judicial Return to Caveat Emptor for U.S. Investors in Foreign Markets}, 19 N.C. J. INT'L L. & COM. REG. 313, 328 (1994) (noting significant advantages of U.S. securities law over English law at the time of the litigation, including lower scienter and causation requirements, established private right of action, and possibility to recover treble damages and attorney fees).
Of late, Congress has shown interest in the costs of heightened \textit{ex post} liability.\footnote{Until 1995, the last time Congress revisited the scope of the Securities Act scheme of heightened liability was in 1934, when it revised the Section 11 liability scheme in response to securities industry concerns that securities underwriting in public offerings would be squelched by the new Act’s strict liability scheme.} In the Private Securities Litigation Reform Act of 1995,\footnote{Pub L. No. 104-67, 109 Stat. 737 (1995).} Congress accepted the story that class-action securities fraud litigation is out of hand — a machine fueled not by securities fraud, but the extortion value of securities litigation. The Reform Act recognizes that suboptimal liability standards and procedural rules in securities class actions impose costs on issuers (good and bad) that are passed on to investors.\footnote{See Janet Cooper Alexander, \textit{Do the Merits Matter? A Study of Settlements in Securities Class Actions}, 43 STAN. L. REV. 497 (1991) (finding that class action settlements of securities fraud claims have structural characteristics that decouple the settlement process from expected trial outcomes, so that the “merits do not matter”).} The settlement of securities fraud class actions — the nearly universal outcome in these cases — involves payment by the company (existing shareholders) to the plaintiff class (a sub-group of existing or former shareholders) and to the plaintiff’s lawyers.\footnote{When the allegation is that management fraud artificially depressed prices, current shareholders pay former shareholders who sold low before public revelation of the truth. When the allegation is that management artificially inflated prices, long-term shareholders pay recent purchasers who bought high.} For a diversified investor, these intra-shareholder wealth transfers would be irrelevant, except that they are accompanied by heavy litigation costs. Some costs, such as those extracted by securities litigators, are direct. Others, which impact the quality and quantity of disclosure, are indirect as issuers avoid public disclosures for fear they will be misinterpreted by the trading markets — and securities litigators. In addition, issuers with highly volatile returns (and thus stock prices) shun public equity offerings, the usual targets of securities fraud litigation. These issuers, instead, prefer offerings to institutional investors of investment grade debt, collateralized securities,
and other instruments rarely targeted by securities litigation.\footnote{See Joseph Grundfest, Why Disimply?, 108 HARV. L. REV. 727, 731 (1995) (pointing out that, in the first half of 1994, more than 80% of domestic securities issues were in the form of "investment grade debt, collateralized securities and other instruments rarely targeted by securities litigation").} Individual and other non-institutional investors, denied direct access to these offerings, must content themselves with intermediated investments.

Yet the Reform Act recognizes that securities fraud liability can be beneficial and attempts to set a liability level that best meets the mutual desire of issuers and investors for disclosure that minimizes offering and trading costs.\footnote{Other authors have focused on whether class action settlements in securities fraud litigation are commensurate with class losses. See, e.g., James D. Cox, Making Securities Fraud Class Actions Virtuous, 39 ARIZ. L. REV. 497 (1997) (noting that if the question is whether securities fraud litigation improves or worsens disclosure, it is irrelevant whether securities class recoveries (which involve wealth-shifting among various shareholder groups) are related to securities mispricing and nominal shareholder losses).} How well has the Reform Act balanced the costs and benefits of ex post liability on investor welfare? A review by Professors Grundfest and Perino of preliminary data on post-Reform Act class-action securities fraud litigation shows the Reform Act has had little effect on the aggregate number of companies sued, though apparently has made plaintiffs more cautious (the average stock price decline preceding litigation is now 31%, while before the Reform Act it was 19%) perhaps due to the Reform Act's "strong inference" pleading requirement.\footnote{See Joseph A. Grundfest & Michael A. Perino, Securities Litigation Reform: The First Year's Experience (John M. Olin Program in Law and Economics, Stanford Law School, Working Paper No. 140, Feb. 1997), cited in Michael A. Perino, Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action, 50 STAN. L. REV. 273, 299 n.114 (1998).} But this data does not reveal the value to investors of the Act's revised ex post standards.
Other analysis, however, suggests Congress overreacted and got the cost-benefit balance wrong.\textsuperscript{226} A study by Ashiq Ali and Sanjay Kallapur shows a positive correlation between stock price reactions to President Clinton's veto of the Reform Act bill (which Congress overrode) and measures of a firm's vulnerability to price-change suits — namely, the firm's market model beta and its status as a high-tech company. That is, the prices of vulnerable firms increased when President Clinton expressed his disapproval of the bill's provisions limiting investors' ability to sue. When Congress overrode the veto, stock prices for these firms reversed. The study suggests that shareholders of firms with high litigation risk disapproved of the legislation, perhaps based on their concerns that the bill's restrictions would reduce the deterrent effect of securities litigation and weaken financial disclosure.\textsuperscript{227} Congressional concern for the costs of mandatory liability rules in securities litigation (particularly as they affect high-tech financing) may have been well-intentioned but seems to have been poorly executed. Extant judicial reform efforts, such as the "bespeaks caution" doctrine and pleading requirements for fraud allegations, may have been making headway against litigation abuse without the need for legislative interference.

\textsuperscript{226} See Branson, Running the Gauntlet, supra note 162, at 24 (concluding that the flood of 1980s securities litigation was a temporary phenomenon related to the 1980s takeover boom, the rise in customer-broker disputes, a wave of tax-shelter frauds, and class action suits triggered by price drops — and the first three were winding down when Congress passed the Reform Act in 1995 and the fourth may not have been significant).

IV. DISCLOSURE CHOICE: A PROPOSAL

What will be the tomorrow for the Securities Act? Judging from current trends — at the SEC, in the courts, and on Capitol Hill — federal regulation of securities offerings is moving ineluctably toward disclosure choice. Federal regulation of securities offerings, which arose as a political response to the financial crisis of the Depression, has over time staked a regulatory place alongside federal regulation of securities markets and intermediaries. But the Securities Act regime, which has been whittled away even as market regulation under the Exchange Act has expanded, survives not because of its time-proved efficacy. Rather federal regulation of securities offerings persists because of the regulatory environment in which it lives, one which has led to an institutional game in which the various players (securities regulators, industry members, issuers, and investors) have accepted co-existence. But as market forces erode the regulatory stronghold, the trend is toward a new game. In this part, I outline and consider a possibility.

A. Disclosure Choice in Securities Offerings

The Securities Act often compels issuers to disclose and warrant more than investors are willing to pay for, driving issuers to avoid mandatory disclosure or to choose other financing techniques. Disclosure choice in securities offerings promises to expand the methods and reduce the costs of capital formation by aligning disclosure (both its contents and methods) with actual investor information demands, not legislative or administrative assumptions. For example, public offerings that issuers or underwriters now shun because of the overhang of registration-based liability

238 See Mark J. Roe, Chaos and Evolution in Law and Economics, 109 HARV. L. REV. 641 (1996) (asserting that certain economic forms survive not because of efficiency, but because of initial, often accidental, conditions that established institutional structures; the economic forms solve problems that may no longer be relevant).
would become feasible; private offerings now limited to investors qualified under SEC criteria could be offered to a wider investor pool; and auctioning of securities, unconstrained by the timing rules for registered offerings, could lead to greater price accuracy.\textsuperscript{239}

The varied use, by issuers, of the current disclosure options available under SEC forms and exemptive rules reflect that informational cost-benefit balancing by issuers and investors, in direct and intermediated transactions, can reduce capital costs. Regulatory experience has also shown that across a wide range of offerings, issuers, and investors have been, and can be, left to their own devices. Disclosure choice in securities offerings would enable information providers and users to measure the marginal benefits of \textit{ex ante} disclosure and its marginal costs, and determine when and the extent to which benefits exceed the costs. As the Advisory Committee on the Capital Formation and Regulatory Processes recently recognized, greater disclosure flexibility will permit issuers to market their securities according to investor informational needs.\textsuperscript{240} In the end, disclosure choice builds on our national commitment (already reflected in the Securities Act) to private choice, intermediated by markets, rather than regulated solutions.

1. SEC exemption for "no-registration" offerings

The market-driven tendency toward disclosure choice in securities offerings suggests an evolution toward a regime in which issuers are permitted, in their issuance of securities, to choose the nature and level of \textit{ex ante} disclosure they provide investors, subject to background \textit{ex post} liability rules. My proposal calls for the SEC to adopt a rule that exempts from the registration provisions of Section 5 any offering as to which the issuer had chosen "no-registration"


\textsuperscript{240} See Committee on Capital Formation, supra note 68, at 88,419.
status. Otherwise, a public offering would remain subject to the usual Section 5 gun-jumping, filing, and prospectus-delivery requirements of a registered offering or the conditions (and criteria) of existing SEC exemptive rules. Private offerings exempt under Section 4(2) would not be affected.

Issuers choosing "no-registration" could choose any disclosure level, including line-item disclosure currently required in a registered offering, line-item disclosure permitted under any of the various SEC exemptive rules, some other disclosure standard, or no disclosure. In one respect this approach would parallel the SEC's plan in its "aircraft carrier" proposal to permit Form B issuers to choose the form and style of disclosure given investors during the offering period. This, in the agency's view, would permit issuers "greater freedom . . . to cut some boilerplate disclosure and to omit non-material disclosure from the prospectus."243

"No-registration" offerings would, however, be subject to one mandatory disclosure obligation. As a condition of the exemption, issuers would be required to disclose to investors (and the SEC) that the offering was unregistered and to describe the disclosure level the issuer had chosen.244 Investors would receive a mandatory cover sheet (or comparable document) in which the issuer would provide the fol-

241 This option would not be available to investment companies, given the general absence of intermediated selling of mutual funds. See Romano, Empowering Investors, supra note 4, at 2371-72 (excluding mutual funds from her proposal for state-based securities regulation since large, informed institutional investors typically do not invest in mutual funds, which are held instead by individual investors).

242 See Aircraft Carrier Proposal, supra note 2, at 67,182-83.

243 Id. at 67,183.

244 This would go beyond the current requirements of the statutory private placement exemption, which requires no specific disclosure. Nonetheless, disclosure of the offering's disclosure level would seem implicit in the 10b-5 ban on misleading material omissions. See Note, Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) (1998) (advising issuers providing information to non-accredited investors to "consider providing such information to accredited investors as well, in view of the antifraud provisions of the federal securities laws").
lowing information on the level of disclosure provided in the offering:

- unless the issuer had chosen a registered offering, "framing" warnings that the offering is not registered with the SEC;
- the SEC or other line-item disclosure standards with which the offering complies, if any; and
- disclosures, if any, subject to heightened liability assurances and who is giving them.

SEC exemptive authority. The SEC has exemptive authority to make registration in a securities offering a matter of issuer choice. Added by the National Securities Markets Improvement Act of 1996 (the Improvement Act), new Section 28 of the Securities Act authorizes the SEC to exempt

any ... transaction, or any class ... of ... trans-
actions, from any provision or provisions of this ti-
tle ... to the extent such exemption is necessary
or appropriate in the public interest, and is con-
sistent with the protection of investors.  

The legislative history of the provision leaves little doubt about the breadth of authority delegated to the SEC:

Section 28 allows the Commission enhanced flexi-
bility to more easily adopt new approaches to

246 Section 28 reads in its entirety:

The Commission, by rule or regulation, may condi-
tionally or unconditionally exempt any person, security,
or transaction, or any class or classes of persons, securi-
ties, or transactions, from any provision or provisions of
this title or of any rule or regulation thereunder, to the
extent that such exemption is necessary or appropriate
in the public interest, and is consistent with the protec-
tion of investors.

registration, disclosure, and related issues, such as are being considered by the Commissions [sic] Advisory Committee on Capital Formation. The Committee expects that the Commission will use this authority to promote efficiency, competition and capital formation in the marketplace, consistent with the public interest and investor protection.\(^{247}\)

In addition, the 1996 Improvement Act sought to clarify that "investor protection" should not be the exclusive focus of SEC rulemaking. Under new Section 2(b) of the Securities Act, the SEC is to "consider efficiency, competition, and capital formation" when it engages in Securities Act rulemaking under a "public interest" standard.\(^{248}\)

The House Report specifically calls on the SEC to "analyze the potential costs and benefits of any rulemaking initiative."\(^{249}\)

**Secondary distributions.** The Securities Act defines certain sales by insiders and resales by purchasers of restricted securities as public offerings, subject to full-blown registration requirements. My proposal would not change the scope of these regulatory definitions, but would offer an exemption from registration for secondary distributions that opt for "no-registration" status, subject to "cover sheet" disclosure.\(^{250}\)

**State "blue sky" regulation.** Disclosure choice at the federal level would be undone if issuers remained subject to *ex ante* registration and disclosure requirements at the state level. Although the National Securities Markets Im-


\(^{249}\) H.R. Rep. No. 104-622, at 103

\(^{250}\) Easing the restrictions on secondary distributions should have a beneficial effect on primary offerings, particularly to venture capitalists who will want to sell after a public offering. See Kevin S. Lapidus, *Venture Capital and Rule 144: The Chilling Effect of Securities Regulation on Venture Capital Investing*, 26 Sec. Reg. L. J. 75 (1998).
provement Act of 1996 took a useful first step in removing state authority over a variety of federally registered and exempt offerings, the thesis of my proposal for disclosure choice is that Congress did not go far enough.\footnote{Calls to eliminate state "blue sky" registration are increasing. See Rutheford B. Campbell, Jr., An Open Attack on the Nonsense of Blue Sky Regulation, 10 J. Corp. L. 553 (1985) (characterizing blue sky laws as costly and superfluous); see also Brian J. Fahrney, Comment, State Blue Sky Laws: A Stronger Case for Federal Pre-emption Due to Increasing Internationalization of Securities Markets, 86 Nw. U. L. Rev. 753 (1992).} To enable a "no-registration" exemptive regime, federal legislation would be necessary to preempt state "blue sky" registration laws. Issuers, of course, could choose to register under state law for marketing or other purposes — but under my proposal this would be a matter of choice.\footnote{See Perino, supra note 235, at 318-29 (proposing a federal statutory scheme that would permit issuers to opt into one state's securities antifraud rules).}

\textbf{Ongoing issuer disclosure to trading markets.} My proposal does not call for disclosure choice for issuers now or in the future required to make ongoing, continuous disclosure. Issuers with securities on a U.S. stock exchange or that meet the size thresholds of the Exchange Act would continue to be subject to the Act's panoply of regulation, including its mandatory periodic disclosure requirements. For companies going public, the "no-registration" exemption under the Securities Act would provide only temporary (albeit potentially significant) relief from SEC disclosure mandates. The real value of the "no-registration" exemption would be for seasoned issuers making additional offerings, as well as for non-public issuers seeking to raise capital without the worry or expense of meeting SEC exemptive criteria.\footnote{As to seasoned issuers, my proposal would expand upon the approach of the SEC's recent Aircraft Carrier proposal to permit larger, seasoned issuers to choose the amount and content of information distributed to investors in a public offering. See Aircraft Carrier Proposal, \textit{supra} note 2, at 67,181-86.}
2. Optional heightened (but mandatory) antifraud liability

An issuer in a public offering, by choosing "no-registration" status, would also opt out of heightened Securities Act liability. Under my proposal, the issuer and other participants in a public offering could choose not to offer investors the informational warranties now imposed by Section 11 (strict liability for the issuer and liability for other participants who failed in their "due diligence" defense) and Section 12(a)(2) (liability for misrepresentations made without "reasonable care"). Heightened liability would be broken out as an optional term — to be negotiated and priced separately.

Making heightened liability optional would avoid the general "one size fits all" philosophy of the Securities Act and permit the development of more alert and nuanced private liability standards. As many commentators have pointed out, heightened ex post liability imposes significant costs on registered offerings, oblivious to informational efficiencies in developed markets and the realities of modern securities marketing. Further, it would carry forward the Supreme Court's apparent purpose in Gustafson to remove heightened "due care" liability for sellers in private transac-

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254 To the extent there were any doubts about the liability effects of choosing "no-registration," the SEC exemptive rule could clarify that the choice also exempted the offering from liability under Sections 11 and 12.


256 Professor Banoff, commenting on the liability conundrum created by shelf registration, urged modifying the "due diligence" standard for all offerings into an efficient market. See Banoff, supra note 106, at 184 (concluding that "underwriters should be exempted from due diligence liability for all offerings into an efficient market, whether or not the offering is shelf registered").

257 See Cox, Electronic-Based Federal Securities Act, supra note 74, at 883 (viewing liability standards in securities offerings as a "regulatory challenge").
tions given doubts that the buyers would have negotiated, and paid for, such a liability standard. In fact, the Gustafson parties had negotiated their own different re-pricing mechanism if financial results were less than promised. Heightened liability in a public offering often adds a non-negotiated, unwanted cost; my proposal would restore it to the bargaining table.

Under my proposal, the issuer and other selling participants would remain subject to general antifraud standards — namely, private Rule 10b-5 liability and SEC enforcement actions. Disclosure choice in securities offerings should not implicate an abandonment of mandatory ex post disclosure standards. These rules are implicit in all commercial transactions. Rules compelling issuer honesty may be essential even in situations of costless bargaining between well-informed investors and competing issuers. Moreover, antifraud rules assure the truthfulness and thus reduce the costs of other veracity signals, such as outside verification by auditors and underwriters, debt-dividend strategies, and management stock ownership. To avoid

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258 Disclosure liability might also arise under state fiduciary law. Delaware’s Supreme Court has recently inferred a fiduciary duty of disclosure that parallels, and potentially could supplant, federal 10b-5 liability. See Malone v. Brinca, 722 A.2d 5 (Del. 1998) (holding that directors may violate their fiduciary duties by materially misstating the corporation’s financial condition, even though the corporation does not engage in any specific transactions with investors or shareholders).

259 A move toward disclosure choice in securities offerings would have no effect on current regulatory systems that assure the efficient and faithful consummation of securities transactions. See Wallman, supra note 69, at 368-70 (noting the importance of market center operations). The question of disclosure by securities issuers and intermediaries (like disclosure in consumer transactions) is separate from the question of payment-system operations.

260 If the issuer has informational advantages and can target gullible investors, Professor Ayres has argued that asymmetric information and adverse selection can generate inefficient corporate debt contracts even though contracting is costless and there is vigorous competition among numerous lenders. See Ayres, Inefficient Corporate Contracts, supra note 9.

261 See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 677-80.
the possibility of forum-shopping in securities fraud litigation, issuers and investors in national offerings should have the certainty of a national forum and fraud standard — namely, Rule 10b-5 liability in federal court. 262

Nor, under my proposal, would party choice as to heightened liability mean an abdication of regulatory oversight. Administrative enforcement under the broad standards of Section 8A (cease and desist orders for any violation of the Securities Act) and Section 20 (court injunctions for any violation) 263 would continue to serve as a useful supplement to private enforcement, particularly in any areas where private enforcement might be suboptimal. Moreover, investors would continue to receive significant protections in their dealings with securities intermediaries. Broker-dealers are subject to a comprehensive set of professionalism standards arising under Exchange Act rules, NASD requirements, and the Rule 10b-5 "shingle theory." 264 They include ex ante disclosure standards in the confirmation of securities transactions and the disclosure of the broker-dealer's position in a transaction. They also include a rich and dynamic set of ex post standards administered by the NASD, the SEC, the courts and arbitral panels. For example, the malleable "know thy security" standard that arises out of federal securities and state agency law may be a better fit than the "due care" standard imposed on participating broker-


263 The SEC has broad authority (broader than under Rule 10b-5) to seek judicial injunctions or other equitable remedies under the authority of Section 17 of the Securities Act, which prohibits false or misleading statements in any securities offerings — whether or not intentional or reckless. See 15 U.S.C. § 77q(a) (1994).

264 See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION, 876-86 (3d ed. 1995) (discussing the "shingle theory" as a duty to disclose markups and other conflicts of interest) [hereinafter LOSS & SELIGMAN, FUNDAMENTALS].
dealers in a registered public offering. In short, securities intermediaries would continue to be subject to strict standards of disclosure and professional conduct.

3. SEC role as purveyor of disclosure forms

A regime of disclosure choice in securities offerings would transform the SEC from form-regulator to form-giver. This new role would predictably produce a number of benefits. It would sensitize the SEC to investor informational needs, as measured by the disclosure levels chosen by issuers and their intermediaries. Disclosure forms that issuers did not use, presumably for failing to align disclosure costs and benefits, would give telling evidence that the agency should return to the drafting table. Disclosure forms that issuers choose with frequency would signal regulatory success. The role of form-giver would clarify the agency’s mission to facilitate market processes, rather than guess the needs of investors.

In addition, the SEC could facilitate issuer certification of its disclosures by developing guidelines on particular disclosure matters that issuers could choose to follow — with appropriate disclosure of their choice. For example, if investors would benefit from clearer risk disclosure, as some commentators claim, the SEC could proffer guidelines on "Risk Disclosure and Analysis." Issuers could then choose to disclose (certify) their compliance with the guidelines.

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265 As developed by the courts, the 10b-5 standard contemplates different levels of investigation and caution depending on the circumstances. See, e.g., Weiner v. Quaker Oats Co., 129 F.3d 310 (3d Cir. 1997) (distinguishing the foreseeability of post-acquisition increases in debt level and post-acquisition decreases in earnings growth for purposes of the sufficiency of cautionary statements).

266 See Romano, Empowering Investors, supra note 4, at 2396 (anticipating that under an enabling approach "market response will feed back into the SEC’s decision-making process, leading it to readjust its beliefs ... and, ultimately, to alter the default rule to be more compatible with investors’ needs").

267 See Donald C. Langevoort, Toward More Effective Risk Disclosure, 75 WASH. U. L.Q. 753, 763-64 (1997) (urging clearer risk disclosure,
The SEC could also facilitate choice in liability standards. Building on its authority to define terms, the SEC could define various levels of liability through such terms as "outside director", "reasonable investigation", and "reasonable care" found in the current legislative causes of action. Issuers and other participants could certify compliance with various levels of due diligence.

Because disclosure choice would permit issuers to choose the disclosure formats of other form-givers — such as the stock exchanges, private securities organizations, state authorities, or foreign disclosure regimes — the SEC's pre-eminence would be a matter of market success, not regulatory fiat. The possibilities would not necessarily supplant the SEC. Although Professor Romano has imagined that, states in their roles as purveyors of corporate law, should become the natural givers of securities disclosure forms — principally on-going disclosure to trading markets — there is little reason to believe that state disclosure rules would in the long- or short-run supplant the well-known SEC forms. Moreover, choice of foreign disclosure standards is a rarity among U.S. issuers and does not seem a viable option. The most likely competition to SEC hegemony, it
seems, will come from the private International Accounting Standards.

4. Disclosure choice in trading markets?

My proposal, limited to securities offerings, raises an obvious question. Why not also permit issuers to choose the timing and level of disclosure in ongoing disclosures to secondary trading markets? My answer is tentative. In the end, I find a significant element in primary offering markets absent in secondary trading markets, namely the privity relationship in a securities offering between issuer and investors. Unlike trading in secondary markets, issuers in a securities offering must convince investors of their securities' worth. Disclosure is an element of the issuer-investor bargain, normally struck with an underwriting firm or syndicate.

Secondary markets, though an extension of the investment relationship formed in primary markets, involve a diluted relationship between issuer and investor. As Professor Coffee observed in his classic defense of mandatory disclosure:

the theory of voluntary disclosure does seem to have some validity as applied to initial public offerings and, to a lesser extent, to all primary disc-


271 See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 683. Professors Easterbrook and Fischel's doubts about mandatory disclosure focus on issuers' dealings with "actual and prospective investors." Id. at 683. The core of their argument is that firms that sell stock will have incentives to disclose, both good and bad news, to increase the price at which the firm sells. Firms will distinguish themselves as "high quality" by using outside auditors, selling through reputable investment banks, increasing management stock ownership, and promising high dividends or high leverage to increase management's dependence on capital markets.

272 In a securities offering, the issuer and investors are in privity, and "the Coase Theorem suggests that firm and investors can strike a mutually beneficial bargain." Id. at 682-83.
tributions. This theory has far less persuasive force, however, when applied to secondary market trading, which the '34 Act chiefly governs.\footnote{273}

The many traders in a secondary market have far less leverage to compel the issuer's compliance with disclosure demands. Absent government mandated information, traders will both underinvest and overinvest in pricing information.\footnote{274} Managers' incentives to follow through on promises in a primary offering or to gain a reputation for veracity may not be sufficient to overcome the incentives to cheat on ongoing disclosure. Withholding good news can depress prices and thus increase the value of a management buyout or create insider trading opportunities; withholding bad news can inflate prices and buy management time to turn the firm around.\footnote{275}

Aside from its value for accurate pricing and risk assessment, ongoing disclosure to securities markets is also critical to key corporate control mechanisms: the market for corporate control; share price-based management compensation; and allocation decisions based on the cost of capital.\footnote{276} It is a symbolic and substantive act of manager contrition. Ongoing disclosure, through the power of shaming and the threat of enforcement, reduces management incentives to engage in self-dealing or other mismanagement. By improving pricing accuracy in trading markets, ongoing disclosure exposes the issuer's management

\footnote{273 Coffee, Mandatory Disclosure, supra note 29, at 746.}
\footnote{274 See id. at 717-53. Unable to capture fully the benefits of price accuracy, actors will underinvest. And absent a coordinating information clearinghouse, actors will overinvest in identifying and analyzing the same pricing information separately and duplicatively.}
\footnote{276 See Merritt B. Fox, Rethinking Disclosure Liability in the Modern Era, 75 WASH. U. L.Q. 903, 908-11 (1997) [hereinafter Fox, Rethinking] (noting that improvement in project choices and operation occurs through disclosure's effects on these control mechanisms, "whether or not the issuer is offering new securities for sale").}
to the disciplining effects of control changes and stock-based compensation. Beyond securities markets, ongoing disclosure ensures corporate transparency and signals the issuer's financial strength or weakness to management, capital providers and other constituents who deal with the issuer.\footnote{See John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multiplayer Game, 78 GEO. L.J. 1495 (1990).}

Rules mandating ongoing disclosure also enforce implicit promises, when a company goes public, to disclose at levels sufficient to maintain market liquidity and to reveal compliance with management duties across the owner-manager separation.\footnote{For example, Professor Georgakopoulos has argued that absent mandatory disclosure corporate decision making would be dominated by long-term shareholders, with less use for disclosure, to the detriment of short-term traders and market liquidity. See Nicholas L. Georgakopoulos, Why Should Disclosure Rules Subsidize Informed Traders?, 16 INT'L REV. L. & ECON. 417, 418 (1996).} Stock exchange requirements of ongoing disclosure, a listing condition that predates and has kept pace with the federal mandatory regime, provides an example of this implicit promise.

Nonetheless, disclosure choice in U.S. secondary markets may be coming of age.\footnote{See Romano, Empowering Investors, supra note 4, 2365-72 (describing state-based competitive federalism as substitute for federal securities regulation).} Recent experience in international securities markets, where the tendency is toward voluntary adoption of international disclosure standards, suggests that private disclosure choice is leading and could well lead to a disclosure "race for the top."\footnote{See, e.g., Elizabeth V. Mooney, Vancouver Exchange Tries Role as Farm Team for NASDAQ Firms, Radio Comm. Report at 12 (Mar. 4, 1996) (describing the Canadian implementation of prospectus-type disclosure requirements for private placements of exchange-listed stock).} Using a model of international securities disclosure, Professors Huddart and Hughes anticipate managers would choose to list their firm's securities on an exchange with higher disclosure requirements.\footnote{Steven J. Huddart et al., Disclosure Requirements and Stock Exchange Listing Choice in an International Context (draft Feb. 6, 1998),
natural informational advantages) make listing decisions depending on which exchange permits them to maximize profits from their post-disclosure informational advantage. The model further assumes liquidity traders can and will allocate trading volume over exchanges and firm securities to minimize trading costs. When disclosure requirements increase and liquidity traders receive more precise public information, their trading costs fall. As trading flows to the high-information exchanges, managers maximize their profits on these more liquid exchanges, even as their informational advantage shrinks.

The Huddart and Hughes model does not depend on the Easterbrook and Fischel assumption that managers will disclose to signal their firms' informational reliability, thus lowering capital-raising costs. Unlike earlier models that predict competition for trading volume will lead to greater disclosure as managers seek to maximize their firms' current market value to distinguish themselves from lesser firms, Huddart and Hughes do not assume the alignment of manager interests with shareholder interests in maximizing current market value. Even with their assumption that managers will seek to exploit their non-public informational advantages, they model exchange-listing decisions that gravitate toward higher-disclosure exchanges.

Models, however, are fraught with dangers. Others have modeled international securities trading and have concluded that disclosure tends to be governed by dynamics akin to a "race for the bottom," suggesting a need for strong international institutions to curb the trend. In the end, it

available at <http://papers.ssrn.com/sol3/paper.taf?abstract_id=40260> (on file with the Columbia Business Law Review). Professor Fox, like a ship passing in the night, has devised his own model to come to different conclusions about issuer behavior in a system of regulatory competition. See Fox, Political Economy, supra note 61, at 798 (positing model in which countries set disclosure rules with a goal of investor protection).


can be said we have had more experience with disclosure choice in securities offerings — with favorable results — than in trading markets.

5. Comparison to other "disclosure choice" proposals

Mine is not the first call for disclosure choice in securities transactions. Some proposals have been broader, urging disclosure choice for public issuers in both primary and secondary markets. Others have limited their proposals for disclosure choice to international securities transactions: foreign issuers in primary and secondary markets, and foreign and domestic issuers in cross-border transactions. One proposal has focused on disclosure choice for LLC issuers. Yet other proposals have focused on choice

abstract_id=71188> (abstract) (using 2x2 game models and insights from international regime theory to identify factors influencing regulatory competition and cooperation in three major subjects: disclosure, securities fraud, and insider trading).

284 See Romano, Empowering Investors, supra note 4, at 2365-72 (proposing state-based competitive federalism to replace federal securities regulation).


286 A number of commentators have urged disclosure choice for foreign issuers. See, e.g., Hurley, supra note 144, at 731 (proposing that foreign issuers be permitted to use foreign securities disclosure standards, provided they are accompanied by risk warnings and disclaimers concerning the lack of public information); Demmo, supra note 118, at 720 (proposing bifurcated listing system for foreign securities in recognition of the prevalence of sophisticated institutional trading in secondary markets).

as to particular disclosures, such as forward-looking statements and segment-of-business information.

My proposal differs from these other proposals in important respects:

(1) It contemplates full choice over all ex ante disclosures in securities offerings, both private and public;
(2) It extends disclosure choice to both domestic and foreign issuers whose offerings fall within the U.S. registration jurisdiction;
(3) It encompasses only securities offerings, not ongoing disclosures to trading markets; and
(4) It leaves intact the current baseline ex post antifraud regime administered largely by federal courts.

Professor Kitch has suggested that the rules mandating forward-looking information come as a range of choices:

For instance, in connection with its current initiative reviewing the treatment of forward-looking statements, [the SEC] could consider addressing the problem by giving issuers a range of choices, requiring only that issuers select one, that they disclose which selection they have made, and that they provide notice when they change their selection.

Kitch, supra note 22, at 886-87.

Professor Cox has criticized U.S. disclosure rules mandating quarterly and segment-of-business disclosure, neither of which are required by other regulatory systems. See Cox, Rethinking in the Shadow, supra note 59, at 187-89. Cox has proposed that issuers be able to choose how much segmental information (or other competitively sensitive information) they reveal, leaving it to analysts to fill in gaps from alternative information sources or to discount prices of low-disclosure issuers. Cox, however, would limit disclosure choice to prospective plans, events, and negotiations as well as existing conditions whose premature disclosure would threaten expected corporate gains.

Cox's proposal raises a number of questions. If competitively-sensitive segmental information warrants disclosure choice, why should other information that management determines is competitively-sensitive be subject to different regulatory treatment? And if private mechanisms exist to account for information shortages on segmented information, why shouldn't these mechanisms permit the broadening of choice to other (or all) matters?
Two proposals, similar to mine, deserve specific attention. The first, by Professor Park McGinty, calling for LLC participants to be able to choose whether their LLC interests would be treated as securities, is a limited version of my proposal. McGinty proposes that Congress revise the definition of "security" to enable LLC members to opt for federal securities law coverage.\footnote{291} The current judicial approach to defining partnership-type interests as securities looks to the terms of the parties' agreement, the particular investors' business acumen, and their relative dependence on the manager's abilities. According to McGinty, this fact-dependent focus on investor protection obscures the greater purpose of the securities law — transaction cost reduction. It imposes "excessive lawyering [on] well-counseled businesses and inadvertent securities law exposure [on] businesses not counseled by sophisticated securities experts."\footnote{292}

Professor McGinty's proposal is limited, as are LLCs that seek flow-through tax treatment, to non-public LLCs. Assuming that LLC members tend to be more sophisticated (or at least better advised) than typical partners and that the evidence for mandatory securities disclosure is mixed, McGinty urges controlled experimentation. Treating LLC interests as non-securities, McGinty points out, comports with the judicial assumption that privately negotiated investments are weaker candidates for securities regulation.\footnote{293} Although McGinty would permit full opting out by LLC members, including from Rule 10b-5 antifraud

\footnote{290} See also Perino, supra note 235, at 278 (criticizing securities fraud actions brought in state court against national issuers for imposing "significant costs, in the form of inconsistency and duplicative litigation").

\footnote{291} See McGinty, supra note 287.

\footnote{292} Id. at 375.

\footnote{293} See id. at 412. See also Reves v. Ernst & Young, 494 U.S. 56 (1990) (citing "common trading for speculation or investment" as one of four relevant criteria for judging whether an investment is a security); Marine Bank v. Weaver, 455 U.S. 551, 559 (1982) (citing "trading" as relevant to defining a security under the Exchange Act, since the Act "was adopted to restore investors' confidence in the financial markets").
protection, his principal ground for allowing an opt-out is the planning costs generated by the uncertain scope of the exemptions from Securities Act registration. Guess wrong in a private placement about an investor's sophistication and not only is the LLC interest a security, but all investors obtain a statutory "put" for having invested in an unregistered, nonexempt offering. Furthermore, this liability uncertainty extends beyond the business assets to participants who promoted the offering and control persons of the issuer.

Under McGinty's proposal, LLC interests would fall within the statutory definition of "security," unless excluded by the LLC investment documents — namely, the articles of organization and the certificates evidencing an LLC interest. The SEC would promulgate rules concerning minimal disclosure to be given to anybody acquiring an excluded LLC interest. McGinty postulates that disclosure in LLC financing would follow different patterns: (1) some LLCs would choose SEC-regulated disclosure under current securities laws as an effective warranty of truthfulness; (2) others would disclose voluntarily using either SEC-style disclosure to permit cross-firm comparisons or modified SEC disclosure; (3) some LLC issuers would remain silent, selling on an "as is" basis. Undergirding this voluntary regime is the assumption investors can assess (and price) the net value of disclosure under each regime given the "direct and indirect transaction costs." McGinty imagines that "market forces, including the financial press" will assess and give notice of additional risks. And for investors unwilling to plunge into an LLC without SEC-mandated disclosure or federal antifraud protection, there exists a "panoply of investment regulated by the current system."

A recent and more ambitious proposal by Professor Roberta Romano offers additional support for and insights regarding disclosure choice in securities offerings. Romano has proposed a "market-oriented approach of competitive

\[\text{294 McGinty, supra note 287, at 440.}\]
\[\text{295 Id.}\]
\[\text{296 Id.}\]
federalism" for securities regulation of both securities offerings and market trading. Building on the "successful experience of the U.S. state in corporate law," Romano would permit issuers to choose

one sovereign [with] jurisdiction over all transactions in the securities of a corporation . . . . The aim is to replicate for the securities setting the benefits produced by state competition for corporate charters — a responsive legal regime that has tended to maximize share value C and thereby eliminate the frustration experienced at efforts to reform the national regime. As a competitive legal market supplants a monopolist federal agency in the fashioning of regulation, it will produce rules more aligned with the preferences of investors, whose decisions drive the capital market.\footnote{Romano, Empowering Investors, supra note 4, at 2362.}

Like incorporation-based corporate law, securities disclosure standards (both \textit{ex ante} line-item disclosure and \textit{ex post} liability) would be supplied by the state the issuer had chosen as its "securities domicile." In the end, competition among different regulatory regimes (which Romano assumes would include the 50 states and the SEC) would benefit public investors by facilitating regulation aligned with investors' preferences.\footnote{For a five-year transition period, issuers would be required to disclose their "securities domicile." Curiously, reflecting doubts about general investor capacity, Romano also contemplates a permanent mandatory disclosure rule for securities trading in markets (such as penny stocks) where institutional investors' presence is limited. See id. at 2414.}

In urging the move from a monopolistic SEC to competing state regulators, Romano points to studies that question whether the federal securities legislation of 1933 and 1934 produced greater price accuracy for new offerings and market trading.\footnote{See id. at 2373-77.} She also notes the SEC's regulatory failures in "understanding the working of financial markets," in
particular the SEC's long-misguided approach to forward-looking information and its snapshot, bank-based approach to issuers disclosing derivative risk exposure. As to federal antifraud rules, she points out that no study has investigated whether securities outside the SEC's registration jurisdiction (intra-state offerings and municipal securities) have higher frequencies of fraud or price manipulation than SEC-registered securities.

Romano's proposal, however, may overstate the case for deregulation by conflating the problem of mandatory disclosure in securities offerings and disclosure regulation in securities trading markets. By treating the question as one simply of "regulated disclosure," Romano fails to consider the differences in issuer incentives in an offering compared to market trading. She justifies her proposal on the ground issuers ("promoters") would "bear the cost of operating under a legal regime inimical to investor interests," but without clarifying how these incentives operate in trading markets. Absent mechanisms by which managers feel compelled to disclose at levels investors would choose, issuer choice as to ongoing disclosure is problematic. In apparent recognition of this, Romano's proposal does not permit issuers to choose disclosure rules set by stock exchanges, for fear that exchange preferences to maximize trading volume may not coincide with investor welfare. In fact, she points to an impressive array of studies that indicate issuers voluntarily improve their disclosure when contemplating the issuance of securities, indirect evidence of the relative weakness of non-regulatory incentives to motivate issuer

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300 Id. at 2377-80.
301 See id. at 2382.
302 Id. at 2366.
303 Curiously, Romano does not contemplate foreign countries supplying disclosure rules for U.S. issuers. This possibility is at the core of corporate choice of law. See McDermott Inc. v. Lewis, 531 A.2d 206 (Del. 1986) (applying law of Panama to corporation traded on U.S. stock market, even though Panamanian law conflicted with Delaware law on parent ownership and voting of subsidiary's shares).
disclosure on an ongoing basis.\textsuperscript{304} The studies, by negative implication, suggest market failure with respect to disclosure in secondary markets where issuers are less driven to capture investors' interest, their immediate capital needs sated.

Romano assumes that issuers would choose some form of regulated disclosure, not open-ended disclosure choice.\textsuperscript{305} This assumption comes, perhaps, from her lingering doubts, which resurface intermittently, that issuers will not disclose optimally to trading markets if disclosure is entirely voluntary. Some regulation, she seems implicitly to concede, is necessary. This introduction of a disclosure regulator limits the possibilities for aligning disclosure supply to meet demand. By deregulating only disclosure in primary markets, my approach would permit issuers the flexibility to choose different regimes for different offerings. If states could generate fees on an offering-specific basis, the inter-jurisdictional competition that Romano contemplates would be even crisper. Rather than being captured by one disclosure supplier, issuers could choose to shop at different stores for particular offering situations.

In the end, Romano's proposal makes a leap of faith that state regulators would be up to the task of adopting \textit{ex ante} rules sensitive to cost-benefit balancing of regulated disclosure. State regulators, to the extent they have experience in securities disclosure rules, have proved to be remarkably inexpert. Although state experience with corporate law rules is well-established, none rely on systems of mandatory \textit{ex ante} disclosure. In fact, to the extent states have experience with disclosure systems — in particular, Delaware's proxy disclosure rules built on \textit{ex post} liability standards — the rules have grown out of a common law, case-specific

\textsuperscript{304} Romano, \textit{Empowering Investors}, supra note 4, at 2374 n.38.

\textsuperscript{305} Nonetheless, she does contemplate the possibility of an "enabling national regime" in which SEC disclosure rules would be default rules and issuers could specify alternative provisions in their organizing documents or by contract. \textit{Id.} at 2396. She finds such a system preferable to mandatory disclosure, but less preferable to one of inter-jurisdictional competition. \textit{See id.}
approach. Regulatory reforms with no real-life precedent often flounder. Romano proposes to stretch a workable system of private choice beyond its operable limits.

B. Disclosure Choice in Securities Offerings: Can It Work?

Mandatory disclosure in securities offerings operates at two levels. First, registered offerings are subject to marketing limitations, disclosure mandates, SEC pre-review, and heightened antifraud liability. The level of regulation varies depending on issuer size, issuer seasoning, and the degree of public trading. Second, offerings exempted from registration by statute or rule are subject to conditions that impose modified disclosure mandates and marketing limitations, but generally no SEC clearance or heightened antifraud liability. The conditions vary depending on factors that include offering size, marketing methods, issuer qualifications and size, investor qualifications or sophistication, and sophisticated intermediation.

306 For example, Congress in the 1995 Reform Act adopted an academic suggestion that institutional investors should (and would) become lead plaintiffs in securities fraud class actions, as an antidote to strike-suit plaintiffs and their attorneys. See Elliott J. Weiss & John S. Becketman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 YALE L.J. 2053, 2062 (1995) (proposing "lead plaintiff" provision adopted by Congress in 1995 Reform Act); Janet Cooper Alexander, Rethinking Damages in Securities Class Actions, 48 STAN. L. REV. 1487 (1996) (proposing opt-in requirement for large investors, which would then become managers of securities class action litigation, as alternative to current bounty-hunter system). Yet it appears the "lead plaintiff" opportunity has fallen on deaf ears. See Elliott J. Weiss, The Impact to Date of the Lead Plaintiff Provisions of the Private Securities Litigation Reform Act, 39 ARIZ. L. REV. 561, 565 (1997) (concluding it is "too early to tell whether institutional investors with large stakes in class actions will begin to volunteer to serve as lead plaintiffs").

Disclosure choice would permit issuers to avoid the mandatory terms for both registered and conditionally-exempt offerings. Offerings currently subject to registration would not be subject to gun-jumping limits, line-item disclosure requirements, SEC review or acceleration, prospectus-dissemination rules, or heightened liability — if the issuer chooses "no-registration" status for the offering. For exempt offerings, issuers would be permitted to opt out of current conditional limits, such as prohibitions on mass-marketing, required intermediation and mandated disclosure — again by issuer choice.

"No-registration" would not, however, remove federal regulatory oversight. Offerings for which the issuer had elected "no-registration" status would remain subject to large swaths of federal securities regulation. First, and most important, offering disclosures would be governed by the ex post standards imposed by Rule 10b-5 antifraud liability. Second, offering participants would remain subject to existing rules applicable to securities intermediaries. For example, broker-dealers would continue to be subject to SEC and NASD oversight, as well as "know thy customer" and "know thy security" responsibilities. Non-industry participants would be subject to "primary violator" liability under Rule 10b-5. Disclosure choice in securities offerings, far from a regulatory abdication, would be largely a change in regulatory emphasis.

Would the combination of Rule 10b-5 antifraud liability and current regulation of securities intermediaries, each left to further development, be up to the task?

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308 That conflicted brokers overreach and that investor-customers are often victims of their own greed and wild risk-taking — a story of joint responsibility — suggests the importance of focusing attention on intermediaries' motivational influences and responsibilities, but not necessarily adding "the heavy enforcement costs that protectionism entails." See Donald C. Langevoort, Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers, 84 Cal. L. Rev. 627, 700 (1996).

1. Investor tenacity: first line of protection

Disclosure choice in securities offerings hinges on investors identifying their disclosure needs and demanding the desired level of informational assurances — or refusing to invest. Praising Arthur Levitt's "Investor Protection and Education" initiative, Steven M.H. Wallman has said, "With an educated investor, detailed rules become less necessary and the public becomes its own best policeman."310 The history of the Securities Act confirms this insight. For the last sixty years, disclosure choice has worked for qualified investors in private placements. In addition, the SEC has expanded this choice, without apparent negative effect, to public investors under its small offering exemptive rules and private placement safe harbor. Whether disclosure choice should be expanded to offerings currently subject to registration or SEC exemptive conditions, largely depends on our confidence in investor discipline and securities intermediation.

Recent experience strongly suggests that investors in primary markets have become savvy and demanding. They do not take whatever is thrown their way. Issuers know this and often undertake to disclose at levels higher than required to attract new capital. For example, issuers increase the quantity and quality of voluntary disclosure, particularly of forward-looking statements, in anticipation of the issuance of securities.311 Smaller issuers, without a significant analyst following, make additional voluntary disclosures in annual reports to lower the cost of capital.312

Issuers choose to voluntarily register with the SEC their otherwise exempt offerings so as to provide investors with

310 Wallman, supra note 69, at 354 (viewing investor education as perhaps "the best practice" toward a goal-oriented approach to regulation in which market forces, not regulators' views, operate where they can).
311 See Romano, Empowering Investors, supra note 4, at 2374 nn.38-39 (collecting sample of studies that find increased voluntary disclosure, particularly earnings forecasting, when issuer accesses capital markets).
312 See Christine Botosan, Disclosure Level and the Cost of Equity Capital, 72 ACCT. REV. 323 (1997).
assurances of veracity and to facilitate post-offering trading.\textsuperscript{313} The Plain English disclosure movement began in the private sector, where companies adopted plain language practices on their own, without mandated regulation.\textsuperscript{314}

In addition, investor response to unregulated offerings belies a story of market failure. Issuers that have attempted direct, unintermediated Internet offerings have met a remarkable wall of investor reticence, leading many to seek intermediaries for these offerings.\textsuperscript{315} Some issuers shy from Regulation A offerings because private investors (and their advisers) find the limited unaudited financials permitted in such offerings to be unacceptable.

2. Securities intermediaries: second line of protection

Investors in securities offerings receive information principally from securities intermediaries. "Truth in secu-

\textsuperscript{313} Some issuers have registered exchange offerings with institutional QIBs (whose trading is exempt under Rule 144A) on Form S-4 even though the original offering was exempt as a Section 4(2) private placement and the exchange offering was exempt under Section 3(a)(9) (exchange exclusively with existing security holders and no commission or remuneration). \textit{See} McGeehan, \textit{supra} note 7 (noting the frequent use of registration rights agreements in 144A deals).


\textsuperscript{315} Direct offerings on the Internet have floundered. Few companies have raised the capital they hoped to, and many have had to abandon the Internet for more traditional offering methods. \textit{See} Fisch, \textit{Internet Offerings}, \textit{supra} note 89, at 75-77; Donald C. Langevoort, \textit{Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers}, 84 CAL L. REV. 627 (1996); Mahoney, \textit{Property Rights in Information}, \textit{supra} note 70, at 824 (finding that Internet offerings tend to be through underwriters or placement agents, "with the Internet used simply as a more efficient (or perhaps more eye-catching) means of getting the prospectus or offering circular into the hands of investors").
urities" is in fact truth not to investors but to their intermediaries. Direct offerings by issuers, even in private placements and on the Internet, are unusual. The variety and roles of securities intermediaries are growing.

Securities firms (broker-dealers). Securities firms serve as the principal buffer between issuers and investors, bundling advice and reputational assurances with transaction-consummation services paid by investors through brokerage commissions or offering spreads. Acting as underwriters, securities firms are indispensable in securities offerings, providing certification of quality and pricing judgment that investors cannot replicate elsewhere. By providing investors securities analysis, securities firms are instrumental in moving both primary and secondary markets, a truth not lost on issuers that seek favorable attention from securities analysts.

Securities firms operate under increasing pressures, beyond the heightened liability scheme of the Securities Act, to ensure honesty and fair-dealing in recommending and marketing securities offerings. Reputation remains the lifeblood for these firms, often overwhelming other incentives. For example, whether a registered public offering

318 See Fisch, Internet Offerings, supra note 89, at 75-77.
317 See Mahoney, Property Rights in Information, supra note 70, at 831. Sometimes the role is played by other securities professionals. In the disintermediated venture capital market of Silicon Valley, law firms retained by start-up ventures perform the role of "channelers" who influence their clients so as to gain the trust of venture capital providers. See Langevoort, Angels on the Internet, supra note 77, at 16-17 (describing role of Silicon Valley lawyers as similar to traditional underwriters in bringing new issues to market).
318 Foreign issuers often list their securities in the United States to garner securities analyst attention. See Fanto & Karmel, supra note 117, at 54.
319 For example, IPOs underwritten by a securities firm with a venture capital subsidiary that holds a prior equity interest in the IPO company perform as well or better than IPOs in which none of the underwriters held a prior equity position. See Paul A. Gompers & Josh Lerner, Conflict of Interest and Reputation in the Issuance of Public Securities: Evidence from Venture Capital (Dec. 1997), available at <http://
or a private institutional placement, the reputation of the underwriter may be more relevant to investors than any particular disclosure. In addition, competition in the market for securities advice — such as from investor newsletters, investing guides, media investment programs, and accountants — has led to the unbundling of brokerage services.320

Moreover, to the extent that the Securities Act seeks to filter out fraudulent offerings, the sales process (not mandatory disclosure) is the weak link. It is securities salespeople who are charged with "arming investors with sufficient information to make a fair comparison among competing securities."321 And enforcement of the professional duties of securities firms and salespeople rarely turns on the Securities Act registration or antifraud provisions.322 Recent and past experience indicates that fraudulent offerings are not the product of inadequate issuer disclosure, but rather over-reaching, high-commission sales tactics.323 Such tactics face sturdy regulation under current Rule 10b-5 standards, NASD disciplinary rules, and specific rules such as those applicable to penny-stock marketing.


320 Some brokers now have graduated commission schedules depending on the access to broker advice. See D. Bruce Johnsen, Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage, 11 YALE J. ON REG. 75 (1994) (describing soft dollar brokerage, a practice in which brokers bundle the cost of investment research and execution for money managers).

321 Cox, Rethinking in the Shadow, supra note 59, at 872.

322 Interestingly, Professor Romano would exclude from this market-based system of inter-jurisdictional competition the regulation of market professionals. As Romano points out, brokers (unlike issuers) are not subject to capital market forces that prod regulatory competition to adopt rules preferred by investors. See Romano, Empowering Investors, supra note 4, at 2369.

Trading organizations (stock exchanges). Stock exchanges have long served to signal informational reliability, both through their listing rules and supervisory functions. The issuance of securities into a developed public trading market, such as the New York Stock Exchange or NASDAQ, signals that securities analysts are following the issuer and liquidity will be available.

Listing on an exchange in one market, a signal of the issuer's informational reputation, can also be leveraged in other markets. International securities regulatory arbitrage illustrates this. For example, U.S. issuers that raise capital offshore in countries with lower regulatory demands and costs, as in the Eurobond market, attract foreign investors on the basis of their disclosure reputation, built in no small measure on U.S. disclosure standards.

Issuers can achieve these reputational gains through informal trading organizations, as well. For example, foreign issuers can signal their merit by having sold into the developed U.S. private-placement market, because of the disclosure demands in the U.S. market. Over time, these private disclosure systems can be expected to operate like mandatory corporate rules (such as boards of directors, annual elections, shareholder voting and liquidity rights, derivative suit enforcement) which have achieved a remarkable uniformity, though no national corporate code compels their existence.

Rating services. In certain markets, such as for debt and mutual funds, rating services have assumed great importance. Ratings by Standard & Poors or Moody's are essential in the pricing and placement of debt securities. Morningstar ratings figure prominently in mutual fund advertising. A favorable rating from the debt rating services may make investor-directed disclosure superfluous. Moreo-

224 See Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453 (1997); Choi, Gatekeepers and Internet, supra note 90, at 51.
ver, technological innovations promise to expand the range and depth of these kinds of "reputational intermediaries."

Financial accounting boards. Currently, the accounting practices and standards required of companies subject to mandatory disclosure come not from the SEC but the FASB. The SEC's delegation of this standard-setting to a private self-regulatory organization, though reducing some bureaucratic disincentives, is insulated from competitive pressures. Disclosure choice would create a demand for a private disclosure standard-setting board, perhaps modeled on the FASB. Private intermediation, compared to governmental certification, offers a variety of advantages. The costs of private intermediation are borne most directly by investors, thus making it less likely that sub-optimal intermediation will survive. For example, full-service brokers have discovered that investors choose discount brokers and buy their advice elsewhere. Competition among private certifiers also increases the probability of certification quality. For example, issuers pay the debt rating services, but can choose the one investors (and their intermediaries) perceive as more reliable. Mutual funds pay Morningstar to advertise its ratings, but investors could well turn to other informational sources if Morningstar proves to be biased.

3. Signaling alternatives: new possibilities

Direct disclosure and heightened liability are not the only means by which issuers signal the merits and veracity

325 See Choi, Gatekeepers and Internet, supra note 90, at 53 n.111 (describing an Internet search engine which provides a sort of rating of quality and interest in Internet sites).

326 See Lowenstein, supra note 62, at 1342 (describing the FASB's essentially private, independent nature).

327 Choi and Guzman make similar arguments with respect to "international certifiers," given their greater ease in crossing international borders, their greater expertise in evaluating investments, and their greater incentives — compared to government agencies. Choi & Guzman, Regulation in Global Capital Market, supra note 285, at 1901.
of an offering. Signaling can come from many sources. Disclosure choice opens a variety of non-disclosure signaling possibilities.

**Smart money.** The presence of smart money in an offering signals an offering's strength. In an IPO, for example, institutional buying signals to other investors that the issuer has told a sufficiently convincing story. Under disclosure choice, issuers could signal their offering’s merits by requiring a particular level of participation by qualified investors. In fact, reversing the logic of the prevalent rule that any unqualified offeree or purchaser voids a private placement exemption, the participation of sophisticated investors would evidence that investors have "fended for themselves." In fact, a recent study indicates private placements of equity convey favorable information to investors about future earnings.

**Type of offering.** Issuers signal their merit through the nature and method of offering. A firm-commitment offering, compared to a best-efforts or auction offering, connotes financing strength. Dutch-auction and all-or-none offerings provide assurances of a critical mass of investor consensus. A seasoned issuer’s issuance of new debt, rather than new equity, signals that debt purchasers (typically institutions) view the issuer’s prospects favorably, revealing more about the issuer's prospects than any boilerplate management discussion and analysis.

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328 See Romano, Empowering Investors, supra note 4, at 2366-67 (describing how the presence of informed investors in market protects uniformed investors through the pricing mechanism).

329 See Michael Hertzel & Lynn Rees, 13 J. ACCT., AUDITING & FIN. 21 (1998) (finding that earnings increase significantly subsequent to the private equity offer and that post-offer earnings changes are positively correlated with announcement period stock price effects, contrasting with earlier studies that announcements of public equity issues convey unfavorable information about future prospects).

330 In fact, commentators regularly assume that regulatory protections are less relevant in debt offerings, given that they are sold mostly to institutional investors. See Delayed or Continuous Offering and Sale
Liability options. Issuers can signal by opting into heightened or participant liability. Just as issuers in private placements give disclosure warranties to signal the reliability of their representations, issuers (and participants) in public offerings might conclude that Section 11-type verification assurances would increase the value of the offering above the costs of heightened liability. Private liability levels would give issuers a means to signal their quality and size. Or, issuers might decide that proportionate liability for directors, officers and underwriters (with strict liability running to the issuer) might be a more effective liability scheme.

Electronic updates. Technological innovations create new signaling possibilities. Issuers could, for example, predicate a delayed or continuous offering on electronic updates.

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331 See Langevoort, Information Technology, supra note 255, at 776-78 (arguing that Section 11 may frustrate alternative mechanisms by which underwriters verify information to investors). Heightened liability might signal veracity even more strongly than indirect non-disclosure signaling techniques — such as dividend increases or stock splits — given the greater penalty to which firms expose themselves by disclosing apparent good news rather than indirectly signaling it. See Robert M. Lawless et al., The Influence of Legal Liability on Corporate Financial Signaling, 23 J. CORP. L. 209, 231-39 (1998) (using a model of managerial choice between disclosure and non-disclosure signaling, as well as surveys of financial managers, to conclude that antifraud rules penalize managers more heavily for direct disclosure than indirect signaling).

332 See Stephen J. Choi, Company Registration: Toward a Status-Based Antifraud Regime, 64 U. CHI. L. REV. 567, 597 (1997) (discussing liability levels as a method for information gatekeepers, such as underwriters and directors, to signal the quality of information).

333 See Fox, Rethinking, supra note 276, at 914-16.

334 Professor Donald Langevoort anticipated some of these. Arguing that the present practice of discrete, periodic paper filings is both too slow and too bulky, he urged a mandatory system of continuous electronic filing in which issuers update and transmit to the markets, in
Non-disclosure signaling is important to investor protection. For issuers that do not sell in intermediated offerings or to institutional investors — namely mutual funds — the absence of these disciplining effects has led to disclosure indolence. Mutual funds have been criticized for not disclosing such matters as tax-adjusted fund returns, the risk profile of the fund's top holding, the fund manager's compensation package and investment stake in the fund, and a breakdown of marketing fees. But securities offerings into intermediated markets (both public and private) raise signaling possibilities that have been and will continue to be important.

4. SEC as form-giver: moderator of disclosure experimentation

Disclosure choice in securities offerings would modify the role of the SEC. Rather than a regulator of line-item disclosure in securities offerings, the agency would become a provider of optional standardized disclosure forms. (The agency's long-standing roles in securities offerings as fraud monitor and antifraud enforcer would continue.) This new role would be a natural next step in the ongoing progression of SEC disclosure reform. Originally conceived as the writer of a mandatory one-size-fits-all disclosure form envisioned in Schedules A and B of the Securities Act, the SEC has transformed itself over the last two decades into a regulator offering multiple standardized forms — each subject to various mandatory conditions.

nearly real time, all material information — or, at least, all adverse material information. See Langevoort, Information Technology, supra note 255, at 786-89.


335 Standardization is an important feature of investment information. See Easterbrook & Fischel, Mandatory Disclosure, supra note 20, at 687.
The SEC as form-giver offers many possibilities.\textsuperscript{337} Continuing its historic role as the national "filing cabinet," the SEC would serve as a clearinghouse of disclosure methods and levels. Aided by the information-gathering and distributional powers of EDGAR, the SEC could collect and disseminate information on which disclosure formats are being used, which are not being used, and what disclosure is being made. Not only would this augment information to issuers and investors about private choices in disclosure contents and methods, it would also give the SEC guidance. Rather than guess at which line-item instructions or disclosure guidelines best suit investor informational needs and issuer disclosure concerns, the SEC can model its forms according to actual usage. It can revise, discard, and create forms as disclosure trends develop.\textsuperscript{338}

Disclosure choice would likely encourage issuers to experiment with additional disclosure formats, beyond those currently mandated by SEC line-item rules.\textsuperscript{339} In practice,

\textsuperscript{337} Conceivably, the SEC could branch out to specifying non-disclosure clauses for issuers. See Gabaldon, supra note 89, at 264 (proposing that issuers in a Rule 504 or 505 offering stipulate to fiduciary duties applicable to the promoter relating to the formation, conduct, and dissolution of a business).

\textsuperscript{338} As Professors Easterbrook and Fischel have pointed out: Regulation is more failure-prone than markets, because there are few automatic forces that correct regulations gone awry. The regulatory system lacks a competitor, and the very fact of regulation often suppresses the information necessary to detect regulatory failure. Easterbrook and Fischel, supra note 20, at 700.

\textsuperscript{339} Professors Marcel Kahan and Michael Klausner have argued that corporate contract terms (of which disclosure is a subset) frequently involve learning and network externalities. They wonder whether cognitive biases that lead to herd behavior among lawyer-drafters would result in suboptimal standardization. See Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 WASH. U. L.Q. 347 (1996). If true, this is an inevitable effect of corporate contracting — whether the contracting is carried out through privately-drafted agreements or publicly-provided forms. If nothing else, recent experience with non-disclosure corporate contracting suggests that a state form-giver (Delaware) creates greater dynamism when compared to a static regulator.
mandatory rules in registered offerings (particularly heightened liability rules) have tended to focus securities drafters' attention on SEC line-item requirements and to stultify any inquiry into whether additional nonmandatory disclosure would be valued by investors. Just as investor pressures have led issuers in other countries to disclose according to "international standards," even though not mandated in their home country, disclosure choice could well break the current regulatory focus on historic information — one which often serves investors poorly.\textsuperscript{340} For example, freed of the historic-based disclosure culture of SEC mandatory disclosure, issuers might find more effective forward-looking disclosure formats. As Professor Kitch commented in his criticism of the SEC's inconsistencies toward forward-looking and competitively-sensitive disclosures:

\begin{quote}
A result of a one-size-fits-all disclosure system is that it suppresses any opportunity for experimentation, change and innovation in accounting and disclosure. Rather than observing particular firms successfully adopt changes in accounting procedures that are then adopted by others, any reform must be channeled through the FASB or the SEC on an all-or-nothing basis, and either adopted before it is tried or rejected without a trial.\textsuperscript{341}
\end{quote}

As form-giver, the SEC role would come to parallel that of providers of U.S. corporate law, namely state legislatures

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\textsuperscript{340} \textit{See} Robert Mednick, \textit{Reinventing the Audit}, 172 J. ACCT. 71, 71-74 (Aug. 1991) (partner in Arthur Andersen & Co., and chair of its worldwide committee on professional standards) (\"[I]nvestors and others want and expect . . . more predictive and value-based information; more of the whys — not simply what — of financial data; and more early warning that a company is making poor decisions or may be nearing the brink of financial collapse.").
\textsuperscript{341} Kitch, \textit{supra} note 22, at 885.
\end{raggedright}
and principally the Delaware legislature. To the extent agency revenues would depend on use of its forms, disclosure choice would create incentives similar to those inherent in state corporate chartering competition. The difference would be that the SEC would compete against private and foreign regulatory regimes. This development would serve as a powerful counterpoint to bureaucratic inertia.342

5. Lessons from state charter competition

State corporate law offers useful lessons. Disclosure choice, with the SEC as principal form-giver, would move corporate disclosure toward the private ordering model applicable to other aspects of the manager-investor relationship.

Reinventing the SEC as form-giver revives the debate on state chartering competition that has roiled in U.S. corporate law for the last three decades. If issuers can choose their disclosure forms, will the SEC or another form-provider lead a disclosure "race to the bottom"? This seems unlikely. First, the evidence that state chartering competition has engendered a "race to the bottom" in corporate law standards is weak. By many accounts, Delaware's prominence is rooted in its ability to provide a corporate environment that investors most prefer. Managers who choose Delaware are rewarded by investors; those who choose less investor-friendly states are punished.343 Second, as we have seen, the evidence that issuers (and their managers) can set disclosure levels in securities offerings is weak. Although public securities offerings (both initial and seasoned) suffer

342 Some critics doubt the SEC's cultural capacity to embrace regulatory metamorphosis. 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). Yet when faced with foreign regulatory competition, the SEC has shown itself capable of responding to challenges to its disclosure hegemony.

343 See Romano, Genius of American Corporate Law, supra note 119, at 37-44.
from chronic mispricing, it is unclear that any ex ante disclosure mandates would reduce the phenomenon.\textsuperscript{344} The more relevant question is whether the SEC will have incentives to supply optimal disclosure forms or whether it will cater to its traditional interest groups — revolving-door bureaucrats and politically-connected big business. In the context of state chartering competition, Professors Jonathan Macey and Geoffrey Miller have argued that states, in their desire to maximize charter revenues, might offer less than optimal corporate law to benefit private interest groups within the state — chiefly local bar members.\textsuperscript{345} Building on this insight, Professor Ayres outlines three sources of possible supply-side inefficiencies.\textsuperscript{346} First, a state's corporate rules have no intellectual property protection, so a desirable corporate law innovation can easily be copied by other states.\textsuperscript{347} Unable to realize the full value of a good idea, states will underproduce good corporate rules. Second, states may find that the best strategy to win the chartering competition is to mimic the leader (even if the leader is ungainly and slow) so as not to take the chance of exhausting resources.\textsuperscript{348} Third, leading states (such as Delaware) will change corporate rules for the sake of change, to make copying its corporate code more difficult and to give its lawyers more work as corporate clients seek to stay current.\textsuperscript{349}

\textsuperscript{344} For example, in Professor Branson's vivid recounting of the role of professionals in enabling a series of fraudulent securities offerings, nothing suggested that greater ex ante disclosure requirements would have prevented the harm. \textit{See} Douglas M. Branson, \textit{Chasing the Rogue Professional After the Private Securities Litigation Reform Act of 1995}, 50 SMU L. REV. 91, 94-103 (1996) (recounting stories of "rogue" professionals who participated in egregious frauds in series of offerings exempt under Regulation D and registered under state securities laws).


\textsuperscript{347} \textit{See id.} at 545-50.

\textsuperscript{348} \textit{See id.} at 550-56.

\textsuperscript{349} \textit{See id.} at 556-60.
These inefficiencies, to the extent they exist in corporate law, seem less accentuated in a system of disclosure choice in which the SEC takes the leading role — particularly when compared to the current mandatory system that depends on bureaucratic incentives in an environment of monopoly regulation. As the software industry illustrates, the SEC's first-actor advantages and its ability to set highly-desirable uniform standards may compensate for the lack of idea protection.\footnote{Professor Ayres' arguments on network externalities undercut his argument that innovation is sub-optimal in the absence of intellectual property protection. That a majority of U.S. firms choose to incorporate in Delaware to take advantage of its law's knowability and its judges' competency (network externalities) suggests first-actors are in fact rewarded, despite the ease of competitive copying. See \textit{id}.} Non-SEC sources of disclosure forms, lacking the feature of comparability, could not adopt a strategy of mimicry, but rather would have to outperform the SEC to attract business. Obfuscatory disclosure leadership seems unlikely also since issuers can change their method of disclosure from offering to offering without significant costs. In the end, as has happened in the burgeoning marketplace of business organization forms, it is likely that providers of disclosure forms will fill different niches. Just as smaller firms opt for local business organization forms and larger firms opt for national corporate forms, market segmentation in securities offering disclosure can be expected. For example, IPO issuers might choose the SEC's full-blown, registration-style disclosure (including heightened liability) to signal their veracity. Established publicly-traded issuers might opt for New York Stock Exchange or other industry-standard disclosure.

In fact, using state corporate law as a guide, it might be expected that disclosure choice would lead to certain uniform disclosure standards — within certain categories. The history of incorporation-based private choice has been that corporate law rules have tended toward a mean — often
with Delaware as the pace-setter. 351 Consider the uniformity of the essential (sometimes nominally mandatory) terms in publicly-traded companies: a board of directors with full authority over corporate business and affairs; directors elected annually by shareholders, by majority shareholder vote; freely transferable shares, recorded on the company books; and directors with fiduciary duties, enforceable in shareholder derivative suits. These rules have arisen over time, with experimentation fixing the current core rules. As new rules supplant older ones — such as new rules on voting flexibility or waiver of fiduciary duties — states typically follow national trends with Delaware as the leader.

6. Lessons from international regulatory competition

International regulatory competition also offers important insights for U.S. deregulation of disclosure in securities offerings. Foremost, the globalization of securities markets exposes the fallacy that mandatory disclosure can be pursued without regard to its costs. When investors (as many do in the United States) can choose to invest in securities offered in other markets, the costs and benefits of mandatory disclosure rules are brought into focus. When issuers can engage in regulatory arbitrage, their ability to choose lower-disclosure markets starkly reveals the trade-off.

Regulatory competition also offers evidence on whether U.S. investors and markets are ready for disclosure choice. First, evidence of issuers in cross-border transactions disclosing opportunistically is sparse. Although cross-border issuers often have significant discretion to choose the disclosure level for their securities, disclosure in public and private markets appears to be significantly investor driven. For example, trading of foreign securities listed on the Lon-

don exchange (which requires relatively high disclosure levels) often outpaces trading in the issuer's home market.  

Second, U.S. investors have shown themselves capable of discounting foreign securities to reflect different levels of disclosure and investor protection. In fact, U.S. investors do a better job of pricing equities offered by foreign issuers, compared to U.S. equity offerings (both IPOs and seasoned) for which there is systematic overpricing. ADRs traded on the "pink sheets," where only home country disclosure is required, trade at discounts and with larger spreads compared to ADRs listed on a U.S. stock exchange or NASDAQ, where U.S. disclosure standards apply. To avoid this disclosure risk, individual U.S. investors have shown a preference for intermediated investment in foreign securities, such as through U.S. mutual funds with international portfolios.

Not surprisingly, overly regulatory SEC disclosure policies have led some to urge that issuers and investors with international contacts be permitted to choose among different countries' disclosure regimes. Professors Stephen

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352 See Lowenstein, supra note 62, at 1337 & n.4.
353 Cox, Rethinking in the Shadow, supra note 59, at 160.
355 See Iain Jenkins, "Pink Sheets" Mix Risk with Rewards, INT'L HERALD TRIB., Nov. 19, 1994, Money Report Section (reporting that spread for ADRs in the OTC market is as much as 10 percent).
356 Michel Hurley has urged the removal of U.S. regulatory barriers to issuance and listing of foreign securities by permitting foreign issuers to use foreign securities disclosure standards. See Hurley, supra note 144, at 731. At a minimum, Hurley asserts, the SEC should allow the issuance of unregistered or minimally registered foreign securities in U.S. markets provided they are accompanied by risk warnings and disclaimers concerning the lack of public information. See id. at 743-744.

Nicholas Demmo has made a proposal for a bifurcated listing system for foreign securities in recognition of the prevalence of sophisticated
Choi and Andrew Guzman in two companion articles have argued for jurisdictional rules that would enable issuers and investors to choose among different countries' securities regimes. In their first article, they assert that investors (with their focus on institutional investors) consider the risks and returns offered by a security in light of available information and the applicable regulatory regime, and then identify and pursue their own interests based on that information. Assuming that capital mobility encourages issuer responsiveness, Choi and Guzman argue that disclosure rules are sufficient if they put investors on notice when they invest in foreign securities. Beyond this, investors can and must accept the risk of their investments.

Choi and Guzman limit themselves to disclosure in global securities markets, and focus on the extra-territorial reach of U.S. disclosure rules and antifraud liability. Assuming U.S. protections "are costly to issuers and not valued by sophisticated investors, global capital market efficiency is thus increased by allowing such issuers and investors to bypass these regulatory protections through their selection of an alternate securities regime." They call for bright-line rules on the extra-territoriality of U.S. securities jurisdiction to permit planning by issuers and investors, as well as new U.S. securities rules that would permit parties to opt out of domestic securities regulation.

In a second article, Choi and Guzman expand on this notion of competition among country-based securities regimes. Individual countries will compete, they assert, to maintain and expand their securities markets to create institutional trading in secondary markets. See Demmo, supra note 118, at 720. For exchange-listed foreign securities traded mostly by institutions, Demmo asserts, sophisticated institutional investors can determine whether disclosure is sufficient. See id. at 706.

See Choi & Guzman, Dangerous Extraterritoriality, supra note 3, at 285, at 240.

See id. at 239-240.

Id. at 220.

See Choi & Guzman, Regulation in Global Capital Market, supra note 285, at 1857.
greater liquidity for domestic investors, greater power and prestige for securities regulators, and increased tax revenues. Faced with heterogeneous views among issuers and investors about the net benefit of various disclosure levels, they predict countries will seek to attract segments of the securities market rather than appeal to the entire market. They conclude that disclosure regimes that account for these differences will have an "unambiguously positive impact" on the efficiency of securities markets.\textsuperscript{361}

This vision of international disclosure choice — built on fundamental doubts about the mandatory nature of U.S. disclosure regulation — is valuable, but overly timid. The arguments for disclosure choice in global securities markets are equally applicable, perhaps more so, to domestic securities offerings. If U.S. investors can be trusted to invest wisely in less-regulated markets, why should we abdicate this trust when the securities offering occurs in U.S. markets? If, as seems true, issuers and investors have heterogeneous views about the net-benefits of disclosure, the value of disclosure choice would only be magnified by permitting domestic issuers to distinguish themselves to heterogeneous investors. If one believes private disclosure and other signaling occurs at sufficient levels in international investing, which Choi and Guzman assert have seeped into national markets, disclosure choice in U.S. markets is an inevitable conclusion.

Effect of U.S. disclosure choice abroad. How might a policy of disclosure choice for U.S. securities offerings fare in a world of securities regulatory arbitrage? For one, U.S. disclosure choice would predictably open the floodgates for new U.S. offerings by foreign issuers, if such issuers could opt to disclose under their home country standards. Many foreign issuers, compelled to meet higher U.S. disclosure standards, report that different accounting requirements

\textsuperscript{361} Id. at 1858.
cause them to avoid U.S. stock listings. In fact, it has been estimated that 4,000 foreign issuers meet the listing criteria for trading on the New York Stock Exchange and NASDAQ but have not sought a U.S. presence because of greater U.S. disclosure costs. Disclosure choice would open investment opportunities, at reduced costs, for U.S. investors. Moreover, disclosure choice for foreign issuers would also predictably lead to experimentation in signaling methods as these issuers sought to distinguish their quality and veracity — or face heavy discounting by U.S. investors faced with expanded investment options.

Some have argued, nonetheless, that a U.S. policy of disclosure choice could lead to a general relaxation of disclosure standards worldwide. By foreswearing mandatory disclosure, the United States would reverse its role as the most vigorous securities regulator leading to a "race to the bottom" among world securities regulators. In a groundbreaking 1992 article that stressed the importance of aggregating international and domestic transactions in the formulation of disclosure policy, Professor James Cox urged harmonization of disclosure policy — that is, a multi-jurisdictional regulatory floor below which issuers could not go. Concluding that "regulatory uniformity and rigor are necessary to assure competitive regulatory equilibrium," Cox argued that U.S. policymakers should reach agreements with other nations on the minimum content of all nations' securities laws. Otherwise, the overly-regulatory United States would lose in international regulatory competition, as U.S. issuers moved to less-costly foreign markets and U.S. markets lost trading volume to their less-regulated foreign counterparts.

The argument for mandatory disclosure floors, at least as it concerns U.S. disclosure policy for securities offerings, is flawed at two levels. First, it assumes market failure

363 See id. at 13-15.
364 Cox, Rethinking in the Shadow, supra note 59.
365 Id. at 159.
without distinguishing between primary and secondary markets. As we have seen, issuers face significant market pressures to disclose in a securities offering, even when regulation does not demand it. 366 Although there may be reasons for coordinated regulation of post-offering market disclosure and trading practices, where different regulatory standards create gaps inviting opportunism, 367 disclosure in securities offerings stands on different ground.

Second, the argument for international disclosure minima assumes that without regulatory coordination securities regulators would engage in a disclosure "race of laxity." Evidence that non-U.S. regulators, faced with the possibilities of regulatory arbitrage, are lowering their disclosure standards to attract listings is simply lacking. 368 In fact, disclosure standards outside the United States are headed in the other direction — even without coordinated regulation. The trend worldwide is toward regulatory convergence, as countries with historically lax disclosure rules impose greater regulation while more regulatory countries (like the United States) shed regulation. 369

366 Cox admits as much. Accepting that managers will not (or cannot) be opportunistic when initially selecting the country where the firm goes public or first lists its securities, Cox argues that managers' later decisions may be opportunistic. See id. at 165-66.


368 There are some who make this assertion, but without support. See, e.g., Cox, Rethinking in the Shadow, supra note 59, at 163-64 (arguing that unregulated competition among international exchanges is likely to result in a "race to the bottom" if regulatory approaches can cater to the self-interest of managers).

C. A 10b-5 Antifraud Floor: Can It Bear the New Load?

A critical adjunct to my proposal of disclosure choice is that issuers in public offerings would be subject to a mandatory antifraud standard — namely, Rule 10b-5 liability. Disclosure choice would shift compliance from ex ante line-item disclosure to ex post liability standards. Squeezing the disclosure balloon at one end inevitably distends it at the other. Is 10b-5 liability, with its enforcement costs and liability overhang, capable of this expanded role?

There is much to recommend 10b-5 liability. Developed in a common law tradition, it has proved flexible over time and malleable according to the setting. Its scope has been addressed and refined by the Supreme Court more frequently than any other securities law topic. The 10b-5 materiality and culpability standards, both of which continue to evolve, have proved useful tools against overenforcement. Private 10b-5 liability offers a national standard, capable of national enforcement through class action procedures. The relatively high 10b-5 standards, compared to antifraud rules outside the United States, permit U.S. issuers to disclose with greater certification of veracity. Courts, in a number of specific settings, have

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370 Issuers could, under my proposal, choose to make this the exclusive antifraud standard for their offering.

371 See Cox, Rethinking in the Shadow, supra note 59, at 177.


373 A recent study finds that U.S. issuers making disclosures to trading markets provide less voluntary forward-looking statements than do foreign issuers outside the United States, apparently due to the higher antifraud standards that U.S. issuers face. But when U.S. issuers do disclose, their disclosures have a greater effect on prices. See Carol A. Frost, Characteristics and Information Value of Corporate Disclosures of Forward-looking Information in Global Equity Markets (working paper
fashioned *ex post* standards that guide disclosure behavior — such as in the disclosure of future-looking projections in the context of a corporate acquisition. Moreover, these standards have been largely intelligible to highly-specialized securities lawyers, who are "essential participants" in assuring veracity in the issuer's disclosure for a securities offering.

Federal courts as 10b-5 arbiters have been sensitive to disclosure costs, perhaps more so than the SEC in its role as line-item regulator. The Supreme Court's 10b-5 materiality standard, which considers the "total mix" of information, is based explicitly on a cost-benefit analysis. Similarly, the Supreme Court has rejected aiding and abetting liability in private 10b-5 actions out of concern for the costs


375 See Manning Gilbert Warren III, *The Primary Liability of Securities Lawyers*, 50 SMU L. REV. 383, 386-90 (1996) (describing role of the securities lawyer in disclosure process of a securities offering, where lawyer ultimately is responsible for ensuring that disclosure to investors is honest and complete). Securities lawyers in this context are expected to identify informational pitfalls, particularly those that may be identified by underwriters or may lead to fraud liability. For this reason, the predictable biases that normally compromise the corporate-securities lawyer's vigilance may not operate as fully in the securities offering context as they do in contexts involving disclosure of ongoing business operations. See Donald C. Langevoort, *The Epistemology of Corporate Securities Laundering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 638 (1997) (describing cognitive biases in context of corporate concealment to secondary markets).

376 See Basic Inc. v. Levinson, 485 U.S. 224 (1988) (adopting "total mix" standard of TSC Industries v. Northway); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good.").
of expansive liability.\textsuperscript{377} Lower federal courts have recognized the competitive harms imposed by strict adherence to a "price accuracy" analysis. In the tender offer context, for example, federal courts have refused to require that bidders and targets disclose projections and other "soft information," even in circumstances where the bidders and others relied on the projections in their own pricing calculus.\textsuperscript{378}

Over time, federal courts have developed a regime of antifraud liability that reflects both judicial imagination and adaptability. Perhaps the private securities bar, whose perspective is translated into judicial decisions, is a font of greater insight and wisdom than is available to the SEC through the regulatory process. The 10b-5 elements have become richly detailed and variegated. Materiality has come to vary according to the context, courts requiring objective price effects in market cases while accepting subjective relevance in face-to-face transactions. Scienter (properly pleaded) must be shown in market trading cases, where a lower negligence standard would impose stultifying caution on market speakers. But negligence is the accepted culpability standard in broker-dealer cases, where a professionalism ethic carries the day.\textsuperscript{379} Reliance is essentially excused in cases of market fraud, but required when the

\textsuperscript{377} See Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (reading "manipulative or deceptive device or contrivance" language of Section 10(b) to require that 10b-5 defendants engage in actual fraudulent behavior, not merely provide collateral assistance); see also Finter v. Dahl, 486 U.S. 622 (1988) (limiting collateral-participant liability in Section 12 rescission actions to those who solicit securities sales for personal gain).

\textsuperscript{378} See, e.g., Isquith, 847 F.2d at 186; Walker, 802 F.2d at 703 (not requiring disclosure of projections because of their uncertainty and volatility).

\textsuperscript{379} See Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944); see also Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (J. Clark, concurring) (describing the "shingle theory" under which broker "who sells securities to the public — who hangs out his shingle — implicitly warrants the soundness of statements of stock value," and generally his professional conduct); LOSS & SELIGMAN, FUNDAMENTALS, supra note 264, at 876-86 (discussing the "shingle theory").
case involves a negotiated transaction between sophisticated parties. In short, federal courts have shown themselves remarkably able to distinguish between settings of inherent informational asymmetry and those characterized by informational parity.\textsuperscript{380}

But \textit{ex post} litigation is a costly disclosure system, even if federal courts are sensitive to disclosure costs and context.\textsuperscript{381} If litigation is too costly, investors will under-enforce their rights and the quality of issuer disclosure will suffer. If too easy, there may be a proliferation of nuisance suits. Finding a balance is inevitable, whether disclosure turns on \textit{ex ante} line-item regulation or \textit{ex ante} enforcement. Experience teaches that federal courts have shown institutional awareness of this problem, not only in formulating common law solutions to over- and under-enforcement, but also in accepting negotiated solutions. For example, federal courts have accepted such private controls on litigation costs as arbitration and attorney fee clauses. And if \textit{ex ante} disclosure (with its possibility of administrative review) is more beneficial on a cost-benefit basis than \textit{ex post} litigation, issuers under a regime of disclosure choice can choose SEC registration and heightened liability. In fact, in some contexts, participants in offerings have voluntarily sought greater liability exposure to signal their greater reliability.\textsuperscript{382}

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\textsuperscript{381} In fact, many foreign issuers say they avoid U.S. securities markets not because of the burden of SEC registration, but rather the fear of becoming grist in U.S. securities class actions mills. See Cox, \textit{Rethinking in the Shadow}, supra note 59, at 192; Hurley, supra note 144, at 730 (noting that fear of securities class actions makes foreign issuers less willing to issue securities in the United States). \textit{See also} Grundfest, \textit{supra} note 233, at 733 (pointing out that over-litigation of securities fraud cases can raise financing costs or even discourage issuers from coming to market).
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Ultimately, *ex post* antifraud liability offers the possibility of evolving common law standards to solve informational asymmetries that lie beyond market and negotiated solutions. Entrenched administrative *ex ante* regulation has proved less flexible. Compare the SEC's inept regulatory struggle with forward-looking information that culminated in an unworkable "reasonable basis" and "good faith" standard with the courts' development of the "bespeaks caution" standard that has culminated in legislative imitation. Administrative *ex ante* regulation has also proved toothless. Compare the SEC response to systematic management delays in releasing bad news and avoidance of bad news forecasts with the judicial response to lawsuits based on the same allegations. Given the differences in institutional competence, it would seem a regime of refined antifraud liability is the preferable antidote to information asymmetries.

**The SEC as liability standard-setter?** Should the SEC take on an additional role as modulator of antifraud standards, pursuant to its rule-making power under Section

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333 *See* H.R. CONF. REP. NO. 104-369, at 43-46, *reprinted in* 1994 U.S.C.C.A.N. 730, 742-45 (stating that the statutory safe harbors added to Securities Act Section 27A and Exchange Act Section 21E by the Private Securities Litigation Reform Act of 1995 were derived from, but not intended to replace, the judicially-created "bespeaks caution" doctrine).

334 *See* Cox, *Rethinking in the Shadow*, *supra* note 59, at 186.

335 U.S. liability rules for forward-looking information, while chilling this kind of disclosure, apparently also increase the credibility of the disclosure when made. A recent study of corporate disclosure of forward-looking information in five countries (United States, United Kingdom, France, Germany and Japan) concludes that while U.S. and U.K issuers are less likely to disclose forecasts, the market responds more to such disclosures than to reports of actual earnings and sales. *See* Frost, *supra* note 373. On the other hand, forward-looking disclosures are more frequent in France, Germany and Japan where the liability climate is less foreboding, but these disclosures are greeted with less market interest. In fact, in Japan where 80% of corporate announcements include forecasts (more than any other country in the study), there is no statistically significant market reaction to the forward-looking information. *See id.*
10b(5) of the Exchange Act? Professor Grundfest, despairing of securities fraud class actions, has urged precisely this. Yet this role seems poorly suited to SEC capacities and incentives, when fraud comes in dizzying varieties and gradations. The value of the 10b-5 liability scheme has been its case-by-case focus. To the extent the SEC has overarching views, perhaps from its independent observations or empirical study, these can be expressed (as they frequently are) through amicus participation in court proceedings.

V. CONCLUSION

U.S. securities regulation is at a turning point. The regulatory assumptions that have animated mandatory disclosure to investors for the last 65 years are being rethought — from all quarters. We are in the "spring of 1933." The Securities and Exchange Commission, already permitting broad choice in offering methods and disclosure levels, is considering a historic overhaul of the registration system for securities offerings. Federal courts are privatizing fraud liability standards in unregistered offerings, validating party choice in domestic and international securities transactions, and upholding disclosure disclaimers and other contractual waivers in securities fraud cases. Congress is seeking to realign the costs and benefits of securities fraud class actions.

As Professor Mahoney has noted, "A plausible endpoint of this evolution is a regulatory system that focuses on two core missions. One is to combat fraud . . . a theft of someone else's information. The second is to set clear rules that enable market participants to recognize where informational asymmetries exist and adjust valuations accordingly." Disclosure choice in securities offerings, buttressed by a fraud liability floor, moves us closer toward this rational destination.

386 See Mahoney, Property Rights in Information, supra note 70, at 847-48.