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CIVIL LIABILITY AS AN ENFORCEMENT TOOL OF SECURITIES UNDERWRITER GATEKEEPING DUTY

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SHORT STRUCTURE OF THE BOOK

TABLE OF CONTENTS

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LIST OF ABBREVIATIONS

AIM	Alternative investment market of the London Stock Exchange
EU	European Union
FSMA	The UK Financial Services and Markets Act of 2000
FSA	The UK Financial Services Authority
GLO	Group Litigation Order
IPO	Initial Public Offering
LSE	London Stock Exchange
MIFID	EU Directive 2004/39/EC on Market in Financial Services
OFT	UK Office of Fair Trading
PSLRA	Private Securities Litigation Reform Act of 1995
SEC	The Securities and Exchange Commission
SEO	Seasonal Equity Offering
UK	United Kingdom
USA	United States of America

INTRODUCTION

„The "product" of the financial industry is promises for an uncertain future, marketed as dreams that can readily become nightmares". Martin Wolf, published in Financial Times on April 15 2008

1. INTRODUCTION

Inaccurate and incomplete disclosure of material corporate information has always been a well-acknowledged problem of capital markets. Corporate disclosure scandals have occurred since the very beginning of modern corporations and are still common today. In early 1900 in the USA it was believed that financial fraud was prevalent, the amount of disclosure was meager and securities sold at the prices far above their value. There were at least 79 notorious stock-watering cases during the period of 1897-1910. In a typical case of that period promoters of the issue would buy up the competing industrial plants in order to merge them and sell to the public the stock in a newly established entity without even disclosing the value of original plants or their value after the merger.[1] Later on such investments would turn out to be a total flop and cause significant losses to investors. The same picture was also observed on the European side.

Major changes in securities regulation took place since 1900, notably the introduction of a mandatory disclosure system and various mechanisms of its enforcement. Measures to enforce mandatory disclosure obligations could be roughly divided in two main groups – primary enforcement against the issuer of securities and its internal personal, and secondary or gatekeeper's enforcement strategy, involving parties somewhat related to the securities distribution. The first group usually includes such enforcement tools as issuer corporate administrative, criminal and civil liability. The second group involves different types of enforcement against independent directors, auditors, lawyers, underwriters etc. All of these enforcement tools should have contributed to the common goal of prevention of

[1] Joel Seligman, "Historical Need for a Mandatory Corporate Disclosure System, The," *Journal of Corporation Law* 9 (1984 1983): pg. 18-19.

misstatements of material corporate information, thus improving the quality of corporate disclosure and the efficiency of capital markets.

Nevertheless, more than a century later, misstatement cases are still quite common. Notably, a huge wave of corporate disclosure scandals followed the burst of the dot.com bubble of the 2000. As an example, Worldcom – one of the biggest US telecommunication company managed to hide its declining earnings by painting a false picture of financial growth and profitability. It was established that Worldcom's value had been inflated by around 11 billion dollars and upon the revelation of the fraud this turned out to be one of the largest bankruptcies in the American corporate history.[2] One of the most memorable cases of 2000 in the EU was a huge fraud by the Italian dairy producer Parmalat that was successfully hiding from investors its debt that was more than double that on the balance sheet. More recently, Dutch investors were shocked by the revelation of misstatements by the CEO of the Internet provider World Online. What started as the largest ever IPO for the Amsterdam exchange and the largest IPO of any European Internet company, turned to be a complete disaster with investors suffering the estimated 3 billion euro losses after the market discovered that the CEO sold her stake in the company immediately before the floating. Finally, as this books goes to print, the business world is shaken by the news of decade-long story of disclosure violations at the camera producer Olympus.[3]

Thus, one may be tempted to conclude that despite all the measures put in place in order to prevent corporate disclosure violations, the current enforcement system fails to prevent all cases of misstatements. This also demonstrates that the subject of the enforcement of mandatory disclosure rules is quite topical and warrants re-examination. The problem is that, as described above, the system of enforcement of mandatory disclosure requirements is very complex and multi-layered. Thus, the key is to determine what exactly in this complicated enforcement system does not work well.

This book is dedicated to the analysis of one particular device for enforcement of mandatory disclosure requirements: securities underwriter (hereinafter – underwriter) liability. Many countries see underwriters – financial intermediaries hired by the securities issuer to help in

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[2] Beresford, Dennis R., Nicholas deB. Katzenbach, and C.B. Rogers. "Report of Investigation by The Special Investigative Committee of the Board of Directors of Worldcom, Inc.", March 31, 2003.

[3] The New York Times, "Olympus Sues Executives Over Cover-Up, but Does Not Dismiss Them", 10 January 2012, http://www.nytimes.com/2012/01/11/business/global/olympus-sues-executives-over-cover-up.html

the complex process of organizing, promoting and distributing securities, as important gatekeepers of corporate disclosure. The term "gatekeeper" in the context of securities distribution means "reputational intermediaries who provide verification and certification services to investors".[4] More precisely, corporate gatekeepers are imposed a legal duty to monitor issuer's disclosures as regards the correctness and completeness of information. It is usually framed as a duty to perform a due diligence investigation of information disclosed in the prospectus. Again, there are numerous enforcement techniques to sustain this gatekeeping function.

One of the mostly discussed mechanisms of enforcement of the underwriter gatekeeping duty is the imposition of civil liability. For example, under Section 11 of the USA Securities Act underwriters are subject to a negligence liability standard with an investor-friendly burden of proof. In the Netherlands they can be held liable for negligence in lawsuits for misleading advertising and unfair commercial practices. These provisions are also applied in practice as demonstrated by the series of corporate disclosure cases where underwriters are sued side-by-side with central culprits – top management and directors. For example, in the USA *Worldcom* litigation as many as 17 major investment banks that participated in the company's offering were found liable for failing to discover the issuer's fraud. In the Dutch *World Online* case, AMN AMRO and Goldman Sachs were accused and charged for failing to disclose the information in the prospectus and to correct the later public statements made by the CEO of the company.

Given this background it is important to analyze what is the role and the real effect of underwriter liability, as one of the enforcement strategies, in ensuring compliance with mandatory disclosure requirements. It is also fair to question whether the current design of legal rules on underwriter liability is optimal for ensuring deterrence. Answering these questions will help to solve one piece of the puzzle as regards the occurrence of corporate disclosure scandals and will likely suggest the way to improve the whole system.

2. RESEARCH QUESTION

The main research question of this book concerns the role of civil liability as a tool to enforce underwriter gatekeeping duty. It fits within the more general topic of enforcement

[4] John C. Coffee, "Understanding Enron: It's About the Gatekeepers, Stupid," *SSRN eLibrary* (July 30, 2002): pg. 1405, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=325240.

of mandatory disclosure requirements. By answering this question I will attempt to contribute to the academic and policy debate on the relative efficiency of different enforcement strategies in policing financial fraud. To structure the discussion, I will try to answer the following three subquestions:

1). What is the rationale for using civil liability as an enforcement device? Does it have any advantages or disadvantages over other enforcement mechanisms?

It will be seen that there are numerous enforcement devices available to provide the underwriter with incentives to perform its monitoring function well. Those are market-based mechanisms such as reputation or economic risk taking and legal mechanisms such as *ex ante* regulation and different types of *ex post* enforcement. Thus, the question will be asked what is so special about civil liability to justify its wide use? It will be important to establish the comparative costs and benefits of using civil liability and to relate it to other enforcement devices.

2). How is civil liability used in practice? What is the real deterrent threat created by the existing liability regimes? Do existing civil liability regimes achieve their deterrent function?

Having analyzed the theoretical arguments for the use of civil liability as an enforcement tool for underwriter gatekeeping duty, this book will engage in a thorough examination on how real legal systems treat the topic of underwriter civil liability. The analysis will consist of three approaches. First of all, "the law on books" will be examined to determine what are the applicable legal rules. Secondly, the attention will be dedicated to the "law in action". Thirdly, the relationship between the "law on books" and "law in action" will be examined seeking to establish and explain possible deviations between them. This book will also examine whether civil liability is able to achieve its main goal – the provision to the underwriter of optimal incentives to monitor the issuer.

3). Is there a need to improve or modify the current civil liability systems? If yes, by what means?

To complete the discussion of the topic the question will be asked whether the existing civil liability regimes are optimally structured and the search for the alternative ways to structure civil liability will be performed.

3. RELEVANCE

3.1. Scientific relevance

The subject of underwriter liability is not completely new in the academic and the policy debate. On the one hand, the literature discussing the role of underwriters in the public capital markets is quite extensive. Numerous law, management and economics text-books (*eg.* Williamson (1988), Cox, Hillman and Langevoort (2006), Hazen (2009), Iannotta (2010)) describe the practical functioning of investment banks and their functions in raising public capital. Scholarly articles also try to explain why the services of underwriters are extensively used despite of associated costs (Booth and Smith (1986), Chemmanur and Fulghieri (1994), Benveniste, Busaba & Wilhem (2002)). Other authors focus on specific topics of underwriter activity such as the underpricing phenomenon (Jenkinson and Ljungqvist (2001)), post-IPO activities (Aggarwal (2002), Ellis *et al* (2000), Lombardo (2007, 2009)), underwriting fees (Chen and Ritter (2000)) etc.

On the other hand, there is also an extensive literature on gatekeeping as a third-party enforcement mechanism. Most prominently Kraakman (1986), Hamdani (2003), Choi (1997), Partnoy (2001), Coffee (2004, 2006) discuss the advantages and disadvantages of using third parties in order to achieve compliance with mandatory disclosure requirements. Some of these papers also analyze the current regulation of gatekeepers' liability and propose alternative liability regimes (Partnoy (2001, 2004), Coffee (2004a, 2004b), Choi (1997)). Although these works are extremely relevant to the topic of underwriter liability, they are usually rather general and discuss the underwriter liability only as one of many examples of gatekeepers' liability.

Despite the existence of these two wide streams of literature, there is almost no literature (with the notable exception of Sher (2006)) exclusively dedicated to the economic analysis of underwriter liability for gatekeeping failures.

The problem of underwriters' liability is widely covered by American scholars. In Europe, there are some works on this topic in national languages. For example, in the Netherlands the comparative analysis of the problem was performed by Bloom (1996) in "Prospectusaansprakelijkheid van de lead manager". However, there is little comparative research in English. Notable exceptions are works of Kalss and Gerner-Beuerle. Kalss (2007) discusses the main features of disclosure liability in general, overviews the European regulation and briefly presents several selected national implementation (including Germany, Austria, Switzerland, UK, France). Gerner-Beuerle (2009(a) and 2009 (b)) *inter alia* also touches upon the issue of underwriter liability in some European countries. However, the analysis of European practice is very fragmented and incomplete. Certain Dutch scholars such as Arons and Pijls (2010) also discuss the issue in English on their national level.

Taking into account the lack of academic research both as regards the specific focus on underwriters and intra-country analysis, the comparative assessment of different underwriter civil liability regimes fills an important gap in the existing literature. The focus on underwriter liability as opposed to the general gatekeeping will allow investigating how the specificities of this particular gatekeeper may influence the need for the liability and its design. The comparative analysis of legal regimes will provide important insights about the current state of the law in this field and illustrate the different approaches taken by analyzed countries. Finally, the book will also contribute to the literature discussing the alternative ways to regulate gatekeeper liability.

3.2. Practical relevance

This book is of interest also for practitioners. First of all, it can be a valuable source of information for lawyers practicing securities law and especially those engaged in securities litigation. They can discover important economic arguments that can be helpful seeking to engage the underwriter as a potential defendant in a misstatement case. Secondly, practicing lawyers may learn important insights about the current state of law in the USA, the Netherlands and the UK and its requirements both as regards substantive and procedural aspects. The analysis of the case-law will provide some information on the content of gatekeeping duty. The book will also show to the practitioner the possible litigation routes open before them. Overall, it should be able to provide the securities lawyer with up-to-date legal information and underlying economic reasoning.

This book should also be relevant for the people engaged in policy making. Policymakers may gain many important information and insights required to evaluate civil liability regimes whose introduction may be under discussion. They also may find it interesting to see how the legal regimes perform in practice and discover alternative ways in which underwriter liability can be regulated. This will help them to choose policy options choices that will ensure the enhancement of current systems of enforcement of corporate disclosure obligations.

4. METHODOLOGY

The overall approach adopted in this book can be characterized as comparative Law and Economics analysis. Following this method legal rules are analyzed and compared at as tools to provide behavioral incentives to economic actors.

First of all, this book analyzes the activities of underwriters using the mainstream neo-classical economic approach. It analyzes the working of financial markets and seeks to determine possible market failures that would justify the introduction of the underwriter in the capital market system. Secondly, it is investigated why there is a need for the regulation of underwriters. It is assumed that regulatory intervention in the functioning of underwriting markets is justified only if the market forces fail to encourage the underwriter to perform its duties. Once the need for the regulation of the underwriter is established, it is assumed that there are various ways to achieve the same outcome. However, these different scenarios should be measured against each other using cost-effectiveness criterion, *i.e.* one should choose the form of legal intervention that achieves the set goal at the lowest cost. Thus, some simplified of cost-benefit analysis is used in this book to evaluate various enforcement mechanisms.

The relationships in capital and underwriting markets are assessed following classical notions of social welfare, economic rationality, utility maximization and cost minimization. Actors are considered as economically rational individuals each maximizing their own utility. By assumption firms are run by the economically rational individuals.

Social welfare is defined as the sum of utilities of all participating parties. Consequently, behavioral biases and related departures from rational choice are not taken into account. The analysis also does not engage in formal economic analysis based on theoretical modeling or econometric techniques for testing the latter.

Finally, a legal comparison of selected jurisdictions – the USA, the EU, the Netherlands and the UK is conducted. This comparison demonstrates not immediately evident differences in the approaches to the legal liability and their impact on the effective liability threat. The legal analysis is based on a systemic assessment method that stresses the importance of discussing legal rules within the context of the broader legal system and of analyzing the links between different elements.

5. SCOPE OF RESEARCH AND LIMITATIONS

As it was discussed above, this book discusses the topic of underwriter civil liability using a Law and Economics approach that combines neoclassical economics and comparative legal research. This allows for a rather wide scope of research both as regards the multidisciplinary character and the structure of comparative analysis. However, practical and methodological reasons also suggest several limitations to the research undertaken:

This book looks at an underwriter as an economically rational corporate entity. However, in real life the underwriter is nothing more than a network of corporate agents who act based on their own private utility maximization and behavioral biases.

Given that this book is dedicated to the normative analysis of civil liability, it logically follows that deterrence will be considered the only goal of the civil liability regime. According to this approach civil liability is a tool to provide incentives to both parties of a relationship with the ultimate goal of the minimization of total accident costs. Liability should also have an influence on the victims' incentives. Within this approach compensation is not important as such but it is regarded as a tool to achieve deterrence. While standard in Law and Economics, this understanding of the function of civil liability is not the only possible one. In fact, many legal scholars argue that the compensatory function of civil liability is the main and the most important one. Closely related to the compensatory function is the corrective justice function of civil liability according to which the compensation of harm is meant to correct the imbalance caused by the wrongful act to fairness or justice.[5] Compensation and corrective justice will not be considered in this book.

This book considers the underwriter as a solitary gatekeeper in the market. However, the underwriter is only one among many different corporate gatekeepers. All of these actors participate in securities distribution and form an interlocking web of protection against mandatory disclosure requirements. The presence of multiple gatekeepers rather than a single gatekeeper (as is assumed in this work) means that they intersect, overlap and complement each other. On the one hand, these overlaps may improve the incentives of each of them to comply with their duties. On the other hand, they can lead each of the gatekeepers to become a mere functionary, who takes care only of a determined part of corporate disclosure. This could undermine the gatekeepers' effective ability to monitor.

While this book provides some description of what activities constitute a typical gatekeeping duty of underwriters, it does not aim to evaluate the optimality of underwriter behavior. For example, it is not assessed whether underwriters should use certain verification procedures, conduct interviews with the issuer's employees or do anything else. It is simply assumed that there is some optimal level of underwriter due care that needs to be taken in order for the gatekeeping to be carried out efficiently. Thus, this book is mostly concerned with the enforcement rather than substantive law issues.

While appreciating the importance of all above issues and their potential repercussions on the outcome of this research, discussing these issues within this book would both imply a methodology different from mainstream Law and Economics and inject unnecessary complications into an already complex topic. On the other hand, the clear focus on the corporate liability of the underwriter assessed from a straightforward deterrence perspective can be regarded as a first, but very important step towards establishing of a clear Law and Economics framework for this topic, on which basis precise policy recommendations can be formulated.

[5] Kenneth S. Abraham, *The forms and functions of tort law* (Foundation Press, 2007), pg. 206; Peter Cane and P. S. Atiyah, *Atiyah's accidents, compensation and the law* (Cambridge University Press, 2006), pg. 421.

6. STRUCTURE OF THE BOOK

This book is divided in three Parts that correspond to the three subquestions of this research.

Part One creates the background for the main topic of this book – the gatekeeping function of the underwriter, analyzes its possible enforcement mechanisms and determines the place of civil liability among them. It is divided into three Chapters.

Chapter I analyses underwriters from a practical and business perspective. It describes the underwriter practical role in the process of securities offerings as a financial intermediary that stands between the issuer and investors and helps to bridge the informational gap between these two actors. This intermediary provides advisory, sale intermediation, gatekeeping, underwriting and price discovery services during the offering process. After the offering is over the underwriter further engages in the provision of liquidity, stabilization, analyst coverage and other services. Chapter I concludes that the underwriter is an indispensable and a central figure in the process of securities offering.

Chapter II is dedicated to the analysis of one specific function of the underwriter – the gatekeeping function. The gatekeeping function of the underwriter is defined as a duty to monitor the issuer's disclosure during the distribution of securities in order to ensure that such disclosure does not contain materially misleading statements or omissions and to take preventive action if misdisclosure takes place. Some attention is dedicated to reasons why there is a need for gatekeeping. Chapter II further argues that the underwriter should be given incentives to perform the gatekeeping function and discusses possible market-based and legal enforcement mechanisms. Finally, Chapter II discusses three main legal mechanisms of enforcement (civil liability, enforcement by the public authority and enforcement by the stock exchange) seeking to determine relative advantages of each of them.

Chapter III provides a connection between the previous two Chapters. It explores the impact of the imposition of the gatekeeping duty on other functions of the underwriter that were identified in Chapter I.

Part Two is dedicated to the legal analysis of underwriter civil liability system in four jurisdictions: the USA, the EU, the Netherlands and the UK. It looks at how the civil liability is structured in real life liability regimes and how it functions in practice. It consists of five Chapters.

Chapter IV seeks to detect the most important legal rules that determine the expected liability. It describes the regulatory options available to the lawmaker as regards five main issues: potential parties to a dispute, liability standard, measure of damages, procedural rules, and the nature of the liability rules.

Chapters V to VIII tackle particular legal systems going into the great detail of certain legal rules and their application in practice. Chapter V discusses the federal USA regulation of underwriter liability. It focuses on Section 11 and 12(a)(2) of the Securities Act of 1933 and Rule 10b-5 adopted under the Securities Exchange Act of 1934 as well as procedural rules applicable to class actions. Chapter VI deals with the harmonized EU regulation. It mostly speaks about the relevant provisions of the Prospectus Directive. The relationship between the EU law and the national laws of Member States is also analyzed. Chapter VII covers the situation in the Netherlands with a special attention dedicated to the rules of the Dutch Civil Code on unfair commercial practices and misleading advertising. Procedural rules regulating representative actions and collective settlement are also discussed. Chapter VIII is dedicated to the analysis of the British regime stressing Section 90 of the Financial Services and Markets Act of 2000 as well as the torts of misleading and fraudulent misrepresentation. From a procedural perspective, rules regulating the issuance of the Group litigation order are analyzed.

Based on the results of the analysis in Part One and Part Two, Part Three proposes possible solutions for the drawbacks of existing underwriter liability systems. It consists of two Chapters.

Chapter IX covers two countries where civil liability is actively used as an enforcement regime for the underwriter gatekeeping function – the USA and the Netherlands. It points out the most problematic issues of these regimes and proposes an universal solution that can help to achieve optimal deterrence of underwriter negligence.

Chapter X explores the situation in the UK where currently civil liability is not being used as an enforcement device. It analyzes the reasons and consequences of such approach and provides suggestions for improvement.

PART ONE. UNDERWRITERS. FROM PRACTICE TO THEORY

PREFACE

The goal of Part One is to lay down the background for the main topic of this book – the gatekeeping function of the underwriter. For a non-specialized reader both the phrases "the gatekeeping function" and "underwriting" may sound mysterious. The first legitimate question that arises in this context is who or what is an underwriter and what is its role in securities markets. The second question is what is the gatekeeping function and why should the underwriter perform it? To provide answers to all of these questions Part One presents three Chapters.

Chapter I is dedicated to the analysis of an underwriter from the practical or business perspective. It answers relatively simple question – what is the underwriter practical role in the process of securities offerings. Capital markets are looked at as essential facilities for the capital raising process of companies. Positioned between investors and companies, they enable the investors to obtain a financial gain on their savings, *i.e.* to forego consumption today in order to increase it in the future. They also serve as the conduits of savings to those companies needing funds for investment or operational business. In this context, the main function of financial markets is the facilitation of the allocation of resources across space and time, in an uncertain environment.[6] In such a way capital markets have an impact on "real" markets and, therefore, are the central and an important part of modern economic systems.[7]

At the same time capital markets are extremely complex and involve the participation of numerous actors, each performing its unique role. The main players are companies issuing corporate securities, such as shares and bonds, on the one side, and investors wishing to receive returns on their investments, on the other side. Besides these two groups we have a variety of intermediaries: commercial and investment banks, brokers, dealers, market makers, auditors, credit rating agencies and securities analysts, lawyers, clearing and

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[6] Robert C. Merton and Zvi Bodie, *The Framework for Analyzing the Financial Systems*, in Dwight B. Crane, *The Global Financial System: a Functional Perspective* (Harvard Business Press, 1995).

[7] For the importance of the financial system for economic growth see, for example, Ross Levine, "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35, no. 2 (June 1, 1997): 688-726. The author suggests positive, first-order relationship between financial development and economic growth. The article concludes that both theoretical and empirical studies find that the well-developed financial system leads to an efficient allocation of the capital and thus benefits the real economy.

settlement institutions and many others. There is also a system of regulators, market authorities and supervisors who are charged with assuring the proper functioning of the financial markets and given certain enforcement powers.

Chapter I shows that the underwriter is a financial intermediary that stands exactly between the issuer and investors. As a rule, the issuer chooses the underwriter as the first step in the securities offering process. The underwriter provides advisory, sale intermediation, gatekeeping, underwriting and price discovery (bookbuilding) services during the offering process. Once the offering is completed it further engages in provision of liquidity, stabilization, analyst coverage and other services.

Chapter I reconstructs the stylized time-line of the securities offering process and post-offering activities and describes the underwriter functions in this process. The stylization is possible because the underwriter functions are rather similar across major jurisdictions. The reason for such relative uniformity is that the underwriter participation in securities distribution is mostly a market solution, in a sense, that it is not imposed by law.[8] Those are practices that developed over time in the business community, mostly in the USA, and later spread globally.

Given the absence of mandatory rules, variations in the securities distribution process and the involvement of intermediary largely depend on the type of offering the issuer plans to implement. As an example, in public offerings with listing on the stock exchange, it is customary to require the participation of an underwriter. At the same time, the listing rules of some stock exchanges might require the company to appoint the financial intermediary to act as a sponsor. Usually, these two functions will be assumed by the same intermediary. Finally, the company might need the engagement of other financial intermediaries to help it distribute securities; therefore, a selling group of intermediaries might be formed. Further, the company will require the services of a security analyst to provide research reports. Therefore, unless the company opts for a self-directed offering, which is quite rare

[8] There are some exceptions to this rule. For example, in China all securities offering have to be underwritten. Only two types of underwriting are known: sale on a commission basis of securities and exclusive sales of securities, which corresponds to best-effort and firm-commitment underwriting. Exclusive sale of securities is the most common method and it accounts for 90% of underwriting. See Ming Jia, Difang Wan, and Zhe Zhang, "Financial Intermediations, Underwriter Reputations and Underwriting Risks in China's Stock Market," *International Journal of Networking and Virtual Organisations* 6, no. 4 (2009): 367 - 378.

In addition, the participation of the underwriter may be formally required or at least preferred by the listing venue.

and is used only for some fairly simple transactions, it will have to engage one or more underwriters in its securities offering. As a result, Chapter I concludes that in practice the underwriter is an indispensable figure in the process of securities offering and plays a central role.

Having discussed the practice of underwriting in Chapter I, Chapter II of this Part is dedicated to the analysis of only one of its' identified functions – the gatekeeping or monitoring function. It notes that, in fact, the economic theory emphasizes gatekeeping function of the underwriter as its main *raison d'etre.* Gatekeepers are described as "private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoer".[9] The core of the gatekeeping function of the underwriter is to prevent the misleading disclosure of material information or omission of information by the issuer by not accepting to act as an underwriter for the issuer or forcing the issuer to correct the misleading information.

Chapter II uses the paradigm of a perfect market and market imperfections to present the case for underwriter involvement. In perfect securities markets the allocation of scarce resources, in our case – the capital, is *Pareto* efficient. As there is no scope for further improvement of social welfare, intermediaries are redundant. Therefore, the only justification of the participation of the underwriter in the distribution process is the existence of a market imperfection which affects the proper functioning of capital markets.

Chapter II shows that the main market imperfection in securities distributions is the asymmetric information on the issuer side and the lack of credible signal to overcome it. It may lead to the lemons' problem and cause the adverse selection in distribution markets. The solution for this problem can be provided by the underwriter. By agreeing to underwrite the company, the underwriter can help to bridge informational gaps, as it would provide the monitoring and certification of the issuer. This "borrowed" signal would enable the issuer to credibly disclose its quality and separate itself from other companies. Thus, the economic theory states that underwriters' services are used in securities offerings because underwriters can mitigate the market imperfections arising in distribution markets at relatively lower costs than the issuer.

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[9] Reinier H Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy," *Journal of Law, Economics, and Organization* 2, no. 1 (March 20, 1986): pg. 53.

Chapter II argues that the underwriter should be given incentives to perform the gatekeeping function. While performing its gatekeeping function the underwriter faces many incentives and has real possibilities to act opportunistically. It is demonstrated that none of non-legal mechanisms, such as reputation, is capable of discouraging the underwriter from engaging in such behavior.

According to Chapter II, the aim to deter the underwriter from behaving opportunistically in performance of its gatekeeping function and the failure of non-legal mechanisms to provide necessary incentives, rationalizes the imposition on the underwriter a formal legal duty to act as a gatekeeper. To ensure that the underwriter complies with this duty some sort of legal enforcement mechanism is necessary. Chapter II discusses several available enforcement mechanisms and concludes that the threat of *ex post* legal liability can be used as an appropriate instrument to change the pay-offs of non-compliance for the underwriter and to provide incentives to exert optimal monitoring effort.

Chapter II further distinguishes between different types of *ex post* legal intervention. It concludes that both civil liability, enforcement by the securities regulator and the stock exchange are capable of providing the underwriter with incentives to monitor the issuer's disclosure. At the same time, all have significant disadvantages.

It is also noted that any *ex post* liability regime is associated with a number of costs, namely, administrative, private and tertiary costs. Mostly emphasized impact is the disruption of capital issuance market caused by the residual risks of liability and the underwriter imperfect ability to prevent issuer's misconduct. Nevertheless, it is pointed out that within the context of primary markets these costs should not be overly burdensome as they should mirror the discount investors would have applied to the securities in the absence of liability. In addition, there is a threat that private civil liability will lead to the duplication of administrative costs and *might* cause overenforcement.

Chapter I made it clear that gatekeeping is not the only function of the underwriter. In addition, they perform advisory, sale intermediation, underwriting, price discovery, liquidity provision, stabilization and analyst coverage functions. These functions are equally valuable as they target other important market failures of securities markets. The imposition of gatekeeping duty (and liability) is interconnected with these functions. Some of them can be enhanced by the imposition of the gatekeeping duty (liability) whereas it may have a chilling effect on others. In any case, the gatekeeping function cannot be simply discussed in isolation from other functions and it is important to take them into account when constructing the gatekeeping duties and corresponding enforcement mechanism. Therefore, Chapter III concludes Part One by providing a connection between previous two Chapters. It identifies the possible impact that the imposition of gatekeeping duty and liability as described in Chapter II can have on all other functions that were described in Chapter I.

The main conclusion of Chapter III is that it is likely that besides its main purpose to provide credibility to underwriter certification, the gatekeeper liability will contribute to the performance of other functions of the underwriter. The imposition of gatekeeping duty is likely to improve the overall quality of advisory services given the risen level of professionalism and quality of information about the company. It would also give underwriters additional incentives to exert optimal effort in extracting the information from informed investors as such information may indicate the mistakes of underwriter initial pricing and thus warn them against a possible liability threat.

Nevertheless, Chapter III warns that the imposition of a gatekeeping duty and liability may also have a negative impact on the quantity of disclosure. On top of the statutorily required minimum, the issuer and the underwriter might not be willing to provide additional positive information but disclose more cautionary information. Further, the imposition of a gatekeeping duty and liability may increase the level of underpricing as underwriters will seek to protect themselves from the liability risk.

Chapter III also warns us that the advisory role rather than underwriting should be the main criteria for establishing whether the financial intermediary is subject to a gatekeeping duty and liability. Therefore, the gatekeeping duty and liability should be imposed on underwriters engaged in either firm-commitment, stand-by or best effort underwriting. However, it should not be imposed on members of an underwriting syndicate engaged exclusively in the sale of securities.

Combined, Chapter I, II and III should provide the reader with an understanding of the actual practical world of underwriters and the economic thought which provides a justification or a rationalization of this business practice. They should also help to understand why the legal systems impose civil liability on underwriters. However, they do not seek to justify the civil liability as the *only* possible mechanism for enforcing the underwriter gatekeeping duty.

CHAPTER I. WHAT DO UNDERWRITERS DO?

1. WHERE DO UNDERWRITERS OPERATE?

Financial markets are not homogenous. The distinction between primary markets and secondary markets is of particular importance because the underwriter – who is the main focus of this book, performs its core economic function specifically on primary markets while its participation in secondary markets is limited.

Primary markets are dedicated to the sale of new securities. Transactions usually[10] take place between the issuing company and outside investors/creditors and the purchase price and the allocation of securities in this market is a result of the interaction between the issuing company, underwriter and investors. Therefore, they are the entry point for new securities to get into the market. Given their importance as the entrance to the marketplace, the exchange of securities in primary markets is a subject to regulation by securities law. All the major jurisdictions do not allow offering of securities to the public without disclosure of the relevant information to potential investors and upon the approval of such disclosure by relevant authorities.

In contrast to primary markets, on secondary markets transactions take place directly between investors. The company and the underwriter are not involved in transactions and do not receive any income from negotiated stocks. In secondary markets the price is set by the market forces and reflects the cumulative belief of all market participants as to the accurate fundamental value of the company. In the context of the secondary markets, the underwriter performs certain post-offering activities (*eg.* price stabilization) and provides additional services such as market making and analyst coverage.

A number of offerings can take place in primary markets. These can be:

Initial public offering (hereinafter – IPO) – an offering in which securities are sold to the public for the first time;

Seasonal public offering (hereinafter – SEO) – an offering in which already listed and traded company issues new securities;

Private placement – an offering in which securities are sold to the private sophisticated parties.

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[10] In primary equity markets, in certain cases initial shareholders (entrepreneurs) can also sell their share of the company together with new securities.

Within the primary market segment the IPO market should be specifically highlighted. The IPO of company's securities is a process whereby for the first time company raises finance by offering securities to investors in the market. It is often the case that the IPO is the only public offering of equity in the life of the company. After the IPO to satisfy its financing needs the company often tends to rely upon the retained earnings and debt.[11] Other subsegments of primary markets are similar to the IPO market to the extent that transactions take place between the company and investors. However, they differ in a number of other respects. In SEOs the company's securities are already traded in the market, therefore, the reference price for such type of securities is already established by market forces, the company is subject to periodic and *ad hoc* financial reporting requirements and is analyzed by the financial community. The company already has some experience in securities markets and there is more information available in the market. On the other hand, the private placement takes place between sophisticated parties who are assumed to be informed. Therefore, both SEO and private placements markets are considered to be less informationally opaque than the IPO markets and receive somewhat differential legal treatment. For example, private placements are often exempted from regulation by securities laws and are subject to private contracting.

Only a handful of securities offerings come under the scope of regulation – namely public offerings (*i.e.* certain IPO and SEO). In other cases the problems are believed to be sufficiently mitigated by contractual solutions. The term "offer" is defined by the securities law as "a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities"[12] or "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value"[13]. To define when the offer is public, the EU legislation uses an exclusionary criterion, *i.e.* all offers, as a default, are public unless they are explicitly excluded in the Articles 3 and 4 of the Prospectus Directive. For example, an offer of securities addressed solely to qualified investors or an offer addressed to fewer than 100 natural or legal

[11] Tim Jenkinson and Alexander Ljungqvist, *Going public: the Theory and Evidence on How Companies Raise Equity Finance* (Oxford University Press, 2001), pg. 4.

[12] For example, Article 2 (1) (d) of the EU Prospectus Directive or Sections 102B(1), (3) and (4) of the FSMA.

[13] Section 2 (3) of the USA Securities Act.

persons will not be considered public and, thus, will not fall under the scope of EU regulation. The UK follows the same structure to define the public offer. In the USA, the term "public offer" is not used in the Securities Act of 1933 (hereinafter – the Securities Act). Instead, the notion of "offer to sell" and the explicit list of what does not constitute an "offer to sell" is employed.

2. UNDERWRITER ROLE IN SECURITIES OFFERINGS

2.1. Pre-contractual phase

The timeline of the securities offering process, as regards the involvement of the underwriter, starts when the issuer takes the decision to make the securities offering and selects the lead underwriter (alternatively called a lead manager or book runner/manager). The parties sign a non-binding letter of intent – a precontractual agreement which tentatively seeks to establish a relationship between the company and the financial intermediary and sets forth the important points of the agreement before the offering is approved by the relevant authority and the real underwriting agreement is signed.[14] This document sets the main duties of the underwriter: structuring of the offering, determining the size and structure of the syndicate, drafting the terms of origination and sales, determining the size of the participation by each member, etc.. The particularity of this agreement is that it can be easily cancelled upon the request of any party.

2.2. Syndication

After signing the letter of intent, the lead underwriter assembles the underwriting syndicate – a temporary group of financial intermediaries formed for marketing of a new securities issue. The underwriting syndicate consists of a lead underwriter, co-managers and the selling group. Each member of the syndicate is assigned clearly delineated functions. The lead underwriter performs the core functions in structuring, executing the offering and performing the post-offering activities. The lead manager also performs the investigation of the company on behalf of other members of the syndicate who rely on its representations. Other members are mostly involved in the purchasing the securities from

[14] James D. Cox, Robert W. Hillman, and Donald C. Langevoort, *Securities Regulation: Cases and Materials*, 4th ed. (Aspen Publishers, 2004), pg. 121-122.

the issuer and distributing them to investors. Once the distribution is effectuated, the syndicate breaks down.

This work is mostly concerned with the activities of the lead underwriter as its activities carry the core economic weight within the offering process. Moreover, it also distributes more than 60% of allocated securities. Therefore, for the sake of simplicity, hereinafter the lead underwriter will be referred to simply as “the underwriter” and no distinction will be made between the various roles of individual syndicate members. Nevertheless, the syndicate structure of underwriting has separate economic function.

2.3. Prospectus and due diligence

The main task of the underwriter after the letter of intent is signed is to help the company to draft the registration statement and/or prospectus. The registration statement and the prospectus are documents that contain information about the issuer and the planned offering. Submission of these documents to the relevant market authority is required by securities laws as a prerequisite for a public distribution to be approved.

Preparation of the prospectus *inter alia* implies the performance of “due diligence” of the company. Due diligence refers to the investigation of the company performed by the underwriter in order to ensure the accuracy, truthfulness and completeness of the company’s registration statement and prospectus, and to understand any issues associated with the company.

The due diligence process around the globe follows three main steps: collection, review and verification of the information. As a first step, the underwriter collects all relevant information. In practice this involves the review of corporate documents, onsite inspections and interviews with company officials. The underwriter reviews the issuer’s industry, its reputation and the reputation of the principal officers, the issuer‘s business, and its financial position and financial statements. Once the information is collected and reviewed, it is thoroughly verified using both internal and external sources. Verification means producing the supporting material to establish the accuracy of each of the statement made in the prospectus. As a general rule, the underwriter performs most of the due diligence before the first filing of the registration statement/prospectus with the relevant authority. They then regularly update it whenever new information comes out.

2.4. Pricing

After the due diligence process is completed the underwriter has to price the securities. The mostly used securities pricing mechanism is the bookbuilding. It is the absolute favorite in the USA and is very popular elsewhere. [15] In the bookbuilding the underwriter seeks for non-binding expressions of interest by investors during the marketing phase and sets the final price and allocation at a much later stage. The price reflects the collected information about the demand by investors.

One of the main alternative methods is the fixed price offering. Using the fixed-price method the price is set relatively early, before the closing of the deal and the collection of information from investors. Investors submit their bids based on the fixed price proposed by the company/underwriter and rationing rules are used to allocate the securities. In contrast to the bookbuilding, the fixed-price method does not reflect the demand by investors – the fixed-price is set very early in the process when the actual demand is not known. Therefore, it can differ substantially from the optimal value. Its advantage is the low cost and easy implementation that provides investors with the certainty about the price and ensures non-discriminatory allocation.

Fixed-price offerings are also quite common. They exist in the majority of countries, except Austria, Greece, Finland and Spain. They are mostly used to distribute the securities to retail investors (public).

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[15] See Jay R. Ritter, "Differences between European and American IPO Markets," *European Financial Management* 9, no. 4 (December 2003): pg. 426. According to the data of Ljungquist, Jenkinson and Wilhelm (2000) in 1999 about 80% of non-US offerings were priced using the bookbuilding. It is notable that some European countries use not a pure bookbuilding but employ a two stage pricing mechanism: the bookbuilt offering to institutional investors and a fixed-price offering to the public. Nevertheless, in this case the bookbuilding serves as a basis for the pricing of the fixed-price offering. To provide a clear example of how it works in practice, let us look at the Italian example. First of all, the underwriter determines a price range. After that it starts gathering indications of interest from institutional investors which usually fall inside this non-binding range. This collection helps the underwriter to determine the final offer price and a list of potential buyers. While these indications are collected, a prospectus addressed to retail investors is published that specifies only the non-binding price range. After communicating a maximum price of the offer (within 2 days before the beginning of the offer to public), bids are solicited from retail investors and securities are finally assigned at the price that is fixed at the end of the process. This is a hybrid offering which is common in Italy with private placement for institutional investors (with securities discretionally allocated) and an open offer for retail investors (see Stefano Paleari, Enrico Pellizzoni, and Silvio Vismara, "A comparative study of Initial Public Offerings in Italy and in the United Kingdom" (Borsa Italiana, December 2005), pg. 9).

There are only two countries in the world where the bookbuilding is not used: Israel and Taiwan. However, this can be easily explained by bookbuilding being explicitly banned in Israel and it being restricted in Taiwan (see Ann E. Sherman, "Global Trends in IPO Methods: Book Building Versus Auctions with Endogenous Entry," *Journal of Financial Economics* 78, no. 3 (December 2005): 615-649.)

The second alternative to bookbuilding is the auction whereby the issuer sets the minimum price and investors submit limit orders. The appointed auctioneer sets the price as a function of the aggregate demand. For its ability to extract the pricing information and non-arbitrary allocation rules auctions earned a high acclaim in the academic literature. Nevertheless, they are not widely used in practice. Auctions have disappeared in Germany and Switzerland. It is reported that they still exist in France, the Netherlands, UK, Poland and Portugal.[16]

Coming back to the bookbuilding, to see its advantages and disadvantages more clearly consider the following main stages.[17] First of all, the underwriter determines the indicative price range using one of the methods for securities pricing developed by financial economics. The main methods are: the market multiples method – the security price is determined on the basis of the multiples of firms from similar industries or involved in similar transactions, and the discounted cash flow method, according to which the stock price is determined as a discounted stream of cash flows (capital gains and indefinite stream of dividends) over the life of the company. In practice, underwriters tend to rely more on the market multiples method because future cash flows forecasts are often unavailable or unreliable, therefore, the market multiples method is easier to use.[18] The empirical research also found that both methods lead to the comparable results as regards

[16] See Jean-Francois Gajewski and Carole Gresse, "A Survey of the European IPO Market," *ECMI Paper*, no. 2 (n.d.): pg. 18-19.

[17] The description is a stylized example of the American bookbuilding practice. In practice, the pricing process may have certain regional specificities. Nevertheless, the basic idea of price extraction from the institutional investors remains the same. For example, in EU primary markets have additional feature which allows the price discovery in IPO markets – the parallel, so called "when-issued" or "grey" market. A when-issued market is dedicated to the trade in forward contracts for the soon to be issued securities. It is an over-the-counter market focused on institutional investors. It opens once the initial price range for the IPO is announced and operates until the first secondary trading day. It is claimed that the observation of the pricing behavior on this market allows the underwriter to determine the demand for the security and set the more accurate price. Nevertheless, the price discovery *via* a when-issued market does not fully supplant bookbuilding as a means for obtaining information. Rather, those two methods coexist: the bookbuilding is used as a main tool to obtain the initial price ranges for the IPO but once the price range is published and a when-issued market opens, the latter dominates the bookbuilding as a source of information. (see Wolfgang Aussenegg, Pegaret Pichler, and Alex Stomper, "IPO Pricing with Bookbuilding and a When-Issued Market," *Journal of Financial and Quantitative Analysis* 41, no. 4 (2006): 829-862).

[18] Some exceptions exist as documented by Deloof, de Maeseneire and Inghelbrecht (2006) for the Belgian market during 1993-2001. In this case the discounted free cash flow method was used to value all the IPO in the sample.

the accuracy of initial estimation.[19] However, some argue that the initial price setting by the underwriter is “no more scientific than a car salesman’s price on a used Toyota. The outcome is easy to manipulate depending upon the assumption that one builds into analysis, and indeed the assumptions chosen by the underwriter are dubious at best since there is no obvious benchmark comparison for an as yet non-existent security”.[20]

As the second step in the bookbuilding process, the underwriter markets securities to institutional investors. This involves the organization of road shows – presentations by senior managers to potential investors. According to representations of major underwriters, the aim of the road show is to provide investors with the information about company’s business operations, financial results, performance, markets, products and services delivered by the company’s top management. Investors are also given an opportunity to ask questions. However, some commentators think that the main objective of road shows is not the distribution of information to investors but rather the collection of information from investors about their demand. It is noted that during road shows the company does not provide any additional information on top of already disclosed in the prospectus (as this opportunity is also limited by law – all the information has to be disclosed in the prospectus). Most probably the truth lies somewhere in between: these meeting serve as the forum for the exchange of information between sellers and potential buyers.

The underwriter role in the preparation of the road show includes assisting the issuer in the preparation of slide presentations, organizing rehearsals, preparing sales force, education materials, mapping the road show itinerary, targeting investors for one-on-one meetings with senior management, organizing road shows, logistics. Underwriters play crucial role in finding and choosing suitable investors and therefore they can determine the outcome of the allocation process.

The third step in the bookbuilding process is the solicitation of bids from informed investors in order to determine their demand for securities. As a response to the marketing

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[19] See Steven N. Kaplan and Richard S. Ruback, “The Valuation of Cash Flow Forecasts: An Empirical Analysis,” *The Journal of Finance,* 50, no. 4 (September 1995): 1059-1093; Henk Berkman, Michael E. Bradbury, and Jason Ferguson, “The Accuracy of Price-Earnings and Discounted Cash Flow Methods of IPO Equity Valuation,” *Journal of International Financial Management and Accounting* 11, no. 2 (June 2000): 71-83; SC Gilson, ES Hotchkiss, and RS Ruback, “Valuation of Bankrupt Firms,” *Review of Financial Studies* 13, no. 1 (January 1, 2000): 43 -74.

[20] Sean J Griffith, “Spinning and Underpricing - A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings,” *Brooklyn Law Review* 69 (2004 2003): pg. 620.

efforts, investors submit formal but not binding bids of a different informative value: strike bids – bids for certain amount of securities at a fixed price, limit bids – bids indicating the relationship between the price and the number of securities, or step bids – a number of limit bids. In this sequence, strike bids are considered to be the least informative while limit bids the most informative. The underwriter assesses the quality and quantity of the bids and takes this information into account when setting the final price. It can also file the price-range adjustment with the regulator if necessary (if the change in price range is significant).

The fourth step in the bookbuilding process is for the underwriter to finally price the issue. It should be noted that the price setting is not based on the simple matching of the supply and demand. The underwriter has a full discretion in this matter. The discretion is only limited by underwriter considerations about the potential future likelihood of repeated dealings with the issuer (SEO‘s, bond offerings or any other services) and the fact that the issuer might cancel the offering if it finds the underwriter pricing suggestion unacceptable.[21]

The widely documented fact is that when pricing securities the underwriter usually underprices them. The securities are underpriced relative to the open-market price once the secondary trading starts. Underpricing is a recurring and common phenomenon on primary markets, although, its amount varies considerably across the time, industry and market. In the 1980s, the average IPO underpricing was 7%. It jumped to 15% during 1990-1998 and reached the peak of average 65% in 1999-2000.[22] On average, the IPO underpricing is equal to 10-15%.[23]

Underpricing cannot be explained as the risk premium for the uncertainty associated with the investment in securities because its size is much higher than the normal risk premium. It is also clear is that this jump in the price benefits buying investors but takes the money from the company. Buying investors gain because they can sell or, in banking parlance,

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[21] Raymond P.H. Fishe and Ekkehart Boehmer, “Equilibrium Rationing in Initial Public Offerings of Equity,” *SSRN eLibrary* (June 14, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=273610.

[22] Gajewski and Gresse, “A Survey of the European IPO Market,” pg. 28.

[23] *The Cost of Capital: An International Comparison* (City of London: London Stock Exchange, June 2006), pg. 4.

"flip" the undervalued securities in the open secondary market at a profit.[24] Issuers, on the other hand, loose some funds or "leave money on the table". Moreover, stakes of original shareholders get diluted and, as a result, there is a value loss.

Why this happens and what is the role of the underwriter in this case is, however, subject to a long-lasting and still unsettled debate.[25] Some of the theories allow for the explanation of the underpricing as an efficient tool used by the underwriter to overcome serious market failures. Others warn that the underwriter power to underprice can be used opportunistically. The middle ground is that the underwriter provides a useful service to the market by setting some level of underpricing. If, on the other hand, the underwriter sets the level of underpricing higher than it is necessary, the pricing discretion might turn contrary to the interests of the company.

2.5. Allocation

Finally, the underwriter has to use its discretion to allocate securities. Securities distributed *via* the bookbuilding method are often oversubscribed. Therefore, the underwriter has to ration them. However, there are no fixed rules for such allocation. The lack of clear rules is explained by the different needs of particular offerings. It is argued that the underwriter is in a position to assess these needs on the case-by-case basis. As a result, it is in a better position than the issuer to decide on the allocation.[26] On the other hand, this discretion in allocation provides the opportunity for the underwriter to put the securities into the hands of particular investors. This, coupled with the freedom to underprice, may be used in conflict with the interests of both the issuer and investors.

The empirical analysis shows that the largest part of the securities is usually allocated to the institutional investors. For example, Aggarwal (2003) finds that within the sample of

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[24] It is also empirically observed that IPO tend to perform much worse than their seasoned peers in the long term. This phenomenon was first observed by Roger G. Ibbotson (1975) who found that the returns on IPO are positive in the first year, negative in subsequent three years and become positive again in the fifth year. Using the sample of companies that went public during 1975-1985, Jay R. Ritter (1991) also found that the companies underperformed the matching sample within three year time frame. Therefore, unless sold pretty fast, the IPO investment is believed to be inferior than investing in the more mature companies.

[25] See Jenkinson and Ljungqvist (2001) for the most comprehensive overview of the underpricing theories. Also see Section 3 of Chapter III for the discussion of some underpricing theories.

[26] Fishe and Boehmer, "Equilibrium Rationing in Initial Public Offerings of Equity," pg. 4.

the USA IPOs that took place during the period May 1997 to June 1998, the proportion of IPO securities allocated to institutions, on average, is 73.33% (median of 74.66%). This result is not surprising given both the structural conditions of the market and characteristics of such investors.

In sum, the current wide use of the bookbuilding method, on the one hand, significantly improves the informed price formation and thus contributes to the efficient allocation of resources. On the other hand, it creates the potential for a serious conflict of interest within the issuer-underwriter relationship as the issuer does not receive the full price for its stock. Additionally, securities may be allocated not according to certain preferences of the issuer (for example, long-term investors) but rather those investors favored by the underwriter.

2.6. Underwriting

Depending on the agreement between the issuer, the underwriter undertakes to provide one of the following services: best-efforts, firm-commitment or stand-by underwriting. These different types of underwriting provide the issuer with different solutions to the problem of proceeds risk.

Whenever the company enters the equity market it faces the problem of proceeds risk. Usually there is a more or less precise sum the company requires to collect and some other amount would not satisfy the company's needs for funding. However, offerings might not always be successful. If the company does not sell as many securities as it has forecasted, it can either settle for the smaller amount or call the distribution off. Both scenarios entail costs. In the first case, some changes should be made to the project or the residual funds collected from other sources for a much higher price. In the second case, there is direct sunk cost associated with the costly and time-consuming preparatory procedure. Moreover, as a consequence of the cancelled offering the issuer "may be lumped with the other businesses whose offerings did not sell because of questionable accounting practices or gross mispricing".[27] As a result, it may be difficult for the issuer to raise the capital in the future. Therefore, the company is interested in minimizing the proceeds risk.

[27] Joshua Lerner, "Venture Capitalists and the Decision to Go Public," *Journal of Financial Economics* 35, no. 3 (June 1994): pg. 312.

According to Mandelker and Raviv (1977) "one of the fundamental economic function of the investment banker is to underwrite the risk of fluctuations in the market price of the securities being issued, during the time of the offering".[28] A contract with the financial intermediary thus allows shifting the proceeds risk between the issuer to the financial intermediary.

The most common is the firm-commitment underwriting – the underwriter distributes the issuer's securities on its own account, *i.e.* it purchases the securities from the issuer for a fixed fee and then distributes them to investors.[29] Very similar to the firm-commitment is another possible arrangement, the stand-by underwriting. In this case, the underwriter does not buy securities *ex ante*, but instead buys *ex post* only those that it is unable to sell. Firm-commitment and stand-by underwriting are functionally similar. In both firm-commitment and stand-by underwriting contracts, the issuer is guaranteed to receive the fixed proceeds of the offering. The difference is mainly due to the presence of pre-emptive rights of the old shareholders in case of the capital increase. In Europe, corporate laws usually grant existing shareholders a priority over new investors to buy the securities in case of capital increase. Therefore, the issuer cannot sell new securities directly to the underwriter.

The third type of underwriting contract, the best-efforts underwriting, is functionally different. Here, the underwriter does not purchase securities from the company but undertakes to put its best-efforts to find investors and distribute securities for a fee. The issuer bears the proceeds risk. This means that the best-efforts offering may fail even after going through a long, expensive preparatory process and revealing considerable amounts of information.

The literature has suggested that none of the described contracts is *ex ante* more advanced and the choice of the underwriting contracts depends on the risk preferences of individual

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[28] Gershon Mandelker and Arthur Raviv, "Investment Banking: An Economic Analysis of Optimal Underwriting Contracts," *The Journal of Finance* 32, no. 3 (June 1, 1977): 683-694.

[29] In some contexts the term "underwriting" is understood in a narrow sense as only including firm-commitment underwriting. For example, in the UK the firm-commitment underwriting is called "the underwriting", while the best efforts underwriting is referred to as "placing". Another example, one popular Internet informational site describes the underwriting as "the procedure by which an underwriter brings a new security issue to the investing public in an offering. In such a case, the underwriter will guarantee a certain price for a certain number of securities to the party that is issuing the security (in exchange for a fee). Thus, the issuer is secure that they will raise a certain minimum from the issue, while the underwriter bears the risk of the issue". See, http://www.investorwords.com/5136/underwriting.html, or http://en.wikipedia.org/wiki/Underwriting# Securities_underwriting;

companies.[30] The practice, however, shows great convergence towards using the firm-commitment and stand-by underwriting as a default. Indeed, firm-commitment underwriting is currently the prevailing method in the USA to go public. On a global scale, the firm-commitment offering is often used for the IPO's offering in the largest markets, *eg.* Germany. Stand-by offerings are dominant in some other continental European countries, such as Italy.[31] Therefore, most often the underwriter role in the offering process will be closely connected with the provision of the proceeds risk-bearing function.

2.7. Listing on the trading platform

When filing the draft prospectus with the authority, the company might also choose to apply for the listing on the trading platform and admission of its securities to trading. Trading platforms can be of different kinds: official stock exchanges, multilateral trading facilities and others. Here, I will focus mostly on the registered stock exchanges because they provide an exchange forum for the biggest companies and represent the traditional environment of securities markets. In case of admission to trading on the trading platform, on top of the requirements of applicable securities laws the issuer additionally becomes subject to the listing rules of the particular exchange. And while securities laws usually do not require the participation of the financial intermediary in the offering, listing rules might contain provisions requiring its participation in the admission to trading.

One of the usual requirements by the stock exchange is for a company to have a financial intermediary who would act as its *advisor* or *sponsor*. The main role of this intermediary is to guide the company through the listing process and vouch for the company at the stock exchange. In other words, stock exchanges require the financial intermediary to act as a monitor of the company and to accept the liability in case of violations. This function is similar to the duty to conduct the due diligence of the company mandated by the securities laws.

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[30] See, for example, Gershon Mandelker and Raviv, "Investment Banking."

[31] Stefano Lombardo, "The Stabilisation of the Share Price of IPOs in the United States and the European Union," *European Business Organization Law Review (EBOR)* 8, no. 4 (2007): pg. 526.

2.8. Underwriting fee

The participation of the underwriter does not come for free. Underwriter fees form the largest cost element of the offering. Fees are usually calculated as a gross spread – the difference between the amount paid by the issuer to the underwriter and the price at which securities are offered for sale to the public. The gross spread is usually expressed as a percentage of the total distribution proceeds. Therefore, the structure of the underwriting fee provides the underwriter with the incentives to act in the interest of the issuer as to maximize the total proceeds. It should also encourage the underwriter to exert sufficient efforts. For the small offerings other types of underwriter compensation, such as underwriter warrants and "unaccountable expenses allowances", are used as well.[32]

Researchers looked at factors that determine the amount of underwriter compensation. It has been found that factors influencing the gross spread the most are the size of the offering and the location of the stock exchange. Other factors such as the nationality of the issuer or characteristics of the underwriter are not significant. If the company is listed in the European stock exchange, the underwriting fees are in average 3-4% and are similar across different European countries.[33] In the US gross spreads are considerably higher and amount to the average 6.5-7%.[34] Therefore, it is often said that it is cheaper to go public outside the USA. However, it is not precisely correct because this calculation does not account for the pricing method used and other characteristics of the offering.[35] In any case, both numbers constitute a substantive portion of the offering proceeds and there is a lively discussion on whether they are competitive.

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[32] Hsuan-Chi Chen and Jay R. Ritter, "The Seven Percent Solution," *The Journal of Finance* 55, no. 3 (June 2000): pg. 1126.

[33] Results for the period 1986-1999 are available in Sami Torstila, "The Clustering of IPO Gross Spreads: International Evidence," *Journal of Financial and Quantitative Analysis* 38, no. 3 (2003): 673-694. Results for the period of 2003-2005 are available in London Stock Exchange, "Aim Rules for Nominated Advisers", February 2007.

[34] *The Cost of Capital: An International Comparison*, pg. 4.

[35] The higher costs of USA offerings are determined by the more frequent use of the bookbuilding in these offerings. Bookbuilding is associated with considerably higher costs than other flotation techniques. It is estimated that the bookbuilding costs about twice as much as a fixed-price offering. The average cost of bookbuilding in 65 countries outside the USA is equal to 4.6%, while in the USA it is clustered around 7%. However, if one accounts for the size of the offerings (*i.e.* larger offerings require lower spreads) the cost of bookbuilding are lower in the USA and other Anglo-American markets compared to markets in Germany, Sweden, Italy, Japan, Canada and Israel.

Looking at the underwriting fees from a theoretical perspective, it is accepted that they should be higher than the marginal costs of underwriting.[36] Above-competitive fees are required in order to provide the underwriter with an incentive to provide a high-quality service. These incentives come in a form of quasi-rents that the underwriter can earn on its investment in establishing reputation. In summary, the high spreads are necessary "to give the underwriters an incentive to turn down deals that may be attractive in the short-run, but would be bad for investors in the long run".[37]

However, the level of fees higher than it is required for providing incentives might be a direct consequence of the monopolistic power of the underwriter. It is argued that there is a limited scope for the competition on underwriting markets. Underwriters are told to compete not on the basis of price but on the basis of investor coverage and reputation.[38] The importance of analyst coverage and costs of establishing the reputation create a potential barrier to entry for new underwriters. Lack of competition would allow underwriters to charge unjustified fees that would outweigh the benefits brought by underwriters.

Whether the level of the gross-spread is a result of a lack of competition is a subject to debate. Calomiris and Raff (2000) suggest that it is empirically impossible to determine whether the current underwriting fees are within the efficient limit. According to them the truth must be somewhere in between: "without the frictions in the markets for placing securities, it would be virtually impossible to extract rents since the firms could simply choose to auction securities directly to buyers. Furthermore, some payments to bankers in excess of marketing costs may be necessary costs of underwriting as a means to preserve the truth telling incentives of the banker".[39]

Some authors argue that the underpricing can be viewed as a part of underwriter compensation if it is assumed that the goal of underpricing is to allocate securities to the

[36] As modeled by Randolph P. Beatty and Jay R. Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings," *Journal of Financial Economics* 15, no. 1-2 (January): 213-232.

[37] Hsuan-Chi Chen and Jay R. Ritter, "The Seven Percent Solution," *The Journal of Finance* 55, no. 3 (June 2000): pg. 1120.Chen and Ritter, "The Seven Percent Solution," pg. 1120.

[38] Chen and Ritter, "The Seven Percent Solution."

[39] Charles W. Calomiris and Daniel M.G. Raff, "The Evolution of Market Structure, Information, and Spreads in American Investment Banking," in *United States bank deregulation in historical perspective* (Cambridge University Press, 2000), pg. 282.

repeat clients of the underwriter. Empirical studies find that, indeed, gross spreads are positively correlated with the level of underpricing.[40] If this dimension is taken into account, the underwriter compensation becomes considerably higher.

3. UNDERWRITER ROLE IN POST-OFFERING ACTIVITIES

3.1. Market making

After the offering is completed and the company is listed on the stock exchange the relationship between the underwriter and the company is not yet over. First of all, the underwriter usually becomes a market maker for the company. A market maker is a financial intermediary whose role is to provide liquidity in the market by quoting both a "buy" and a "sell" price in a security.

A liquid market for a security means that such security can be easily bought or sold without causing a significant movement in the price and with minimum loss of value. A liquid secondary market is a desirable outcome of any offering. A liquid secondary market reduces transaction costs for investors and lowers volatility in the immediate aftermarket. The initial liquidity may also reduce costs and even bring the profit to the underwriter as a market maker. Finally, a liquid market can improve the issuing firm's future access to capital markets by attracting analysts or investors. Therefore, the secondary market liquidity is a desirable feature for all market participants.

In a liquid market the investor should be able to sell or buy the security without any delay. However, there is often a lack of predictable immediacy of exchange in the financial markets. This occurs because buyers and sellers are not synchronized and at a given point of time there can be no matching counterparty to a transaction. To ensure the synchronization of orders the market maker issues quotes at which it is ready to buy and sell securities at any given time. And, whenever it receives a bid at the quoted price, it has to execute it even if it does not have a corresponding counterparty. In doing so, it is "making a market" and reduces temporary order disbalances and lowers investors' price risk associated with the delayed trade.[41] It also means that, whenever the market maker

[40] Dongcheol Kim, Darius Palia, and Anthony Saunders, "Are Initial Returns and Underwriting Spreads in Equity Issues Complements or Substitutes?," *Financial Management* 39, no. 4 (December 2010): 1403-1423.

[41] Kumar Venkataraman and Andrew C. Waisburd, "The Value of the Designated Market Maker," *Journal of Financial and Quantitative Analysis* 42, no. 3 (2007): 735-758.

does not have two matching investors, it participates in the transaction on its own account, as one of the parties to such transaction. As a result they can incur a large inventory of securities. In case the price drops dramatically, the underwriter can suffer significant losses on such inventory.

The risk it is taking by posting the quotes is covered by the bid-ask spread – the market maker sets a “sell” price a bit higher than the “buy” price. The resulting price difference should ensure the profit that is meant to compensate the market maker for the provision of liquidity. The market maker also receives some compensation either in the form of discounts or some trading privileges for assuming this role.

3.2. Price discovery

In the capacity of the market maker the underwriter often participates in the price discovery process and plays a crucial role is determining the opening market quote. Some stock exchanges, such as Spanish Stock Exchange, Paris Euronext and NASDAQ, have so-called preopening periods. Orders placed in this period are used to determine the opening price and can be cancelled at any moment and at no cost by the traders. Because the preopening is a repeated game to market makers, the information revealed during it tends to be truthful. Therefore, the preopening period serves as a good device for the price discovery.

The only study that examined the participation of the underwriter during the preopening period is Aggarwal and Conroy (2000). This study provides very powerful results: in NASDAQ IPOs the underwriter always becomes a leading market maker for the IPO company and handles the highest part of the trading volume. It also plays a crucial role in the price discovery during the preopening period that lasts for 5 minutes. It is shown that on NASDAQ the underwriter is the one to decide when to start trading and to set the first quote during the preopening period. It is noted that the underwriter uses the offer price as a benchmark and based on his information starts quoting *above* the offer price. For a weak IPO the underwriter sets the quote equal to the offer price. The underwriter revises its price after observing the behavior of other market makers. Real trading starts with the first trading quote by the underwriter and usually captures most of initial returns.[42]

[42] Reena Aggarwal and Pat Conroy, “Price Discovery in Initial Public Offerings and the Role of the Lead Underwriter,” *The Journal of Finance* 55, no. 6 (December 2000): 2903-2922.

This result shows that the underwriter has an impact on the setting of not only the offering price but also on the formation of secondary market price. The underwriter serves as an agent who incorporates the IPO's demand information in its very first quote as well as market pricing information in the market trading quote. The underwriter makes a profit or, in the worst case, does not make any significant losses on participating in the price discovery and subsequent market trading. The lack of empirical data on underwriter participation in the preopening period on other stock exchanges, however, prevents from making further generalization about the role of the underwriter in the price formation on the secondary market.

3.3. Stabilization

As a part of market making activities the underwriter also explicitly or implicitly commits to provide stabilization services. The objective of the stabilization activities stated in the law is to prevent or delay a decline of the security price once the security starts trading on the secondary market due to the selling pressure within the limited period after the offering. The use of stabilizing activities should restore investors' confidence in the securities.[43] In other words, the rationale for allowing the underwriter to intervene into the market mechanism is that the price decline in the aftermarket might happen not necessary for valid reasons. For example, the price decline can be a result of the "excessive" flipping activity, *i.e.* the immediate sale of the underpriced securities in the secondary market by initial investors. Or the price decrease might be caused by the volume shocks – in the absence of any trading history investors have a difficulty in interpreting the motive of volume sales that can signify both a desire of the seller to exit bad investment or simply its need to diversify.[44] The price decrease in the immediate aftermarket can also have larger impact than in the normal secondary market setting. It is feared that the decreasing price in the aftermarket can cause a cascade of cancellation of non-binding orders in the IPO. The

[43] According to subparagraph 11 of the preamble of Commission Regulation No 2273/2003 "Stabilization transactions mainly have the effect of providing support for the price of an offering of relevant securities during a limited time period if they come under selling pressure, thus alleviating sales pressure generated by short term investors and maintaining an orderly market in the relevant securities. This is in the interest of those investors having subscribed or purchased those relevant securities in the context of a significant distribution, and of issuers. In this way, stabilization can contribute to greater confidence of investors and issuers in the financial markets".

[44] William J. Wilhelm, "Secondary Market Stabilization of IPOs," *Journal of Applied Corporate Finance* 12, no. 1 (March 1999): pg. 81-82.

stabilization activity may prevent such cascades.[45] These selling irregularities might impair the interests of investors who bought securities, the underwriter and the issuer. To avoid such situations the underwriter is allowed to place a stabilization bid, which should restore the market confidence.

There are three main types of stabilization permitted by the securities laws[46]:

Pure stabilization (USA term) ***or stabilization*** (EU term) – placing of a bid or effecting of a purchase for the purpose of preventing the price from falling.

Short covering or covering transaction (USA term) ***or ancillary stabilization*** (EU term) – placing of a bid or effecting of a purchase to reduce a short position[47] created in connection with an offering.

Penalty bid (USA term) – an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

Stabilization is a function almost exclusively performed by the underwriter.[48] Short covering is a prevailing method of stabilization in the USA[49] and is also widely used in

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[45] Ivo Welch, "Sequential Sales, Learning, and Cascades," *The Journal of Finance* 47, no. 2 (June 1, 1992): 695-732.

[46] In the USA, stabilization activities are subject to the Rule 104 of Regulation M which permits all of the three mentioned types of stabilization. The regulatory instruments in the EU are the Directive 2003/6/EC and Commission Regulation No 2273/2003. It permits only pure and ancillary stabilization.

[47] Taking a short position means the sale of a borrowed security.

[48] "Almost exclusively" because other actors as, for example, the designated market maker (former specialist) in the NYSE, have a duty to prevent excess volatility which is similar to the stabilizing functions.

[49] In the USA out of the three permitted types of stabilization, only short-covering and penalty bids are observed in practice. The absence of the pure stabilization is usually explained by the regulatory reasons. First of all, the underwriting syndicate usually breaks up before trading begins. This means that the distribution is complete and stabilization bids can no longer be posted. Secondly, the requirement to announce *ex ante* that a certain bid is a pure stabilization bid makes such a bid less effective in supporting the price because such announcement demonstrates the market that the offering is weak. (see Reena Aggarwal, "Stabilization Activities by Underwriters after Initial Public Offerings," *The Journal of Finance* 55, no. 3 (June 2000): pg. 1078). In addition to these regulatory explanations, according to Lombardo (2007) the absence of pure stabilization on American market can also be explained on the basis of the economic rationality of pure stabilization in terms of the potential high risks that this practice can create for the underwriter. The riskiness of the stabilization activities arises from the accumulation a significant inventory position as a result of buying securities on the market. Holding such inventory position is risky as IPO's securities tend to lose value after the initial offer period.

Europe[50]. The main reason for this is that the short covering is less costly and risky.[51] It works in the following way. As it was explained before the underwriter is responsible for the allocation of securities to investors according to solicited bids. The underwriter owns a part of these securities, *i.e.* it has bought them from the issuer. The underwriter borrows the missing part of the securities for the allocation from other investors. This is referred to as "taking a short position". According to the contract with the share lender the underwriter pays the lending fee and any dividends due, and, at some point of time, it has to return the securities to the lenders. In case the price goes down and the underwriter needs to stabilize it, it simply buys securities on the market. These "buy" orders show increased demand and the price goes up. However, due to the created short position the underwriter does not have to hold the bought securities but uses them to cover the short position. In this case the underwriter manages to stabilize the price at little expense that consists of the lending fees due to be paid to the securities lenders. Creating a short position can, however, be dangerous because, instead of going down, the price may rise. Consequently, the underwriter will not only have to pay the lending fees but also bear the difference between the subscription price and the increased market price. However, the underwriter is also protected from this situation. First of all, the underwriter usually agrees with the issuer to be granted a so-called green-shoe (or overallotment) option – a contractual agreement where the issuer grants the underwriter a possibility to sell more securities than guaranteed at the offering price. Therefore, if the price rises, the underwriter covers the short position not by buying on the market but by exercising the green-shoe option. As a result, in both cases the underwriter closes the short position without loosing money or even making a profit. In the first case (stabilization), the underwriter can potentially make a profit on the difference between the market price and the offering price (if this difference is higher than the lending fees). In the worst-case scenario the underwriter only risks the lending fees

[50] There are no aggregate studies of the stabilization practices on the European level but some research exists on the national basis. In contrast to American findings, for Italy Lombardo and Boreiko (2009) find that both the pure stabilization and ancillary stabilization are used. They explain that the pure stabilization is used in Europe because there is no requirement to disclose the bids promptly, *i.e.* in the EU the information about the stabilization activities becomes public only one month later.

[51] Additional reason for popularity of the short covering as a stabilization technique is that it can be done without disclosure. It should be noted that this argument only applies to the USA market. In the EU the disclosure rules apply to the pure and ancillary stabilization (see Aggarwal, "Stabilization Activities by Underwriters after Initial Public Offerings," pg. 1100).

which have to be paid to the share lenders. In the second case, the underwriter earns the additional commissions on the securities sold *via* the green-shoe option.

The bottom line is that by using techniques such as taking of a short position and inserting the green-shoe option into the underwriting contract the underwriter is able to perform the stabilization function at a low cost and can thus add the value to the offering process.

3.4. Brokerage

The underwriter participates in the aftermarket trading also as a broker. A broker is the financial intermediary who executes investors' orders for a fee, *i.e.* it operates as an intermediary between the seller and the buyer. As a broker the underwriter participates in a number of different transactions and earns the brokerage commission on each such trade.

Empirical studies have shown that trading in IPO securities during the first days after the opening is usually very intensive but it slows down very quickly. Aggarwal (2003) looked into the causes and structure of aftermarket trading in IPO securities in the USA for 1997-1998. First of all, she reported that the trading volume in the immediate aftermarket is extremely high, reaching on average 81.97% of the securities offered. According to her findings, the high trading volume is a result of various transactions: the flipping – a sale of the underpriced securities by the original investors (18.95% of trading volume), the sale and purchase by other investors than original offering investors, *i.e.* the once flipped securities are traded several times, the trading activity between market makers and the short selling also contributes to the trading volume.[52]

There is some controversy surrounding the underwriter activities as a broker. The problem is that one of the transactions in which the underwriter gets involved as a broker is a flipping transaction. Flipping benefits initial investors because they can make an immediate profit resulting from the difference between the discounted offering price and the high aftermarket price. Although in its essence legitimate, flipping might have an undesirable impact on market prices. Flipping, as any other sale, can create a downward price pressure. However, in contrast to normal market practices, this downward price pressure can be unjustified and excessive. This sale can simply reflect the decision to reap

[52] Reena Aggarwal, "Allocation of Initial Public Offerings and Flipping Activity," *Journal of Financial Economics* 68, no. 1 (April 2003): 111-135.

the easy profit (short-terminism) rather than the judgment about the fundamental value of such security. This is particularly dangerous in weak offerings because it can lower the price even below the offering price. In the hot offerings the demand is so high that it usually can absorb the flipped securities and still keep the market price above the offering price. The swift decrease of price because of flipping can be harmful for the number of individuals: the issuer, as it is interested in the high security price, the non-selling investors whose securities are worth less, arguably, also the underwriter itself as it would have to engage in price stabilization.[53]

Several measures can be taken to stop this from happening. A first step to limit flipping is to hand-pick particular long-term, "strong" hands investors. Additionally, in the USA, the underwriter is given a statutory right to explicitly punish flipping investors by imposing penalty bids or implicitly by excluding them from future allocations. That is, in case the hand-picked investors would turn-out to be flippers, the underwriter can discourage them. However, it is a right of the underwriter but not the statutory duty to assess a penalty bid.

Even though the underwriter is not a direct party to the flipping transaction (which takes place between two investors), the underwriter receives the commissions on every trade where the underwriter acts as a broker. It follows that the prospects to earn profits on the brokerage activity could provide the underwriter with the incentives to behave opportunistically and encourage secondary trading (for example, by using the excessive underpricing and favorable allocations) or, at least, not to take active actions to discourage it (for example, by avoiding to use the penalty bids).

The empirical work has shown that following the objective to put new securities into strong hands, underwriters indeed allocate the large proportion of new securities to institutional investors.[54] However, it was also shown, that those investors do not hold the securities for a long-term but immediately flip them and, thus, benefit the most from the flipping activity.[55] Moreover, the underwriters do not impose the penalty bids very often.[56]

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[53] As it will be discussed later, it has been shown in the literature that in fact the price stabilization is not costly to the underwriter.

[54] Reena Aggarwal, "Allocation of Initial Public Offerings and Flipping Activity," *Journal of Financial Economics* 68, no. 1 (April 2003): 111-135; Reena Aggarwal, Nagpurnanand R. Prabhala, and Manju Puri, "Institutional Allocation in Initial Public Offerings: Empirical Evidence," *The Journal of Finance* 57, no. 3 (June 2002): 1421-1442.

[55] The analysis of the flipping activities within the sample of the USA IPOs that took place during the period May 1997 to June 1998 by Aggarwal (2003) shows that institutions flip a larger percentage of securities

These findings may confirm the prediction that the underwriter has incentives to act contrary to the interests of the issuer and encourage excessive flipping. On the other hand, the study has also shown that flipping does not constitute the major part of the trading volume. Therefore, it cannot have a decisive influence on the incentives of the underwriter within the offering process.

3.5. Profitability of underwriter aftermarket activities

For the underwriter, participation in the secondary trading is usually a profitable activity. It can generate two types of profits:

Trading profits/losses**:** including both profits resulting from the bid-ask spread and brokerage fees.

Inventory profits/losse**s:** Inventory profit or losses result from the inventory of securities the underwriter holds being marked-to-the-market and as a result changing according to the market movements.

Ellis *et al* (2000) finds that in general, participation in the aftermarket trading is a profitable activity for the underwriter with the total returns remaining positive both on the first day of the trading and during the first month of trading. The major part is due to the trading profits while inventory profits form a smaller part. Profit from the aftermarket activities account for 23% of underwriter compensation compared with 77% coming from the underwriting fees. This demonstrates that aftermarket trading is a profit generating activity. This also leads to the conclusion that the underwriter is interested in the high trading volumes on the secondary markets that would allow it to earn extra profits.

It was long assumed that stabilization is costly for the underwriter. However, empirical research has found the opposite. Aggrawal (2000) states that "the costs of the aftermarket

allocated to them than do individuals. They flip 10.62% (median of 7.22%), 26.40% (median of 22.87%), and 32.07% (median of 25.94%) of the securities allocated to them in IPOs priced below, within, and above the filing range, respectively. Retail flipping is 13.15 % (median of 2.17 %) for IPOs priced below the filing range and 40.83% (median of 20.99%) for IPOs priced above the range. Institutional flipping accounts for a much larger percentage of trading volume (mean of 15% to 20%) than retail flipping (mean of 2%-6%). The same pattern holds true using the third measure, securities flipped by institutions as a percentage of total securities offered.

[56] According to Ibid. penalty bids are assessed in only 13% of all offerings and amount to a small percentage of the total spread. It should also be noted that this number does not take into account the deterrent effect of their possible imposition and the threat of reduced allocations in the future.

short covering <…> are found to be minimal, amounting to three-four percent of the underwriting fees".[57] This result follows from the active management of the stabilization activities by the underwriter that allows limiting of the losses. Ellis *et al* (2000) comes to the same result. They state that "with exception of the fist day of trading, price support, on average, is not costly to the underwriter".[58] This happens because while conducting the stabilization activities the underwriter acts as a market maker and earns trading commissions that offset any costs.

3.6. Research coverage

Underwriters also provide research coverage services for their underwritten companies. The market values analyst recommendations because usually there is not much information available about the newly listed company and investors, as a rule, make their investment decisions based on the research reports about the company and rely on "buy" or "sell" recommendations. This allows investors to save the transaction cost of collecting and analyzing the information and therefore it is considered a valuable function of the underwriter. Therefore, the content of the report will move the firm's stock price either upwards or downwards.

Research reports produced by the underwriter are considered to be conflicted because the underwriter has already participated in the offering process.[59] Therefore, it has numerous incentives to issue overly optimistic reports as to support its previous claims about the company and ensure good market acceptance of the company. First of all, despite the fact that the company does not participate in the transactions on secondary markets, it gives a lot of importance to its stock price.[60] As the market stock price responds to the analyst recommendations, issuers often chose the underwriter based on the analyst coverage one

[57] Aggarwal, "Stabilization Activities by Underwriters after Initial Public Offerings," pg. 1100.

[58] Katrina Ellis, Roni Michaely, and Maureen O'Hara, "When the Underwriter Is the Market Maker: An Examination of Trading in the IPO Aftermarket," *The Journal of Finance* 55, no. 3 (June 2000): pg. 1071.

[59] As opposed to the independent analysts who have no affiliation with the underwriter.

[60] High valuation opens a profitable opportunities for insiders to exit the company, protects the company from hostile takeovers and can serve as important managerial compensation device. It also increases the liquidity of the securities which benefits investors at large. Therefore, the company is interested in both raising maximum proceeds during the offering and keeping the secondary market price high (see Chen and Ritter, "The Seven Percent Solution," pg. 1116.

can provide. For example, Corwin and Schultz (2005) report that "a top-ranked analyst in the issuer's industry significantly increases the likelihood that an underwriter is included in a syndicate either as a co-manager or in a non-managing role".[61] Indeed, issuers often name analyst coverage as a main determinant for choosing the underwriter.[62] Therefore, in order to get the underwriting business, underwriters might be interested in issuing positive recommendations.

The empirical studies on the quality of the conflicted research do not lead to conclusive results. For example, contrary to the theoretical concerns that the research by underwriters may be overly optimistic, Cowen, Groysberg and Healy (2006) find that conflicted analysts issue less optimistic forecasts and recommendations than independent analysts.[63] Lin and McNichols (1998) state that recommendations are more optimistic with respect to growth; earning forecasts are equally optimistic, underwriters are reluctant to downgrade the issuers, however "buy" recommendations are equally optimistic compared with the recommendations by the independent analysts.[64] On the other hand, Michaely and Womack (1999) find that underwriters issue more "buy" recommendations than independent analysts and that those recommendations are positively biased. Underwriters begin the research coverage with a "buy" or "strong buy" recommendations, these recommendations are well-received by investors even though the company performs badly afterwards. The findings as regards the investors' perception of the conflicted recommendations also point to the opposite directions. Some studies, such as Michaely and Womack (1999) report that investors do not fully discount the bias and place considerable value on the conflicted recommendation of the underwriter.[65] Others find the opposite. As

[61] Shane A. Corwin and Paul Schultz, "The Role of IPO Underwriting Syndicates: Pricing, Information Production, and Underwriter Competition," *The Journal of Finance* 60, no. 1 (February 2005): pg. 444.

[62] Laurie Krigman, Wayne H. Shaw, and Kent L. Womack, "Why Do Firms Switch Underwriters?," *Journal of Financial Economics* 60, no. 2-3 (May 2001): 245-284.

[63] Amanda Cowen, Boris Groysberg, and Paul Healy, "Which Types of Analyst Firms are More Optimistic?," *Journal of Accounting and Economics* 41, no. 1-2 (April 2006): pg. 119.

[64] Hsiou-wei Lin and Maureen F. McNichols, "Underwriting Relationships, Analysts' Earnings Forecasts and Investment Recommendations," *Journal of Accounting and Economics* 25, no. 1 (February 26, 1998): pg. 103.

[65] R Michaely and KL Womack, "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations," *Review of Financial Studies* 12, no. 4 (July 2, 1999): 653-686.

a result, it is difficult to draw any strong conclusions on the factual state of the conflict of interest.

There is an alternative point of view on the role of the conflicted advice. It is argued that due to their engagement in the offering process analysts of the underwriter have more access to information than independent ones who can only use the information publicly disclosed in the prospectus. Much of the information obtained during the due diligence and other offering activities never gets published in the prospectus. Therefore, reports produced by the underwriter should be more valuable and reliable. To support the point that the independent advice is valueless, Spindler (2006) notes that the market is indeed dominated by the conflicted advice. According to this commentator underwriters perform an important function in issuing the research. Such research "signals the underwriter inside information both at the time costly promise to provide positive research is made and also when the report is actually issued (essentially a confirmation of the underwriter earlier forecast). As opposed to prospectus disclosure, which is subject to the strict liability [in the USA as regards issuer prospectus liability], this signal is subject only to fraud liability. While strict liability has a well-recognized effect of chilling disclosure regarding firm's future prospects and opportunities, fraud liability presents an acceptable cost to the issuing firm, which allows the information to make its way to the marketplace". Moreover, Spindler (2006) claims that "by committing to publish positive analyst research prior to the offering, the underwriter binds itself to the mast of incurring, upfront, a substantial cost on behalf of issuer".[66]

3.7. Other post-offering services

After the offering is closed the underwriter often continues to arrange presentations by company management to institutional investors, so called "non-deal road shows". Typically, in this process the underwriter-affiliated research analyst organizes visits by company management to institutional investors in the institutional investors' home city or proactively coordinates a visit to the company headquarters.[67]

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[66] James C. Spindler, "Confict or Credibility: Analyst Conflictsof Interest and the Market for Underwriting Business," *American Law & Economics Association Annual Meetings*, no. 55 (n.d.): 2006.

[67] Anna Kovner, "Do Underwriters Matter? The Impact of the Near Loss of an Equity Underwriter," *Federal Reserve Bank of New York Staff Reports*, no. 459 (July 2010): pg. 4-6.

4. CONCLUSIONS

The goal of this Chapter was to describe the role of the underwriter in the securities offering process and post-offering activities. Underwriting practices are fairly similar in all major jurisdictions. The largest part of underwriter activities concern primary markets, *i.e.* transactions between the issuing company and investors. However, the underwriter continues to be associated with the company also after it starts trading in the secondary market.

There is no common definition of the underwriter but it is usually understood as a financial intermediary performing the following functions:

Advisory: advises the issuer on the offering process, preparation of the registration statement/prospectus and pricing and allocation of securities. In this sense, underwriter role is similar to that of lawyers, accountants and other consultants.

Sale intermediation*:* facilitates trading both on the primary and secondary markets. On the primary market, finds investors willing to buy securities either within its regular clients or the retail public and arranges the distribution. On the secondary market, acts as a broker and thus facilitates the secondary market trading by executing the orders of investors for a fee.

Gatekeeping: by getting closely involved and informed about the issuer and performing the due diligence investigation, monitors and certifies the quality of the issuer's disclosure and regulatory compliance.

Underwriting**:** provides the issuer with the guarantee that all of the offering will be distributed by either buying all securities on its own account or standing ready to buy residual securities.

Price discovery (bookbuilding): takes central position to coordinate the price discovery during the bookbuilding process and the pre-opening period.

Liquidity provision: enhances the liquidity in secondary markets by acting as a market maker for the stock by quoting both a "buy" and a "sell" price in a security and standing ready to execute the orders at any given time.

Stabilization: provides the price support within the limited period after the offering and, thus, helps to alleviate the unjustified sale pressures.

Analyst coverage: provides valuable analytical information to investors.

All functions are valuable to investors, although, their importance might be weighted differently. As it will be seen in the following Chapters, economists mostly stress the gatekeeping function of the underwriter. In contrast, practitioners would point at the advisory, underwriting and post-IPO support functions.

CHAPTER II. UNDERWRITER GATEKEEPING FUNCTION AND ITS ENFORCEMENT MECHANISMS

1. UNDERWRITER GATEKEEPING FUNCTION

1.1. Asymmetric information

As Chapter I has shown, the underwriter is expected to collect, review and verify the information the issuer discloses in connection with its public offerings of securities. This is a natural outcome of the underwriter function as an advisor of the issuer in drafting the offering documents. The economic science had sought for the rational explanation why such function of the underwriter is required. The basic reply to this question is the need to address the problem of asymmetric information between the issuer's insiders and outside investors.

The economic theory states that on the perfect capital market characterized by the absence of market failures the unrepressed interaction of market forces would generate efficient outcomes.[68] It is assumed that individuals or companies will behave as rational utility-maximizers and, *via* the price mechanism, will allocate the resources – the capital, to its best use. However, as famously developed by Coase (1960) transaction costs of negotiating, formulating and enforcing individual rights may hinder the working of the market mechanism.[69] The high transaction costs usually arise due to the presence of market failures such as inadequate information, restrictions of competition and externalities. In capital markets such market failure is the asymmetric information between the issuer and outside investors.

Insiders of the company, by definition, know more about the quality of securities than outside investors. Moreover, investors cannot perform a simple check or inspection of the quality of the security before the purchase as they would be able to do with other goods. The reason for this is that the security is an experience good meaning that its quality can

[68] Kenneth J. Arrow, "The Potentials and Limits of the Market in Resource Allocation," *Issues in Contemporary Microeconomics and Welfare* (1985): 107-124.

[69] R. H. Coase, "The Problem of Social Cost," *The Journal of Law and Economics* 3, no. 1 (January 1960): 1.

only be established after purchasing.[70] Hence, in the absence of credible information *ex ante* their quality is uncertain and investors cannot accurately set the price.

Ex post, the security will be deemed of a good quality if the secondary market price would not fall significantly. Conversely, the security would be of a low quality if the price falls down. Although the determination that the security is of the low quality is pretty straightforward, it is difficult to determine what exactly caused the drop of the price. It can be caused by the *ex ante* fraud or negligence on the part of the issuer, bad pricing by the underwriter or independent *ex post* contingencies. Therefore, without additional information the investor cannot identify with certainty whether the investment was of bad quality *ex ante* or it is just a victim of bad luck or *ex post* managerial misconduct.

The quality and, consequently, the accurate price might, however, be ascertained if the issuer releases the truthful and complete information about the company. However, in capital markets such disclosure by the issuer might be problematic. The problem is that investors understand that the issuer faces incentives to behave opportunistically in releasing information about securities. The issuer has incentives to behave opportunistically because by providing false information it receives short-term profit. The gain of deception might be bigger than the loss of future profits especially given that securities are not frequently purchased goods. As the securities are not purchased on a regular basis, the threat of future loss of sales in case the quality proves to be lower than promised, or the probability of repeat purchases, does not affect incentives of the issuer. Therefore, it cannot serve as a good restraint on the misdisclosure of information.[71] As a result, some firms might find opportunistic behavior to be the project with the highest net present value. In addition, the *ex ante* asymmetric information about the quality of security, the *ex post* lack of monitoring and control of the management and a general risky environment of securities markets create a fruitful soil for such opportunistic behavior.

This book is mostly focused on one type of issuer's opportunistic behavior – material misrepresentations about the company. Misrepresentations can take several forms. Most straightforward one is when the issuer discloses incorrect or misleading information. For

70 Thomas J. Chemmanur and Paolo Fulghieri, "Investment Bank Reputation, Information Production, and Financial Intermediation," *The Journal of Finance* 49, no. 1 (March 1, 1994): 57-79.

71 Frank Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1996).

example, the issuer may lie about the size of its assets. Alternatively, the issuer may omit some information and such omission would lead investors to evaluate the issuer incorrectly. For example, the issuer can "forget" about the loans which it still needs to pay or "forget" to mention that the license permitting the company to engage in a certain activity is about to expire. Moreover, the issuer may use some sophisticated accounting tools in order to inflate its assets or to hide the liabilities.

Due to the misdisclosure by the issuer investors will suffer private financial losses. Financial loss features a distinguishing characteristic. While physical harm always implies the destruction of wealth, economists agree that private financial loss, also known as pure economic loss, may or may not amount to the social loss.[72] From an *ex post* perspective it might simply mean a redistribution of wealth from one subject to another, so that the total wealth of society remains unaltered. From a policy perspective, it is however, important to see the effect which such redistribution of wealth has on the *ex ante* incentives in the market.

a). Effects on primary markets

A primary market is a forum for a rather simple exchange: a company wishes to acquire the capital for a certain investment project and therefore sells a good, a security, to investors willing to contribute their capital and earn the profit on their savings. However, this exchange can be hampered by the problems caused by the asymmetric information possessed by the seller of the security.

The asymmetric information and the lack of transparency and accountability may give rise to opportunistic behavior by the issuer. This causes the redistribution of the capital from investors to the issuer. Such transfer signifies private financial losses to investors. At the same time, it affects *ex ante* incentives of market players and, thus, results also in social losses.

[72] Willem H. van Boom, Helmut Koziol, and Christian A. Witting, *Pure economic loss* (Springer, 2004); Giuseppe Dari-Mattiacci and Hans-Bernd Schäfer, "The core of pure economic loss," *International Review of Law and Economics* 27, no. 1 (March 2007): 8-28.

Social losses caused by the misdisclosure in primary markets are associated with the famous "lemons" problem (adverse selection) as developed Akerlof (1970).[73] Unable to independently distinguish between the quality of different securities *ex ante* and appreciating the possibility that issuers can lie about the quality of their securities, investors discount all the securities at the same rate reflecting the average probability of misstatement. This results in a pooling equilibrium whereby the same price is paid both for the high, average and low quality securities, *i.e.* the formation of accurate securities pricing is compromised. The same relative price is paid both for all securities. This drives good quality issues out of the market and can eventually lead to the complete dismantling of the market. This would not only harm individual investors but will cause social losses in a form of market contraction or even unraveling. Social welfare is reduced because the investors willing to buy a security of a certain quality are unable to do so.

In addition to the adverse selection problem described above, misdisclosure will lead to a number of other market distortions. One of the most important of these externalities is the distortion of the efficient allocation of resources in the economy. Financial economics postulates that the expected quality of investment projects determines the cost of capital for the issuer (*via* price). Investors are willing to invest in companies whose investment projects yield the biggest cash flows, thus, streaming scarce resources to their best use. Additionally, the securities price also affects the interest rate of borrowing from banks and management's willingness to use funds to implement new projects. Therefore, if the security price is inaccurate and companies cannot obtain funds at a reasonable cost or, in contrast, can obtain them very cheaply, they might forego otherwise useful projects or engage in socially wasteful projects. This leads to conclusion that the misdisclosure of information will affect the efficient allocation of capital to the best-ranked projects and, therefore, is socially inefficient.

Without going into a more detailed discussion of this topic, it should be mentioned that the practical significance of this argument is, however, hotly disputed in the literature. Some authors point out that contrary to the theoretical predictions about the influence of the accurate price for the efficient allocation of resources in the economy, the price of securities is not relevant simply because, in practice, the majority of real investments are not funded by public offerings. Therefore, prices of newly issued securities might have

[73] George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics* 84, no. 3 (1970): 488-500.

only marginal impact on the development of the real economy and are not of particular concern. Therefore, if we take just a separate case of primary equity markets, counter intuitively, the empirical evidence suggests that the accurate pricing in not of the major importance.

Further, misdisclosure can lead to social losses related to the distortion of exit venues for original investors. If the pricing of securities is distorted, original investors and entrepreneurs, such as venture capitalists, cannot efficiently exit their investments, and thus loose *ex ante* incentives to provide venture capital financing for start-up companies.

In sum, the possibility to suffer private losses due to misdisclosure provides investors with *ex ante* incentives to discount securities and in the worst-case scenario even to completely abandon financial markets. As a result, the misdisclosure affects the efficient allocation of capital and economic development. Therefore, it is socially inefficient both from a private and from a social perspective.

b). Effects on secondary markets

The effects of asymmetric information and issuer's opportunistic behavior on the secondary markets are somewhat different. First of all, in case of secondary markets the misdisclosure results in the redistribution of capital not from investors to the issuer but from one investor to another. Such transfer causes private loss to the buying investor in the form of a reduction of the security price. At the same time, the selling investor gains from selling for the high price. It is also assumed that the individual investors hold a diversified portfolio of securities and plan neither to save nor disinvest. Their only motivation for the selling and buying securities is to improve the structure of portfolio, to spread risks and to accommodate the portfolio to changing economic conditions. Therefore, they face the same probability to sell or buy the security over the given period of time. Therefore, theoretically in total the losses should get balanced out with the gains resulting in zero net loss.

Investors appreciate *ex ante* this equal probability to win or loose and should not be discounting securities as it is the case in primary markets. Diversification would protect them from private damages. Therefore, in theory, the decrease of price accuracy due to the misdisclosure should not be relevant to secondary market investors.[74]

Such conclusion, however, misses several important points. First of all, the full diversification of investors is often unachievable. Investors might hold too few securities or hold them for a very limited period of time. Those investors who cannot fully diversify will suffer private losses. For example, Evans (2009), using observational data and simulated trading data, finds that undiversified individual investors are likely to suffer net losses from securities fraud. Losses occur also to large numbers of diversified institutional investors.[75] The *ex ante* appreciation of such private losses will start the mechanism of adverse selection and will result in a social loss. Note that in this case the adverse selection (discount on all securities) will not be as severe as in primary markets because only some part of private losses will be relevant to investors. From this point of view, only the partial and not the total elimination of misdisclosure is socially efficient.

Secondly, despite the balancing effect discussed in the previous paragraph, the misdisclosure affecting secondary markets causes social losses in another manner. Most prominently, it can lead to distortion in the functioning of numerous market mechanisms, such as merger and acquisition activity, takeovers, compensation schemes and other instruments that are dependent of the issuer's securities price.[76] This will have an impact on the efficient allocation of resources and thus signifies an important social loss.

Finally, the wealth transfer on the secondary market may affect the link between primary and secondary markets. When entering primary markets the issuer does not only guarantee to investors that the initial price will be accurate but also that *via* listing they will create conditions for investors to resell the securities. Primary investors may want to sell securities at a price that is not discounted taking into account the probability of misdisclosure. So do all subsequent investors because nobody wants to purchase a security

[74] Frank H. Easterbrook and Daniel R. Fischel, "Optimal Damages in Securities Cases," *The University of Chicago Law Review* 52, no. 3 (July 1, 1985): 611-652; Paul G. Mahoney, "Precaution Costs and the Law of Fraud in Impersonal Markets," *Virginia Law Review* 78, no. 3 (April 1, 1992): 623-670; Hans-Bernd Schäfer, "Efficient Third Party Liability of Auditors in Tort Law and in Contract Law," *SSRN eLibrary* (June 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1137886; Merritt B. Fox, "Civil Liability and Mandatory Disclosure," *Columbia Law Review* 109, no. 2 (March 2009).

[75] Alicia J. Davis Evans, "Are Investors' Gains and Losses From Securities Fraud Equal Over Time? Some Preliminary Evidence," *University of Michigan Law & Economics Working Paper 09-002* (January 26, 2009).

[76] Fox, "Civil Liability and Mandatory Disclosure."

that will "negatively modify its rights and entitlements when in his hands".[77] If there are misstatements in the market investors will seek to avoid being on the losing side of a trade and therefore will limit their trading. Thus, the absence of misstatements in secondary markets is one of factors that ensures the liquidity that, in turn, allows raising of the capital at the first place.[78]

Fox (2009) also argues that the misdisclosure in secondary markets has more direct impact on the allocation of resources in economy and thus affects social welfare. Share price that is inaccurately inflated as a result of misdisclosure may lead to the implementation of socially undesirable projects. This would happen because the share price can "affect the cost of financing a project by influencing the terms demanded by the intermediaries constituting the other available external sources of funds".[79] Moreover, Fox (2009) argues that the secondary market price affects the discount rate managers use to evaluate future projects. Theoretically, to assess the project managers should use the discount rate associated with other similar existing projects. However, in reality they use the discount rate implied by the price earning ratio of their own company. As a result, if the secondary market price is inaccurately inflated, the discount rate will be lower. Thus, even negative net present value projects can be deemed as having positive net present value and undertaken.

The analysis above shows that misdisclosure in secondary markets is significant from a social point of view. The significance of credible disclosure, however, is mostly based on the improvement of economic efficiency through better corporate governance and

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[77] Paolo E. Giudici, "Auditors' Multi-Layered Liability Regime," *ExpressO* (n.d.): pg. 47, http://works.bepress.com/paolo_giudici/1.

[78] Pritchard (1999) provides a more sophisticated explanation of the liquidity story. According to him, on the secondary market the best way for investor to protect themselves from losses due to misstatements is to hold a diversified portfolio. Therefore, it is optimal that investors spend no resources to investigate the disclosures by companies but instead simply diversify. However, if there are misstatements on the market, they may induce some investors to "try to beat the market by investigating the statements made by the company". As a result, a new kind of informed traders will appear on the market. They will be able to earn extra profit because uninformed traders will systematically lose when trading with informed investors. This will lead to the increase of spreads by uninformed market makers which will reflect the possibility of dealing with in inside trader and suffering losses. Uninformed investors will also trade less frequently. Less trading means less liquidity and lower liquidity signify higher trading costs. The decrease of liquidity will be finally reflected in lower stock prices. A. C Pritchard, "Markets As Monitors: A Proposal to Replace Class Actions with Exchanges As Securities Fraud Enforcers," *Virginia Law Review* 85 (1999): 925.

[79] Fox, "Civil Liability and Mandatory Disclosure," pg. 263.

increased liquidity rather than on investor protection. This holds at least in respect of established issuers who trade in efficient markets.

Indeed, the value of disclosure in secondary market greatly depends on the ownership structure. The typical USA ownership system is dispersed. The main corporate governance problem is the divergence of interests between management and investors. Disclosure is secondary market can be very helpful in solving in this problem through corporate governance mechanisms described above. As a result, the significance of truthful disclosure in secondary markets should be equal to primary markets and a similar level of disclosure and its enforcement should be provided whenever or not an issuer is offering securities.[80]

Elsewhere corporate ownership structure is concentrated. In this setting the management agency problems are not so important because the controlling shareholder can monitor managers. As a result, a high level of disclosure is not required to discipline managers. However, concentrated ownership systems feature another problem – possibility of expropriation of minority shareholders and other stakeholders by the controlling shareholder. The influence of disclosure on solving this problem is tricky. The problem is that the concentration of voting power in the hands of one shareholder makes the working of many corporate governance tools, such as takeovers, useless. In this context, Fox (2009) notes that "whether disclosure has some other kind of deterring effect depends both on the overall social and business mores of the country and the extent to which such behavior can be meaningfully challenged in court".[81]

c). Commitment problems

However, the major problem for the functioning of capital markets is not the presence of asymmetric information and opportunistic behavior as such. More important is the failure of the issuer, in absence of external intervention, to convince investors that it will not behave opportunistically. Classic literature posits that high quality issuers can credibly commit not to behave opportunistically by using costly signaling mechanism. Booth and

[80] Ibid.

[81] Merritt B. Fox, "Civil Liability and Mandatory Disclosure," *Columbia Law Review* 109, no. 2 (March 2009): pg. 275.

Smith (1986) explain the functioning of this mechanism as developed by Klein and Leffler (1981): "<…> under certain conditions a non-salvageable capital expenditure can serve as an effective bond to guarantee the quality of a firm's products. The non-salvageable investment is perceived by customers as a commitment to product quality. Their willingness to pay a premium over product cost for the commitment provides a stream of quasi-rents on the initial investment which will only continue to be paid as long as the firm does not cheat".[82] However, for this mechanism to work several conditions must be satisfied. First of all, signaling should be costly to the company, therefore only those issuers who take it serious can engage in it. Secondly, costs should vary across the types so that it would be cheaper for high quality types than for low quality types. Thirdly, only high quality types should able to reap net benefits of the costly signaling.[83]

Investment in reputation by the issuer can be a good example of such a costly signal. It is costly because any subsequent discovery of opportunistic behavior will make the investment in reputation valueless. By investing in the reputation for quality the issuer signals its belief that when investors find out the truth about the company *ex post,* the quality of the company will be proved to has been high. Issuers who plan to access the capital market repeatedly will consider the fact that investors who are disappointed *ex post* will demand a higher cost of capital for future issues. Issuers will internalize these costs and will disclose only truthful information. Therefore, by investing in reputation the issuer may be able to credibly commit not to compromise its signal.

However, the issuer is not always capable of making investment in reputation and therefore producing the costly signal. First of all, the issuer might not have available capital for building of reputation. Secondly, it might lack the time to build it. Thirdly,

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[82] James R. Booth and Richard L. Smith, "Capital Raising, Underwriting and the Certification Hypothesis," *Journal of Financial Economics* 15, no. 1-2 (January 1986): pg. 261.

[83] Booth and Smith (1986) provide formal definition of this problem. The issuer will choose not to cheat and disclose the truthful information if $Y/(E^{rt}-1)>W/e^{rt}$ where $Y_t/(E^{rt}-1)$ is a perpetuity of quasi-rents which is earned if outsiders believe insiders will not cheat, and W/e^{rt} is a one-time gain from cheating. The quasi-rent Y_t represents the difference between X^I_t – value to existing shareholders of projects that can be profitably undertaken at time t if outsiders know the issue price is consistent with inside information and X^P_t – time t value to existing shareholders of such projects if outsiders respond negatively to an announced new issue. Since only insiders know whether $Y/(E^{rt}-1)>W/e^{rt}$ condition holds, outsiders require proof that can be supplied in the form of a bond, B. To insure non-cheating the investors demand the bond to exceed the value of the potential one-time gain from cheating: $B>W/e^{rt}$. (see Booth and Smith, "Capital Raising, Underwriting and the Certification Hypothesis.")

investors might still not believe the credibility of such signal.[84] The unavailability of the costly reputational signal means that issuers lack the mechanism for commitment regarding the accuracy of disclosed information. Therefore, they cannot overcome the adverse selection problem. The lack of adequate incentives to disclose the truthful information suggests that there might be a need for the external intervention in the functioning of this market in order to improve on the market failure caused by the asymmetric information.

1.2. The primary solution to the failures of securities markets and its limitations

The primary response to the lack of the costly signaling mechanism by the issuer across the majority of economies around the globe is to impose regulatory solutions on the main participant of the exchange, namely the issuer. The most common way is to statutorily require the issuer to disclose the truthful information and not to omit material information and to impose certain sanctions in case the issuer violates this requirement. The threat of sanctions would make it more costly for low quality firms to mimic high quality ones by making false disclosures while it would impose relatively low or no costs on honest, high quality firms. This should deter the company from engaging in the misdisclosure.

The great majority of legal systems have either general or specific rule against the misdisclosure in securities markets. For example, Romano (2001) notes that "it is inconceivable that a securities regime would have no liability for fraud or no financial disclosure requirement when investors have even a modicum of sophistication, as such individuals would not invest in securities under such circumstances (or they would pay a trivial sum for securities). More important, as no reputable issue would register under such regime, it would not be adopted in a nation with public or multinational corporations that desire domestic registrations. <…> In all states of the world in which one would model stock purchases, there will be rule against fraud and hence there will be a mechanism for commitment regarding the accuracy of disclosed information prior to the specific disclosure".[85]

[84] Ronald J Gilson and Reinier H Kraakman, "The Mechanisms of Market Efficiency," *Virginia Law Review* 70 (1984): 549.

[85] Roberta Romano, "The Need for Competition in International Securities Regulation," *Theoretical Inquiries in Law* 2, no. 2 Article 1 (July 2001): pg. 16.

Most legal systems also have a rule making the issuer liable for negligent representations. These can be both strict liability and negligence regimes. Depending on the jurisdiction issuer's fraud and negligence can be subject both to private and public enforcement; civil, administrative and criminal sanctions.

Nevertheless, the prohibition of negligence and fraud *via* the imposition of liability has its limitations as a mechanism of ensuring the quality of disclosure. First of all, it suffers from the standard drawbacks common to any real-life enforcement mechanism. The issuer can have inadequate assets in order to be able to bear all social costs of misdisclosure. Frequently, the issuer will become bankrupt at or about the time the misdisclosure fraud is discovered. The probability of detection and enforcement is uncertain. The issuer can be judgment proof, *i.e.* have nothing to lose, and, therefore, nothing that can deter it from committing fraud. There can be principal-agent problems within the issuer that is, by definition, a collective entity. Therefore, the issuer can be non-responsive to the impact of the liability for misdisclosure and continue with misconduct. Moreover, it might not be possible to raise the expected penalties.

This is not to deny the importance of the primary liability for misdisclosure. It definitely forms a basis for any regulation of financial markets. It is only to conclude that issuer's liability for misdisclosure cannot solve all problems related to the credibility of issuer's disclosure. Appreciating this, investors will still discount the price of securities taking into account enforcement problems. Hence, there is a scope for additional mechanisms that can ensure the credibility of issuer's disclosure.

1.3. Underwriter as a gatekeeper

How can the underwriter help to solve the problem caused by the asymmetric information insecurities markets? The underwriter is regarded as a participant in the distribution process that can help to provide a credible signal or to certify the correctness and completeness of the issuer's disclosure. For the reasons that will be described in detail further in this book, it is believed that it is easier and cheaper to ensure that the underwriter does not cheat in its certification than to prevent the issuer from cheating (on top of what can be realistically achieved through first party enforcement). Credible signaling would positively affect social welfare as adverse selection and other related problems would be alleviated. Investors with a preference for higher quality goods, through underwriter certification, would be able to satisfy their preferences. Other negative consequences would also be avoided.

There are several reasons why the underwriter can serve as a credible certifier:

Private knowledge (due diligence). The argument goes that the central position of the underwriter in the offering should enable it to get informed about the issuer's quality. In order to prepare the registration statement/ prospectus required by law the underwriter collects the information about the issuer and reviews it. The verification process then allows the underwriter to ascertain that the information about the company is correct. Moreover, differently from other participants in the distribution process, such as lawyers and auditors, the underwriter engages in the overall inspection of the offering and not a specific part. Based on this knowledge the underwriter should be able to vouch or certify that all the information disclosed by the issuer is true and complete.

Independence. In comparison to other persons closely involved in the offering, namely directors of the issuer, the underwriter is not an insider. Therefore, it is the most independent person capable to examine the credibility of disclosure. Moreover, the underwriter has many clients each of whom pay it a fee that is modest in proportion to the underwriter overall revenues. Therefore, the underwriter should be relatively independent from any particular issuer.

Experience and resources. Being a professional in the securities distribution business the underwriter possesses necessary skills and both monetary and human resources to perform the extensive investigation. The experience in the sector allows performing these activities at the lowest cost.

Compensation. The underwriter will be directly compensated for gatekeeping services by the issuer. In the absence of the underwriter, the issuer would have to compensate multiple investors.

Ability to exert influence. The underwriter also has real possibilities to stop the fraudulent behavior of the issuer by either lowering the initial price for the securities and requesting a disclosure of the information or a forecast that will convey the gist of the information, or simply refusing to proceed with the offering. Other underwriters will interpret such refusal as a sign of bad quality and would not bid for the underwriting.

The underwriter would also be able to achieve credible signaling efficiently. The certification by the underwriter would attain economies of scale and scope. Firstly, some information would be used cross-sectionally and temporally.[86] Secondly, the cost-saving would be achieved by the avoidance of the duplication in information production that would happen if individual investors would have to screen issuers.[87] If investors would be able to rely on underwriter representations, they would also decrease the costs of maintaining the system of examination and costs of information verification.

Another advantage of targeting the underwriter rather than the issuer in seeking to enforce disclosure duties is that the so-called circularity problem is avoided. The problem of targeting the issuer as the main subject is that as a result of the enforcement of primary liability, some of investors gain while other totally innocent investors and a company as a whole suffer losses. As a result, money resulting from settlements merely flows out of one pocket to another. In case of the underwriter acting as a gatekeeper this problem does not arise simply because the negative consequences in case of misstatement and application of the sanction do not arise to the company but to the underwriter. Thus, the deterrence is targeted directly on the responsible party and not on the parties who have nothing to do with the violation.

To describe this function of the underwriter the literature uses several terms. The most basic definition is one of the “certifier” or “certification intermediary” – is an intermediary which screens the products quality and confirms the value to purchasers in the market. Further, a term “reputational intermediary” is used to describe the underwriter who “represents to the market that it has evaluated the issuer’s product in good faith and that it is prepared to stake its reputation on the value of the innovation”.[88] Finally, a more generic term “gatekeeper” is employed to describe “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoer”[89] or “parties who sell a product or provide a service that is necessary for clients wishing to enter a particular market or engage in certain activities”[90], or in securities market context “reputational

[86] Sudipto Bhattacharya and Anjan V. Thakor, “Contemporary Banking Theory,” *Journal of financial Intermediation* 3 (1993): pg. 2-50.

[87] Ram T. S. Ramakrishnan and Anjan V. Thakor, “Information Reliability and a Theory of Financial Intermediation,” *The Review of Economic Studies* 51, no. 3 (July 1, 1984): 415 -432.

[88] Gilson and Kraakman, “The Mechanisms of Market Efficiency.”

[89] Kraakman, “Gatekeepers,” pg. 53.

[90] Assaf Hamdani, “Gatekeeper Liability,” *Southern California Law Review* 77 (2004 2003): 53.

intermediaries who provide verification and certification services to investors".[91] In this case, the misconduct means the misleading disclosure of material information or omission of information by the issuer. Cooperation means the acceptance by the financial intermediary to act as an underwriter for the issuer and by this providing a certifying signal to the market that the disclosure by the issuer is not misleading.

It should be noted that underwriter gatekeeping activities would be mostly limited to the time of the offering. The underwriter engagement with the issuer is quite specific in a sense that it is usually limited only to the offering process. Once the offering is completed, the underwriting syndicates dissolve and the contractual relationship is over. Therefore, disclosures in which the underwriter takes part mostly affect primary sales, *i.e.* transactions between the issuer and investors. Secondary trades, *i.e.* exchanges between investors, get affected only marginally.

Moreover, within the offering the underwriter is mostly engaged (or at least has possibilities to engage) in the preparation of official documents, *i.e.* the registration statement and/or prospectus. These documents are the single most important documents on which investors can rely in making their investment decisions. They are written and usually standardized. As a rule they are required to be filed with the supervisory authority as a condition for the legality of public distribution.

The underwriter gets involved in the preparation because to perform its advisory function underwriters need to make a thorough investigation of the company. Based on this knowledge and given their professional experience they can participate in the preparation of official offering documents. The due diligence process allows underwriters to assess the information in the prospectus and decide if they are ready to vouch for it. This should not be very costly because underwriters do not need to put any additional efforts on top of those required for the performance of their direct underwriting responsibilities.

Official documents are the main but not the only source of information containing the disclosure about the issuer and the offering in primary markets. Information can also be disclosed in other ways such as oral statements, advertisements, letters to regulators and investors, analyst reports etc. (hereinafter – other documents). In comparison to official offering documents these documents are sporadic and non-standardized. Statements can be

[91] Coffee, "Understanding Enron," pg. 1405.

made by the underwriter itself, for example, the oral statements during the marketing process or written research reports. They also can come from the issuer; for example, the CEO of the issuer may make a public statement related to the offering or issue a press release. The misdisclosure in such statements can affect the initial pricing of issued securities and cause negative outcomes in a same manner the misstatements in the official registration statement and/or prospectus does. Nevertheless, their importance is secondary in comparison to official documents.

Underwriters' involvement in the preparation of these other disclosures may vary significantly. It is obvious that when underwriters make their own statements, they have possibilities to control the content. On the other hand, underwriters often rely on the information provided by issuers. Arguably, some of this information they can verify based on their participation in the offering. Some other information can, however, be verified at a very high cost. Thus, the underwriters' ability to monitor the disclosure about the issuer and the cost of such monitoring will depend on the type of information in question.

The underwriters' monitoring capability will also depend with respect to statements made by the issuer in sources other than official offering documents. First of all, it must be appreciated that it is very costly for underwriters to control all the information coming out from the issuer. Thus, *ex ante* monitoring is only possible when underwriters take part in the preparation of a certain document. While such participation in the preparation of the registration statement and/or prospectus can be assumed, in other cases it will depend on the actual circumstances of the situation.

In both of these cases the optimality of the underwriters' monitoring effort will vary depending on the actual circumstances of the case. These circumstances will affect the underwriter monitoring ability and costs. Costs will be the lowest when underwriters have an active participation in the drafting of the document or can verify the information based on their role in the offering. They will be the highest when the document is prepared without the involvement of the underwriter and using information they have no access to.

In sum, underwriters can be assumed to monitor disclosures in the most important documents with a relatively high accuracy and at low cost. Underwriters' monitoring ability and costs in respect to disclosures in other, less important documents are highly variable and depend on the circumstances of a particular case.

2. ENFORCEMENT OF THE UNDERWRITER GATEKEEPING FUNCTION

Recognizing the natural qualities of the underwriter, in principle, allows the underwriter to become a gatekeeper for the issuer. However, this does not mean that the underwriter would necessarily be willing to provide such services. Gatekeeping is costly. Moreover, the underwriter, in the same way as the issuer, faces many incentives and has real possibilities to act opportunistically. For example, the structure of the gross-spread and engagement in the investment advice business might provide incentives to inflate the offering price. This can be done simply by using "creative" pricing methods or by engaging in straightforward fraud, such as misdisclosure of information. The relative obscurity of its underwriter actual activities that are usually claimed to be protected by the business confidentiality and secrecy rules creates a scope for these practices to go unnoticed. Therefore, the underwriter would provide these services only if costs of not providing them are higher than the benefits of providing.

2.1. Goals of enforcement mechanisms

The term gatekeeping is usually understood quite narrowly and covers the underwriter duty to monitor the issuer's disclosure regarding any incorrectness and incompleteness of information. Therefore, Law and Economics sees the main goal of an enforcement mechanism in respect of underwriters – to encourage them to monitor issuer's disclosure or to prevent the underwriter from cheating or shirking in performance of its gatekeeping function. Thus, the main function of the enforcement mechanism is deterrence.

In the Law and Economics literature it is often argued that in addition to simply monitoring the issuer, underwriters can serve as insurers or compensators of investors against the risk of misstatements.[92] This involves somewhat more activities that merely checking the quality of disclosure as regards the completeness and correctness of information, including guaranteeing the general quality, riskiness or profitability of the companies the underwriter underwrites.

To justify the imposition of a duty to bear the risk of an accident on a certain party, the Law and Economics literature states that when accidents can be avoided by either of two

[92] Noam Sher, "Underwriters' Civil Liability for IPO's: An Economic Analysis," *University of Pennsylvania Journal of International Economic Law* 27 (2006): 389.

parties either by taking care or acquiring insurance, the costs of accidents should be borne by the party that can do this at the lowest cost.[93] Thus, the underwriter should be made to bear the risk of misstatements only if it can do this at a cheaper cost than investors. However, as it will be seen immediately below, there is an unsettled debate which of the parties – the underwriter or investors is the cheapest risk-bearer.

On the one hand, there are arguments supporting the underwriter as the cheapest risk-bearer. According to Sher (2006) the underwriter is able to obtain the best insurance policy. The underwriter is diversified and has many underwriting clients therefore it is more risk-neutral than other capital market participants. Moreover, it is also able to negotiate the best reinsurance premiums because it is a reputable repeat player on the market and enjoys vast economies of size. In addition, it has a knowledge and ability to negotiate with the insurance companies.[94] Therefore, the underwriter can have a comparative advantage in respect to investors in bearing the risk of misstatement and should play a role of an insurer.

Within this position, there is a big debate how much of the insurance coverage it is optimal for underwriters to provide. Sher (2006) argues that underwriters should provide insurance only for the residual cases, *i.e.* in cases they are negligent. Others think that underwriters can be efficient in providing insurance for all cases of misstatements (also when they have monitored at the level set by the law) but the coverage should be capped.[95]

Others argue that investors are considered to be the most suitable parties to evaluate the terms and riskiness of an investment and to bear the consequences of this estimation. This is consistent with general disclosure philosophy that is widely accepted as the main regulatory paradigm on the modern financial markets. It rejects the merit control of investment opportunities by the state and relies on the disclosure of information about the

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[93] Guido Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (Yale University Press, 1970); Guido Calabresi and Jon T Hirschoff, "Toward a Test for Strict Liability in Torts," *Yale Law Journal* 81 (1972 1971): pg. 1060.

[94] Sher, "Underwriters' Civil Liability for IPO's," pg. 483-484.

[95] See John C. Jr Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," *Boston University Law Review* 84 (2004): 301., proposing a strict liability regime with damages calculated as a multiple of the highest annual revenue from the client. Frank Partnoy, "Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime," *Washington University Law Quarterly* 79 (2001)., also argues for strict underwriter liability with the magnitude of damages limited by allowing the underwriter to choose a percentage of the total issuer's liability.

issuer as the primary regulatory device. In such case, the only function underwriters should perform is to furnish investors with relevant reliable and complete information to make their choices. In contrast, if the insurance function were imposed on the underwriter in addition to the simple provision of information the underwriter would be forced to engage into the assessment of the terms and riskiness of the investment.

Moreover, it is argued that due to the number of reasons there can be problems in the provision of insurance by investors' compensation. One of such problems is the structure of financial markets that often prevents the compensation reaching the real victims. For example, Cox and Thomas (2002) and Cox and Thomas (2005) reveal that nearly two-thirds of the institutional investors they studied, who are assumed to have both the economic interest and a legal duty to collect the settlement, failed to submit their requests.[96] Moreover, Cox and Thomas (2005) show that recoveries by institutional investors are not always allocated to the individual fund beneficiaries but instead to the fund suffering the loss or, in some cases, to the institutional investors' general fund. Therefore, there is a serious mismatch between the beneficiaries of the settlement and those who have been harmed by the securities violation. Authors claim that "given the enormous importance of institutional investors in the market, this mismatch raises serious doubts about whether securities fraud class actions can be justified as compensatory mechanisms". On the other hand, the deterrent function is not affected as the unclaimed settlements do not return to the injurer but are rather redistributed to those investors who present their claims. Thus, it is argued that the liability system should not try to compensate class members but should instead impose a sanction of sufficient size and content to deter others from failing to monitor.[97]

[96] A number of potential explanations have been offered. First, there may be potential misunderstandings by institutional investors of the amount that they can recover. Secondly, investors may not understand that filing claims is part of their fiduciary duties. Thirdly, it may be rational for institutional investors not to redeem the settlement. They may expect to receive small recoveries in these cases, even if their losses are large, because the settlements pay out only a small fraction of the loss. Or the recovery amounts make seem large to outsiders but be very small in relationship to the size of their portfolios and therefore have no material impact on their returns. Fourthly, investors may simply not have personnel to handle these claims. Finally, institutions may never receive the notices of settlement. (see James D Cox and Randall S Thomas, "Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions," *Washington University Law Quarterly* 80 (2002): 855; James D. Cox and Randall S. Thomas, "Letting Billions Slip through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements," *Stanford Law Review* 58, no. 2 (November 1, 2005): 411-454.)

[97] James D. Cox and Randall S. Thomas, "Letting Billions Slip through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements," *Stanford Law Review* 58, no. 2 (November 1, 2005): pg. 414.

In addition, the reality of securities litigation also shows that settlements in securities cases are often quite disproportionate to the damage suffered by investors. Therefore, even if they achieve compensation, it tends to be very small.[98]

Moreover, the possible costs of treating underwriters as insurers are widely acknowledged. Making the underwriter bear the risk of a misstatement means that the underwriter would have to compensate investors for either some (in case of a negligence regime) or all cases of misstatement (under the strict liability). As the underwriter has an imperfect ability to detect and prevent misstatements, this means that there is always going to be some residual risk for an underwriter even if it performs its monitoring duty well. This risk would force the underwriter to increase its underwriting fee. However, such an increase of fee would be unindividualized (because underwriter cannot distinguish between the probability of misstatement by each individual company) and can thus cause an adverse selection.[99]

Given that there are unsettled and strong arguments both for and against treating underwriters as insurers from the risk of misstatements, whereas the case for gatekeeping in a narrow sense is much more clear-cut, it seems reasonable, first of all, to focus on gatekeeping in the narrow sense as the main function of the underwriter. One could clearly see that treating the underwriter simply as a gatekeeper rather than an insurer produces completely different regulatory consequences. In particular, the deterrent function is mostly concerned with the *ex ante* preventive effect whereas the insurance (risk-sharing) function emphasizes *ex post* compensation of the victim. As a result, focusing on a gatekeeping will allow avoiding numerous problems related to investor compensation.

Also, as will be seen further in this book, treating the underwriter as a gatekeeper has an effect on the magnitude of the optimal deterrent threat.

2.2. Optimal monitoring effort

If monitoring is the main function of the underwriter, then the goal of the enforcement system is to provide the underwriter with incentives to monitor at a socially optimal level. A socially efficient level of due care (gatekeeping) by the underwriter is achieved when the

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[98] See the discussion of settlements in securities cases in following Section 6.2 of Chapter V and Section 5.2 of Chapter VII.

[99] For more detailed discussion of the costs of imposition of gatekeeping duty see Section 4.3 of Chapter II.

marginal social benefit associated with the gatekeeping (reduction of misstatement cases) is equal to the marginal social costs (costs of monitoring and the costs of residual violations).

As taking care is costly, the optimal monitoring effort should not be at its highest possible level and should not lead to the total elimination of misstatements but only to the elimination of those misstatements that can be avoided by taking care whereby marginal benefit is higher that marginal cost. The highest level of care may lead to the situation whereby marginal costs exceed marginal benefits.

2.3. Types and ranking of enforcement mechanisms

Enforcement mechanisms can be classified into market and legal mechanisms. Market enforcement mechanisms are ones that ensure the compliance with a certain duty or that some function will be performed based on the internal working of relationships between different market participants. They are not imposed from the outside, and can be either self-enforcing or need a certain private party to control their functioning. In the context of the underwriter gatekeeping function the most prominent market enforcement mechanisms are the reputation and taking of economic risk of underwriting and private contracting between the issuer (investors) and the underwriter.

Legal enforcement mechanisms signify the regulatory intervention into the working of free markets. They include both public and private, *ex ante* and *ex post* types of legal interventions. They always rely on certain enforcement agent or agents to enforce them.

At this point there is again a need to apply the economic paradigm of perfect markets and market failures. Following this logic, market enforcement mechanisms should be given a priority over legal mechanisms that should only be used if, due to the imperfections of enforcement markets, market solutions fail.[100] Therefore, as the first step of the further analysis I will try to determine the role of the main market mechanisms in enforcement of underwriter gatekeeping duty.

[100] Note that a market failure is a *prima facie* but not the conclusive requirement for regulatory intervention. This is because the legal solution may be as inefficient to correct the market failure as the market itself. Alternatively, the efficiency gains it achieves may be outweighed by increased transaction costs of such intervention. See Anthony I. Ogus, *Regulation: Legal Form and Economic Theory*, New edition. (Hart Publishing, 2004), Chapter 3.

3. MARKET ENFORCEMENT MECHANISMS

3.1. Reputational sanctions

a). Reputational sanctions in theory

If a number of assumptions hold, the market mechanism based on reputation would provide underwriters with strong incentives to act as gatekeepers. By associating with the particular issuer the underwriter would provide the market with the signal that the disclosure of such issuer is credible. The signal by the underwriter would be credible because, in contrast to the issuer who has no possibilities to build reputation, underwriters can use their reputation as a costly signaling device. They are usually well-established diversified institutions who are repeat players in capital markets and do not suffer from the "final period" problem.

Reputation helps the underwriter to attract new clients and earn profits. By compromising the reputation the underwriter would forego future profits. It is assumed that the short-term gain resulting from the inaccurate certification will be lower than long-term losses from a decline in reputation. The story goes that after comparing costs of loosing its good reputation and benefits associated with closing its eyes on misdisclosure, the rational underwriter would choose to remain faithful in its gatekeeping. Thus, by putting the reputation at stake, the underwriter can signal to investors that is has a lot to loose if the company turns out to be of low quality. Therefore, if reputational markets are efficient, reputational concerns should prevent the underwriter from choosing short-term profit over future income streams.

As a result of credible certification by the underwriter, issuers would be able to charge more than the average price for their high quality securities. Issuers would be willing to buy gatekeeping services as long as the difference in the price that investors are willing to pay for high quality securities is higher than the costs of high quality production and underwriting fees.

This increase of price or, in other words, the value of gatekeeping for the issuer depends crucially on the ability of the underwriter to accurately monitor the companies. However, gatekeeping is never perfect because the underwriter can make type I and II mistakes. It can certify a high quality company as low quality, treating the company's disclosure as misleading. It can also label a low quality issuer as a high quality company. Both of these errors decrease the accuracy of gatekeeping. The possibility of monitoring mistakes will lead some low quality issuers to seek the certification as a high quality. Appreciating this possibility, rational investors will still discount the value of securities.

However, in a competitive gatekeeping market this is not a problem. If investors are rational and possess accurate information on the reputation of different gatekeepers, they would adjust their price accordingly. The better is the reputation for accurate monitoring, the more investors will be willing to pay issuers of the certified securities. Issuers, in turn, will pay greater amounts to gatekeepers with a reputation for a high monitoring accuracy. To the extent this payment is sufficiently large, gatekeepers will have an incentive to maintain their investment in the reputation for the monitoring accuracy.

A competitive gatekeeping market would also force underwriters to reduce their fees to their actual monitoring costs. It would also lead to the optimal monitoring level. The optimal monitoring will be achieved when the cost of additional monitoring is equal to the increase in the price investors are willing to pay for certified over noncertified securities. As a result, if the gatekeeping market were perfect, a market mechanism based on reputation for quality would ensure the provision of credible gatekeeping at the optimal level.[101]

Moreover, the theoretical model of Hansen and Torregrosa (1992) predicts that underwriters would continue to monitor also once the offering is completed in order to preserve their underwriting reputation asset. Underwriters receive rents from their reputations for monitoring, therefore they would continue to monitor since shirking would be unlikely to result in gains that offset the losses to reputational capital.[102]

This means that underwriters should face strong reputational incentives to perform a gatekeeping function and that any additional devices are required inasmuch as reputational mechanisms fail. The functioning of the gatekeeping market depends on a number of assumptions. If such assumptions are relaxed, reputational mechanisms immediately fail.

First of all, investors might not be able and willing to determine the underwriter reputation for quality with precision. There is no standardized, centralized and readily available information about underwriter past performance. Additionally, the underwriting industry

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[101] Stephen Choi, "Market Lessons for Gatekeepers," *Northwestern University Law Review* 92 (1998 1997): pg. 935–937.

[102] Robert S. Hansen and Paul Torregrosa, "Underwriter Compensation and Corporate Monitoring," *The Journal of Finance* 47, no. 4 (1992): 1537-1555.

often undergoes mergers, divisions and acquisition. Moreover, the allegations of misstatements are often kept secret and not disclosed publicly as the majority of disputes are settled without going to the court. Even in cases when facts become public, it is difficult to distinguish between the involvement of various actors. Therefore, it is very difficult for issuers and investors to evaluate the quality of a particular underwriter. Consequently, there is a possibility that investors will discount securities not on the basis of the characteristics of a particular underwriter but based on the average expected level of gatekeeping accuracy in the market. As a result, each individual underwriter by decreasing the accuracy of the monitoring saves a full cost of monitoring. However, it suffers only a fraction of the decreased expectations by investors. Therefore, all underwriters will have incentives to lower their investment in reputation and decrease their monitoring efforts below the socially optimal level.[103]

In addition, there is a concern that investors will not be interested to engage in an evaluation of the quality of underwriting of individual companies. According to economic theory, such estimation would be performed only by professional investors who have sufficient stakes in companies and have skills to do this, *i.e.* institutional investors. However, while the stake held by a certain institutional investor in a particular company may be big as compared to stakes held by other investors, such stake can be a negligible part of that institutional investor's diversified portfolio. Therefore, while institutional investors do care about the average probability of misstatements on the market, they would not take much care to evaluate the possibility of misstatement by each individual member of their portfolio.

Moreover, institutional investors are governed by managers who may face their own agency problems that could prevent them from dedicating enough attention to such issues. Such behavior will be mostly exacerbated during the good economic times and even more in bubbles. During such periods investors seem to care less about the quality of their investments. Indeed, rational and opportunistic managers of institutional investors may not maximize returns to their investors if their personal incentives point in a different direction and marketplace discipline is weak. Given that managers' compensation is often related with performance, it might be optimal for a manager not to go against the market but to join the herd as it might take markets some time to realize the mistake. Therefore, those

[103] Choi, "Market Lessons for Gatekeepers," pg. 940.

investors who are prudent not to invest into a hyped company can loose a lot of money before the bubble bursts. Therefore, institutions often find it rational to "“ride” bubbles rather than counteract them".[104] Therefore, they will pay even less attention to underwriter past performance. As a result, while the market in general may be able to understand the usefulness of the underwriter engagement in the monitoring of the issuer's disclosure, it could be unable to fuel the working of reputational mechanism or any other mechanism that implies the evaluation of individual features.

Secondly, the perfect gatekeeping market assumes that issuers seek credible certification and underwriters do not cheat in their certification. In reality, the managerial agency problems within a company may lead the issuer to cheat in its disclosure. Managers of such issuers may be unwilling to use the reputable underwriter because it would be easier for them to persuade such underwriter to go along with risky practices. The underwriter has similar incentives to behave opportunistically in its gatekeeping as the issuer. Opportunistic behavior can take two forms: negligent behavior – the underwriter can have an incentive to represent the company's securities as a good investment even if it has not properly investigated the company; or, intentional behavior – to intentionally or knowingly participate in misdisclosure. The reason for not engaging in the proper investigation is that the screening is costly. Incentives to intentionally participate in the misdisclosure are related to the fact that underwriter compensation is usually proportional to the proceeds of the offering. Therefore, the higher is the price, the bigger are the proceeds and the larger is the underwriter compensation. The underwriter may also collude with the issuer either because it strives for additional underwriting business or because of other side payments. Therefore, there is a potential gain the underwriter might receive if it chooses to cheat in its gatekeeping. To quantify such a potential gain – it cannot exceed the one time gain the company can receive as a result of cheating. This is a maximum possible amount because the company has no incentives to pay more for false certification and since certification costs in this case are zero. Given, that the gain of cheating can become very high, it is more likely to outweigh the reputational incentives. In addition, the circumstance that investors cannot verify the level of care taken by the underwriter in evaluating the issuer provides the underwriter with the feeling that such conduct can go unnoticed and unpunished.

[104] Donald C Langewoort, "SEC, Retail Investors, and the Institutionalization of the Securities Markets, The," *Virginia Law Review* 95 (2009): pg. 1056.

Finally, if the assumption of perfect competition is relaxed, market participants may be unable to switch between different service providers. As a result, the underwriter might raise the underwriting fees above monitoring accuracy costs or lower the level of monitoring accuracy without suffering reputational sanctions. Thus, limited competition may lower the efficiency of reputational mechanisms.[105]

As a result of all these deficiencies, the market mechanism based on reputation might, in some cases, fail to ensure the functioning of the market for credible gatekeeping. Thus, it cannot serve as a reliable mechanism to sustain the gatekeeping function of the underwriter.

b). Reputational sanctions in practice

In case of underwriting industry, the level of competition in the IPO underwriting market seems to be rather high. This market is characterized by many competing underwriters and no obvious large barriers to entry. For example, a 2011 market study by the UK Office of Fair Trading has concluded that in terms of structural features, there are no significant concerns over the number of available providers of equity underwriting services. Concentration amongst investment banks, both for equity underwriting and for corporate broking services does not appear to be unduly high.[106] For international markets Jenkinson and Jones (2009) also note that "competition between investment banks for lead underwriter mandates in IPOs is fierce" and the winner is selected either on the basis of an existing relationship or after a "beauty contest" in which several banks compete.[107]

However, this big group of underwriters is further divided into specialized circles. For example, there are certain underwriters who specialize in taking public high-tech companies. Therefore, competition is concentrated in a series of local oligopolies based on industry specialization. A limited number of underwriters acquire some market power and

[105] Choi, "Market Lessons for Gatekeepers," pg. 943–945.

[106] *Equity Underwriting and Associated Services: An OFT market study* (Office of Fair Trading, January 2011), pg. 5-6.

[107] Tim Jenkinson and Howard Jones, "Competitive IPOs," *European Financial Management* 15, no. 4 (September 2009): 733-756.

earn rents on the IPOs.[108] Nevertheless, the barriers to entry between such oligopolistic groups should not be too big. If there is a profit incentive, a reputable underwriter from the other oligopolistic group could enter the certain underwriting market and increase the competition. Thus, at the stage of selection the IPO underwriter, there seem to be sufficient competition to ensure the functioning of reputational mechanism.

However, numerous empirical tests suggest that the role of reputation as an enforcement device for the gatekeeping function of the underwriter is questionable. The first line of empirical research tests whether reputable underwriters, *i.e.* ones having the biggest market share, achieve a better pricing for their underwriting clients or, more precisely, the lower level of underpricing. The results of these studies mostly show that, indeed, the more reputable underwriters underprice less. Fang (2005) provides an excellent overview of empirical studies on the relationship between underwriter market share and the underpricing.[109] Early studies conclude that more prestigious underwriters (those who have the biggest market share) obtain better IPO pricing (lower underpricing) for their clients.[110] Later enquiries document no effect or a negative effect (higher underpricing).[111] The reasons for the change are debated: one hypothesis by Loughran and Ritter (2004) is that the underwriters have begun to underprice strategically in order to enrich themselves or their investment clients.[112] Another explanation is that the top underwriters have lowered their criteria for selecting the IPO issuers which has resulted in a higher average risk

[108] Xiaoding Liu and Jay R. Ritter, "Local underwriter oligopolies and IPO underpricing," *Journal of Financial Economics* 102, no. 3 (December 2011): 579-601.

[109] Lily Hua Fang, "Investment Bank Reputation and the Price and Quality of Underwriting Services," *The Journal of Finance* 60, no. 6 (December 2005): 2729-2761.

[110] J. G. McDonald and A. K. Fisher, "New-Issue Stock Price Behavior," *The Journal of Finance* 27, no. 1 (March 1, 1972): 97-102; Dennis E. Logue, "On the Pricing of Unseasoned Equity Issues: 1965?1969," *Journal of Financial and Quantitative Analysis* 8, no. 1 (1973): 91-103; Booth and Smith, "Capital Raising, Underwriting and the Certification Hypothesis"; Seha M. Tiniç, "Anatomy of Initial Public Offerings of Common Stock," *The Journal of Finance* 43, no. 4 (1988): 789-822; Richard Carter and Steven Manaster, "Initial Public Offerings and Underwriter Reputation," *The Journal of Finance* 45, no. 4 (1990): 1045-1067.

[111] Randolph P Beatty and Ivo Welch, "Issuer Expenses and Legal Liability in Initial Public Offerings," *Journal of Law & Economics* 39 (1996): 545; John W. Cooney et al., "IPO initial returns and underwriter reputation: Has the inverse relationship flipped in the 1990s?," *University of Kentucky, Case Western Reserve University, and Iowa State University Working Paper* (2001); Dennis E. Logue et al., "What Is Special about the Roles of Underwriter Reputation and Market Activities in Initial Public Offerings?," *The Journal of Business* 75, no. 2 (April 2002): pg. 213-243.

[112] Tim Loughran and Jay Ritter, "Why Has IPO Underpricing Changed over Time?," *Financial Management* 33, no. 3 (October 1, 2004): 5-37.

profile (the overall market condition (bubble) and common atmosphere of enthusiasm and relaxation of controls).[113] Fang (2005) goes further than the studies mentioned above and tries to identify the net influence of reputation (net proceeds), fees deducted, for the period of 1991-2000. Although, the author finds that reputable underwriters charge premium fees, the increase in price tends to outweigh such costs. He finds reputable underwriters obtain higher prices for their issuers net of costs. Additionally, he shows that reputable banks underwrite fewer junk bonds and those underwritten are of higher quality.

The majority of mentioned studies explains that reputable underwriters are able to achieve a low level of underpricing due to their superior monitoring (gatekeeping) ability. The underlying logic is that the participation of the reputable underwriter helps to lower the information asymmetries and thus decreases the level of underpricing. Several theories explain the mechanism how the presence of a reputable underwriter can lower the level of underpricing. For example, Rock (1986) explains that the underwriter needs to intentionally underprice the issues in order to encourage retail investors to participate in the offering. If, however, underwriters have the reputation for bringing into the market only high quality companies, they can underprice issues to the lesser extent. Benveniste and Spindt (1989) also state that the underwriter needs to underprice in order to award informed investors for the revelation of information. They also conclude that due to its reputation on the market and established relations with investors, the underwriter can reduce the underpricing.[114] In one way or another, these theories suggest that the reputation of the underwriter allows limiting informational asymmetries and that is reflected in the lower extent of underpricing.

An alternative view is that reputable underwriters are able to achieve high valuations not due to their ability to reduce informational asymmetries but because they can ensure greater participation of other higher quality players such as co-underwriters, institutional investors and security analysts. A reputable underwriter is also able to induce stricter short sales constrains which prevent the price from declining. The participation of such actors

[113] Alexander Ljungqvist, "Chapter 7: IPO Underpricing," in *Handbook of corporate finance: empirical corporate finance* (Elsevier, 2007).

[114] Lawrence M. Benveniste and Paul A. Spindt, "How Investment Bankers Determine the Offer Price and Allocation of New Issues," *Journal of Financial Economics* 24, no. 2 (1989): 343-361.

induces retail investors to form heterogeneous beliefs about higher future returns and therefore results in higher prices.[115]

Thus, the first line of research suggests that companies are interested in hiring a reputable underwriter, and underwriters are interested in achieving high valuations for these companies. However, it is not firmly established why reputable underwriters are able to achieve high valuations – whether due to the reduction of asymmetric information (gatekeeping) or due to their market connections. Therefore, the link between the reputation and accurate pricing is not clear.

Another way to study the effects of underwriter reputation is simply to see if the presence of high quality underwriters leads to the reduction of cases of negligence and fraud. Theoretically, a reputable underwriter is supposed to put more effort in monitoring issuers. This should help the underwriter to uncover most of the fraud and financial irregularities. Agrawal and Cooper (2010) look at the financial restatements by IPO companies underwritten by reputable underwriters. Restatements are important because they provide direct evidence of misreporting (material misstatements). Restatements of financial reports cause significant drop in the restating firm market share price. First of all, the authors find that the announcement of the restatement causes negative abnormal returns on the issuers' stock price. Secondly, it is documented that there is no difference between the number of restatements by the issuers who are underwritten by reputable underwriters and less reputable underwriters. These findings lead the authors to conclude that the underwriter is not a reliable reputational intermediary, *i.e.* it does not reduce the probability of fraud by the issuer.[116]

Lee and Masulis (2008) investigate the role of underwriter reputation in restraining earnings management. Issuers have incentives to overstate pre-IPO earnings because those earnings are used to determine IPO prices. Earnings management can, in some instances, be associated with misdisclosure and is considered a harmful practice. The underwriter should have incentives to detect such practices and refuse to underwrite issuers who engage in them. Therefore, it is hypothesized that the participation of a prestigious

[115] Thomas J. Chemmanur and Karthik Krishnan, "Heterogeneous Beliefs, Short Sale Constraints, and the Economic Role of the Underwriter in IPOs," *SSRN eLibrary* (November 1, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890859.

[116] Anup Agrawal and Tommy Cooper, "Accounting Scandals in IPO Firms: Do Underwriters and VCs Help?," *Journal of Economics & Management Strategy* 19, no. 4 (December 2010): 1117-1181.

underwriter should be associated with less earnings management. The article confirms that hypothesis and documents that, indeed, the presence of a more reputable underwriter leads to less earnings management.[117]

The different results of the two studies presented above prevent making any strong conclusions on the role of the underwriter in inducing accurate disclosure of information. They also illustrate the inherent inference problems associated with such studies. Reputation by itself is a noisy signal of quality of underwriting. Investors normally cannot observe the actual quality of monitoring but only market performance of issues. There can be numerous other factors besides the reputation of the underwriter which might influence the presence of earnings management or restatements.

The third line of research tries to determine whether the reputational mechanism works in practice, *i.e*. if the underwriter suffers reputational sanctions in case of misbehavior. The sanction can be characterized by the shifts in underwriter revenues which should follow if the underwriter is proven to set low standards. Song and Uzun (2004) examine the impact of issuers' financial fraud on the reputation of its underwriter. They take a fluctuation of underwriter securities price as a proxy for reputational loss. Underwriter securities price indicates the potential loss of revenue because of harmed reputation and possible liability threat. To separate the two effects they divide their sample into two groups where underwriters were and one where they were not sued together with the issuer. The authors find that the filing of a lawsuit against the issuer has a negative effect on the underwriter securities price which they interpret as harm to underwriters' reputation (effect of underwriters liability is accounted for). This is a very important finding which might provide great support to the use of reputation as an incentivizing mechanism. However, the same authors also find that this effect depends on the overall market sentiment – in good economic times or, so-called, bubbles reputation tends to have lower importance. Moreover, they show that the magnitude of reputational loss depends on the diversification of the underwriter business across industries, extent of fraud damages caused, size of the issuer and number of fraud cases. A diversification criterion leads to the conclusion that, in contrast to specialized investment banks, universal commercial banks do not systematically

[117] Gemma Lee and Ronald W. Masulis, "Do More Reputable Financial Institutions Reduce Earnings Management by IPO Issuers?," *SSRN eLibrary* (n.d.),

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=891757.

suffer reputational loss because their banking activities are very broad.[118] Those results are extremely relevant when considering the current consolidation of banks and tend to warn about the efficiency of reputational mechanisms as a tool to provide adequate incentives to the underwriter.

A final observation on the use of underwriter reputation in order to provide incentives is that the market discipline is only efficient if, after observing improper behavior, shareholders of the underwriter can influence its managers to change their behavior. Investors might not be unable to exercise such influence due to a number of problems including asymmetric information, costly monitoring, principal-agent problems and conflict of interest among stakeholders. Bliss and Flannery (2002) examine the responsiveness of underwriter managers to the investor feedback impounded in the security prices. They do so by investigating whether managerial actions appear to be associated with prior returns on stocks and bonds. They test with different market signals, managerial actions and various lags between signal and potential action and find that market influence is weak and, at best, mixed. It is suggested that one shall be careful in relying on investors to constrain the behavior of underwriter.[119]

c). Summing-up

The empirical findings do not fully bear out the theoretical prediction that reputational concerns would guarantee that underwriters apply rigid standards in evaluating issuers and ensure the truthful disclosure of information which should lead to an accurate pricing of securities. Issuers prefer underwriters who underprice less; however, why such underwriters are able to achieve high valuations is unclear. This can be caused by the prestigious underwriters' ability to decrease informational asymmetries by providing credible monitoring services (*i.e.* that the certification hypothesis holds). Alternative explanation is that a reputable underwriter is able to convince investors about the success of the offering. Further, the participation of a prestigious underwriter does not guarantee the performance of the company and the absence of financial violations. Finally, a

[118] Wei-Ling Song and Hatice Uzun, "The Impact of Clients' Alleged Financial Reporting Fraud on Underwriter Reputation," *SSRN eLibrary* (2004), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=597882.

[119] Robert R. Bliss and Mark J. Flannery, "2002 Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring versus Influencing," *European Finance Review* 6 (n.d.): pg. 361–395.

diversified underwriter does not experience the market punishment which should be associated with such violations. The underwriter management seems immune to market pressures and does not change its behavior.

As a result, it may be concluded that while reputation provides incentives to the underwriter to monitor, it might be unwise to rely on the reputation as the only enforcement device for the underwriter gatekeeping function. However, the deterrent impact of reputational sanctions should be taken into account when developing other enforcement devices.

3.2. Economic risk-taking

One of the most straightforward ways to guarantee that the underwriter performs its gatekeeping function is for the underwriter itself to assume economic consequences of the issuer turning out to have disclosed misleading information. The particularity of this enforcement mechanism is that it is completely self-sustaining, in a sense that underwriters suffer direct economic losses. The threat of such losses prevents the underwriter from underwriting "lemons". Therefore, there is no need for any external enforcement device to make the gatekeeping by the underwriter work.

The underwriter should, in principle, be undertaking the economic risk of the issuer's failure when it acquires securities from the issuer. In the firm-commitment underwriting the underwriter buys all securities from the issuer. In the stand-by arrangement it undertakes to buy the undersubscribed securities. These arrangements mean that the underwriter accepts the risk of being left with the residual securities and negative price movements. This risk should provide the underwriter with incentives to carefully examine issuers and underwrite only those which are of high quality. The decision to underwrite the issuer on the firm-commitment or stand-by basis, thus, would serve as a signal of the issuer's high quality. Consequently, in the third type of underwriting – the best-efforts, the signal should be much less significant because the underwriter would not bear any risk associated with possible revelation of the negative quality of the issue. Given that firm-commitment and stand-by underwritings are very often used in practice, there is scope to consider the economic risk-taking as an optimal enforcement device.

This certification mechanism depends crucially on the level of risk that the underwriter has to bear. The more significant is the risk, the more credible is the underwriter certification.

The literature points at the problem that in practice the underwriting is not associated with any significant risk for the underwriter. First of all, the underwriting industry managed to create a mechanism to reduce the risk of the underwriter being left with any unsubscribed securities in its inventory. Using the bookbuilding method, the demand for the securities is determined on the basis on non-binding indication of interest by institutional investors who disclose truthful information. The offering price is set very late in the offering process, usually within 24 hours before the end of distribution, based on these indications of interests. The collection of information from investors enables the underwriter to estimate how much money will be raised in the process of the offering much more accurately than using any other method. Therefore, the risk of mispricing the securities and, as a result, underdistributing them, is significantly decreased.

Moreover, the underwriting, as a rule, involves participation of not just one financial institution. For this purpose, underwriters form an underwriting syndicate with often a complex and sophisticated structure and allocation of roles, duties and responsibilities. The structure of the syndicate allows the wide reach for institutional investors who facilitate both the informed price formation and wider allocation of securities. Members of the selling group usually buy only the amount of securities they are sure they can sell and thus do not directly affect the risk-distribution. However, they contribute to the elimination of risk by increasing the chances of success and speeding up the process of the distribution and, therefore, reducing the period of underwriter vulnerability.

In addition, if while preparing and marketing the offering the underwriter determines that there is a weak demand for the issuer's securities, both parties can decide not to continue with the distribution. That is because the letter of intent – the only document connecting the issuer and the intermediary before the offering is cleared by the authorities, can also be easily cancelled by the both parties. Therefore, if the underwriter clearly sees that the offering will turn out to be a failure, it will not take that risk but rather cancel the agreement.[120]

[120] In some countries the contractual freedom may be restricted. For example, in Indonesia underwriters are restricted from exiting the offering after the offering begins. Underwriters can only exit deals if Indonesia Stock Exchange share index drops below 10% on three consecutive days, a force majeure as a natural disaster occurs, or because of an event deemed significant by Bapepam. These rules increase the underwriter exposure to the risk of price fluctuations. Therefore, the signal, produced by the underwriter by underwriting the Indonesian offering should be more credible than in other countries. See Rachel Evans, "IPO underwriters exposed by Indonesian regulations," *International Financial Law Review*, December 10, 2009.

Apart from a risk of underestimating the demand, there is also the risk associated with the possibility of securities being reneged by investors.[121] As it was already mentioned, the underwriter determines the demand and number and the price of securities that it buys from the issuer based on the *non-binding* indication of interest by institutional investors. Investors have a right to withdraw their indications of interest and renege to buy securities. If they do so, the underwriter is left with such securities in its inventory. If the price of the securities decreases, the underwriter can suffer losses.

The underwriting industry has found a way to manage this risk as well. It is avoided by a series of financial transactions involving short covering and the use of the green-shoe option.[122] First of all, the underwriter calculates the demand by investors during the marketing stage (*e.g.,* 100). Next, it agrees to buy the securities from the issuer, the number of the securities being lower than estimated demand (say 90). At the same time the underwriter agrees with the issuer on the green-shoe option (in our example – 10, the difference between the estimated demand and possible number of withdrawals). Then, the underwriter allocates (but does not sell) securities to the investors according to the solicited bids (in our example the estimated demand is 100). As it lacks some securities for the allocation (10), it takes a short position. When the offering closes, sales can be effectuated and investors' bids become final and binding. There can be two possible scenarios. If, on the one hand, the expected demand (in our example – 100) does not materialize, the underwriter delivers only the securities it purchased from the issuer (90) and simply returns the borrowed securities to investors. In this case the only expenses the underwriter suffers are the lending fees for the borrowed securities. If, on the other hand, the estimated demand materializes and nobody reneges the securities, the underwriter can either buy the missing securities on the market (if the market price goes down, *i.e.* in case of overpricing) or exercise the green-shoe option (if the market price goes up). As a result of these transactions the underwriter is sure that it will limit the possibilities of being stuck with the sticky issue. In the worst-case scenario the underwriter only risks the lending fees which have to be paid to securities lenders.

[121] Lombardo, "The Stabilisation of the Share Price of IPOs in the United States and the European Union."

[122] For further description of the mechanism of the short covering and green-shoe option see Section 3.3 of Chapter I

In sum, by using the bookbuilding method, ensuring easy exit from the contractual relationship and engineering financial transactions, the underwriter successfully manages to contain the risks associated with the underwriting. The only remaining risk for the underwriter to carry is the low risk of market fluctuation within a short period of time between the purchase from the issuer and allocation to the investors (around a few days or even hours). This risk can in turn be hedged by using derivative instruments. Consequently, neither type of underwriting produces a credible signal of the issuer's quality because the underwriter does not carry any risk associated with the issuer's failure. Therefore, we cannot consider the acquisition of securities from the issuer as an efficient enforcement device for the underwriter gatekeeping duty.

There can be only one type of the offering that can give rise to a certain credibility. This is the case when the firm-commitment is coupled with a fixed price. When a fixed price offering is used the underwriter commits to acquire the entire offering on the spot at a fixed price, and cannot subsequently withdraw or postpone the offering, nor alter the terms of the offering. Therefore, the underwriter can use only pre-announcement information to set the terms of the offering. As the underwriter has less information than what it would have had if the bookbuilding was used, there is a higher chance that it will make more mistakes when setting the price. Those mistakes are important because the reputation of the underwriter depends directly on pricing the issues correctly, *i.e.* clients expect that the securities will not be overpriced. Given considerable reputational and financial capital at stake, the underwriter will be reluctant to underwrite an offering unless it is sure that the offering will be successful.[123] This, can in principle serve as a credible signal of the issuer's quality. Nevertheless, the firm-commitment underwriting is coupled with the fixed price method only very rarely. Therefore, it is not significant in practice.

3.3. Contractual solutions

Although traditional lawyers tend to perceive contractual arrangements as a legal instrument, in economic terms the contract is rather a market solution in the sense that it is not imposed by the regulator, but is the result of the free will and negotiations of the parties. Therefore, one should first consider the possibility to impose the gatekeeping duty

[123] Paleari, Pellizzoni, and Vismara, "A comparative study of Initial Public Offerings in Italy and in the United Kingdom," pg. 19-20.

on a contractual basis. This could be achieved by the issuer, acting on behalf on investors, negotiating particular liability arrangements with the underwriter in the underwriting agreement and disclosing this in the prospectus. Following the Coase theorem, given that transaction costs are zero, the contractual arrangement would lead to the efficient allocation of resources.[124]

The contractual assumption of liability should be valuable for underwriters because it can allow them to acquire a credible signaling device that the reputation cannot provide.[125] To cite Choi (1998) gatekeepers have incentives to subject themselves to contractual liability because “it is often in the best self-interest of certification intermediaries in the market. Particularly those intermediaries that face a high cost in bonding themselves to remaining faithful will benefit from the ability to use the self-tailored liability regime to reduce bonding costs. Once able to bond themselves to remaining faithful in screening, intermediaries may credibly signal quality to purchasers and thereby increase their value and the amount of fees they may charge to producers”.[126] In this way, only some gatekeepers, in fact, only those with strong reputations and considerable business at risk if they screen unfaithfully, will choose to completely disclaim liability. This is because they already have ample market-based assurances that they will act as credible certifiers and as a result the loss of legal liability will not hurt their certification ability.

Another major attraction of the contractual enforcement of the underwriter gatekeeping duty is that it allows individual arrangements as regards the optimal deterrent threat to ensure credible signaling. Investors, issuers and gatekeepers all differ. Therefore, each individual case requires a different solution. For instance, some investors, such as retail investors, prefer a stronger protection while institutional investors can fend for themselves. In turn, it is easier to credibly commit not to cheat in certification for more reputable underwriters than for small and less established. Also, a more established company might have lower needs for a credible signal than a technology start-up. Thus, there is no “one-size-fits-all” optimal deterrent threat. As the contractual solution allows the free choice, it should be able to accommodate all of these preferences without imposing extra costs.

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[124] R. H. Coase, “The Problem of Social Cost,” *The Journal of Law and Economics* 3, no. 1 (January 1960): 1.

[125] For the discussion of the reputational mechanism see Section 3.1 of Chapter II.

[126] Stephen Choi, “Market Lessons for Gatekeepers,” *Northwestern University Law Review* 92 (1998 1997): pg. 955.

However, in these both respects the functioning of contractual mechanisms does not differ much from the working of the reputational mechanism. What makes the contractual solution different from the pure reputational mechanism is that the contract allows setting more precise rules of conduct and determining definite contractual sanctions that can be subject to further enforcement by the courts. Moreover, the extent of underwriter liability becomes one of the explicit issues on the negotiation agenda between the issuer and the underwriter and is further disclosed in the prospectus. For example, Partnoy (2004) argues that, in fact, allowing for a free choice of liability system may encourage more competition between gatekeepers. Gatekeepers will have a new variable to compete upon. As the chosen liability standard will be publicly disclosed, it "would more likely affect issuer share prices, and encourage competitive bidding".[127] Thus, a contractual solution would solve the problems of noisiness, uncertainty, traceability and enforceability associated with reputational sanctions.

In this context, the main question is whether the contractual solution by making the sanction more defined and certain allows overcoming problems of institutional investor's passivity, underwriter lack of competitiveness and issuer's managerial problems. The answer to this question is highly speculative but the balanced prediction could be that in normal times this might be possible. However, there is a legitimate concern that in bubble-times contractual solutions could not be enough. In such circumstances none of the capital market participants would have strong incentives to bargain for a high liability standard.[128] As a result, there will be a "race to the bottom" in establishing the enforcement mechanism on a contractual basis, *i.e.* that underwriters will negotiate suboptimal liability coverage or will even completely disclaim liability. In the short run, markets will not be able to process such a low level of liability as a signal of low quality and investors will suffer losses while still paying a non-discounted price. This will mostly harm retail investors whose portfolio is not diversified enough. As a result, it is reasonable to conclude that while contractual solutions may work in normal times, it might not provide sufficient deterrent incentives in

[127] Frank Partnoy, "Strict Liability for Gatekeepers: A Reply to Professor Coffee," *Boston University Law Review* 84 (2004): pg. 369.

[128] As argued by Coffee, "Gatekeeper Failure and Reform."

other circumstances. Therefore, there might be a need for a regulatory solution for such cases.[129]

It is also argued that the contractual solution implies prohibitively high costs. The underwriter would have to arrange the agreements with investors. This would include a great number of details. “This agreement must define what is to be counted as a breach, how it is to be proven, and how liability is to be distributed among the underwriter, the company, its managers, and those who've composed various opinions in the prospectus. <…> the agreement system envisioned here must ensure an efficient process of discovering, clarifying, and interpreting the facts. The managing underwriter must also include an agreement system that clarifies whether a breach has indeed occurred. Moreover, the extent of damage caused will have to be ascertained”.[130] Specifying *ex ante* all these details on individual bases could be prohibitively expensive.

Moreover, there is the problem of free-riding. Only the first underwriter has to suffer costs of establishing and negotiating the liability contract with the issuer and investors. Others can free-ride on the once established system. There is a chance that appreciating this opportunity none of underwriters has incentives to invest in establishing the contractual liability system in the first place.

Finally, there is uncertainty about the ability of courts to enforce such contractual arrangements.

It should be noted that this concern should not be overly-emphasized because coordination and free-riding problems can be addressed by introducing a default liability rule. However, the default private law rules cannot be regarded as an efficient instrument to achieve deterrence goals. Indeed, while the default rules would solve the problem of high negotiation and coordination costs, they would not mitigate the “race to the bottom” arguments presented above.

Therefore, it can be concluded that without external intervention capital markets mechanisms cannot be able to provide a credible enforcement of the underwriter gatekeeping function. Therefore, there is a need for other solutions.

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[129] Ibid., pg. 541-542. Note that the discussion in mentioned papers is rather on the differences between the default and mandatory liability regime than on the choice between the contract and regulation. However, the same arguments can be used to argue that the contractual solution is likely to fail.

[130] Sher, “Underwriters’ Civil Liability for IPO’s,” pg. 454.

4. LEGAL ENFORCEMENT MECHANISMS

4.1. Ex post v ex ante legal intervention in the gatekeeping market

a) Types of legal intervention

It is common to distinguish between two forms of legal intervention. The *ex post* method of enforcement works "through a deterrent effect of damage actions [or any other kind of *ex post* sanction] that may be brought once harm occurs".[131] *Ex ante* enforcement operates by setting "standards, prohibitions and other forms of safety regulation [which], in contrast, are public in character and modify behavior in an immediate way through requirements that are imposed before, or at least independently of, the actual occurrence of harm".[132]

Law and Economics literature discussed the criteria for choosing one of these types over another in great detail.[133] However, there is almost no analysis of this issue in the context of the regulation of the underwriter gatekeeping duty. It is usually assumed that tort liability (*ex post* legal intervention), as compared to the command-and-control regulation (*ex ante* legal intervention), is a superior form of regulation without giving much reasoning why. This Section will seek to fill this gap.

b) Criteria for making a choice

The literature states that the first factor to assess in making a choice between *ex ante* and *ex post* legal intervention is which party has more information about the character or dangerousness of violation. *Ex ante* regulation is more suitable for "standard", "fixed" objects rather than for changing behaviors where the regulator knows the precise content of the conduct. In contrast, *ex post* intervention is more suitable where it is difficult to

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131 Steven Shavell, "Liability for Harm versus Regulation of Safety," *The Journal of Legal Studies* 13, no. 2 (June 1, 1984): pg. 357.

132 Ibid.

133 Most prominently Shavell, "Liability for Harm versus Regulation of Safety"; Steven Shavell, "The Optimal Structure of Law Enforcement," *Journal of Law & Economics* 36 (1993): 255; A. Mitchell Polinsky, "Private versus Public Enforcement of Fines," *The Journal of Legal Studies* 9, no. 1 (January 1, 1980): 105-127.

describe all the details of conduct before it happens and there can be a considerable variety.

If one looks at the gatekeeping by the underwriter, one can clearly see that this is a complex and highly circumstantial activity. Although, some framework guidance may exist on how to perform the investigation of the issuer, its success very much relies on the discretion and professional experience of the underwriter to evaluate different situations. Given the complexity of financial markets it is the underwriter who can best decide what is required for the best execution of the monitoring function. Therefore, the state will lack information and, thus, will very likely err in prescribing the content of the underwriting function. On the other hand, *ex post* intervention through the adjudication on a case-to-case basis will allow harnessing the underwriter knowledge regarding the costs and benefits of monitoring. It shifts a problem of the duty design to the most knowledgeable party – in this case the underwriter, subject to *ex post* review by the court.

In fact, the *ex post* legal intervention most closely resembles the working of the costly signaling mechanism. If the gatekeeping markets were perfect, the threat of reputation loss would have changed the underwriter pay-offs from cheating and thus would have provided a credible signal that the issuer is of good quality and is not misleading investors. However, reputational signaling is not reliable due to the problems in the certification market as it was discussed in Section 3.1 of this Chapter. *Ex post* legal enforcement would serve the same function of changing the underwriter pay-offs from cheating, however, in this case the sanction in case of violation would be more certain and well defined. It would ensure "direct compensation *in lieu* of the uncertain hostage of reputational injury".[134] Differently from reputational sanctions that create "reputational noise", liability would make the deterrent impact more focused. In case of reputational sanctions, investors tend to assess the reputation on aggregate market level. This creates the possibility of free-riding on the reputation of others. Once the *ex post* enforcement is installed, low quality underwriters will bear full risk of failure themselves. Additionally, any trial of a low quality underwriter will contrast the quality of their services with industry standards and thus localize reputational damage.[135]

[134] Kraakman, "Gatekeepers," pg. 98.

[135] Ibid., pg. 99.

One could argue that *ex post* enforcement may not work because the underwriter will avoid the deterrent threat of the sanction by shifting its costs to the issuer *via* the underwriting fee. However, the ability of the underwriter to shift the fee is restricted by the issuer's and investors' willingness to pay. It can be argued that the issuer would buy underwriter services as long at it its' total benefit, *i.e.* the price it gets for securities minus the underwriting fee, is higher than the price it would get without the participation of the underwriter. This would only hold as long as it is cheaper for investors to use monitoring services of the underwriter than simply accepting the losses of misstatements without monitoring or monitoring by themselves. Indeed, the underwriting fee the underwriter would need to charge the issuer if it does not monitor at all would be equal to the expected investors' damages. There are no reasons why investors would be interested to pay this sum in advance *via* the security price rather than simply accepting the same damages once they materialize.[136] This basically refers us to the main argument, on which this book strongly relies, that underwriters can monitor the issuer better and cheaper than investors. If they monitor they should be able to offer investors the protection from misstatements cheaper than investors would be able to do by themselves. Thus, the liability should make it more profitable for the underwriter to monitor than not to monitor.

The second criterion for making a choice between *ex ante* and *ex post* legal intervention is the relative cost of such intervention. Naturally, one should choose a type that can provide the required result at the lowest cost. Applying this criterion to the underwriting setting one can clearly see that policing the behavior of the underwriter *ex ante* would impose prohibitive costs. As the gatekeeping is a process rather than a single act, it is cheaper to use sanctions to penalize bad monitoring and the resulting harm rather than preventing violations from happening in the first place. As a result, *ex post* regulation should be preferable to *ex ante. Ex ante* regulation of the underwriter gatekeeping duty might be suitable only as regards certain undisputable and easily monitored actions. The core of the underwriter gatekeeping activities, however, is not suitable for the *ex ante* regulation.

The third criterion that can be derived from the literature is the ability of the injurer to sustain the sanction. Shavell (1984) states that generally *ex post* sanctions will not be effective if the assets of the injurer are lower than the expected sanction (judgment proof

[136] This position assumes that participation of underwriters in securities offering is not mandatory.

problem).[137] Applicable to the regulation of underwriters this means that *ex post* intervention should only be used if the underwriter has sufficient assets to sustain them. The underwriter is considered to be a deep pocket defendant. It is a financial institution, most often a bank. In Europe, the underwriting is performed by securities branches of commercial banks. In the USA, however, for a long time underwriters were mostly investment banks. In the USA, which traditionally has been a nest of major underwriters, the participation of commercial banks in the securities distribution business was explicitly prohibited by law from 1933 to 1999. Pursuing the objective to improve the competition within the industry this prohibition was abolished in 1999 by the Gramm-Leach-Bliley Act. As a result, the underwriting industry has seen the entry of major commercial banks. Further, as the consequence of the financial crisis of the late 2000's, majority of the American investment banks were turned into commercial banks. Therefore, at the moment of writing of this work, on the both sides of the Atlantic the underwriting is mainly a job of universal commercial banks. As a result, they have deep pockets to absorb relatively high monetary sanctions.

The fourth criterion states that the choice between the *ex ante* and *ex post* enforcement also depends on the effectiveness and feasibility of *ex post* legal intervention. According to Shavell (1984), the less effective are the *ex post* sanctions, the more *ex ante* regulation should be used and *vice versa.* In turn, effectiveness of sanctions depends on the likelihood that they are going to be applied and on their feasible magnitude. Likelihood of application of sanctions is contingent on how easily the injurer can be identified.

In our case, it is relatively easy to identify underwriters of a certain offering. What is more difficult is to determine actual monitoring actions of the underwriter as they are not observable. This difficulty, should not, however, be crucial in making the choice of timing of intervention. It can be solved by other means, such as investor-friendly procedural rules, powers of enforcer or structuring of the legal intervention. For example, this problem would disappear if the fact of misdisclosure were used as a proxy of the underwriter illicit activities (strict liability).

c). Some caveats

[137] Shavell, "Liability for Harm versus Regulation of Safety."

Three caveats are required here. First of all, the arguments above while favouring *ex post* intervention in general, do not apply only to the tort liability. Other forms of *ex post* intervention such as administrative or criminal fines also make part of this group. The main distinction between *ex ante* and *ex post* types of intervention is that the *ex post* systems rely on the broadly defined culpability standard rather than operational monitoring rules. Thus, all above arguments would also apply in cases when an administrative authority sues the underwriter for its violation of the gatekeeping duty.

The second caveat is that the preference for one particular mechanism of intervention does not deny that it might be efficient to use several different methods of legal intervention complimentary. It may be optimal to use *ex ante* regulation to establish some minimal standards of conduct which is applicable in all cases. That is because markets are not perfect from an informational point of view. On the one hand, regulatory agencies may suffer from lack of information. On the other, in a liability system the parties might not pay fully for harm and might not even be sued. It may be optimal to use *ex ante* regulation to establish some minimal standard of conduct which is applicable in all cases. Therefore, a single system may be unable to produce an efficient outcome separately. In this case, a combined solution, *i.e.* both *ex ante* and *ex post* intervention, may be necessary to provide a complete set of incentives. *Ex post* mechanisms can be used to deal with particular cases which, depending on the circumstances, may require the higher standard.

Finally, so far I only looked at ways to directly influence the behavior of the underwriter. However, there are other ways the legal intervention can operate. Besides the rules directly prescribing the behavior, there can also be structural rules, which, for example, subject gatekeepers to greater public oversight; prophylactic rules, which typically seek to preclude conflicts of interest; "empowerment" rules, which seek to assure greater independence or to give the gatekeeper greater leverage over the issuer who he is expected to monitor. In line with this reasoning Choi (1997) also insists that the principal objective of the legal intervention should be not the deterrence of the underwriter as such but rather “bolstering the market-based incentives of intermediaries to act as certifiers rather than directly command third parties to serve as gatekeepers”. For instance, he observes that competitive forces of the certification market may not ensure the optimal level of accuracy because investors cannot observe the screening procedures or accuracy level of individual certifiers. To cure this situation the state could set the “standards for certifiers to transmit information on their past record and screening procedures. Lawmakers thereby provide the market a focal point to standardize information collection, comparison, and dissemination. Through standardized disclosures, purchasers may make comparisons between certifiers at reduced expense and, therefore, more purchasers will actually undertake this comparison. Other intermediaries, moreover, may arise in the market to assess the quality of different certifiers, acting to certify the certifiers. These intermediaries also benefit from the reduced information costs engendered through government standardization. In markets in which no such intermediaries operate, the government may also establish centralized clearinghouse information agencies to track and collect data on the certifiers in the market".[138]

Legal intervention could also be focused on increasing the number of underwriters with sufficient reputation and business to remain faithful certifiers. For, example, big commercial banks would be the intermediaries for whom it is easiest to commit to screen credibly. When certification fails to arise due to problems with certifier fidelity, lawmakers may seek to increase market concentration through the use of licenses designed to restrict the number of certifiers.[139]

d). Summing-up

The application of criteria for an optimality of *ex post v ex ante* legal intervention developed in the Law and Economics literature to the underwriting setting demonstrates that according to most of them *ex post* legal intervention is a more desirable enforcement tool than the *ex ante* regulation. Therefore, it should be relied upon as a primary regulatory device. However, it does not have to be an exclusive way to enforce the underwriter gatekeeping duty. In addition, it can be concluded that the *ex post* regulation should not necessarily be limited to the tort liability.

[138] Choi, "Market Lessons for Gatekeepers," pg. 950.

[139] Ibid., pg. 960.

4.2. Private vs public ex post legal intervention in the gatekeeping market

a). Types of ex-post legal intervention

Ex post legal intervention includes such legal constructs as civil tort, administrative and criminal liability.[140] They differ on a number of characteristics such as the enforcing party and the procedure. According to this criterion *ex post* legal intervention systems can be classified into private and public. Civil tort liability is a private form of *ex post* intervention. Administrative and criminal liabilities are public.

Law and Economics literature has also dedicated significant attention to determine under which circumstances private enforcement can be superior to the public and *vice versa.* This Section will attempt to answer this question as applied to underwriter *ex post* legal enforcement.

b). Incentives to monitor

Both enforcement systems provide monitoring incentives to underwriters. From this perspective liability will be equally effective whether the collected sanction runs to investors or public enforcers. The important element is that underwriters pay in case of misdisclosure but it does not matter who they pay.[141] In this case what matters is not the identity of enforcer but the ability of a particular enforcement system to reach the optimal deterrence goals.

Nevertheless, there are reasons to believe that public enforcement may lead to underenforcement while private can lead either to under or overenforcement. The reason for this is the incentives of the enforcer to detect and launch misstatement cases and the amount of information about the violation different enforcers posses.

Private enforcement relies on private parties – victims of violation to take action. However, the specificity of misstatement cases is that they involve numerous and usually scattered victims. There are two groups of investors who suffer from misstatements.

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[140] Administrative and criminal law also contain *ex ante* rules. The purpose of ex ante rules is to set standards. In contrast, the purpose of *ex post* rules is to provide enforcement mechanisms to back up *ex ante* rules.

[141] See, for example, Christopher J. S. Hodges, *The Reform of Class and Representative Actions in European Legal Systems: A New Framework for Collective Redress in Europe* (Hart Publishing, 2008), pg. 196.

The first group of investors who may suffer harm from misstatements are initial investors. Those are usually big institutional investors. Usually, initial investors sell the securities which were allocated to them quite fast, well before the revelation of the misstatement takes place. They do not get harmed by the misstatements and thus have no incentives to file lawsuits. However, there can be a fraction of this group who keeps a large stake in the company. Thus, if the price drops down, they can incur big losses. Economic theory usually states that such harm should provide such investors with incentives to bring liability lawsuits. However, this may not be the case with institutional investors. The problem is that while an institutional investor may have a relatively high stake in a particular company, they may not actively engage in litigation because such a stake constitutes a small fraction of their overall portfolio or for other practical reasons.[142]

The second group of harmed investors constitutes retail investors who buy flipped shares from initial investors.[143] These investors have relatively small and scattered individual losses. As a result, the problem of rational apathy may arise.[144] Rational apathy is economically rational behavior when a utility maximizing investor decides not to engage in the litigation because the expected costs of doing so exceed the benefits. The expected benefits might be low because the individual holding of securities might be small and the litigation outcome uncertain while the costs can be high. In addition, an individual investor faces a defendant – usually a big international bank that is likely to be able and willing to spend more resources on litigation. Underwriters are more likely to be able to finance such litigation than individual investors. Thus, asymmetric spending power and resulting negotiation power between individual investors and underwriters can present a large disincentive to file a claim. Rational apathy can be also influenced by attitudes towards risk. If investors are risk averse, they place more value on potential losses than on potential gains, which shifts any weighing of potential costs and benefits towards a more negative outcome. In contrast, underwriters are risk neutral.

Another problem is a free riding behavior – investors have incentives to free ride on the initial investments of others. Investors refrain from suing hoping that others may invest in

[142] See also the discussion in Section 2.1 and 3.1 of Chapter II.

[143] See Sections 3.4 of Chapter I.

[144] See, for example, John C. Coffee, "Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation," *Columbia Law Review* 100, no. 2 (March 1, 2000): 370-439.

starting proceedings. This is advantageous for the investors remaining silent because the evidence gathered in the first proceeding can be applied to the new proceeding thereby reducing their own costs. Therefore, it can be beneficial for investors to delay filing the claim until the public authority brings a case or similar private case is resolved. Free riding on the investment of others makes filing the claim first a disadvantage. As a result, filing of some private claims may be delayed.

As a result of these two problems, private parties will often find filing a case not cost-efficient. Therefore, incentives of private parties to enforce misstatement cases will crucially depend on the rules governing the litigation process and financing of litigation. To cite Hodges (2008) "private enforcement will only be produced to any significant extent if there are significant financial incentives for private actors, or more often intermediaries". At the same time, Hodges (2008) notes that such a system can easily produce abuse "through conflicts of interest <…>, very large transactional costs, disproportional reward for actors <…> and intermediaries <…>, and excessive deterrence and compensation".[145] These are undesirable costs that can be associated with private enforcement. As it will be seen further in more detail, dependant on particular procedural rules, private enforcers may have very strong or, in contrast, very weak incentives to launch misstatement cases. In turn, this will lead either to under, over or even occasionally the optimal enforcement.

In contrast, public enforcers are assumed to be motivated by the social efficiency maximization goal as opposed to the private utility maximization goal. Private parties do not always take social welfare into account when deciding to file the claim against the underwriter. They only evaluate their personal benefits and costs such action would entail. The public authority should act as a social planner and consider the welfare of the society at large when taking enforcement actions. Thus, while private enforcement can often lead to either under or over enforcement, theoretically, the public enforcer may ensure the optimal level of enforcement.

However, from a practical point of view it has been noted that public enforcement generally has weak incentives to pursue underwriters' liability cases. Salaries of public enforcement agents are not aligned with the outcomes of cases. Therefore they have weak incentives to do their job well. Moreover, public bodies have limited resources both in

[145] Ibid.

terms of the budget and staff. Finally, the enforcement of gatekeeper liability case is just one of many responsibilities of the public agency which might not be its political priority. The selection of cases might also be one-sided. Public agencies are likely to choose more prestigious cases in order to raise their political importance. Therefore, they may not be able and willing to deal with all cases brought to their attention. In addition, there might be path-dependence. After the enforcement process has begun, there might be a trend to find the underwriter liable so to justify resources invested in litigating the case.

Moreover, the difference whether this is a public or private enforcer can affect the level of enforcement because of the amount of information available to the enforcer. In this respect, private enforcement is likely to be more superior to the public one. First of all, private parties – investors have better information about violations than the public enforcer. Investors are well informed because they participate in activities and learn about violations as they suffer direct monetary losses. Therefore they can learn about violations at a low cost. In addition, they are often market professionals. Consequently they possess necessary information about general market and company specific conditions. Thus, their costs of detecting possible violations and gathering initial evidence are lower in comparison to those of public enforcers. This, given that the problem of collective action is resolved, can be expected to increase the probability of enforcement as compared with public enforcement.[146]

In contrast, public enforcement is associated with the inherent lack of information about actual violations compared to private investors. The public authority is not a direct victim of the violation and does not suffer direct damages in case of a significant securities price drop. Thus, normally they do not learn about misdisclosure naturally as a part of their professional activities and have limited possibilities to find out about the violation. On the other hand, it is too costly to continuously monitor the disclosures of myriads of companies listed on a given market. Moreover they have poor information of both general market and specific issuers' conditions that makes it is very difficult to assess the correctness and completeness of disclosures. While, they are likely to learn only about the most evident and egregious violations and when the price drops really significantly, the detection of misdisclosure violations on a routine basis is possible only at a very high cost. Therefore, the public enforcement can also lead to the lower level of enforcement.

[146] Assuming that the mechanism for collective litigation is in place.

c). Other impact

Another way the liability system affects financial markets is by supplying incentives to investors to invest. There is, however, a significant difference in the manner and the extent to which public and private enforcements perform this function.

Private enforcement has the most evident impact on the level of investment. Compensation of investors' damages matters because the prospect of compensation increases the expected pay-offs of investment. The investors' investment decision is determined by the net expected return which consists of the expected return in case there is no misleading information net of initial investment and expected liability payments from underwriters. If private enforcement is in place, investors receive, dependent of the given liability regime, a full or partial protection from the losses associated with misdisclosure and carry only business risk of the enterprise. The private enforcement thus should lead to the increase of the price investors are willing to pay for securities.

It should be noted that public enforcement will also have an impact, though a less profound one, on the level on investment. The level of investment is expected to rise in comparison to the one with no liability because the probability that there is no misdisclosure will increase. This will happen due to the incentives provided by the public enforcement to the underwriter to monitor. The higher probability of no misdisclosure will turn into higher expected return. The higher expected return would attract more investors to the market. The level of investment will largely depend on the institution's ability to detect and litigate misdisclosure cases. However, it is unlikely that public enforcer will detect misstatements with 100% accuracy. Therefore, there will remain cases when investors would suffer losses. However, in contrast to private enforcement investors would not receive any compensation in case of misdisclosure. Therefore, the level of investment will never rise as much as it would under the private enforcement. In sum, public enforcement will have some effect on the level of investment but not as big as in case of private enforcement.

The level of issuer's activity can also be affected by the imposition of liability on underwriters. The level of issuer's activity is affected in two different ways. On the one hand, the threat of any liability, be it private or public, forces the underwriter to carefully select the companies. Thus, faced with the threat to pay the sanction underwriters would avoid selecting the riskiest companies. As a result, some issuers would be excluded from capital markets. From this perspective, there is no difference between public and private enforcement.

On the other hand, the availability of compensation has an impact on the expected return of investors and consequently on the issuers' security price. In case of private enforcement the security price would increase reflecting the availability of compensation which investors would receive in case of misdisclosure. In case of public enforcement the price increase would also take place. However, it would not be as big as in the case of private enforcement. The increase of price will lead to the increase the number of issuers willing to raise finance *via* public markets.

A combined impact of these two forces is quite unclear. One scenario is that the liability would increase a number of available options for the underwriter to screen for underwriting. The level of activity on the market thus will increase. The increase will be bigger in case of private enforcement than in case of public enforcement. However, both types of enforcement would equally affect the underwriter decision which companies to select for underwriting – underwriters would become more cautious in selecting companies to underwrite and may reject to underwrite more risky companies.

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d). Enforcement by the stock exchange

Besides purely public and private enforcers the literature points at yet another possible enforcer of underwriter gatekeeping duty. Professors Mahoney (1997)[147] and Pritchard (1999)[148] have strongly argued to grant the enforcement authority to centralized but private bodies – stock exchanges. For example, Pritchard proposes to make access of issuers to secondary markets contingent on the agreement to the enforcement regime administered by

[147] Paul G. Mahoney, "The Exchange as Regulator," *Virginia Law Review* 83, no. 7 (October 1, 1997): 1453-1500.

[148] Pritchard, "Markets As Monitors."

the exchange.[149] In this case the enforcement is left in hands of a third private party but it is not dispersed as it is in case of civil liability. Therefore, this solution could enable to take advantages or mitigate problems of both private and public enforcement.

The first argument supporting the choice of this enforcement agent is that exchanges may have superior incentives, as compared both to purely private and public enforcers, to enforce at the optimal level. In its essence, the argument is rather simple. As it was nicely put by professor Mahoney (1997): "self-interested stock exchanges members will produce rules that investors want for the same reasons that self-interested bakers produce the kind of bread that consumers want".[150] It simply means that stock exchanges act as traditional profit-maximizers on competitive markets. As rational actors seeking to earn revenues, they should develop a reliable enforcement system to safeguard their business and to ensure that they attract high quality issuers.

Modern stock exchanges operate as private for-profit listed companies. Their main function is to provide a forum for securities exchange, including listing venues and follow-up liquidity. They derive their profits mainly from listing fees (currently around 10% of overall revenue), trading commissions (bulk of the revenues), services (revenues generated from clearing and settlement, depository and computer services, membership fees and provision of market information)) and others. Therefore, stock exchanges have monetary incentives both to attract listings and to provide active secondary trading.

As it was shown in Sections 1.1 a) and 1.1 b) of this Chapter, misstatements affect both primary markets and further secondary trading. In primary markets they deprive issuers from the ability to credibly signal their quality. In this context, strong enforcement in case of misstatements during distributions by the stock exchange may serve as a credible signaling device also for the exchange. Thus, issuers in need for a credible signaling mechanism should be willing to list on exchanges with good reputation for enforcement. Such listing would increase investors' confidence in its stock and reduce the discount investors would apply on such securities otherwise. In turn, if there is a demand from issuers, stock exchanges will have incentives to efficiently enforce misstatement violations

[149] Ibid., pg. 964.

[150] Mahoney, "The Exchange as Regulator," pg. 1459.

as it will contribute to its reputation as a listing venue.[151] In other words, stock exchanges will be able to internalize the deterrence benefits of reducing the amount of misstatements and therefore will be interested in credible enforcement.

In addition, misstatements also affect secondary trading by reducing the liquidity.[152] Lower liquidity raises execution costs for both informed and uninformed traders and thus induces both of these groups to trade less frequently. Less trading means lower profits for stock exchanges. Therefore, as misstatements reduce liquidity exchanges are motivated to effectively seek their eradication.

The enforcement by exchanges can also help to overcome some specific problems associated with public enforcement. First of all, as compared to public enforcement, stock exchanges may have an informational advantage, better expertise and knowledge concerning the operation of the market and its needs. Therefore, it may be easier for them to detect and investigate possible violations. Moreover, the competitive environment will push them to become even more competent. Secondly, stock exchanges are financed directly by the industries they regulate. Therefore, no taxpayers money needs to be spend in implementing enforcement. Resources of stock exchanges are independent of the public budget and the political considerations that surround them. Therefore, it can be ensured that significant resources will be spent for supervising the securities industry. Thirdly, stock exchanges are often praised for their ability to establish regulatory standards in an industry through a consensus. The enforcement is driven by the needs of the industry, therefore, members are more willing to conform their behavior to rules promulgated by their representative bodies. Fourthly, from a procedural point of view, exchanges are not subject to the same due process requirements and other procedural restrictions that make government enforcement actions inflexible and often unsuitable for the ever-changing and highly competitive environment of the financial markets.[153]

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[151] It is acknowledged that there is a significant competition between stock exchanges both from other national or foreign exchanges and from alternative trading venues such as multilateral trading facilities and systemic internalizers. See, for example, Reena Aggarwal and Sandeep Dahiya, “Demutualization and Public Offerings of Financial Exchanges,” *Journal of Applied Corporate Finance* 18, no. 3 (June 2006): pg. 105-106.

[152] See Section 1.1 d).

[153] Stavros Gadinis and Howell E Jackson, “Markets as Regulators: A Survey,” *Southern California Law Review* 80 (2007 2006): pg. 1252.

Enforcement by stock exchanges will also not lead to the problems associated with private enforcement both as regards under or overenforcement. It was noted that due to the lack of procedural rules civil enforcement can lead to underenforcement. This would not happen in case of enforcement by the stock exchange because exchanges simply do not face a problem of collective action and have strong incentives to enforce. They will also not overenforce as could happen in civil liability systems with investor-friendly procedural rules because bringing meritless suits would drive listings away.

In addition, the big advantage of stock exchanges as compared to private enforcement is that they can target sanctions taking into account the particularities of individual cases. For example, the lower sanction can be applied to the underwriter with well-established reputation and no history of violations in case of a negligent violation. Thus, they will avoid "one-size-fits-all" approach that is associated with mandatory civil liability regimes.

At the same time there are legitimate concerns about the credibility of enforcement by the stock exchanges. The major worry is that granting enforcement powers to the stock exchange will lead to underenforcement. The reasons for this are different from both cases of private and public enforcement. In sum, incentives of both issuers, stock exchanges and underwriters to seek a strong enforcement environment are put under fire.

To start with the incentives of the issuers – they face managerial agency problems when making the listing decision. It is feared that as the decision to list is in hands of managers, they may chose not the exchange which maximizes shareholder's return but the one with lax standards which can accommodate their own preferences. In company law this debate is known as "race to the top" *vs* "race to the bottom" argument and it is still unresolved.[154] However, according to Pritchard (1999) for primary listings this concern is not so important. This is because managers and venture capitalists making listing decisions are likely to own a significant part of the company. Listing on the exchange with good reputation for enforcement will decrease the discount on securities and therefore will allow receiving higher proceeds for selling managers and venture capitalists. Thus, as these actors internalize the benefits of their listing decision, they will choose exchanges with

[154] See for example, Lucian Arye Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law," *Harvard Law Review* 105, no. 7 (May 1, 1992): 1435-1510; Roberta Romano, *The genius of American corporate law* (American Enterprise Institute, 1993); William J. Carney, George B. Shepherd, and Joanna M. Shepherd, "Delaware corporate law: failing law, failing markets," in *The law and economics of corporate governance: changing perspectives* (Edward Elgar Publishing, 2010).

strong enforcement. Nevertheless, this problem remains more serious for further seasoned issues.

Looking at the incentives of the stock exchange, one could see that while a reputation for credible enforcement is undeniably valuable for stock exchanges, such enforcement is also costly. The costs include administrative costs associated with running the rigorous enforcement system, the loss of listing and trading revenue associated with enforcement actions and reputational costs. While the increase on exchange reputation is rather an abstract process that does not bring immediate results, the costs of operating the enforcement system are real and instant. Thus, shareholders of the stock exchange may be unwilling to forego immediate profits that can put it at a disadvantage with other exchange venues for uncertain future rewards. To cite Fleckner (2005): "stock exchange managers might forget that they trade not only in stocks but also in trust, and could be tempted to reduce regulatory expenses just to increase profits".[155] For example, the exchange might not be willing to sanction underwriters whose activities bring significant profits to the exchange.[156]

In addition, Kahan (1997) argues that stock exchanges would rather convey an image that no violations occur than that there are violations even though they are detected and persecuted. As a result, if the exchange thinks that if some violations can go undetected and unnoticed, it will have reduced incentives to engage in enforcement.[157]

Finally, there is a threat that underwriters may have a significant influence on the management of the exchange. Although after the demutualization of major stock exchanges[158] exchanges are not owned by their members anymore, one still can hypothesize that major broker-dealers retain some leverage against the management of the exchange. Underwriters are important members of the stock exchange as they are often also brokers and market makers for the company they underwrite. Both as monitors and as brokers and market makers in the long-term they are interested in eradicating

[155] Andreas M Fleckner, "Stock Exchanges at the Crossroads," *Fordham Law Review* 74 (2006 2005): pg. 2593.

[156] Gadinis and Jackson, "Markets as Regulators," pg. 1259.

[157] Marcel Kahan, "Some Problems with Stock Exchange-Based Securities Regulation," *Virginia Law Review* 83, no. 7 (October 1, 1997): pg. 1517.

[158] Demutualization is the process by which a customer-owned mutual organization changes legal form to a joint stock company. Most of modern stock exchanges changed their structure in 2000s.

misstatements in the market as it will bring more listings and more trading from which they benefit. However, in individual cases they may lobby against the imposition of sanctions. Thus, given their importance stock exchanges may succumb to their short-term demands and alter their enforcement decisions.

Finally, the exchanges have limited enforcement powers in a sense that they can only sanction their members or listed companies. As the enforcement authority of the stock exchange is derived from the contractual relationship, it cannot cover external financial institutions.

e). Summing up

The conclusion that follows is that both private and public *ex post* enforcement systems and enforcement by the stock exchange are able to provide monitoring incentives to the underwriter. However, they differ in the level of enforcement they can be expected to provide. On the one hand, lack of information about violation and weak incentives to pursue claims associated with public enforcement can lead to a level of enforcement below the socially optimal. On the other hand, dependant on the procedural rules put in place private enforcement can be associated with under or overenforcement. In turn, it is possible that conflicts of interest within issuers, stock exchanges and underwriters will lead to underenforcement by the stock exchanges. Nevertheless, private enforcement can be superior both to public enforcement and enforcement by the stock exchanges if we consider other functions of the *ex post* legal intervention system.

While the discussion does not allow picking one enforcement mechanism over others, it allows seeing that the private enforcement can be used as a tool to provide deterrence and to pointing out the strengths and weaknesses of this enforcement mechanism. It also cautions that private enforcement will always be associated with the problem of collective action which is inherent in misstatement cases.

4.3. Potential costs of gatekeeping and its enforcement

a). General costs of gatekeeping

Before I start discussing the costs of gatekeeping, let me first briefly repeat why do we need gatekeeping at the first place. According to the seminal paper by Kraakman (1986) further legal intervention to enforce the gatekeeping function can be justified only if certain conditions are met:[159]

- There should be some serious misconduct that practicable penalties cannot deter.
- There should be gatekeepers who can and will prevent misconduct reliably.
- There should be missing or inadequate private gatekeeping incentives.
- Costs of gatekeeping should not exceed its benefits.

So far this book has discussed the first three of these conditions.

First of all, securities markets are affected by the misdisclosure of information by the issuer. This is a serious market failure because the issuer cannot credibly commit not to engage in misdisclosure. Moreover, legal regulation of the primary injurer (the issuer) has proven unable to completely resolve this problem. Secondly, due to the nature of their involvement with the issuer underwriters are in a unique position to improve on this market failure. The participation in the preparation of registration statement/prospectus enables them to obtain the required information about the issuer. They possess skills and resources to collect, review and verify such information. Moreover, they can easily have impact on the behavior of the issuer by withholding their services. Therefore, by associating themselves with the issuer they might be able to certify the issuer's quality. Thirdly, it was concluded that incentives coming from contractual relationships, economic risk taking and reputation are insufficient to secure required enforcement of the gatekeeping function. Taken together, these three criteria demonstrate that there is a need for gatekeeping, it can be satisfied by the underwriter, however, to achieve this market mechanisms are not sufficient and we need further enforcement devices. In this context, legal intervention is a natural choice and, at the same time*, ultima ratio,* of the enforcement.

The last criterion advanced by Kraakman (1986) reminds us that every intervention in the market mechanism implies costs. Legal liability operates though adjudication in courts which causes costs for the parties and institutions involved. These costs apply to any type of *ex post* intervention whether it is enforced by public of private actors.

[159] Kraakman (1986) speaks only about one form of legal intervention – tort liability. Nevertheless, it seems that his analysis can be applied to any form of legal intervention because it is not tort law specific but rather focuses on the required features of the gatekeeping market and requires the legal intervention to be efficient.

Kraakman (1986) classifies liability costs into administrative, private and tertiary. Administrative costs are the costs of policing gatekeepers. Private costs are costs imposed on transactions between gatekeepers and regulatory targets. They include the performance costs of monitoring and the risk of residual liability as well as costs of strategies to limit this risk. Tertiary costs are the costs imposed on the third parties affected by the transaction. Among these Kraakman (1986) deems the private costs to be the most important.

In the underwriting setting private costs that the liability system can cause is the possible disruption of both underwriting and capital raising markets. The important point is that in principle the participation of underwriters in the offering is not obligatory. This has two consequences. First of all, underwriters cannot be forced to accept an underwriting mandate. Therefore, they would provide underwriting services only if it is *ex ante* profitable for them. Thus, underwriters would adjust the price of their services or will agree on *ex post* indemnification arrangements with the issuer taking into account the expected liability payments and other expected legal costs at least to reach their reservation utility. Thus, the liability costs will be transferred to investors who will have to pay *ex ante* though a higher underwriting fee for the protection offered by the liability system.

Secondly, while issuers are formally not obliged to hire underwriters for their offerings, in practice public offerings do not proceed without their help.[160] Thus, the increase of the underwriting fee would lead some issuers to exit the market. Normally, this effect is not considered a liability cost but rather a beneficial function. In fact, in this way the issuer is made to internalize the full social cost of its conduct. Hamdani (2003), however, raises the concern that in the underwriter setting liability may not operate perfectly and can cause serious disruptions in markets. The problem is that, similarly to investors, also underwriters are not able to perfectly distinguish between the probabilities of misdisclosure of each individual issuer. Therefore, they will increase the underwriting fee taking into account the average and not the individual probability of misdisclosure in the market. As a

[160] Potentially, issuers can also raise public capital raising without the offer being underwritten. This is indeed true in a sense that there are no statutory provisions requiring using underwriters. The clear example that unintermediated offerings are possible is that direct online IPO auctions are offered by W.R. Hambrecht + Co which uses an online IPO auction process called OpenIPO. Nevertheless, it is also a fact that such direct offerings are very rare or can only be useful for certain already well-established companies like Google. It is argued that for other companies direct offerings are too expensive as they are not able to attract sufficient demand and ensure post-listing support on their own. Thus, in practice non-intermediated offerings are rather an exception than normality. Christine Hurt, "Initial Public Offerings and the Failed Promise of Disintermediation," *Entrepreneurial Business Law Journal* 2 (2008 2007): 703.

result, the underwriting fee will not be equal to the expected social harm the particular issuer can cause. Some issuers will pay too little and others too much. This would lead to adverse selection so that a number of low quality issuers will enter the market. Depending on its magnitude, such a non-individualized underwriting fee increase can lead to a number of undesirable results in primary markets, including even the complete disappearance of underwriting markets.

According to Hamdani (2003) the level of fee increase will *inter alia* depend on the underwriter ability to detect the misdisclosure *ex post.* It was noted that the underwriter may be unable to uncover misdisclosure even if it performs all necessary monitoring activities. In this setting, if the underwriter ability to detect the misdisclosure is low, it will not eliminate the misstatements completely. Therefore, the residual risk of liability for the underwriter will remain high and can lead to a large increase of fees. If such increase is larger than the value of market entry for any law-abiding issuer, the public distribution market will simply unravel. If monitoring is relatively more effective in preventing misdisclosure but still leaves a significant amount of misdisclosure undetected, the fee increase is likely to be in the middle range. Middle range price increase will drive out some but not all issuers. The social welfare implications depend exactly on which type of issuers will leave following the increase of the fee. It is assumed that different types of issuers attach different value to entering public markets. If the gains from entering the market are randomly distributed among all companies, the impact on the social welfare will depend on the trade-off between the costs resulting from driving out law-abiding issuers and savings in social harm associated with prevention of entry by the violating issuers. If monitoring is very efficient, it will lead to only an insignificant rise of the underwriting fee. Such fee would drive no law-abiding issuers from the market but it will induce the underwriter to monitor the issuers and as a result reduce the social harm. While law-abiding issuers will pay a higher price this would constitute a simple wealth transfer and not affect social welfare. The conclusion which follows is that the private costs of gatekeeping mostly depend on the underwriter ability to effectively monitor issuers.

It should be also acknowledged that despite his concern, Hamdani (2003) is ready to admit that in the context of the IPO liability the underwriting fee increase "would approximate the discount in the price that investors would have paid for the securities of a company going public in the absence of gatekeeper liability". Consequently, as the expected costs of misstatement are normally reflected in the price investors pay for the securities, even the most expansive form of gatekeeper liability would lead to the same results as if no liability was attached.[161]

Moreover, it has been argued in Section 1.3 of this Chapter that in the context of primary distributions and especially as regards the disclosure in the official offering documents the underwriter ability to monitor the issuer can be expected to be quite high. This is because of the special role the underwriter plays in preparing the offering and in the drafting of the prospectus. Thus, applying Hamdani's (2003) reasoning the increase of the fee should not be very high.

At the same time the liability threat can also lead the underwriters to adopt the risk-limiting strategies which can foreclose a market entry for some risky but still law-abiding companies. Due to the underwriter inability to totally prevent the occurrence of misdisclosure, there is always a possibility of misstatement occurring even if the underwriter diligently and properly performs its duties. In addition, there may be mistakes of underwriters and courts in evaluating the underwriters' behavior or requirements of law. In order to avoid these residual risks the underwriter may simply refuse to underwrite the most risky companies.[162]

It should be noted that these liability costs would arise even if the liability threat is set at the optimal level and the enforcement is perfect. Thus, this is a general problem of any third party liability regime. Problems in setting the liability threat at the socially optimal level or overenforcement can only exacerbate this problem.[163] Therefore, an overly burdensome liability system can eventually lead to the dismantling not only of the underwriting markets but would also affect capital raising market.[164]

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161 Hamdani, "Gatekeeper Liability."

162 The refusal by one underwriter to underwrite a certain issuer usually precludes the issuer from entering the market. Other underwriters might interpret such refusal as a sign of bad quality and might not bid for the underwriting.

163 Note that the trend that issuers are already retreating from public equity markets has already been observed on the USA market. It was reported that both domestic and foreign issuers prefer private placing rather than public offerings. Commentators blame this on the excessive litigiousness of the USA legal system. See Committee on Capital Markets Regulation, *Interim Report 2006*, n.d.

164 To illustrate that this can indeed happen one should look at the proposal to introduce overly harsh liability regime on credit rating agencies. At some point the SEC introduced the requirement to disclose whether an issuance or sale of any class of offered asset-backed securities was conditioned on the assignment of a rating by one or more rating agencies. The minimum credit rating and the identity of each rating agency had to be disclosed. However, such a disclosure was possible only upon the consent by the rating agency. The Dodd-Frank

b). Specific costs of private enforcement

As this book is primarily dedicated to the private enforcement of underwriter gatekeeping duty it is fair to analyze if there are any costs which are typical particularly to the private liability.

The literature allows identifying the following specific costs of private enforcement which do not arise under public enforcement. First of all, private enforcement normally entails the duplication of investigative and litigation efforts by private enforcers. Under private enforcement, especially in misstatement cases, there will be numerous victims which all have to bear costs to enforce their rights. In contrast, public enforcement would enjoy the economies of scale in information processing and litigating the case.[165] This would mean that in absence of efficient rules to mitigate the duplication of individual litigation costs, such as rules of collective litigation, it is likely that private enforcement will lead to higher administrative costs within the meaning of Kraakman (1986) than the public enforcement.

Secondly, as it was already briefly touched upon in the previous Section, private enforcement can deviate from the socially optimal level of enforcement both on the side of under and overenforcement. On the other hand, public enforcement in the underwriting setting is mostly associated with a probability of underenforcement. Thus, the possibility of overenforcement can be regarded as another unique although not the necessary feature of private enforcement. Overenforcement will lead to the exacerbation of general problems of imposition of liability, including the rise of administrative, private and tertiary costs.

Financial Reform Act of 2010 extended the liability of credit rating agencies by holding credit rating agencies to the same standards as accountants and lawyers. After the Act came into force credit rating agencies realized that the SEC disclosure requirement might expose them to extended liability, and thus started simply indicating that they are not willing to provide their consent for a disclosure. In turn the SEC was forced to issue the so-called "no action" letter and suspend its disclosure requirement as it appreciated that without the rating offerings of asset-backed securities would not be able to be conducted on a registered basis. See "Regulation AB Item 1120: Response of the Office of Chief Counsel Division of Corporation Finance" (Office of Chief Counsel of the Securities and Exchange Commission, November 23, 2010), http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm. and Martha Coakley, "AG Coakley Urges SEC to Enforce Regulations on Credit Agencies as Directed by Dodd-Frank Financial Reform Law", March 7, 2011, http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2011_03_07_sec_letter&csid=Cago.

165 Polinsky, "Private versus Public Enforcement of Fines."

c). Summing up

To sum up, one can clearly see that gatekeeping and its enforcement do not come without costs. Any enforcement system will produce administrative, private and tertiary costs. Most importantly, the imposition on gatekeepers of *ex post* liability may foreclose market entry to some companies. Nevertheless, on primary equity markets such costs can be expected, in the extreme scenario, to mirror the discount investors would have applied to the securities in the absence of liability. In addition, there is a threat that private civil liability will lead to the duplication of administrative costs and *might* cause overenforcement.

5. CONCLUSIONS

The primary goal of this Chapter was to discuss the economic rationale for the imposition of gatekeeping duty on the underwriter and look at possible enforcement devices. It was established that the need to cope with the problems caused by asymmetric information on the issuer's side is considered to be the main imperfection of securities markets. This imperfection leads to issuer's failure to credibly transfer information to investors and, thus, results in adverse selection and other social losses in primary markets. It also causes social losses in secondary markets. It was shown that targeting of the primary culprit of misdisclosure – the issuer, does not provide the complete solution for this problem. Therefore, there is a scope to seek for the solution through a third party intervention. In this context, by agreeing to underwrite a company the underwriter can help to bridge the informational asymmetry. It will lend a credible signal to the issuer that will enable the disclosure of issuer's quality and thus the creation of separating equilibrium in distribution markets. Another important conclusion is that the underwriter is mostly involved in disclosure surrounding primary markets. Moreover, his monitoring ability is the highest as regards the information disclosed in the official offering documents rather than in case of sporadic and non-written disclosures.

It has been discussed that there are numerous market mechanisms to sustain the gatekeeping function. One way is for the underwriter to assume the economic risk of the issuer's failure. Another is to rely on the working of reputational mechanisms. Contractual arrangements can also be used to regulate the relationship between the parties. However, this Chapter demonstrated that none of these mechanisms can provide a complete and effective enforcement tool for the underwriter gatekeeping function. Nevertheless, the impact of market mechanisms in ensuring the compliance with the underwriter gatekeeping duty should be taken into account when thinking of the regulatory intervention.

It is argued that different legal mechanisms can be used to enforce the underwriter gatekeeping duty. Among them *ex post* enforcement is seen as a non-exclusive but an effective enforcement mechanism. It mimics the working of the costly signaling mechanism providing the required credibility to the underwriter certification.

Ex post legal intervention can be enforced by both public, private enforcers or stock exchanges. All provide incentives to monitor. However, all also suffer from numerous enforcement problems. Therefore, if the goal of the liability system is simply to provide incentives to monitor, it is difficult to give any preference to a particular enforcement system. Nevertheless, this Chapter showed that private enforcement possesses the qualities which make it suitable for the enforcement of the underwriter gatekeeping duty. It was also concluded that any *ex post* underwriter liability regime will inevitably lead to certain costs which need to be evaluated when drawing policy recommendations.

CHAPTER III. IMPOSITION OF CIVIL LIABILITY FOR GATEKEEPING: IMPACT ON OTHER FUNCTIONS OF THE UNDERWRITER

1. UNDERWRITER ADVISORY ROLE

1. 1. Underlying problem

On the most basic level the underwriter acts as an advisor or a consultant of the issuer in the securities offering process. It advices the issuer on the structure and timing of the offering process, the nature and amount of the securities to be issued, participates in the preparation of the registration statement/prospectus, pricing and allocation on the securities, listing on the stock exchange and other questions.

From an economic point of view, this function of the underwriter is justified as it helps to save transaction costs related to the preparation of the offering. In contrast to the issuer who often has no experience and special knowledge of the securities offering process, the underwriter possesses an extensive professional experience and skills in the securities offering business. Their continuous exposure to the securities industry and therefore acquired knowledge allows them to achieve the economies of scale and scope. Thus, due to their specialization in securities markets underwriters manage to reduce transaction costs related to the preparation of the offering.

From this perspective, the role of the underwriter is passive – they act following instructions and based on the information provided by the issuer. As advisors, underwriters have no duty to question the information provided by the issuer. Their decisions are not binding on the issuer who can always reject the provided advice. Thus, the advisory function can be clearly distinguished from the gatekeeping function which compels the underwriter to insist on its opinion as regards the quality of disclosure.

1.2. Impact of the imposition of liability

The relationship between the gatekeeping and advisory functions of the underwriter is that the advisory role provides a basis for the imposition of a gatekeeping duty, *i.e.* the involvement in the preparation of the offering is precisely the factor which enables the underwriter to serve as a gatekeeper. If the underwriter would not be performing this function, it would be able neither to get access to the information nor advice the issuer on the disclosure. Therefore, the participation of the underwriter in the preparation of the offering should be considered as the main criterion used to determine whether the financial intermediary is subject to a gatekeeping duty and liability. It seams unreasonable to impose the gatekeeping duty and the liability on the parties who have no practical possibilities to perform it.

This question is important for two reasons. First of all, there are different types of underwriting, such as firm-commitment, stand-by and best-effort. They differ as regards the way the underwriting is performed,[166] however, in all of these types the underwriter is providing the advice to the issuer. This leads to suggest that as long as the advisory function is performed by the financial intermediary, it is not relevant what method of underwriting is used. In contrast, the performance of the advisory function should be regarded as the main determinant for the imposition of liability.

Secondly, one should take into account that not all financial intermediaries within the underwriting syndicate provide advisory services. As was discussed in Chapter I an underwriting syndicate consists of the lead underwriter, co-managers and the selling group. The advisory role is performed mainly by the lead manager and by some co-managers. The selling group is usually assembled on the later stage and does not take any involvement in the preparatory process. Therefore, it would seem logical to at least exclude members of the selling group, *i.e.* financial intermediaries whose sole purpose is to place the securities with investors, from the gatekeeping duty and liability. In this case, investors who bought securities from members of the selling group should have a right to seek damages from the lead manager.

Another question is how the advisory function of the underwriter can be affected by the imposition of liability? For companies which are selected for the underwriting it is likely to have either no or a positive impact. However, the liability threat will provide the underwriter with incentives to exercise more monitoring effort. This will allow collecting more information which can serve as a basis for the high quality advice. Liability may also lead to the general improvement of the quality of underwriter personal and techniques/methodologies and thus improve the quality of advice.

2. SALE INTERMEDIATION BY UNDERWRITERS

[166] For further discussion between different types of underwriting see Section 2.6of Chapter I and Section 4 of this Chapter.

2.1. Underlying problem

Besides providing advisory services to the issuer, underwriters also help to lower transaction costs by acting as sale intermediaries between issuers and investors. According to Hurt (2004), the traditional role of any sale intermediary is to help certain goods get to the market and to connect consumers with these goods. There are supply intermediaries "which facilitate bringing products to market. <…> to bring a product or an idea to the market, supply intermediaries work through distribution networks unknown or inaccessible to the producer" and demand intermediaries "which assist those in the marketplace looking for certain products. <…> Demand intermediaries convey information to consumers, who are either passively or actively acquiring information with which to make purchasing decisions". Demand and supply intermediaries may be one person and work intentionally to increase connections between consumers and certain products. On the costs side, their presence "increases the price of goods and services to consumers and may eliminate some product choices by increasing transactions costs for producers".[167]

Underwriters serve both as supply and demand intermediaries. As supply intermediaries, they help to bring securities to the market by assisting the issuer in preparing, structuring and implementing the offering. They have a relative advantage over the issuer due to their specialization and experience in securities markets. Therefore, they can lower transaction costs related to the preparation of the offering. Further, they assist the issuer in the marketing of the offering and settlement and clearing of sale-purchase transactions.

It is argued that the supply function of the underwriter is loosing its importance. First of all, the development of information and communication technology leads to the ongoing decrease of transaction costs related to the distribution of securities and makes some activities of the underwriters not relevant any longer. For instance, Internet has facilitated the distribution of securities by allowing the electronic delivery of prospectus by posting it on the issuer/security exchange/market authority website or using e-mail. Modern telecommunication facilities also allow the organization of marketing without the need of physical presence. As is demonstrated by the development of the online IPO, in principle, issuers can surpass traditional underwriters and offer their securities directly to investors *via* an Internet auction.[168] Second, securities usually are not tangible goods, *i.e.* the

[167] Hurt, "Initial Public Offerings and the Failed Promise of Disintermediation," pg. 706-707.

[168] Such practice has been introduced by W.R. Hambrecht+Co, however, it is fair to note that it had a limited success as only very few companies has chosen to go public using this method.

delivery of security is executed by making the inscription in the parties' securities accounts. Therefore, although issuers need an intermediary to perform such service, there is no need to establish local branches, organize transportation, storing and physical delivery of share certificates. As a result, the distribution needs of a security offering are much different from sales of many other ordinary goods.

The literature puts more weight on the function of the intermediary as a demand intermediary which "either uses its reputation to vouch for certain products or ideas or who cultivates increased demand for those products or ideas".[169] According to Hurt (2004), underwriters operate as reputational intermediaries and control a "necessary demand network of brokers, analysts and institutional investors".[170] In other words, underwriters have a big base of their repeat clients who become the main buyers of the issue. The added value of the underwriter arises also from its syndicate structure which allows for a wider reach for institutional investors, ensures the participation of more analysts and market makers. For example, Corwin and Schultz (2005) report that the more co-managers there are in the syndicate the more analyst coverage and market makers are following the IPO. Each additional co-manager results in one additional market maker for the offering and 0.8 additional research analyst.[171]

By creating a demand network the underwriter manages to increase the demand for securities which is reflected in the increase of the base market price. It is hypothesized that while issuers have to pay the underwriter for services provided in creating of the demand network they are still better-off than if they had proceeded without the underwriter.[172]

2.2. Impact of the imposition of liability

What would the imposition of liability mean in the context of the sale intermediation function? It can be hypothesized that under the assumption that it is more difficult to launch a collective action than an individual one, the underwriter may face incentives to

[169] Hurt, "Initial Public Offerings and the Failed Promise of Disintermediation," pg.709.

[170] Ibid., pg. 723.

[171] Corwin and Schultz, "The Role of IPO Underwriting Syndicates."

[172] Christine Hurt, "Initial Public Offerings and the Failed Promise of Disintermediation," *Entrepreneurial Business Law Journal* 2 (2008 2007): 703.

inefficiently alter the optimal shareholding structure. The story goes that seeking to protect itself from potential claims the underwriter might be interested to place securities with investors who are less likely to file a suit or to a highly dispersed shareholder base.

However, this theory does not stand criticism. First of all, underwriters also face very strong counterweighing incentives to place securities in solid blocks to institutional investors than to individual ones. It is easier for the underwriter to sell the securities in larger blocks. Secondly, institutional holdings do not always result in a higher probability of enforcement. Cox and Thomas (2005) argue that due to the particularities of institutional markets and uncertainties about the legal duties of the managers of large institutional investors, institutional investors often will not initiate the cases or will not collect their settlement even in cases it is due.[173] Therefore, placing securities in large blocks with institutional investors may not exacerbate the underwriter position. Thirdly, institutional placements are also preferred by the issuer as institutions are considered to be long-term strong-hands investors. The issuer may prefer to have such ownership base as it would protect it from the short-term speculation. Fourthly, the underwriter also can use the possibility to place securities with institutional investors as an opportunity to favor its regular customers. In fact, empirical findings confirm that the biggest part of securities is allocated to the institutional investors.[174] Therefore, on balance, the imposition of gatekeeper liability should not affect the performance of underwriter sale intermediation function.

[173] See James D Cox and Randall S Thomas, "Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions," *Washington University Law Quarterly* 80 (2002): 855; Cox and Thomas, "Letting Billions Slip through Your Fingers."

[174] Aggarwal, "Allocation of Initial Public Offerings and Flipping Activity."

3. PRICE DISCOVERY (BOOKBUILDING) BY UNDERWRITERS

3.1. Underlying problem

Another well-cited function of the underwriter results from the need to resolve the problem of extraction of information from informed investors. By doing this the underwriter contributes to the accurate price formation.

As first suggested by Rock (1986), besides the asymmetry of information on the issuer's side there is also another informational asymmetry on informed investors' side. Investors in securities markets can be divided into informed and uninformed investors (or involved or uninvolved). Informed investors are market participants of economic theory. They are fully informed and are active participants in financial markets who manage portfolios of securities. Institutional investors seem to come close to such definition and thus fall into this group. The second group is formed by uninformed retail investors who are making decisions with limited information both on the nature of financial claims and the information on fair value of securities.

Informed investors know more than the issuer and the underwriter about the prospects of issuer's competitors, economic conditions in general, trends on financial markets etc. Moreover, informed investors know their own demand for issuer's securities. To illustrate this, imagine the institutional investor who has a long experience at valuing companies at a certain sector. Their skills cannot be easily acquired; therefore, their views will be very informative about the expected value of the securities.

The disclosure of information by informed investors would contribute to the formation of the more accurate securities' price. In contrast to the issuer who is interested in the disclosure of information in order to separate itself from the low quality companies but cannot accomplish this, informed investors face no incentives whatsoever to disclose the information in their possession because such information can be used to their disadvantage. This can be especially problematic if the information is costly to acquire and the information, if revealed, would lead to a revision of the issue price.[175] Therefore, in order to improve the accuracy of the offering price it is desirable to extract this information from investors.

[175] Jenkinson and Ljungqvist, *Going public*, pg. 15.

Additionally, the informational asymmetries on the side of informed investors may create opportunities for the opportunistic behavior of informed investors. This effect is discussed by Rock (1986) who argues that whenever informed investors know that the offer is underpriced they submit more orders for securities, therefore, uninformed investors buy on average more of overpriced securities than underpriced ones. As a result, uniformed investors are always worse-off than informed investors and they always make a negative profit while participating in distribution markets. If this was to happen, uninformed investors would gradually leave the market.[176]

Underwriters are seen as a necessary element to efficiently extract the demand and other market information from informed investors. Benveniste and Spindt (1989) state that underwriters use the bookbuilding method as a tool to communicate the information from investors to the issuer. Three main characteristics of the bookbuilding process – soliciting of non-binding bids, discretion in pricing and freedom of allocation help the underwriter to extract the information efficiently. Solicitation of bids allows the centralized collection of information. Underpricing allows compensating the investors for revealing positive information. The amount of compensation depends on how much investors may expect to profit by hiding the information. Clearly, this depends directly on the extent to which withholding positive information results in a lower expected offer price. On the other hand, an investor has fewer incentives to bid low for an issue they value highly if doing so

[176] Kevin Rock, "Why New Issues are Underpriced?," *Journal of Financial Economics* 15, no. 1-2 (January): 187-212. It is assumed that the participation of the retail investors in the primary markets is desirable. In further discussion I will follow this assumption as its challenging is out of the scope of this work. However, it should be noted that the issue is not so straightforward. The participation of the uninformed retail investors can only be valuable if, on the one hand, they serve as a source of financing which cannot be provided by the informed institutional investors and, on the other hand, if the retail investors themselves benefit most from the direct investment in primary market (best combination of risk and return). Single stock or debt offerings are quite risky investments. Given that the retail investors are often much more risk averse than the institutional investors and that they usually do not have skills and capital to properly manage the risks they undertake, it might be more economically efficient for them not to directly invest in securities. Moreover, their participation is not particularly useful because they cannot provide any additional information required for the price formation. The answer to the both conditions depends on the actual structure of the demand side. In the USA it is likely that the structure of demand made the problem virtually non-existent in a sense that there are simply no retail investors to take advantage from. According to Allen and Santomero (1997), the data shows that capital markets are heavily institutionalized while the demand by the individuals has decreased significantly over the years (from 85% in the mid-1960s to around 50% in mid-1990s). The institutional investors seem to provide sufficient capital to satisfy the financing needs of the corporations. At the same time the rise of such financial intermediaries as, for example, mutual and hedge funds, was widely observed. They provide the retail investors with the opportunities to participate in the capital markets indirectly and at the same time lower the risks associated with the participation both by providing the diversification opportunities and investment management skills unavailable to individual investors. In the USA there was a significant decline of the retail ownership. Franklin Allen and Anthony M. Santomero, "The Theory of Financial Intermediation," *Journal of Banking & Finance* 21, no. 11-12 (December 1997): pg. 1467-1468.

jeopardizes their allocations.[177] Allocative discretion permits favoring investors who disclose information and punishing those who withhold it. If the investor provides negative information – it is allocated no or only few securities. This mitigates the incentives to misrepresent positive information. If investors provide positive information they are allocated with high number of securities. The allocative discretion ensures that investors are never better-off claiming bad news when the news is, in fact, good.

The participation of the underwriter in the bookbuilding is important not only because they have the unique expertise in these matters which would lower issuer's costs. In principle, the collection of information, underpricing and allocation are also possible without the participation of the underwriter. The main added value of the underwriter is derived from their ability to reduce the underpricing by selling securities repeatedly to the same regular investors. The repeated interaction enables the underwriter to obtain bargaining power because it is in a position to threaten to reduce the investor's allocation priority in the future in case they do not disclose information. Therefore, the underwriter can use the bookbuilding as a mechanism to extract information and both carrot (underpricing) and stick (allocative discretion) to ensure that such extraction is efficient. In contrast, the issuer does not have possibilities to threaten investors with the exclusion from distributions in the future as it is not a repeat player and can use only the underpricing to compensate investors. Both the issuer and the underwriter have to underprice. Differently from the issuer – the underwriter has to underprice less.

Moreover, the efficiency of bookbuilding is also explained taking into account the syndicate structure of the underwriting. Different underwriters participating in the offering have different clienteles both as regards industry specialization and geographical distribution. Members of the underwriting certificate communicate with each other on a regular basis which allows the steady exchange of information. This permits to draw a more complete picture of the investors' demand for the offering.[178]

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177 Benveniste and Spindt, "How Investment Bankers Determine the Offer Price and Allocation of New Issues," pg. 344.

178 Corwin and Schultz (2005) also find empirical evidence of the information production by syndicate's members. Based on the data from 1600 American IPOs from 1997 to 2002, they find that in the IPOs underwritten by the large syndicates the offer price is revised based on the new information more often than in the small syndicates. They interpret it as syndicate members producing useful information and transferring it to the lead underwriter. Corwin and Schultz, "The Role of IPO Underwriting Syndicates."

Empirical literature appears to largely confirm the Benveniste and Spindt (1989) theory of bookbuilding.[179] It is also widely accepted by financial economists and "has arguably become the dominant theoretical paradigm in the IPO literature".[180]

Despite the overall value of bookbuilding as a method ensuring the efficient extraction of information, there is also a threat that the underwriter will use its discretion to favor its own interests. For instance, Hurt (2004) goes as far as calling the bookbuilding mechanism "root cause of the abuses in the IPO process" and the "pump-and-dump" scheme which allows "insiders and underwriters hype a company's stock and create an illusion of high demand, then sell their securities once the public has accepted the hype and bought the stock".[181] She further states that "each step in the IPO process, when performed by industry players acting in their self-interest, creates an ingenious method to extract wealth from the retail investor. Because industry custom and practices combine together to restrict supply and generate demand, IPO share prices may increase substantially, allowing both issuer insiders and industry insiders to sell early and realize profit. However, the average IPO stock will then see a dramatic decrease, leaving the retail investors with built-in losses".[182]

The first aspect is the underwriter discretion in the setting of the offering price. As discussed before, underwriters can have incentives to overprice the offering. Incentives to do so arise from the structure of the underwriting fee, *i.e.* its proportionality to the

[179] The most direct tests were performed by Cornelli and Goldreich (2001), Cornelli and Goldreich (2003) and Jenkinson and Jones (2004). These studies analyze proprietary datasets of two investment banks which contain information on bids from institutional investors as well as how the securities were allocated. Cornelli and Goldreich (2001) and Cornelli and Goldreich (2003) find support for the information production hypothesis. In contrast, Jenkinson and Jones (2004) results cast doubt upon the extent of information production during the bookbuilding period. However, Ljungqvist (2004) explains differences between the two papers not as contradicting each other but simply as a result of different characteristics of the examined underwriter.

The information extraction theory was also tested using indirect data, *i.e.* aggregate allocation to institutional and retail investors. Hanley and Wilhelm (1995) and Aggarwal, Prabhala, and Puri (2002) find that institutions are favored over retail investors. Institutional allocations are larger the more the offer price exceeds the midpoint of the indicative filing range established at the beginning of bookbuilding. Positive price revisions presumably follow when informed investors reveal positive information, and this is precisely when the underwriter needs to reward investors with favorable allocations.

[180] Tim Jenkinson and Howard Jones, "IPO Pricing and Allocation: A Survey of the Views of Institutional Investors," *Review of Financial Studies* 22, no. 4 (April 1, 2009): pg. 1480.

[181] Christine Hurt, "Moral Hazard and the Initial Public Offering," *Cardozo Law Review* 25 (Winter 2004): pg. 716.

[182] Ibid., pg. 717.

proceeds collected from investors. They can also be related to side-payments by the issuer. The pricing discretion associated with the bookbuilding facilitates the underwriter possibilities to overprice when setting the price. The underwriter is usually not required to disclose neither its pricing methodology nor demand information received from informed investors. Therefore, it can potentially offer any price. However, the pricing discretion should be seen not as an additional incentive for the underwriter to engage in securities fraud. It should rather be considered as a tool which makes the sale of mispriced securities possible. In relation with the imposition of gatekeeping duty and the liability, the pricing discretion may be seen as an additional argument which confirms that the problem of fraud in distribution markets is very serious and requires to be addressed.

The underwriter also has a freedom to underprice the issue. As it was discussed, some level of underpricing is efficient as the underpricing allows the efficient extraction of information. However, the discretion enables the underwriter to underprice more than it is efficient. But why would the underwriter be interested in doing this especially given that he is economically interested in setting price high as the underwriting fee is directly proportional to the proceeds?

3.2. Impact of the imposition of liability

Underwriter liability is significant both in respect to the possibility of overpricing and underpricing. On the one hand, the threat that the underwriter can illegally overprice the issue (*i.e.* by manipulating the information) provides an additional argument for the imposition of liability. In this context, the liability will, at least to some extent, restrain the underwriter from overpricing because it will have to disclose all the information to substantiate the suggested price. The threat of liability should motivate the underwriter to actively seek to obtain as much information as possible from institutional investors. Underwriters would be interested to extract such information in order to ascertain themselves that their estimation about the value of company is correct. The information from institutional investors may reveal certain facts which underwriters did not manage to uncover by making the direct examination of the company. This would allow the underwriter to protect itself from the liability either by adjusting its initial pricing or demanding the disclosure of the relevant information from the issuer.

On the other hand, the imposition of gatekeeper liability may also provide incentives to excessively underprice the securities. In contrast to the information extraction theory which considers underpricing as a costly but efficient way to mitigate market failures, the lawsuit avoidance theory sees the underpricing as a tool which maximizes underwriters' profits. The set of theories by Tiniç (1988) and Hughes and Thakor (1992) postulates that by underpricing, companies and their underwriters insure themselves from potential liability claims.[183] These theories are especially prominent in the USA environment where the threat of litigation is considered to be rather high. Additionally, lawsuits are also associated with reputational damage. Thus, underwriters have strong incentives to protect against possible monetary and reputational losses. To do this underwriters lower the offering price. However, by decreasing the price the underwriter also decreases proceeds of the offering which affects its fees (the underwriters' compensation comes in the form of a percentage amount of the proceeds). The role of the underwriter is, thus, to set the level of the underpricing which would provide the efficient insurance from liability taking into account the trade-off between the minimization of the probability of litigation and maximization of the offering proceeds.

The impact of gatekeeper liability on increasing the level of underpricing can also be achieved indirectly. Gatekeeper liability might have a chilling effect on positive disclosure and motivate the extensive disclosure of the risk factors. The quantity of disclosure has a direct influence on the level of underpricing: the less disclosure, the bigger informational

[183] See PJ Hughes and AV Thakor, "Litigation Risk, Intermediation, and the Underpricing of Initial Public Offerings," *Review of Financial Studies* 5, no. 4 (October 1, 1992): 709 -742; Tiniç, "Anatomy of Initial Public Offerings of Common Stock." It should be noted that besides the two described underpricing theories there are many others. Most of the theories find some empirical support. This led the leading scholars in this field to conclude that the underpricing cannot be fully explained just by one single theory but is affected by the number of factors. Several examples of other explanations for the underpricing are as follows. According to the price stabilization model (Schultz and Zaman (1994)) the underwriter underprices in order to limit investors' possibilities and incentives to renege their bids for securities. According to the USA law, investors have the right to refuse to buy securities within five trading days after the issue opens. They would exercise the right to do so if they expect the price of securities to fall down. To mitigate this incentive, the underwriter commits to keep the price from falling by using one of stabilization techniques and by setting the IPO price low. The trading volume model (Boehmer and Fishe (2001)) explains the underpricing by the underwriter goal to ensure active aftermarket trading. Low IPO price attracts low valuation investors, who flip securities to high-valuation investors who are rationed during the IPO. The underwriter gains from the flipping activity because it often acts as a market maker in the security and it gains extra trading profit on such transactions. A number of principal-agent models (Loughran and Ritter (2004), Hurt (2004), (Griffith (2003)) go even further by seeing the underpricing as an instrument to favor interests of the small group of IPO investors. According to Loughran and Ritter (2003) the underpricing benefits investors who can promise to make unrelated side-payment to the underwriter in return of setting the low price. Therefore, by using its pricing and allocative discretion the underwriter colludes with investors. Hurt (2004) advocates the same explanation and notes that the issuer might agree to such practices due to 1) own moral hazard – opportunity to offer the IPO securities to family, relative and friends; 2) non-competitive structure of the underwriting industry and uniform fee structure.

asymmetry and the higher is the level of underpricing. Therefore, by limiting the positive disclosure and encouraging the negative disclosure, the imposition of liability may lead to the increase of the level of underpricing.[184]

The underpricing is, in its essence, the redistribution of wealth. In the information extraction theory such redistribution is efficient because it serves a goal of extracting information from informed investors. In the lawsuit avoidance theory redistribution favours the underwriter and can affect the functioning of the mechanisms which provide the enforcement mechanism for the underwriter gatekeeping function. Thus, if the lawsuit avoidance theory is correct and the issuer does not achieve any gain from the underpricing (*i.e.* it does not benefit from the extraction of information), it will be reluctant to sell its securities. Thus, the underpricing or its excessive levels can prevent a number of mutually beneficial exchanges in the securities market. This is a social loss and therefore excessive levels of underpricing cannot be socially desirable. Therefore, by increasing the level of underpricing the imposition of liability can have a negative impact on securities offerings.

Lowry and Shu (2002) test the lawsuit avoidance theories in the US and find partial support, *i.e.* they establish that potential litigation might be one of the factors which determine the extent of underpricing.[185] However, Ritter and Welch (2002) object to this explanation. They claim that the underpricing is a too expensive insurance unless very large liability damages are expected.[186] Keloharju (1993) shows that the underpricing exists also in the markets where the risk of securities litigation is truly negligent. He states that in these countries the underpricing is not related to liability.[187]

Non-American findings, however, do not deny the predictions of the lawsuit avoidance theory. Outside the USA the liability does not have an impact on the level of underpricing exactly because the liability regimes are not effective and the threat of liability is negligent.

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[184] James C. Spindler, "IPO Underpricing, Disclosure, and Litigation Risk," *University of Southern California Law School Law and Economics Working Paper Series*, no. 94 (2009), http://law.bepress.com/usclwps/lewps/art94.

[185] Michelle Lowry and Susan Shu, "Litigation Risk and IPO Underpricing," *Journal of Financial Economics* 65, no. 3 (September 2002): 309-335.

[186] Jay R. Ritter and Ivo Welch, "A Review of IPO Activity, Pricing, and Allocations," *The Journal of Finance* 57, no. 4 (August 2002): pg. 1807.

[187] Matti Keloharju, "The Winner's Curse, Legal Liability, and the Long-run Price Performance of Initial Public Offerings in Finland," *Journal of Financial Economics* 34, no. 2 (October 1993): 251-277.

Consequently, we cannot completely disregard the possible impact of the liability on the level of underpricing.

4. UNDERWRITING FUNCTION OF UNDERWRITERS

4.1. Underlying problem

Economic rationale of the underwriter underwriting function consists in sharing of the proceeds risk between the issuer and the underwriter. Issuers face significant uncertainties when entering the securities market. The company faces the proceeds risk, *i.e.* the risk that it will not be able to collect as many funds as it has projected.[188] If this risk materializes the company can suffer costs in a form of sunk costs, the higher cost of capital and the loss of reputation. Therefore, the company would be better-off if it could overcome such risks at a reasonable cost. The uncertainty about the investors' demand and its prospects to raise sufficient sums may prevent the issuer's attempts to enter public markets. As a result, socially beneficial projects can be abandoned resulting in the loss of social welfare.

To share the proceeds risk with the issuer the underwriter can agree to underwrite the issue on the firm-commitment or stand-by basis. In the former case the underwriter buys the whole issue from the issuer and later resells it to investors. In the latter, the underwriter stands ready to buy any residual securities. In Chapter II it was discussed that such risk-taking cannot serve as a credible signal of the issuer's quality because the underwriter manages to protect itself from any economic consequences of being left with the "sticky" issue and negative price moves. It achieves this result by securing the easy exit from the contractual relationship with the issuer, using the bookbuilding method and agreeing on the green-shoe option.

Underwriter ability to reduce its exposure to the risks has led several authors to question the importance of underwriter proceeds risk-sharing function.[189] In author's opinion, the risk managing methods used by the underwriter, however, do not change the importance of the proceeds risk from the perspective of the issuer. The issuer is still worried about the amount of capital it will receive and attaches a value to the certainty. The underwriter ability to manage these risks does not deny the importance of the protection from the

[188] For further discussion of proceeds risk see Sections 2.6 and 3.3 of Chapter I

[189] See, for example, Gilson and Kraakman, "The Mechanisms of Market Efficiency."

proceeds risk for the issuer. It only suggests that the underwriter can indeed act as an efficient proceeds risk-bearer. In the absence of the underwriter the company would not be able (or, in the other words, it would be too expensive) to employ the risk-management techniques which are only available to the specialized underwriter. Therefore, the underwriting function of the underwriter is still highly relevant.

4.2. Impact of imposition of liability

Within the context the imposition of gatekeeper liability the underwriting function suggests the following relationships. First of all, the fact that the underwriter eliminates the risk taken from the issuer means that the risk-taking of underwriting cannot provide the underwriter with incentives to monitor and therefore cannot serve as a credible signal of the issuer's quality. As the monitoring incentives are equally low in both firm-commitment and best-effort underwriting, however, in both cases the underwriter provides the advisory function, there is the same need for the liability to reinforce them. Hence, there is no reason to distinguish between the underwriting types in the context of the liability. It would seem that gatekeeping abilities would not differ dependent on the type of underwriting used.[190] As it was discussed in Section 1.2 of this Chapter, the more important is the

[190] However, there is a concern that underwriters are not able to perform proper examination of the issuer in SEO's. SEO's are the subsequent offerings of the securities by already listed public companies. The main difference with the IPOs is the amount of information available about such companies to the market. First of all, they have disclosed extensive information in their IPO registration statement. Further they are subject to the periodic and ad hoc disclosure requirements. Therefore, they are much less opaque than the IPO companies. Taking into account these factors, the securities laws introduced the expedited and less burdensome disclosure requirements for the SEO's. The most illustrative example is the US regulation. In the 1980s the SEC introduced short form registration for large capitalization issuers and expanded the availability of shelf registration.

Short form registration means that the large, seasoned companies are allowed to use a special registration form for their SEOs. This exemption from the normal offering process is justified by the fact that large listed issuers already comply with the periodical disclosure requirements imposed by the Securities Exchange Act of 1934. Therefore, for new seasoned offerings they are not required to repeat this information but to incorporate it by reference. This position is justified because repetition of information serves no purpose as this information is already reflected in the securities price. Shelf registration was introduced by the Rule 415 and allows issuers to register securities but not to sell them straight away but to "put them on the shelf" and delay the offering for maximum of two years. The use of shelf registration is allowed only to issuers qualified to use short form registration. This rule was justified by the argument that the registration statement need not be current if the offering price will reflect the periodic information filed between the shelf registration and the date of real offering. This allowed large issuers to have a very quick offering and take advantage of market opportunities without excessive regulatory delays.

The main fear was that the speeding up of the process will decrease the quality of disclosure as the underwriter has no time to perform a thorough due diligence. As the short form registration allows the incorporation by reference, the underwriter participation in drafting of these documents is very limited. Moreover, the effect of shelf registration rules is that the issuer can at any point during those two years contact any of the underwriters mentioned in the registration statement, determine which underwriter will give it the best terms and offer the underwriters' actual ability to investigate the issuer. The ability to perform gatekeeping mostly depends on the underwriter advisory function.

The situation in some countries provides evidence that the problem actually exists. For example, in Australia, the definition of an underwriter comprises only firm-commitment and stand-by underwriting. Therefore, if the underwriter only provides best-efforts underwriting, it will not be considered an underwriting, and therefore will not give rise to the liability even though the underwriter might otherwise be involved in the preparation of the offering. This contradicts the statement that the liability should be imposed on the underwriter who has participated in the planning of the offering, rather than predicating liability on whether the underwriter has assumed risk.[191]

security to the market through that underwriter in a matter of hours. As a result, the chosen underwriter is deprived of even the few days in which to conduct due diligence investigation.

As a response to the problems caused by expedited procedures the academics proposed a number of solutions. For example, professor Fox (1984) proposed that the SEC should develop a plan requiring issuers to hire investment bank to participate in the preparation of the issuer's Exchange Act filings and attach the liability for the misdisclosure in such statements. However, this debate did not materialize in the legislative changes, except the confirmation that the liability for the misstatements standards apply equally to this type of offerings. As a result, the underwriter is obliged to perform due diligence in the circumstances where it has little actual possibilities to do so.

[191] Greg Golding, "The Reform of Misstatement Liability in Australia's Prospectus Laws," Dissertation, December 31, 2001, pg. 335.

5. CONCLUSIONS

Chapter III analyzed the effects of the imposition of underwriter liability on other functions performed by the underwriter. The analysis was a hypothetical and abstract exercise rather than the precise estimation of the effects in the real life. It should be valid to any liability design. Only the magnitude of the impact will change dependant on the strength of the liability threat.

The analysis allowed concluding that the imposition of the underwriter liability has the following connection with other functions of the underwriter.

As regards the advisory function of the underwriter, it was asserted that the performance of the advisory function should be considered as the main criterion to determine whether the financial intermediary can serve as a gatekeeper. This is because the participation of the underwriter in the preparatory process is exactly what enables it to collect information, provide advice and verify the content of the issuer's disclosure. Such conclusion has two immediate practical results for the design of a liability regime. First of all, it means that there is no need to distinguish between different types of underwriting (firm-commitment, stand-by and best-efforts) when deciding whether a certain financial intermediary should be subject to liability. Secondly, it suggests that there is a need to distinguish between different members of the selling group of the underwriting syndicate. Financial intermediaries that participate in the distribution but do not provide any advisory services should be exempted from the gatekeeping duty and liability. In addition, it is hypothesized that the imposition of liability on underwriters engaged in the provision of advice may lead to the increase of the quality of advisory services.

I reached two main conclusions regarding the relationship between the imposition of the gatekeeper liability and price discovery function of the underwriter. The first result is that in order to extract information about the demand for securities and the issuer from informed investors the underwriter needs to have a wide discretion as regards the pricing and allocation of securities. However, if unlimited, such discretion creates a fruitful soil for the manipulations and fraudulent activities, mostly related with overpricing of securities or opportunistic allocations. The need to allow the use of bookbuilding and related underwriter discretion and the possibility of opportunistic behavior thus provide an additional argument for the imposition of gatekeeper liability. As a result, the threat of liability will constrain the underwriter in cheating in its pricing and allocational decisions. It should also improve underwriter incentives to extract the information from informed investors as this information would provide it with the assurance that its evaluation of the issuer is correct.

The second result is that while protecting from the risk of overpricing, the imposition of gatekeeper liability may provide the underwriter with incentives to do exactly the opposite – to underprice securities in order to protect itself from liability. Such level of underpricing might be higher than is necessary for an efficient information extraction. This can hinder the efficient allocation of resources as some issuers may find such level of underpricing a too high price to pay for offering their securities to the public and thus refrain from public securities offerings.

I also concluded that taking of the proceeds risk by underwriting does not eliminate the need for imposition of liability. When the proceeds risk is transferred to the underwriter, by using risk management tools it succeeds to almost entirely eliminate this risk. Therefore, the underwriter bears no economic risk both in firm-commitment (stand-by) and best-efforts underwriting. As a result, the underwriting on the firm-commitment basis is not associated with additional monitoring efforts and thus is not related to the gatekeeping function.

PART TWO. UNDERWRITERS. THE LAW ON CIVIL LIABILITY

PREFACE

The previous Part One has described underwriting practices in great detail and built a strong theoretical background for the imposition of as gatekeeping duty on the underwriter and *ex post* legal liability as a tool to provide deterrent incentives and encourage underwriters to monitor issuer's disclosure. The discussion in the previous Chapter did not allow making strong conclusions whether private or public enforcement is a more efficient way to enforce the underwriter gatekeeping duty. However, it provided some arguments why private enforcement can and should be used as an enforcement device. At the same time it also pointed at the possible drawbacks and costs of civil liability.

The aim of this Part Two is to dig further into the subject of private enforcement of underwriter gatekeeping duty. This Part will do so by discussing real life liability regimes in four jurisdictions: the USA, the EU, the Netherlands and the UK. The choice of countries is not accidental. The USA federal regime is chosen as it is well-known as the most established and prominent example of underwriter liability. In fact, it is often claimed that other countries bear it in mind as an example when developing their securities regulation. As the author of this book is European, another natural option is to look at the situation in Europe. However, here there is a two level regulation – the harmonized EU law and national regulations by individual Member States. As will be seen, the nature of the harmonized EU law is very different from the federal USA regulation. So is the relationship between the EU law and national laws of the Member States. Therefore, there is a need to discuss both the EU regime and national regimes which differ considerably from each other. To illustrate the national EU regulation two very different but at the same time similar countries are chosen. Both the Netherlands and the UK have well-developed financial markets with similar market structure. However, from a legal perspective they are quite different: the Netherlands is the typical continental law country while the UK is a representative of the common law legal system. Overall, the chosen selection of countries should clearly illustrate that there are many options how the underwriter liability can be structured and provides a good basis for the comparative Law and Economics analysis.

Liability regimes consist of a myriad of legal rules each of which determines how the liability regime performs its deterrent function. However, focusing on all of them would be an impossible task which would run outside the scope of this book. Thus, the first Chapter of this Part Three seeks to single out the most important legal rules which determine the expected liability or, more precisely, the expected sanction and the probability of enforcement of the underwriter gatekeeping duty. It describes the regulatory options available to the lawmaker as regards five main issues: the potential parties to a dispute, the liability standard, the measure of damages, procedural rules and a broader subject of the nature of the liability rules. Hopefully, this will serve as a benchmark for the further comparative analysis and help to guide the reader through the complexities of the legal analysis.

Chapters V to VIII tackle particular legal systems going into the details of particular legal rules and their application in practice. Chapter V discusses the federal USA regulation concerning underwriter liability. It focuses on Section 11 and 12(a)(2) of the Securities Act of 1933 and Rule 10 (b) (5) adopted under the Securities Exchange Act of 1934 as well as procedural rules applicable to class actions. Chapter VI deals with the harmonized EU regulation. It mostly discusses the relevant provisions of the Prospectus Directive. The relationship between EU law and the national laws of Member States is also analyzed. Chapter VII covers the situation in the Netherlands and pays special attention to the rules of the Dutch Civil Code on unfair commercial practices and misleading advertising. Procedural rules regulating representative actions and collective settlement are also discussed. Chapter VIII is dedicated to the analysis of the British regime stressing Section 90 of the Financial Services and Markets Act of 2000 as well as the torts of misleading and fraudulent misrepresentation. From a procedural perspective, rules regulating the issuance of the Group litigation order are analyzed.

The discussion of legal systems is structured in the following way. First of all, the Chapters analyze the underwriter gatekeeping function and its enforcement mechanisms applicable for the information disclosed in a very specific document: the registration statement in the USA and its equivalent – the prospectus within the meaning of the EU Prospectus Directive. As previously noted, this document is the single most important document in the context of primary markets where underwriters have the largest possibilities to monitor the information provided by the issuer. Thus, the underwriter can be used most efficiently as a monitor of the disclosure in the prospectus. Secondly, the country Chapters analyze the underwriters' gatekeeping duty and liability in respect of misdisclosures related to the distribution in other sources of information. These include oral statements and presentations during road-shows, press releases and research reports.

In its presentation of different legal systems this Part focuses on the legal rules which were identified in Chapter IV as the most important for determining the level of deterrence. In addition, in order to evaluate the actual threat of liability it looks at whether the liability rules are mandatory or whether the underwriter is allowed to limit or disclaim its liability. Finally, for each legal system the procedural rules governing the group litigation are checked to evaluate the real possibilities of private enforcement.

The analysis leads to the following general result. Underwriters are subject to civil liability for failing to perform their gatekeeping duty in two out of three analyzed jurisdictions: the US and the Netherlands. Both the American and the Dutch underwriter liability regimes are capable of delivering remedies in cases of misstatements. However, the size of settlements as a percentage of overall damages in misstatement cases is rather low in both countries. The probability of enforcement is expected to be higher in the USA. Thus, liability is likely to be more extensive in the USA. Differences between these countries are mostly, but not exclusively, related to the procedural aspects of litigating misstatement cases. In contrast to the Netherlands and the USA, in the UK underwriters are not subject to the prospectus liability. This is mostly determined by the deficiencies of the definition of a potential defendant. In addition, Chapter VIII argues that effective enforcement in the UK would not be achieved even if the mentioned defect of the substantive law was corrected.

CHAPTER IV. THE MOST IMPORTANT ELEMENTS OF A LIABILITY REGIME

The goal of this Chapter is to provide a framework for the comparison of real life liability regimes. This goal will be achieved by singling out the most important categories of legal rules which determine the expected liability threat. Further Chapters will then analyze underwriter liability regime comparing them in each category. Among the myriad of various legal rules, the following elements can be considered to be the most crucial for the determination of the expected threat of liability.

First of all, one should look at the substantive legal rules.[192] In this domain the law defines who the parties in this legal relationship are. The law also sets what is the underwriter duty and what constitutes a violation of such a duty. This is done by stipulating the applicable liability standard. Finally, it determines what damages are compensable in such cases.

However, substantive liability rules are useless if the relevant procedural rules do not lead to optimal enforcement. As it was discussed in the previous Part One, misstatement cases are particular in that they involve highly dispersed victims which often lack incentives to pursue individual claims. In addition, misstatement cases are quite complex, technical and thus difficult to prove and litigate. This makes the procedural rules extremely important in determining the level of liability threat. Therefore, to assess the expected liability one cannot avoid talking about the procedural aspects of underwriter liability lawsuits. Procedural rules cover mechanisms for litigating cases in court and settling the case as well as issues of allocation of burdens of proof and financing of litigation.

Finally, the expected liability will highly depend on the more general question of the nature of legal rules: whether they are mandatory or what are possibilities to limit or disclaim liability. As it was discussed in Chapter II, if the liability rules are default rules or allow the limitations of liability, it is likely that the parties will agree on suboptimal liability arrangements. The following Sections describe these issues in more detail.

[192] Substantive law is the part of law that regulates rights and obligations of the parties to a legal relationship. It is contrasted to procedural law, which comprises the rules which provide the machinery for enforcing those rights and duties.

1. PARTIES TO A DISPUTE

Legal theory sees parties as the founding constituencies of any legal relationship. However, as will be shown immediately below it is not that trivial who are or who should be parties to the liability legal relationship in the context of securities underwriting. To start with, the underwriter has a primary contractual relationship not with investors but with the issuer to whom it owes contractual as well as fiduciary duties. On the other hand, there is no explicit contract between the underwriter and investors. Thus, the relationship between the underwriter and investors can mostly be derived on the basis of tort since investors are third parties to the contract between the issuer and the underwriter. Indeed, most of legal systems base the underwriter liability on the tort relationship or quasi-contractual, near contractual or special relationship. The quasi-contractual nature arises if the prospectus is treated as some sort of contract, binding the underwriter and investors. It is assumed that a special relationship exists between the intermediary and investors. As there is no clear contractual relationship where the parties to the contract are clearly named, there can be uncertainties on who are the parties to the dispute.

1.1. Potential defendants

As it has been seen in Chapter I, in the business world the term underwriting usually covers different activities. In firm-commitment underwriting, the underwriter purchases the securities from the issuer for a fixed fee and then distributes them to investors. In stand-buy underwriting, the underwriter does not buy securities *ex ante*, but instead buys *ex post* only those that it is unable to sell. On the other hand, in best-efforts underwriting, the underwriter does not purchase securities from the company but undertakes to put its best efforts to find investors and distribute them for a fee. Moreover, not all underwriters perform the same functions. Within the underwriting syndicate there is a strict division of labor. Only the lead underwriter performs all functions, including the due diligence investigation. Other members are mainly concerned with the distribution.

The question which any legal system is facing is whether all or just some of these financial intermediaries, which in practice are all named underwriters, should be considered underwriters in a legal sense and be subject to liability. Whether underwriters are explicitly included in the liability coverage or whether such inclusion is derived through the interpretation of general norms can also have an impact on how often they become subject to liability. Therefore, the discussion of any underwriter liability regime should commence from the determination of whether and which of the underwriters come under the definition of plaintiff in misstatement cases and how such definition is formulated.

It is quite intuitive that the more business functions will be considered as underwriting in a legal sense, the larger number of financial intermediaries will fall under the scope of liability and the stronger will be the liability threat. This, however, does not answer the question whether the inclusion of a certain financial intermediary is economically justified.

As regards the formulation of the definition of the underwriter, explicit mentioning of the underwriter as a possible defendant in the law will make the liability threat more real. It also brings more legal certainty and saves the costs of litigation of unclear legal standards. On the other hand, when the question whether the underwriters can become defendants is subject to interpretation, the threat of liability is diminished. At the same time, lack of a precise definition can be useful in a constantly changing business environment. Thus, the choice of formulation signifies the trade-off between the legal certainty and flexibility.

The compromise is an explicit but functional definition of an underwriter. Such definition does not explicitly point only at certain financial intermediaries, such as lead underwriters or banks, thus allowing courts to examine the role of a particular intermediary in the offering on case-by-case basis. At the same time it focuses the attention of courts on the determination whether an intermediary in question indeed performs a gatekeeping function.

1.2. Potential plaintiffs

Potentially a very wide circle of investors can be affected by misstatements in the prospectus. In case of a securities offering, misstatements will have a furthermost impact on the initial sales, *i.e.* transactions between the issuer and the primary investor. In addition, they can influence the secondary market in a number of ways.

First of all, the misdisclosure regarding the distribution will have influence on some subsequent secondary market sales of such security as long as investors will be making their investment decisions relying on the initially disclosed information. For example, investors who were not allocated with the securities during the initial allocation will buy them in the secondary market from the original investors relying on the information in official offering documents. As a result, the same misstatement will affect the pricing in both primary and secondary markets.

Secondly, disclosures associated with the offerings can have informational spill-overs to other outstanding securities on secondary markets. As an example, imagine the situation when the underwriter participates in the SEO. In this case there are already some outstanding securities of different kinds on the market. Naturally, the misdisclosure in the SEO prospectus has a primary impact on the buyers in this SEO. Nevertheless, the information related to the offering can also be relevant to other types of investors. Hence, it can affect the price of those outstanding securities. Thus, as in the first case, both primary and secondary trades are affected by the initial misdisclosure.

The problem is whether all of these potentially affected investors or just certain subgroups should be granted with a right to claim damages in misstatement cases. It is intuitive that the more kinds of investors are allowed to sue, the larger the potential sanction and the higher is the probability of a claim being filed. Therefore, the analysis of legal rules on underwriter liability should next look at the other party of the claim – who can be a plaintiff in underwriter liability cases.

2. LIABILITY STANDARD

Once it is clear who the parties to the legal relationship are, one should establish what their duties towards each other are and what will be considered as a violation of such duty which serves as a basis for the liability. This is defined by the liability standard. Two main regulatory options are available to the legislator: strict liability or negligence.

Liability is strict when a legal rule requires the underwriter to avoid a certain outcome and punishes it whenever such outcome materializes. In order to state her case the enforcer has to prove only two elements – the harm and causation. As a result, the underwriter will be held liable in all cases when the material misdisclosure occurs and this causes a price drop. There will be no creation of operational rules *ex post* but it will be totally up to underwriters to choose the monitoring options which will allow it to avoid the negative outcome. The role of courts will be limited to ascertaining that there was the violation, that it has caused the harm and imposing relevant sanctions.

Liability is based on negligence when there is some loosely defined standard of behavior, such as due care or requiring to perform reasonable investigations and the sanction is imposed in case of non-compliance with such a standard. Negligence liability with a vague liability standard provides underwriters with incentives to exert effort because by doing this they reduce the probability of misstatement and the probability that the court will find the underwriter not negligent. To state the claim the enforcer has to demonstrate the harm, causation but also the breach of the duty of due care. As a result, the underwriter will be held liable only in cases where it did not comply with a legal standard prescribing the minimum acceptable level of precaution. The duty of care is usually formulated quite vaguely using the notions of "due care", "reasonable care", "reasonable investigation", "due diligence" or other. What constitutes due care is elaborated upon by courts while adjudicating incoming cases. Therefore, in negligence-based regimes courts have in addition to the harm and causation to determine the content of the monitoring duty. Courts also have to determine whether the underwriter has implemented the optimal level of monitoring activities.

Although both regime designs can serve as a mechanism to achieve deterrence, they differ in a way they operate. Thus, the regulator has to assess which of the regimes is more suitable for misstatements cases and a broader legal system.

3. MEASURE OF DAMAGES

After having established who the parties to a legal relationship are and what are their mutual rights and duties, another important element to establish is the damages plaintiffs can claim. It will be immediately seen that investors suffer various kinds of damages. Damages in prospectus misstatements cases take form of pecuniary loss, also called pure economic loss. Damages for all investors share the common core but may also vary in individual cases. In common, all investors lose the amount equal to the difference between the purchase price and the price after the revelation of a misstatement (hereinafter – "out-of-pocket" loss).[193] Of course, in individual cases the size of such damages will vary depending on the size of holding and the purchase price. On top of this common core, investors may have suffered other individual damages. These take the form of a

[193] Note that the definition of the "out-of-pocket" used for the purpose of this book is rather specific and follows the definition proposed by Easterbrook and Fischel (1985). They state that USA courts often call the drop in price the "out-of-pocket loss" and describe it as the difference between the price paid and the price that would have been paid had all the information that should have been released been released. The definition of the "out-of-pocket" loss does not cover any other expenses and does not necesserily refer to the cash payments.

consequential loss or loss of profits (opportunity or chance). Consequential damages arise when due to the misstatement the investor misses some other profitable opportunity.[194] For example, the investor may forego some other very profitable project because, relying on the misstatement, she has decided not to invest in a certain project.

The task for the regulator is to decide the compensation of which kind of damages will be effective in reaching the goal of optimal deterrence. It has to assess whether these damages should be compensated in full. It also has to take into account the usual mechanism of misstatement cases which tend to end in a settlement.

4. PROCEDURAL RULES

Liability rules in Law and Economics are regarded as tools to provide capital market participants with incentives, namely incentives to take care. This happens because the prospect of being held liable may induce an injurer to take due care, because taking due care is cheaper than taking suboptimal care. However, problems of rational apathy and free-riding, inherent in misstatement cases, can hinder such lawsuits. As a result, the injurer would not face any expected sanction and would not be confronted with the costs it has caused. As a result, behavioral incentives which the law intends to provide would not reach the party causing the harm.

The following three aspects of procedural rules are determinative in defining the system of enforcement of underwriter liability. First of all, it should be assessed whether the underwriter liability cases are more suitable to be litigated *via* joinder procedure or some form of representative action. Secondly, it should be discussed who should be the most suitable initiator of collective cases. Thirdly, the differences between the mandatory, opt-out and opt-in collective mechanisms should be analyzed.

4.1. Cost-sharing rules

Private enforcement of underwriter gatekeeping function, independent of its design, can be seriously affected by the cost-sharing rules. There are two regulatory options. According to the "loser pays" or the British rule, the loosing party is required to compensate also the

[194] Easterbrook and Fischel, "Optimal Damages in Securities Cases," pg. 633.

winning party's expenses (in full or limited). In contrast, the American rule provides that each side to a lawsuit bears its own costs, regardless of who wins.

The rational behind the "loser pays" rule is that by making the prospective of loosing more expensive it forces the plaintiff to consider the consequences of filing a claim and prevents them from initiating meritless cases. To cite the Leuven study (2007) "the "losing party pays" principle aims to discourage weak cases, to encourage early settlements that reflect the strength of each party's case, and to enable a winning plaintiff to have the remedy, or a winning defendant to fend off the claim, without having to meet the costs generated by the losing party opposing or pressing the claim unsuccessfully".[195]

It is quite intuitive that at the same time the "loser pays" rule can also discourage some meritorious claims. If the plaintiff is responsible for paying the expensive lawyers of the corporate defendant as the "loser pays" rule provides, this can prevent many from filing a case in the first place. Parties may face considerable challenges in having sufficient funds to cover the legal costs of an action, or accepting the risk of costs of losing. Indeed, when it is required that the losing party compensates the legal costs of both parties, this can become a strong disincentive to bring a claim. Plaintiffs may refrain from filing a case simply because they are afraid to loose due to the other party's greater financial and legal resources. It is likely that under the "loser pays" rule, will spend even more in legal fees because it would serve the "combined goals of both intimidating and defeating consumers by outspending them".[196] The Leuven study concludes that "loser pays" dynamic may encourage some parties to continue to pursue, rather than settle, litigation that they hope to win on technical or non-substantive merits because they do not want to bear the existing legal costs of the other party".[197] In fact, Hodges (2008) names "the loser pays" rule as "the key impediment to further action by private entities".[198]

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[195] Jules Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings* (The Study Centre for Consumer Law – Centre for European Economic Law Katholieke Universiteit Leuven, Belgium, January 17, 2007), pg. 318.

[196] Ibid., pg. 318-319.

[197] Jules Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings* (The Study Centre for Consumer Law – Centre for European Economic Law Katholieke Universiteit Leuven, Belgium, January 17, 2007), pg. 319.

[198] Hodges, *The reform of class and representative actions in European legal systems*, pg. 47.

The American rule does exactly the opposite. It lowers the potential litigation costs of the plaintiff and therefore serves as an additional incentive to initiate cases. In fact, it can be regarded as one of the devices to overcome the problem of rational apathy.[199] At the same time, it is even blamed of being one of the reasons which causes excessive litigation as the intermediary who initiates the litigation risks nothing but its own time and resources. Thus, the intermediary may be tempted to initiate even weak and meritless cases hoping for the settlement on commercial grounds.

The conclusion which follows is that, assuming all other things equal, the American rule encourages more litigation than the “loser pays” rule. To put it in other words, independent of the chosen structure of the collective procedure whenever the “loser pays” rule is in place, it will highly undermine the functioning of this system. Therefore, in order to see the correct picture of the deterrent threat posed by certain liability system, one should pay special attention to the existing cost-sharing rules.

4.2. Types of collective proceedings

First of all, it should be assessed whether the collective litigation takes the form of joinder proceedings or representative actions. It is noted that in practice the boundaries between these two groups are somewhat blurred.[200]

a). Main features of joinder proceedings

In case of joinder proceedings several individual plaintiffs bring their individual actions before the same court and, if the claims are not filed together at the outset, at an early or a later stage of the proceedings, the different but similar actions are joined by the court. A joinder action should, however, legally still be considered as a multitude of individual lawsuits. In each of these lawsuits, plaintiffs may invoke their procedural rights and claims.[201]

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[199] Tull, *New Trends in Financing Civil Litigation in Europe*, pg. 8.

[200] Hodges, *The reform of class and representative actions in European legal systems*, pg. 2.

[201] Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings*, pg. 261-262.

Joinder proceedings are case management techniques which simply assume that individual cases have sufficient points of similarity to enable them to be managed efficiently together.[202] The case is then solved in two stages. As the first stage, the managing court decides which questions of these cases are common and can be solved collectively. As a second stage, individual issues are solved on the individual basis.

Joinder cases do not have a formal "leader" but the case joining can be usually initiated upon the request of one of the parties or by the court *ex officio*.

They are strictly opt-in procedures where victims are required to take a positive action in order to join the case. Normally this implies filing of an individual claim, although some simplified procedures for joining the case can be put in place in order to lower individual costs of initiation.[203]

b). Main features of representative proceedings

In contrast, in representative actions the exactly defined category of persons brings an action to enforce their individual claims together, in one procedure, in accordance with specific rules designed for such purpose. Representative mechanisms allow one party to file a case on behalf of the whole group of similarly situated victims. In this case it is assumed that all cases are identical and are resolved as one common case.

Representative actions can be initiated by one or several individual investors who act as so-called lead plaintiffs. However, in reality these cases are usually led not by individual investors but rather by lawyers or other intermediaries. Alternatively, rules can grant a right to file a claim to a specialized association, organization or public body.

Representative actions can be opt-in or opt-out. An opt-in system requires victims to explicitly express their wishes to take part in a collective litigation. Usually, opt-in systems require some activity on the side of victims who have to inform themselves about the consequences of opting-in, to fill in some forms and participate in financing of the litigation.[204] The second form is an opt-out system which requires victims to become active

[202] Hodges, *The reform of class and representative actions in European legal systems*, pg. 86.

[203] Ibid., pg. 126.

[204] Sonja Keske, *Group Litigation in European Competition Law* ([S.l.]: Intersentia, 2010), pg. 53.

only if they do not wish to participate in litigation. It should be noted that even in an opt-out system victims need to take action to participate in the distribution of settlement.

c). Other types of collective proceedings

Formal collective procedures are not the only way to bundle individual cases together. This can also be achieved *via* contractual arrangements for assignment of claims or by providing a mandate to a third party to litigate a case on investors' behalf. However, these procedures do not follow specific rules and are also treated as a pool of individual cases.

d). Comparison of collective proceedings

As regards the intensity of enforcement it is quite intuitive that representative actions, even opt-in, will lead to a higher liability threat than joinder proceedings. This is because individual participation costs in a joinder proceeding are higher than in any representative action. In a joinder proceeding individual victims have to exert significant effort to file a case and further resolve individual issues. In contrast, in representative proceedings the need for all injured investors to carry out the procedures themselves is avoided. In representative opt-in action investors simply need to express their will to join and do not need to file an individual claim. In representative opt-out actions investors are not required to take any action at all (except for in the stage of allocation of the settlement). Therefore, joinder proceedings are likely to lead to a lower rate of participation of individual investors and thus guarantee a lower liability threat than representative actions.

This is, however, not the only difference between joinder and representative mechanisms. In addition, traditional legal scholars present the trade-off between choosing representative actions over joinder proceedings as the compromise between the respect of individual rights and the efficient resolution of numerous cases.[205] In economic terms this trade-off can be framed rather as a compromise between the possibility of errors, mostly errors of compensating meritless individual cases, and the cost-efficiency of managing similar cases together. This reasoning goes back to Posner (1973) who argued that the function of procedural rules is to minimize the sum of error costs and enforcement or direct costs. Error costs are the social costs generated when a judicial system fails to carry out the

[205] Hodges, *The reform of class and representative actions in European legal systems*, pg. 88.

allocative or other social functions assigned to it. Direct costs are costs of operating the legal dispute-resolution machinery, including lawyers', judges', and litigants' time.[206]

Joinder proceedings can be claimed to result in a fewer errors than representative actions because they allow separating common issues from individual ones. It is claimed that "there may be situations in which all individual claims are identical <…>. However, history shows that such situations can be rare".[207] On the other hand, representative actions may automatically include also the cases where individual issues differ to such an extent as to make the common decision inappropriate. Therefore, in choosing between joinder proceedings *vs* representative actions there is always a trade-off between the possibilities of making errors and the efficiency of managing cases.

The choice will be mostly determined by the nature of the cases in question. If a certain category of cases is more likely to contain identical cases, then representative actions can be more desirable than joinder proceedings and *vice versa*. This also means that there might be no "one-size-fits-all" in the choice between joinder and representative proceedings. In other words "the principal issue in designing an aggregation system is to be able to identify the situations in which a single determination might be more appropriate than proceeding individually".[208]

In addition, a Leuven study (2007) noted that representative actions have an advantage over joinder action because they can "offer companies an opportunity to achieve early finality because, if the collective action mechanism is coupled with some element of *res judicata*, then all potential claims about the same issue will be settled at once and the company can move forward with a clean slate. Additionally, it is likely that there will be a lower cost for the company in being able to litigate an issue once, rather than having to repeatedly litigate it many times".[209]

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[206] Richard A. Posner, "An Economic Approach to Legal Procedure and Judicial Administration," *The Journal of Legal Studies* 2, no. 2 (June 1, 1973): pg. 400.

[207] Hodges, *The reform of class and representative actions in European legal systems*, pg. 88.

[208] Ibid., pg. 118.

[209] Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings*, pg. 265.

4.3. Choice of initiator of the claim

A right to initiate collective actions can be granted either to any member of the class of injured investors or to some organization. However, the nature of an enforcer in itself does not allow making any judgments about the possible liability threat. The liability threat will depend on a complex of additional rules, such as rules on compensation, which will determine the incentives of a particular actor.

a). Initiation by any member of the class

In the first model a right to file a claim is granted to one or several individual investors. In practice, these cases are led by lawyers or other third-party funders (hereinafter – intermediaries).

Aggregation of claims through a representative action creates high stakes for litigants. Such high stakes attract intermediaries to initiate cases on behalf of harmed investors. The strength of the incentive to initiate collective misstatement cases will directly depend on how much the compensation of the intermediary depends on the outcome of the case.

Incentives of an intermediary and investors can be aligned in different ways. The mostly cited instrument is the contingency fee. The contingency fee is a contract between investors and the lawyer by which the parties agree that the lawyer receives as a fee an agreed percentage of the recovery but gets nothing in case of failure. However, one should not forget that a contingent or conditional or success fee under which the lawyer is paid on hourly basis and is offered a success bonus in case the client wins the case, can also serve the interest-aligning function. Naturally the contingency fee will provide lawyers with greater incentives to bring cases than contingent or simple hourly fees.

The problem with the contingency fee is that only some legal systems allow such compensation arrangement for lawyers.[210] This prohibition, however, does not affect other intermediaries. Therefore, for other third-party funders the same function can be performed

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[210] The rationale for such prohibition is that lawyers "can only maintain their independence and can only serve justice if their private interests are not in any way affected by the outcome of the case". In more detail, this means that a contingency fee can cause a conflict of interest between the lawyer and his client. Lawyers will accept a settlement sooner and for lower amounts. By doing this they can save costs and encourage the defendant to accept the settlement offer. It can also stimulate frivolous litigation. However, *Faure et al* in Mark Tull, *New Trends in Financing Civil Litigation in Europe: A Legal, Empirical, and Economic Analysis* (Edward Elgar Pub, 2011). also cite authoritative sources rebutting these arguments.

by some form of "profit" sharing arrangements when the third party receives a part of the damages.

Therefore, any collective litigation system which provides a right to file a claim on behalf of the whole group to any member of such group and does not prohibit tying the compensation of the representative of the group with the success of the case, can give rise to a class of professional intermediaries. In other words, if there is a potential for the intermediary to make a profit as a result of litigation, lawyers or other intermediaries will behave in "normal and predictable ways in a capitalist economy"[211] and will seek to maximize their income by initiating misstatement cases on behalf of harmed investors.

At the first glance it would seem that aligning economic incentives of intermediaries with those of investors should encourage intermediaries to work for the benefit of their principal as the intermediary only benefits if it is providing equal or greater benefit to the group. However, the concern often raised in the literature is that intermediaries will abuse their position.

First of all, the profit incentive can encourage intermediaries to bring also unmeritous cases or strike suits hoping for "blackmail" settlements. Intermediaries are repeat players who can afford to invest in a case of low merit either because they are rich or because they can hedge by holding a portfolio of cases or spreading risk with others. Therefore, enlisting intermediaries as enforcement agents may lead to high error costs and thus can be inefficient.

Secondly, there is a concern that settlement amounts even in strong cases will be very low. It is claimed that private intermediaries are not interested in demanding high compensation for their clients for two main reasons. First of all, they are rather risk-averse. Once they invested their time and resources in the case, they have a lot at stake in case of failure. Therefore, they would choose a smaller but certain settlement over the higher but more risky one. Secondly, there is a threat that they can collude with the underwriter for low settlement in return of higher fees. To cite Coffee (1983) "the parties can find a variety of means by which to trade low settlement for a high attorney fee, once the clients becomes only a distant bystander".[212]

[211] Hodges, *The reform of class and representative actions in European legal systems*, pg. 148.

[212] John C. Jr Coffee, "Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working," *Maryland Law Review* 42 (1983): pg. 230-232.

Thirdly, there is a concern that private intermediaries will charge excessive fees for their services. This argument is, however, very weak if they operate in a competitive market without considerable barriers to entry.

Therefore, risks associated with intermediary-led litigation may call for additional rules to control the potential for abuse related to the excessive costs of intermediaries, cases that involve a high proportion of unmeritorious cases and “blackmail settlements”. According to Hodges (2008) “in a system in which intermediaries operate, they will seek to maximize rent-seeking – and under the theory that they operate as “private attorneys general” are encouraged to do so – and it can be difficult to impose effective controls under which costs remain proportionate”.

b). Initiation by a representative organization

In the second model a right to file a claim is granted to a private or semi-private association, organization or public body. These types of mechanisms can further be classified in private and public models. In a public model a right to initiate proceedings on behalf of victims is granted to the public authority. In this case the public body’s incentives to launch enforcement actions on behalf of investors are the same as discussed in Section 4.2 of Chapter II. On the one hand, the public authority should be motivated by the social efficiency maximization goal. Thus, such form of enforcement will not lead to the excesses which are often associated with rent-seeking behavior typical to cases initiated by the private intermediary. On the other hand, it has weak incentives to pursue underwriters’ liability cases as its incentives are not completely aligned with outcomes of cases and because of the possible lack of political will.

In a private model a right to file a claim is granted to private representative associations or organizations. If the right of standing is provided only to certain established organizations, the system gets closer to the public model. In this case these organizations are simply delegated with enforcement tasks of public authorities. The limitation of enforcement powers to a small group of permanent organizations is aimed “to prevent arbitrary and inappropriate action and to promote consistent and balanced enforcement policy”.[213] However, incentives of such a representative organization may be somewhat different from

[213] Hodges, *The reform of class and representative actions in European legal systems*, pg. 46.

incentives of a public authority. While state authorities are financed only by the governmental funding, private representative organizations can collect fees from their members. If their activities are publicized, successful cases will attract new members with their membership fees. Therefore, representative organizations have some incentives to initiate misstatement cases. Nevertheless, one cannot really compare these incentives to incentives provided by the direct alignment of interest through profit-sharing arrangements.

The situation changes completely if the right of initiation is granted also to *ad hoc* associations, the system starts to resemble the intermediary-led litigation. *Ad hoc* association can be established by intermediaries as a mean to obtain a right of standing and put a "profit" sharing arrangement in place.

Therefore, it can be concluded that it is crucial what kind of representative organizations is allowed to represent the collective interest of a group of investors. If only certain organizations can do this, then the system will closely resemble public enforcement and the potential for abuse will be low. At the same time, incentives of such parties are rather limited. The smaller is the circle of organizations which are allowed to initiate cases on behalf of investors, the more is the scope of abuse and the higher is the probability of enforcement.

4.4. Opt-in and opt-out

The basic intuition is that the adoption of an opt-in collective procedure where there was previously none increases the liability threat. On the other hand, an opt-in rule will still impose some entrance costs. The efficiency of opt-in will thus depend on individual stakes. If stakes are low, then investors will not bother to spend the costs to opt-in. In this case, the opt-in rule can discourage some genuine claimants from joining the case. If stakes are high, the opt-in regime is likely to ensure high rates of participation. This also means that an opt-in arrangement is mostly suitable in cases where individual stakes are rather high. Following the same logic, an opt-out regime will be mostly suitable when there are many low value claims.

In addition, investors do not always behave rationally, *i.e.* make choices that maximize their own welfare. Research has found that even if it is economically rational for plaintiffs to participate in litigation, more people tend to participate if the default is that they are automatically included rather than if they are not. Therefore, it would follow that in order to increase the level of participation the opt-out would be a more suitable regime. As the Leuven study (2007) puts it "an opt-out regime is also considered to better fulfill the deterrent function of law".[214]

Another aspect in the opt-in *vs* opt-out debate is the trade-off is between the considerations of cost-efficiency and error costs. Hodges (2008) notes that also in this case "a key question is whether it can reliably be assumed that all cases are essentially the same and that judicial economy can be gained, or that the cases contain some similarities that might be resolved in some efficient manner, but they cannot be resolved without dealing with significant individual issues".[215]

Error costs can arise *via* another channel, *i.e.* as a result of "blackmail" settlements. Opt-out can lead to a large number of claims being asserted that all have insufficient merits, but because of their size force defendants to pay since this is cheaper on a commercial basis. Therefore, the opt-out mechanism is likely to lead to a larger number of baseless settlements.

There can be mechanisms to counterbalance this abuse, such as a strong control over cases by judges at the certification stage, court's approval of the settlement and intermediary's compensation. The effectiveness of some of these is, however, doubted.[216]

It also should be noted that any opt-out regime ultimately also involves an opt-in procedure at the time of identifying the individual share of damages and participation in the settlement. It is observed, that if the individual loss is small, many may choose not to collect their share of compensation. However, from the deterrence perspective this is not a problem as long as damages are paid by the underwriter (even if they remain in escrow or are donated to some charity or representative organization).

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[214] Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings*, pg. 290.

[215] Hodges, *The reform of class and representative actions in European legal systems*, pg. 121.

[216] Ibid., pg. 119. It is argued that a certification stage con only impose a low threshold of merit, amounting effectively to whether there appears at that stage to be plausibly arguable case, and the result is that certification of a large opt-out class inevitably imposes considerable pressure on defendants to reach settlement on economic grounds.

In addition, Hodges (2008) correctly notes that the opt-out system is only compatible with legal systems which do not have a "loser pays" rule because it would go against the principle that one cannot force individuals to pay legal costs in which they have not had relevant information and agreed to be bound. However, if the funding of the case is provided by the initiator of the case, this problem seems to disappear.

As a final note, the legal theory often raises the problem of acceptability of opt-out system on the individual rights basis. The due process and individual justice principles state that a person who desires not to litigate should not find him or herself "roped in" to a group action as a result of mere silence. In contrast, it favors opt-in as it avoids problems with the binding effect of the final decision or settlement. There is no risk that a decision is binding on a person who remains unaware that proceedings of potential interest to him or her have even begun.

However, this position can be criticized because in an opt-out collective action class members are not bound by results of the proceeding *unless* they are first given the opportunity to opt-out of the settlement. Moreover, class members are also given notice and the opportunity to intervene in proceedings to request a different settlement structure. In addition, the Leuven study (2007) also makes a very good point that "the idea that an opt-out system would prevent victims from pursuing their claims on an individual basis is rather a theoretical problem, as in many cases the vast majority of consumers would never bother to pursue their case on an individual basis".[217] Therefore, the legal argument for the opt-in system can be easily dismissed.

4.5. Burdens of proof[218]

Main burdens of proof in misstatement cases are the burden to prove the incorrectness/incompleteness and the misleading mature of information, negligence and causation.

[217] Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings*, pg. 291.

[218] Further burdens of proof will be mostly discussed together with substantive provisions rather than as a part of procedural rules. This is because in practice they are usually stipulated together with other substantive elements in a particular article or section of the law while procedural rules are consolidated in other documents. Thus, burdens of proof are rather targeted to the misstatement cases while the procedural law is usually of the general nature. However, from the legal perspective the burdens of proof should be placed under the heading of procedural law.

Incorrectness/incompleteness of information is generally a matter of fact while the misleading nature of information usually involves some value judgment of how certain information would affect an average reasonable investor.

The proof of negligence usually constitutes showing that the underwriter has not taken the required level of care or, more precisely, that it has not performed a proper due diligence investigation.

Causation is divided in transaction causation and loss causation. Transaction causation means the causal relationship between misleading information and the investment decision. It is often framed in terms of investor's reliance on information when deciding to acquire the security. Loss causation means the causal relationship between the misleading information, transaction and investor's damages.

It is also quite intuitive that some of these elements are easy to prove for investors (for example, incompleteness of information). Some other (for example, negligence) can be more difficult to prove. Thus, the obligation to prove various elements of the case may constitute a hurdle for a plaintiff to bring cases. If she estimates that she will not be able to prove various elements of the case, such as negligence, causation etc., or if proving them may be very costly she may not initiate the procedure in the first place.[219] Therefore, the allocation of the burden of proof is an important determinant of the expected liability and needs to be assessed.

5. NATURE OF LIABILITY REGIME

Finally, the discussion of the liability regime would not be complete if one does not speak about the nature of legal rules. Legal rules can be either mandatory or default.

Mandatory rules set the rules of conduct and do not to allow limitations, modifications or other deviations of liability. Limitations or disclaimers are the most straightforward methods of limiting one's liability. In this case the underwriter can simply state (usually in the prospectus) that it refuses any liability for the prospectus. Alternatively, the underwriter can assume liability only for some information in the prospectus.

[219] Mark Tull, *New Trends in Financing Civil Litigation in Europe: A Legal, Empirical, and Economic Analysis* (Edward Elgar Pub, 2011), pg. 8.

Mandatory liability rules are often also meant to prohibit various agreements between the issuer and underwriters which allow compensation or sharing of underwriter liability costs *ex post.* These are so-called indemnification agreements according to which the issuer undertakes to compensate any underwriter losses to which the underwriter may become subject under the liability provisions of securities laws. Some exceptions may be provided for cases when there is clear underwriter fault for inserting incorrect information.

There also can be contractual "contribution clauses" which provide that if the underwriters and the issuer are found jointly liable for a violation of the securities acts, damages are allocated away from underwriters to the issuer.[220]

In contrast to mandatory rules default rules set a certain liability standard but allow parties to modify it by agreement. In most legal systems the general legal principle is that something is allowed unless it is explicitly prohibited. This is especially applicable to the contract and sometimes also to the tort law. Thus, the default rule will be applicable unless the parties agree otherwise.

It should be noted that the possibility to change tort law rules is not so straightforward. The problem is that there is no contractual relationship between the tortfeasors and victims. Thus, some legal systems do not allow tortfeasors to unilaterally change rules governing their liability to potential victims.

It is pretty straightforward that mandatory rules will normally lead to a stronger liability threat than the default rules. Thus, in order to estimate the liability threat of a certain underwriter liability regime one should definitely assess how the law treats the limitations and disclaimers of liability.

6. CONCLUSIONS

The aim of this short Chapter was to provide the reader with the roadmap for the following four Chapters dedicated to the analysis of underwriter liability regimes in the USA, EU, Netherlands and the UK. Out of the sea of different legal rules which constitute the liability regime it pin-pointed the most important ones, explained what difficulties the lawmaker faces when making a regulatory choice and what options are available.

[220] Helen S Scott, "Resurrecting Indemnification: Contribution Clauses in Underwriting Agreements," *New York University Law Review* 61 (1986): 224.

It was determined that the most significant provisions of substantive law are the rules defining the potential parties to the dispute, stipulating the liability standard and defining the damages. Most relevant procedural rules are rules on collective litigation of misstatement cases, financing rules and provisions allocating the burden to prove various elements of the case. Finally, the more general question whether liability rules are mandatory or default is crucial for estimating the liability threat.

The general conclusion which follows from the discussion in this Chapter is that the effect of regulatory choices on the liability threat is a rather complex matter. The impact of each of these regulatory options needs to be assessed and put into the context together with other aspects in order to draw any conclusions.

CHAPTER V. UNDERWRITER CIVIL LIABILITY IN THE USA

1. GENERAL REMARKS

It is impossible to seriously discuss the topic of underwriter gatekeeping function and its enforcement without analyzing the American legal system. The usefulness of gatekeepers and civil liability as its enforcement device in the US is widely accepted and recognized both on the statutory level and in the court practice. It also forms an important part of ongoing academic and political debate.

This book will focus on the federal regulation of the underwriter gatekeeping duty and its private enforcement. However, one should not forget that the securities law, including the question of underwriter liability, is subject to regulation both at the federal and at state level. Each state has its own blue sky statute which is applicable when the securities are offered within this particular state.[221] They contain registration, offering and well as liability provisions. Despite the efforts of unification, individual statutes are significantly different between each other.[222]

Federal regulation does not preclude the applicability of the state "blue sky" laws unless the issue is explicitly pre-empted by federal regulation. The issues of liability are not subject to pre-emption.[223] Thus, liability provisions are subject to both state and federal regulation. Both the federal Securities and Exchange Commission (hereinafter – the SEC) and state authorities have the power to investigate and bring the actions on the basis of, respectively, federal and state laws. Investors can also have recourse to courts on the basis of both state and federal statutes. In other words, in the USA the federal regulation does

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[221] The first statute was adopted by Kansas in 1911. The example of Kansas was quickly taken over by other states and spread all over the USA. They are called "blue sky laws" because they are meant to prevent "speculative schemes which have no more basis than so many feet of "blue sky"".

[222] Partial harmonization was achieved by the adoption of 1956 and later versions of the Uniform Securities Act. Nevertheless, one cannot speak about the complete uniformity of the securities regulation on the state level.

[223] National Securities Markets Improvement Act of 1996 and Securities Litigation Uniform Standards Act of 1998 in part pre-empt the application of the blue sky laws at least in respect to the "covered securities" which, *inter alia*, include securities listed on the NYSE, AMEX, Nasdaq and other securities exchanges registered with the SEC. (See Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (Aspen Publishers Online, 2004)., pg. 79 – 82). However, the application of blue sky laws is pre-empted only as regards several aspects such as registration, preparation of offering documents, proxy statement and merit regulation. Other issues, including enforcement are not excluded from the dual regulation.

not replace or have supremacy over state laws. Both have to be complied with and are directly applicable. Obviously, this creates additional incentives for underwriters but also costs as regards compliance. Discussing each individual regime of the state regulation in any further detail would run outside the scope of this book. However, its impact should not be ignored.

2. REGISTERED PROSPECTUS LIABILITY. SECTION 11

2.1. Requirement to disclose information

Underwriters' gatekeeping duties and liability for misleading information on the federal level is dealt with by the Securities Act of 1933 (hereinafter – the Securities Act). Section 5 of the Securities Act allows the distribution of securities only after they have been registered with the market authority – the SEC and a prospectus has been delivered to each of the investors.

A prospectus is a part of the registration statement which must contain various disclosures about the issuer, including audited financial statements, financial information, management discussion and analysis, a detailed description of the issuer's business, properties, transactions with management, legal proceedings and executive compensation. The full list of items to be disclosed in the registration statement and prospectus is provided in the schedules attached to the Securities Act and implementing documents. The prospectus must also include "such material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading". Thus, the Securities Act imposes a double requirement. First of all, to include all listed information. Secondly, to ensure that the information as a whole does not create misleading impression. The prospectus is recognized as "a document prepared with care, following well established procedures relating to investigations with due diligence and in the context of a public offering by the issuer or its controlling shareholders".[224]

[224] *Gustafson v Alloyd Co., 513 U.S. 561 (1995)* (n.d.).

2.2. Basis for liability

To ensure that this requirement is complied with, Section 11 states that "in case any part of the registration statement <…> contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading" investors have a right to ask for compensation of their damages. Section 11 further deals with substantive (definition of parties, liability standard, damages) and some procedural aspects (burden of proof) of the liability regime.

2.3. Potential defendants

Section 11 names every person who signed the registration statement[225], directors, accountants, engineers, appraisers, other experts and underwriters as possible defendants in suits concerning the prospectus liability. This provision features the main idea of gatekeeping theory – it imposes liability not only on the primary actor – the issuer but also a number of secondary actors. Among these actors the underwriter is mentioned explicitly.

The notion of the underwriter is formally defined in USA law. Whether one is an underwriter is determined not with reference to a particular person's general business but functionally in terms of a person's involvement in a particular offering.[226] Thus, Section 2 (a) (11) of the Securities Act stipulates that there are four broadly defined roles that qualify any person, both an amateur and a professional investment bank, as an underwriter:

- any person who purchases from an issuer with a view to distribution of a security; or
- any person who offers or sells for an issuer in connection with a distribution; or
- any person who participates or has a direct or indirect participation in the activities covered by 1 or 2 above; or
- any person who participates or has a participation in the direct or indirect underwriting of any such undertaking.

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225 These usually include the registrant, its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer and at least a majority of the board of directors or persons performing similar functions. See Item 17 of Form S-1 Registration statement under the Securities Act of 1933.

226 Loss and Seligman, *Fundamentals of Securities Regulation*, 1177.

The important element of this definition is that the participation of the financial intermediary has to be "with the view to" or "in connection with" the security's "distribution". The term "distribution" is usually interpreted by courts as sales to those who cannot "fend for themselves".[227] There is no doubt that this includes all public offerings while there is a controversy of its even wider scope. The term "with the view to" means that the securities in question have to be acquired without the long-term investment intent.[228]

The language of this definition clearly covers financial intermediaries participating in both firm-commitment and stand-by offerings. It applies to investment banks assisting an issuer in a public offering as well as other actors.[229] However, members of the selling group are expressly excluded with the condition that the commission they receive is "not in excess of the usual and customary distributors' or sellers' commission". In *Harden v Raffensperger*[230] the court also held that the definition of underwriter covers financial intermediaries that simply perform due diligence of the registration statement without neither purchasing nor selling any securities. As a result, best-efforts offerings are covered under this definition as well as other types of offerings where the role of the underwriter is purely advisory.

Thus, the American law makes all parties who functionally fall under this wide definition of the underwriter liable for misstatements in the prospectus. Underwriters are easily identifiable because standard registration forms developed by the SEC require the

[227] *SEC v Ralston Purina Co., 346 U.S. 119 (1953)* (n.d.).

[228] Donald C. Langevoort, James D. Cox, and Robert W. Hillman, *Securities Regulation: Cases And Materials*, 5th ed. (Aspen Publishers, Inc., 2006), 345. It is assumed that if the securities have been held for less than two years they were purchased with the view to distribute. If they have been held for more than two years, there is a rebuttable assumption of the investment intent.

[229] Stephen Choi, *Securities Regulation: Cases and Analysis* (New York [St. Paul Minn.]: Foundation Press; Thomson/West, 2005), pg. 634-642.

[230] *Harden v Raffensperger, 65 F. 3d 1392 (7th Cir. 1995)* (n.d.). In this case it was ruled that a financial intermediary, known as qualified independent underwriter, who NASD rules require to perform due diligence of the registration statement, falls under the definition of "participates" and "has participation" language of Section 2(a)(11).

information about the underwriter be provided in different items of the registration statement.[231]

2.4. Potential plaintiffs

On paper, Section 11 gives a right to file a claim to anyone who purchased a security at the time it was offered or within three years of the offering. That is, there is no requirement of privity – the direct contractual relationship between the investor and the underwriter. Nevertheless, it must be shown that the person must have purchased a security issued under that, rather than some other, registration statement. In other words, such investors have to be able to trace the security as being part of the offering of securities covered by the registration statement.[232] Therefore, Section 11 can be potentially applicable to subsequent secondary market transactions but only as long as the traceability requirement is satisfied.

In the case of the initial offerings the question of traceability is not problematic as all the outstanding securities in the open market can be traced to the initial offering. The problem arises in cases when investors buy securities some time after an additional offering of already outstanding class of securities. Traceability in such cases is difficult because brokers hold stock in general accounts. Moreover, securities are fungible. Neither brokers nor investors know which issue is being bought. In such cases it is impossible to use direct traceability methods.[233] Thus, only original investors know the origin of their securities. Others do not. As a result, the threat of liability for seasoned issues becomes very limited as only initial subscribers can sue. Initial investors are usually institutional investors,

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[231] See, for example, Item 8 of Form S-1 Registration statement under the Securities Act of 1933 requiring to include the name of the managing underwriter or underwriters and a brief statement as to the nature of the underwriter obligation to take the securities; if any securities to be registered are to be offered otherwise than through underwriters, a brief statement as to the manner of distribution.

[232] *Barnes v. Osofsky, 373 F.2d 269, 272 (2nd Cir. 1967)* (n.d.).

[233] Hillary A. Sale, "Disappearing Without A Trace: Sections 11 and 12(2) of the '33 Act," *SSRN eLibrary* (n.d.), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=189869., pg. 463, cites *Kirkwood, 590 F. Supp. 1375 (D. Minn. 1984)* (n.d.). decision which provides the following indicia for determining the traceability: (1) a broker indicating interest on behalf of a customer; (2) a customer who receives a copy of the "red herring", or preliminary prospectus; (3) a purchase order with a notation indicating an offering purchase; (4) a purchase price matching the offering price; (5) a lack of a commission; (6) a confirmation slip with language regarding the offering: and (7) a special code for the transaction at the brokerage firm. In only five cases as of 2000 investors were able to prove traceability.

politicians, and those with connection to underwriters. These investors are known to be short term investors and flip the shares shortly if not immediately after the allocation. Having gotten rid of the securities before the revelation of misstatements, they do not suffer losses and thus have no incentives to file misstatement claims. On the other hand, retail investors do not take part in initial allocation and receive securities as a result of aftermarket purchases.[234] Due to traceability requirement this group is, however, not able to prove the origin of their securities and claim damages.

2.6. Liability standard

Section 11 not only names the underwriter responsible for the prospectus but sets the applicable liability standard. In short, it can be described as a negligence standard with the reversed burden of proof.[235] Underwriters can avoid the liability if they demonstrate that they have not been negligent and have taken the due care. The due care standard varies depending on the type of the statement in question. The registration statement consists of (1) expertised statements "purporting to be made on the authority of an expert and copies of or extracts from a report or valuation of an expert", *eg.* audited financial statements or attorneys' opinions, and statements "purporting to be made on the authority of a public official document or statement" *(eg.* a license*)* and (2) non-expertised statements. Persons who act as experts are usually named in the prospectus. Additionally, if any part of the registration statement purports to be made on authority of an expert, the consent of the expert must be included as an exhibit.[236]

As regards non-expertised statements the underwriter has an explicit duty to perform a reasonable investigation of the registration statement and to ensure that after such reasonable investigation it has reasonable ground to believe and believes that the statements in the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements not misleading. For the expertised statements the law does not require the underwriter to

[234] Sale, "Disappearing Without A Trace." pg. 441. The suggested solution for this problem could be found in allowing using statistical reference methods in order to prove the traceability.

[235] This standard applies to all possible defendants except the issuer who is subject to the strict liability.

[236] Harold S. Bloomenthal, *Securities Law Handbook* (Thomson West, 2008). pg. 76.

conduct a separate investigation. However, the statute states that the underwriter has to ensure that it has no reasonable ground to believe and does not believe that anything contained in the expert opinion is untrue or misleading. Therefore, Section 11 imposes on the underwriter a duty to perform a two-step analysis: there must be an investigation and, after such investigation there should be no reason to doubt the accuracy of the registration statement. The underwriter can violate its duties of care both by not investigating adequately and in cases when investigation was done but the underwriter has decided to go forward with participation in the offering with doubts about accuracy of the registration.[237]

The law further provides that the applicable standard in determining what constitutes the reasonable investigation is that required of a prudent man in the management of his own property. The standard of reasonableness under Section 11 depends to some extent on what constitutes commonly accepted commercial practice. While compliance with business practices does not automatically guaranty the immunity from the liability, doing less than other underwriters with respect to similar transactions may be used as a proof of lack of a reasonable investigation.[238]

Some guidance as to the standard of care under Section 11 is available from the SEC. The SEC Rule 176 provides guidance by presenting the following nonexclusive factors to be considered in determining the adequacy of a due diligence investigation: type of issuer; type of security; type of person; type of underwriting arrangement, role of the particular person as an underwriter and availability of information with respect to the registration; and whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated. This list is, however, not very useful as a practical guidance for underwriters. Rather, it indicates the elements developed by the case law which should be taken into account when defining the standard of the due diligence.

The case law further developed the content of the underwriter duty under Section 11. In general terms, the standard of care required from the underwriter lays somewhere in between very strict requirements applied to the firm's insiders such as executive directors and a more lenient duties imposed on such actors as outside directors. The underlying logic

[237] Langevoort, Cox, and Hillman, *Securities Regulation*, pg. 476.

[238] Snyder Kearney LLC, "Nature of the Due Diligence Obligation."

for such a distinction is that the standard of care depends mostly on the specific position of the defendant and his access to the issuer.[239] For example, while outside directors are allowed to evaluate the disclosures in the registration statement on the basis of their knowledge of corporate affairs developed *via* normal exercise of their functions as the outside director,[240] the case-law obliges underwriters to play "devil's advocates" and to verify the information received from the issuer rather than accepting the representations of management and the issuer's counsel.

The importance of the underwriter has been recognized many times by courts. A good illustration is the decision in *Chris-Craft Industries, Inc. v Piper Aircraft Corp.* which states "no greater reliance is placed on any single participant in the issuance of securities than upon underwriter…Prospective investors look to the underwriter – a fact well known to all concerned and especially to the underwriter – to pass on the soundness of the security and the correctness of the registration statement and prospectus".[241]

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[239] C. Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects: Elements of Third Party Enforcement in US and European Securities Law," *European Company and Financial Law Review* 6, no. 4 (2009): 476–515. pg. 481.

[240] *Weinberger v Jackson, 1990 WL 260676 (N.D. Cal 1990)* (n.d.).

[241] *Chris – Craft Industries, Inc,. v Piper Aircraft, Corp., 480 F.2d 341 (2d Cir.) cert denied, 414 U.S. 910, 94 S. Ct. 231, 38 L. ed. 148 (1973);* (n.d.).

In *Escott v BarChris Construction Corp*[242] the court has formulated the principle that underwriters cannot rely on the representations of the management but have to independently verify all the statements. How far such investigation should go "is a question of degree, a matter of judgment in each case". In *Feit v Leasco Data Processing Equipment Corp*[243] and *In re Software Toolworks, Inc*[244] the court demonstrated what kind

[242] *Escott v BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y, 1968)* (n.d.). This was the first major case heard almost 30 years after the adoption of the Securities Act. The issuer, BarChris Construction Corporation (hereinafter – BarChris), was involved in the construction of bowling alleys. Its business method involved constructing the alley for the customer for a very small down payment. Therefore, it had to defray the cost of construction before it received reimbursement. As a result, BarChris always needed some cash to finance its operations. To satisfy this need Bar Chris issued debentures within the public offering. At some point, BarChris started to experience difficulties in collecting amounts due from some customers and eventually filled for the bankruptcy protection and defaulted in the payment of the interest on debentures.

The court established that the lead underwriter indeed performed the investigation of the registration statement. It familiarized himself with general conditions in the industry, read older prospectuses, annual reports, inaudited financial statements, inquired about BarChris of certain of it banks and partners, attended the meeting to discuss the prospectus with BarChris representatives, asked questions. However, when the underwriter was advised that some minutes were not written up it did not pursue the matter. Additionally, the review of major contracts was cursory and did not include a review of contracts that would have disclosed serious issues. The Court held that, given the circumstances of the case, such examination was not reasonable and thus underwriters failed to fulfill their duty:

"The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "data presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the company's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.

It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient. <…> It follows that although Drexel and the other underwriters believed that those portions of the prospectus were true, they had no reasonable ground for that belief, within the meaning of the statute."

[243] *Feit v Leasco Data Processing Equipment Corp. 332 F. Supp. 544 (E.D.N.Y.)* (n.d.). In this case the investigation was recognized as reasonable although noting that the underwriters had just barely established the reasonableness. Leasco decided to acquire the Reliance Insurance company on the basis of reports which demonstrated that the latter had a big amount of cash surplus which was not needed to ensure the integrity of company's insurance operations (so called "surplus surplus"). The acquisition involved the exchange of securities with public investors who later claimed that the registration statement did not disclose the approximate amount of Reliance "surplus surplus" or Leasco's intended use of the "surplus surplus".

The court acknowledged the difficulty underwriters had in obtaining the accurate value of the "surplus surplus". They held the meetings with the Leasco's management to discuss the issue, examined the reports. They could not calculate the surplus because there were multiple calculation methods available and the Reliance refused to provide the necessary data. Therefore, it was decided not to include the estimate of the "surplus surplus" in the registration statement.

of effort will be considered as reasonable. Finally, in the latest in the series of cases, *In re Worldcom Securities Litigation*[245], the court *inter alia* provided guidance as regards the

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The court held that even though the underwriters were well aware that there is a "surplus surplus" and made several inquiries about this, they were justified in their conclusion that it could not be calculated with any accuracy and thus can be omitted from the prospectus. The critical argument which allowed the underwriter to avoid the liability is that it performed the detailed enquiry and was still unable to access relevant information.

244 *In re Software Toolworks, Inc., 50 F 3d 615 (9th Cir. 1994)* (n.d.). While in the previous two cases the underwriters conducted virtually no due diligence, here the main question was whether the level of due diligence undertaken by the underwriters was adequate. Software Toolworks, Inc was a software company which just had its IPO. Soon after the IPO the company announced significant operating loss.

The investors claimed that the underwriters failed to conduct proper due diligence of the business and financial condition of the company and as a result the prospectus was misleading. The court ruled in favour of underwriters, noting that they have secured written representations to virtually all matters and circumstances in question as well as made actual, personal inquires of the company's clients, survey of company's distributors. Moreover, they were consistently advised by the manager on the facts in question. Therefore, the court concluded that the made "substantial effort" to determine the various facts and circumstances.

It was also alleged that the underwriters unreasonably relied on the audited financial statements in spite of numerous "red flags" indicating that information was incorrect. The court, however, came to the opinion that by confronting the auditor, asking for the written reconfirmation and contracting other accounting firm to verify the auditor's accounting methods, the underwriter did not blindly relied on the auditor and performed reasonable investigation. Regarding the specific accounting issues the court also held that given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.

245 *In re WorldCom, Inc. Securities Litigation. 2004 U.S. Dist. LEXIS 25155 (S.D.N.Y. 2004)* (n.d.). WorldCom was a telecommunication company. Its largest operating expense was its line costs. WorldCom reported in its SEC filings its ratio of line cost expense to revenues (the E/R ratio). The low ratio was considered as a sign of the good performance. At some point WorldCom's business results began to deteriorate and its actual E/R ratio and reported income were unacceptable to management. To avoid this situation the management with the help of their auditors began to manipulate accounting results. These manipulations caused WorldCom's financial statements to contain materially false information. In the meanwhile, WorldCom issued two series of debt securities under two shelf registration statements. Later WorldCom announced a massive restatement of its financial statements and eventually filed for bankruptcy protection.

The court, first of all, made the distinction between the audited and unaudited financial statements. It noted that the SEC has previously stated that auditors are not experts with respect to unaudited financial statements. A comfort letter relating to unaudited financials does not change that result - the unaudited financial statements remain unexpertised. Therefore, underwriters have a duty to examine them in the same manner as for other unexpertised information contained in the registration statement.

As regards the underwriter investigative duties in respect of audited financial statements, the court held that, while in most situations it would be reasonable for underwriters to rely on audited financial statements; this reliance may not be blind. The court stated that where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability. The court defined a "red flag" as any information that strips a defendant of his confidence on the accuracy of those portions of a registration statement premised on audited financial statements.

The court also pointed that the underwriter has a duty to take into account the general context in which the offering takes place. The offerings in question were massive in size and occurred at a time that WorldCom, and the telecommunications industry in general, were known to be encountering difficulties. These facts, without more, appeared to suggest to the court that the underwriters had an obligation to review the audited financial statements with a dose of healthy skepticism rather than blindly rely.

underwriter duties in respect of expertised statements and within the context of shelf registration. In sum, while the number of cases under Section 11 is not very big,[246] the existing case-law is rather explicit and provides guidance as regards the numerous details of the gatekeeping duty.

2.5. Burdens of proof

The general principle of civil litigation in tort cases is that plaintiffs have to prove their allegations. Section 11 changes this principle and excuses plaintiff investors from most of evidentiary burdens. The underwriter can protect itself from the liability by rebutting the assumptions made.

First of all, investors are not required to show that the underwriter breached its duty of care by not performing a reasonable investigation. It is up to the underwriter to prove otherwise. It can use the performance of the due diligence investigation as a defense from the liability.

Secondly, investors are not required to demonstrate their reliance on the misstatement if they acquire the security within 12 months beginning after the effective date of the registration statement. In any case such reliance may be established without a proof of reading of the registration statement by the investor. The underwriter can reverse this assumption by proving that at the time of such acquisition the investor knew of such untruth or omission.

Further the court rejected the underwriters' argument that they have fulfilled their duty because further inquiry would have been futile, as WorldCom's management would have simply fabricated responses to continue to hide the fraud. The court noted that perceived futility does not relieve underwriters from conducting a reasonable investigation. The decision makes clear that underwriters facing fraudulent activity need not uncover the fraud in order for their investigation to be sufficient to establish a due diligence defense. On the other hand, underwriters must establish futility by engaging in a reasonable investigation; they may not limit their investigation on the grounds that further inquiry would be futile.

Underwriters also questioned the applicability of the developed strict standards of Section 11 in the context of the speed of shelf registration statements. The imposition of liability within the context of shelf registration has been a controversial issue taking into account the speed at which such offerings take place. A number of commentators have suggested that Section 11 regime is inappropriate for these offerings. However, there has been no regulatory move to change the status of shelf offerings. The court did not address this argument in detail but noted there is nothing in law which suggests different treatment of such procedure, therefore, the existing guidelines and decisions continue to apply. It also cited a statement by the SEC to the effect that considerations of competitive timing and pressures are not to be considered when evaluating the reasonableness of an underwriter investigation.

[246] See Section 6.2 of Chapter V below.

Finally, investors are not required to show the causality between the misstatement and the loss. This relationship is assumed to exist. The underwriter can reverse this assumption if it proves that the damages were caused by factors other than the depreciation of value of the security due to the revelation of the misstatement. Section 11(e) states that the statutory damages shall be reduced to the extent that the defendant is able to prove that any portion of (or all of) said damages "represents other than the depreciation in value of each security resulting from" the misstatement or omission. Since the burden of proving the absence of a causal connection falls on the defendant, loss causation need not be shown in order for plaintiff to establish a prima facie case under Section 11. Thus, when the entire decline in the price of the stock is attributable to external market forces, there will be no damages under Section 11.[247]

Everything investors need to prove is that they have bought the securities, that the misstated facts are material and the information is misleading.

The role of the materiality standard is to screen out trivial from substantial misstatements. The fact is considered to be material when "there is a substantial likelihood that a reasonable [investor] would consider it important in deciding whether to purchase the security".[248] The materiality requirement is satisfied if the misstatement or the omission significantly alters the "total mix" of information made available to a reasonable investor. Obviously, this definition raises a number of interpretative issues. In deciding whether the fact is material the court would view each case as a discrete set of circumstances and judge on its own unique facts.

2.6. Definition of damages

Harmed investors can request compensation of damages. Damages are described as the "out-of-pocket" loss, *i.e.* difference between the purchase price and the price after the revelation of a misstatement. They are strictly limited by the offering price. Moreover, the underwriter cannot be charged any damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public.

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[247] Thomas Lee Hazen, *The Law of Securities Regulation, 6th Edition Hornbook*, 6th ed. (West, 2009), Chapter 7.3.

[248] *TSC Indus v Northway Inc., 426 U.S. 438, 449 (1976)* (n.d.).

3. BEYOND PROSPECTUS LIABILITY

American law imposes some duties on the underwriter also as regards the information contained in sources other than the registration statement. The law distinguishes further between different types of information.

3.1. Liability for other offering documents and oral statements in connection to the distribution. Section 12(a)(2)

Section 12(a)(2) imposes liability for negligent material misstatements and omissions in the prospectus or oral communications. Within this section the meaning of prospectus is very wide. In the leading case on this issue, *Gustafson v Alloyd Co,*[249] the court has ruled that prospectus means “a document that describes a public offering of securities by an issuer or controlling shareholder”. Section 12(a)(2) applies not only to registered prospectuses (which form part of the registration statement) but also to any offering documents related to public distributions even if such offering is not subject to registration. However, Section 12(a)(2) does not apply to the communications made in connection with private transactions and ordinary aftermarket trading (*eg.* research report on the security made by a broker). It also does not apply to the securities exempted by Section 3 (a) (2), municipals, banks and interests in certain tax exempt plans.[250] Thus, there is some overlap between Section 12(a)(2) and Section 11 in case of registered offerings but Section 12 (a)(b) can be the only remedy for other types of public offerings.

Moreover, Section 12(a)(2) also covers certain oral communications that relate to a prospectus both for registered and other public offerings.[251] The underwriter has a duty of care in respect of the disclosure in “<…> a document prepared with care <…>” and not “<…> for every casual communication between buyer and seller in the secondary

[249] *Gustafson v Alloyd Co., 513 U.S. 561 (1995).*

[250] Loss and Seligman, *Fundamentals of Securities Regulation*, pg. 1297.

[251] In *Gustafson v Alloyd Co.* the court noted that “the parties (and the courts of appeals) agree that the phase oral communications is restricted to oral communications that relate to a prospectus. Later decisions, such as *Pollack v Laidlaw Holdings Inc.,* confirmed this limited interpretation”.

market".[252] This category would include the oral representations made during road-shows and other marketing activities. However, oral statements can give rise to liability only if they materially affect the total mix of information available to the investor. Often accurate disclosure in the prospectus will control over any alleged misstatements made orally or outside of the prospectus when the investor has had access to the prospectus prior to making his or her investment decision.

In contrast to Section 11, Section 12(a)(2) does not name special categories of capital market actors as possible defendants. It simply imposes liability for material misstatement and omissions on any person who offers or sells a security. Earlier case-law construed this as a strict privity requirement, *i.e.* that claims under Section 12(a)(2) were possible only against the immediate seller. This meant that in a typical firm-commitment underwriting the ultimate investor could file a claim against the dealer who sold the securities. In turn, the dealer could recover against the underwriter and the underwriter possibly from the issuer.[253] However, the ultimate investor could not file the claim directly against the underwriter if it has not acquired securities directly from them.

However, in *Pinter v Dahl* the Supreme Court held that within the meaning of Section 12 (1),[254] a "seller" is a person who either passes title to a security or solicits a purchase of securities, while "motivated at least in part by a desire to serve his own financial interests or those of the securities owner".[255] As a result, the definition of a seller got extended also to parties who have simply collaborated in soliciting investors for a profit. Thus, underwriters can potentially fall under the scope of this Section. Both firm-commitment and best efforts underwriters can be liable if they are in contact with the investors and promote the offering, either by direct personal or telephone contact or by participating in road shows and placing their name on the securities prospectus or other advertising

[252] *Gustafson v Alloyd Co., 513 U.S. 561 (1995).*

[253] Loss and Seligman, *Fundamentals of Securities Regulation*, pg. 4239-4240.

[254] Although *Pinter v Dahl* concerned Section 12(1) and not Section 12(a)(2) liability there is a consensus among following courts decisions that *Pinter v Dahl* standard applies to Section (12)(a)(2) as well. See Therese H Maynard, "Liability under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets," *William and Mary Law Review* 32 (1991 1990): pg. 73.

[255] *Pinter v Dahl, 486 U.S. 622 (1988)* (n.d.).

material.[256] However, merely participation in the preparation of the registration statement does not satisfy the active participation requirement so as to render such participants in privity with a purchaser. Even substantial involvement in the preparation of registration and offering materials will not create liability unless there is also active involvement in the negotiations leading to the sale in question.[257]

Section 12(a)(2) imposes on the underwriter a duty to exercise reasonable care to find out whether there is an untrue statement of a material fact or omission to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. There is very little case-law as regards the content of the duty of care under Section 12(a)(2). The major findings in respect of underwriters come from *Sanders v Josh Nuveen & Co* case.[258] The court held that, although Section 11 and Section 12(a)(2) stipulate different standards of care, respectively "reasonable investigation" and "reasonable care", that difference was not intended to reduce the underwriter standard of care. Thus, in order to establish its exercise of reasonable care under Section 12(a)(2) the underwriter is required to conduct a reasonable investigation, similar to one required by Section 11.

Other courts and commentators have identified the following most important factors in determining the adequate standard: the nature of the seller; its role in the selling process; the relationship between the buyer and the seller; the relationship between the seller and the issuer of the security, the availability of the corporation-seller as the seller's source of

[256] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects.", pg. 488 citing *ZZZZ Best Securities Litigation, Fed. Sec. L. Rep. (CCH) 94485, 1989 WL 90284 (C.D. Cal. 1989)* (n.d.).

[257] Hazen, *The Law of Securities Regulation, 6th Edition Hornbook*, Chapter 7.2.

[258] *Sanders v John Nuveen & Co, Inc., F.2d 790 (7th Cir. 1977)* (n.d.). The case involved the exempted public offering of unsecured promissory notes of Winter &Hirsch, a consumer finance company. Josh Nuveen & Co (hereinafter - Nuveen) acted as an underwriter and prepared a report on the securities in question and made oral statements about their quality. As it was discovered later, the issuer with the connivance of the certified public accountants for a long period of time was continually overstating the receivables and failing to reflect the indebtedness. As a result, at the time of the offering the issuer's liabilities exceeded its assets. Subsequently, Winter &Hirsch defaulted on its securities. The court acknowledged that the underwriter was not aware of the fraud but it held "the mistaken but honest belief that financial statements prepared by certified public accountants correctly represented the condition of Winter &Hirsch". Nevertheless, the court held that the underwriter failed in its duty of care because it did not conduct the reasonable investigation of the issuer and its business. In reaching this conclusion the court heavily relied on the underwriter role in the offering process. It reached the conclusion that the same degree of involvement of the underwriter as required by section 11 in the case of a registered offering should apply in the context of an unregistered, exempt public offering. Whether or not the offering is registered, "a greater quantity of information is "reasonably ascertainable" by an underwriter than by a mere broker".

information; circumstances under which the statements were made; what the representation purports to state. Accordingly, although the reading of Section 12(a)(2) makes no difference between underwriter duties as regards the disclosures in the expertised and non-expertised statements, the case law makes such distinction along the lines of Section 11.[259]

Section 12(a)(2) provides two remedies: rescission or damages. Upon the rescission the plaintiff receives the purchase price, plus interest less the income received on the securities. The amount of damages should result in substantial equivalent of rescission.[260]

The evidentiary burdens of Section 12 are analogical to those of Section 11. Investors are required neither to show causality between the misstatement and the loss nor negligence of the underwriter nor their reliance on the misstatement. In addition, the assumption of loss causation is not rebuttable, *i.e.* the defendant cannot protect itself by claiming that a demise of price was not due to the misstatement disclosure.[261]

3.2. Underwriter liability in all other cases. Rule 10b-5

Rule 10b-5 was adopted implementing the SEC authority granted under Section 10 of the Exchange Act to prohibit any manipulative or deceptive device or contrivance in connection with the purchase or sale of any security. The rule imposes on the underwriter a duty to abstain from:

(a) employing any device, scheme or artifice to defraud;

(b) making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

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[259] Maynard, "Liability under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Postdistribution Markets," pg. 95.

[260] Edward A Peterson, "Recent Developments in Civil Liability under Section 12(2) of the Securities Act of 1933," *Houston Law Review* 5 (1968 1967): pg. 284.

[261] Hazen, *The Law of Securities Regulation, 6th Edition Hornbook*, Chapter 7.6.

While Section 11 and Section 12(a)(2) are very limited as regards the sources of information they apply to, Rule 10b-5 applies to almost all cases of misdisclosure of information. It is often described as the general anti-fraud prohibition or catch-all provision. It applies to registered public offerings, non-registered public offerings, offerings exempted from registration under the Securities Act as well as to secondary market transaction and can be analyzed as the lowest common denominator of conduct in the securities market.

Obviously, such a wide coverage creates unavoidable overlap with more specialized provisions. Therefore, in case of public offerings of securities Rule 10b-5 is of secondary importance. Specialized provisions of Section 11 and 12(a)(2) stipulate a comparatively stricter standard of underwriter conduct (negligence) and facilitate the filing of the claim (the burden of proof rests mostly with the defendant). Therefore, whenever they can be used as a cause of action, they will be preferred to the general Rule 10b-5. Thus, in public offerings Rule 10b-5 will be used in cases when, for certain reasons, other specialized provisions of the Securities Act are not applicable. For instance, it can be used by plaintiffs when the statute of limitation governing Section 11 or 12(a)(2) has expired. It can also be used when the plaintiff fails to prove one of the required elements of these sections, *eg.* that the document in question is a prospectus within the meaning on Section 12.[262] Despite this logical prediction, the practice shows that plaintiffs invoke Rule 10b-5 not only in these marginal cases but always claim the violation of Rule 10b-5 alongside the violations of Section 11 or Section 12(a)(2).[263]

Rule 10(b) (5) is also significant for other reasons. First of all, it prohibits types of fraud other than misdisclosure of information. For example, in the massive class action, known as the IPO litigation case, plaintiffs used Rule 10b-5 to allege widespread manipulation of IPOs and IPO aftermarkets, including nondisclosure of commissions and other compensation, undisclosed pre-arranged "tie-in arrangements" and the issuance of misleading analyst reports.[264] The underwriter may be also accused of participating in a

[262] For example, in *Sanders v John Nuveen & Co (II)* the court held that the underwriter liability should rest on Rule 10b-5 as Section 11 was inapplicable because no registration statement was filed and Section 12(a)(2) was not violated because the selling document did not qualify as a prospectus.

[263] For example, in *In re Software Toolworks, Inc.*, the plaintiffs raised the same issues against the underwriters under Section 10(b) as under Sections 11 and 12(2).

[264] See http://www.iposecuritieslitigation.com/.

number of scam transactions with the issuer which are used in order to inflate the issuer's assets.

Secondly, the role of Rule 10b-5 in regulating the underwriter conduct in offerings which are not subject to specialized provisions of the Securities Act is paramount. The Securities Act exempts certain types of securities, such as commercial paper and securities issued by banks or municipalities, and certain types of offerings, such as private placements, from registration and thus regulation by the Section 11.[265] However, the sale of securities exempted under the Securities Act remains subject to the antifraud provision of Rule 10b-5. As a result, Rule 10b-5 is the primary provision regulating the underwriter duties in the context of exempted securities.

Unlike Section 11, Rule 10b-5 does not define the classes of defendants. The basic principle stated in *Central bank, N.A. v First Interstate Bank of Denver*[266] (hereinafter – *Central Bank*) is that a private right of action under Rule 10b-5 is provided only against primary violators. A primary violator is an actor who "<…> makes a material misstatement (or omission) on which a purchaser or seller of securities relies <…>, assuming all the requirements for primary liability under Rule 10b-5 are met".[267] On the other hand, *Central Bank* stated explicitly that Rule 10b-5 "does not include giving aid to a

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265 The offers on municipal securities are exempted from the registration requirements of the Securities Act (see 15 U.S.C. 78o-4 (d) (1994)). However, then statements are made in connection with the offering of a municipal security, those statements must be true and cannot omit material fact. In *Sonnenfeld v City and Country of Denver* the court stated that "Congress also clearly intended that municipal securities would remain subject to the antifraud provisions". In *SEC v Dain Rauscher* the court also recognized that the underwriter in such offering has a duty to conduct reasonable investigation.

According to the Rule 144A certain private resales of minimum $500,000 units of restricted securities to qualified institutional buyers are exempted from the registration requirements under the Securities Act.

The main rationales for such exclusion are the sophistication of a given set of purchasers, the actual or theoretical likelihood of adequate state regulation, and the needs of business to raise comparatively small amounts of capital without the burdens of registration.

266 *Central bank, N.A. v First Interstate Bank of Denver, 511 U.S. 164 (1994);* (n.d.).

267 Ibid. It shall be noted that the decision in *Central bank* concerns the activities of the Central bank of Denver who acted as indenture trustee but not the underwriter. Underwriters were sued as well in this case. However, they have settled early in the case (see *First Interstate Bank of Denver, N.A. v Pring, 969 F.2d 891 (C.A.10 (Colo.) 1992)* (n.d.). The case provides little details about the role of the underwriter (1988 issue underwriter) in this case. It is clear that they have been aware about the controversy surrounding the disclosure, however, no further detail is provided. It can be speculated that the underwriters' conduct clearly amounted to the primary violation. Had they chosen not to settle, they would have lost the case anyway. The reasoning which the court applied in respect of the Central bank would not be applicable to underwriters simply because they would be considered primary violators and not the aiders and abettors.

person who commits a manipulative or deceptive act".[268] An example of an obvious primary violation by the underwriter can be when the underwriter recklessly issues a misleading research report about the company. In this situation it is pretty clear that the underwriter is "making" a statement within the meaning of Rule 10b-5. To illustrate, in *Cooper v Pickett*[269] the misleading statements were made by the securities analysts of the underwriter who issued erroneous reports. The court held that underwriters were primarily liable because their analysts were aware of undisclosed facts showing that there was no basis for the optimistic forecast, and therefore, that they did not genuinely believe in these forecasts. Similarly, in *In re MTC Electronic Technologies Shareholder Litigation*[270] the misleading statements in the research report about the company issued by the underwriter were attributed to the underwriter within the meaning of "making" under Rule 10b-5. Therefore, given that investors can prove other required elements of their claim, such as scienter, the underwriter will be held primarily liable for the information in research reports, oral statements and other sources of information.

However, even in such cases certain interpretative issues arise. For example, how should we treat cases where the underwriter makes a statement on the basis of the erroneous information provided by the issuer or another third party. In *Picard Chemical, Inc. Profit Sharing Plan v Perrigo Co*[271] underwriters were held liable for recklessly and knowingly making materially misleading representations in the form of baseless predictions of growth for the issuer in their reports to the public. They hid certain facts "whereby successfully creating a bubble which ensured the success of secondary offering and maintained the market for a short time thereafter". Underwriters argued that they should not be held liable because they simply relied on the information by the issuer. The court, however, held that, although, the underwriters have received the information from the issuer, it "was invariably edited or incorporated in a broader analysis by the Underwriter. <…> Because the Underwriter defendants are alleged to be the original source of each alleged material

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268 *Central bank, N.A. v First Interstate Bank of Denver, 511 U.S. 164 (1994);.*

269 *Cooper v Pickett, 137 F.3d 616 (9th Cir. 1997)* (n.d.).

270 *In re MTC Electronic Technologies Shareholder Litigation. 898 F. Supp. 974 (E.D.N.Y. 1995) and 993 F. Supp. 160 (E.D.N.Y)* (n.d.).

271 *Picard Chemical, Inc. Profit Sharing Plan v Perrigo Co, 940 F. Supp, 1101 (W. D. Mich. 1996)* (n.d.).

misrepresentation, they may be held primarily liable for securities fraud under Central Bank".

Courts developed a number of duties as regards the disclosure of information applicable to the primary actors which would apply also to the underwriter when it makes an explicit statement. Courts are usually of the opinion that there is no duty to disclose in the absence of the fiduciary relationship between investors and the underwriter. Courts have stated that there is no such relationship between the underwriter and investors. Therefore, courts agree that the mere possession of material non-public information does not give rise to a duty of disclosure. However, if the statement is already made by the underwriter and later becomes materially false and misleading, the underwriter has a duty to correct these statements.[272] There is also a duty to speak completely when voluntary statements are made. Therefore, when it makes a statement, the underwriter cannot tell half-truths and make material omissions.[273]

In summary, the case-law suggests that whenever the underwriter explicitly makes a statement it has a duty to ensure that the information it discloses is not materially misleading and incomplete. The underwriter cannot blindly rely on the information provided by the third parties and has to correct the information if it later becomes misleading.

However, most often underwriters do not make statements in a literal sense. The case-law on which actions of secondary actors constitute "making of statement" under Rule 10b-5 is a highly complex matter. District courts are split on this subject. Supporters of the "substantial participation" test claim that anyone who substantially participates in the preparation of a fraudulent document is making a statement within the meaning of Rule 10b-5 and thus can be held liable as a primary violator. This test does not require the secondary actor to sign the document containing the misrepresentations, distribute the misrepresentations to investors, or otherwise to be identified to investors in order to become subject of Rule 10b-5.[274] This test simply demands the secondary actor's knowing

[272] See, for example, *In re MTC Electronic Technologies Shareholder Litigation. 898 F. Supp. 974 (E.D.N.Y. 1995) and 993 F. Supp. 160 (E.D.N.Y)*.

[273] Langevoort, Cox, and Hillman, *Securities Regulation*, pg. 665.

[274] Elizabeth Cosenza, "Rethinking Attorney Liability Under Rule 10b-5 In Light of the Supreme Court's Decisions on Tellabs and Stoneridge," *George Mason Law Review* 16 (2009 2008): pg. 21.

participation in the preparation of material misrepresentations for inclusion in its client's public disclosure.[275] In contrast, the adherents to the "bright line" test require a determination of whether the secondary actor engaged in a deceptive act and mere participation in the drafting process is insufficient to establish primary liability. In order to "make" the statement under this test the secondary actor must actually publish a material misstatement or omission, rather than merely participate in its creation.[276] The secondary actor can be primarily liable for a misrepresentation only if it signs the document containing the misrepresentation or is otherwise identified to investors at the time of the misrepresentation's dissemination to the public.[277] The practitioners, however, note that in reality, the lines between the two tests are not always so bright.[278] Other methods to include secondary actors into the scope of Rule 10b-5 have also been used.[279]

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[275] The supporters of this test are the Ninth Circuit (*In re Software Toolworks, Inc.* – the case against auditors and underwriters holding that underwriters' and auditors' participation in the drafting of the letters to SEC is sufficient to sustain a primary cause of action under section 10 (b)), *Howard v Everex Systems, Inc.* – the case against directors holding that signing and attesting to a statement so that for all practical purposes, the signor made the statement, can constitute a violation of antifraud provisions), Fourth (*In re Mutual Funds Investment Litigation* – the case against mutual fund manager finding that "a service provider who allegedly "helped draft the misleading prospectuses" of a different company can be held primarily liable in a private securities – fraud action "even if the statement on its face is not directly attributed to the defendant. <…> by participating in the writing and dissemination of the prospectuses, [JCM] made the misleading statements contained in the documents") and some district courts (*eg. In re U.S.A. Classic Securities Litigation* – the case against underwriters supporting that allegations that underwriter participation in the issuance of prospectus and thereby employing a deceptive device constitutes fraud under Rule 10b-5).

[276] This test was approved by the majority of the Circuits: the Tenth (*Anixter v Home – Stake Production Co.* – the case against auditors holding that "the critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or omission, made by the defendant, that is relied upon by plaintiff. Reliance only on representations made by others cannot itself form a basis for liability"), Second (*Shapiro v. Cantor* – the case against auditors holding that accountant can be only liable for a failure to disclose if they had a duty to do so. As there is no "fiduciary or other similar relationship of trust and confidence" between the accountants and investors, they have no duty to disclose), *Wright v Ernst &Young LLP* – the case against auditors holding that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that Actor as the time of its dissemination"), Eleventh (*Ziemba v Cascade International, Inc.* – the case against lawyers and auditors confirming the "bright line" test and stating that "Section 10 (b) liability can not attach to those who were never identified to investors as playing role in the representations") and others.

[277] Cosenza, "Rethinking Attorney Liability," pg. 17.

[278] Thomas O. Gorman, "Who Does the Catch-all Antifraud Provision Catch? Central Bank, Stoneridge, and Scheme Liability In the Supreme Court," in *Securities Litigation & Enforcement 2007*, Corporate Law and Practice Course Handbook Series No. 11072, 2007, pg. 21.

[279] In response to the increasing difficulties in bringing a Rule 10b-5 (b) misrepresentation cases, plaintiffs tried to frame the actions of the secondary actors under Rule 10b-5 (a) and (c) fraudulent schemes notions. However, in *Stoneridge Investment Partners V Scientific – Atlanta, Inc.,* case the Supreme Court rejected the scheme liability concept. The court, however, held that in order to succeed in its case the plaintiff has to prove reliance. In the absence of reliance the mere involvement in the third party conduct is insufficient to establish Rule 10b-5 liability. In this case, the defendants were too remote from the investors. Therefore, it was impossible to

In this context, two recent decisions in *In re Mutual Funds Investment Litigation*[280] *(*hereinafter – *Mutual Funds)* and in *SEC v Tambone*[281] (hereinafter – *Tambone*) demonstrate the ongoing disagreement. Two almost identical situations were treated completely differently. The important development is that in one of the cases the Supreme Court has already granted the *certiorari, i.e* the Supreme Court will review the case and make a final decision.

In both cases it was alleged that the statement in prospectus of mutual funds was misleading.[282] The defendants were secondary actors which were closely involved with the funds but were not explicitly mentioned as drafters of prospectuses.[283] In *Tambone* it was claimed that the defendants knew that the statements were false, or were reckless in not knowing. Consequently, by using the prospectuses in their sales efforts, allowing the prospectuses to be disseminated and referring clients to them for information the underwriters "made" false statements. This became known as the implied statement theory which rests on the premise that a securities professional engaged in the offering of securities has a "special duty" to undertake an investigation that would provide it with a reasonable basis for believing that the representations in the prospectus are truthful and complete. In *Mutual Funds* the plaintiffs alleged that by causing mutual fund prospectuses to be issued for Janus funds and making them available to the investing public through

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establish that investors relied on their actions and there could not be any Rule 10b-5 liability. Nevertheless, this decision did not bring more clearness because the court made a remark that in order for the Rule 10b-5 to apply it is not absolutely necessary that "there must be a specific oral or written statement". The court held that the conduct itself can be deceptive <…> as long as the participation of the defendant is disclosed to investors. As a result, it is expected that courts will remain split on the distinction between primary and secondary liability.

280 *In re Mutual Funds Investment Litigation, 566 F.3d. 111 (4th Cir. 2009).*

281 *SEC v Tambone, 597 F.3d 436 (1st Cir. 2010)* (n.d.).

282 Ibid. pg. 439, *In re Mutual Funds Investment Litigation, 566 F.3d. 111 (4th Cir. 2009)*. pg. 115.

283 In *Tambone* the defendant was the principal underwriter and distributor of mutual funds who sold the securities and disseminated their prospectuses to investors. Columbia Distributor did not explicitly participate in the preparation of prospectus and did not explicitly accept the responsibility for it. However, the prospectus was prepared by and responsibility for it explicitly accepted by wholly owned subsidiary of the mother company of the underwriter and the materials of the case demonstrate certain involvement of the underwriter in the preparation and drafting of the prospectus. In *Mutual Funds* investors sued Janus Capital Management, who served as investment fund manager and investor advisor to mutual funds, helped to prepare prospectuses, participated in the dissemination of the interests in such funds and performed other related tasks. While responsibilities of JCM were a common knowledge, this was not explicitly mentioned in the offering documents.

filings with the SEC and dissemination on a joint Janus website the defendant made the misleading statement.

Essentially, both cases consider the same question – whether the defendants are making a statement within the scope of Rule 10b-5. However, the lines of reasoning and final responses by the courts are completely different. In *Tambone* the court held that if the underwriters are not indicated in the prospectus they use to distribute securities, they are not "making" a statement. In contrast, the *Mutual Funds* court held that "a service provider who allegedly "helped draft the misleading prospectuses" can be held primarily liable "even if the statement on its face is not directly attributed to the defendant".[284]

To come to such divergent decisions, the courts used different lines of reasoning. *Tambone* held that recognizing that by participating in the offering underwriters "make" an implicit statement within the meaning of the Rule 10b-5 is (1) inconsistent with ordinary meanings of the phrase "to make statement", (2) inconsistent with the structure of the rule and relevant structure, and (3) is in considerable tension with Supreme Court precedent in *Central Bank.*[285] *Mutual funds* used a completely different approach. First of all, the court explicitly refused to follow both the "bright line" and "substantial participation" tests. Instead, it read *Central bank* as requiring showing that a plaintiff relied upon the [defendant's] statements or actions in order to hold the secondary actor liable. Further, it was pointed out that following "fraud-on-the-market" doctrine developed in *Basic Inc. v Levinson*[286] the reliance is assumed whenever the statements are public and securities are

[284] "09-525 JANUS CAPITAL GROUP V. FIRST DERIVATIVE TRADERS - Questions presented", n.d., http://www.supremecourt.gov/qp/09-00525qp.pdf.

[285] The court stated the broad interpretation of the underwriter duties would obscure the distinction between secondary and primary liability and create a "mischief" by imposing a burdensome duty for underwriters. According to the court the actions of the underwriter can be interpreted "at most, as aiding and abetting (a secondary violation)". The use and dissemination of prospectuses created by others does not satisfy neither "substantial participation" nor "bright line" tests because "albeit to different degrees, [they] focus on the actual role that a defendant played in creating, composing, or causing the existence of an untrue statement of a material fact. The SEC's attempt to impute statements to persons who may not have had any role in their creation, composition and preparation falls well short". The court went on to examine if the underwriter has a duty to disclose. It recalled the precedent in *Chiarella v United States* decision in which the Supreme Court held that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so" and that the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them". Without much elaboration, the court rejected the existence of the fiduciary duty of underwriters to investors and, as a result, came to the conclusion that under Rule 10b-5 they have no duty to disclose material information not included in prospectus.

[286] *Basic Inc. v Levinson, 485 U.S. 224, 247, 108 S.Ct. 978, 99 L.Ed.2d. 194 (1988)* (n.d.). According to the *fraud-on-the-market* doctrine, the market efficiency ensures that the public information is promptly reflected in

traded on an efficient market. Therefore, in order to state the claim under Rule 10b-5 investors have to demonstrate that the investing public would have attributed a particular statement to a particular defendant even if the statement on its face is not directly attributed to the defendant. The court recalled that in order to determine whether the statement was attributable to the defendant "the courts analyzed the precise relationship between the defendant and the entity or analyst issuing the allegedly misleading statement". In this particular case, the court ruled that taking into account the relationship between the defendant and the mutual funds "interested investors would have inferred that if JCM had not itself written the policies in the Janus fund prospectuses [], it must at least have approved these statements". Therefore, the court held that "given publicly disclosed responsibilities of JCM [fund manager], interested investors would infer that JCM played a role in preparing or approving the content of the Janus fund prospectuses <…>".[287]

To sum up, the courts diverge in interpreting if there is a duty of the secondary actor under Rule 10b-5 to investors. This was demonstrated by the split between the District courts and more recently in the *Tambone* and *Mutual Funds* decisions. While *Tambone* explicitly rejects the existence of such duty without analyzing the particular relationship between the underwriter and the issuer, *Mutual Funds* recognizes that investors can imply such a duty based on the actual relationship between the issuer and the secondary actor. This results in an uncertain situation for underwriters which makes the litigation under the Rule 10b-5 highly unpredictable.

Other Rule 10b-5 case-law, which related exclusively to underwriters, suggests that they are treated somewhat differently from other secondary actors. First of all, the main case that has developed the "substantial participation" test included, *inter alia,* underwriters. In *In re Software Toolworks, Inc.*[288] underwriter liability under Rule 10b-5 was discussed in

the market price of security. Therefore, it can be assumed that an investor who buys or sells stock at the market price relies upon the statement.

[287] *In re Mutual Funds Investment Litigation, 566 F.3d. 111 (4th Cir. 2009)*. In should be noted that, the court, however denied imposing the liability on the sponsor of the mutual funds and the parent company of JCM. The role of the sponsor was solely to disseminate the prospectuses *via* website. According to the court "this fact, taken by itself, is insufficient in this case for us to infer that interested investors would believe JCG [the sponsor] had prepared or approved the Janus fund prospectuses".

[288] *In re Software Toolworks, Inc., 50 F 3d 615 (9th Cir. 1994)*. It should be noted that the main question in this decision was whether there were material issues of facts which precluded the court to issue the summary judgment. Therefore, the court only recognized that the facts about the underwriters' participation in the drafting of the letter constitute a material issue of fact which must be resolved before the summary judgment can be granted.

the context of its participation in the drafting of the letter to the SEC which described the issuer's performance. The court stated that "active involvement in discussions of how to respond to the SEC' inquires" and participation in the process of creating the response could be considered sufficient to bring the underwriter under the scrutiny of Rule 10b-5 as the primarily liable. The court, however, did not go into detailed discussion of the underwriter position.

Several district courts also recognized underwriter participation in the offering as sufficient to be considered as a primary conduct. In *SEC v Dain Rauscher*[289] it was claimed that the underwriter should be liable because offering documents misrepresented and omitted material facts that the underwriter knew, or through reasonable investigation, should have known. The underwriter helped to prepare and draft the offering documents and was responsible for reviewing the final offering statements prior to issuance of the notes. The court recognized that some extreme reckless deviation from the duty to obtain and review an official statement can bring the underwriter in the ambit of Rule 10b-5. In *In re U.S.A. Classic Securities Litigation*[290] the court supported allegations that the underwriter participated in the issuance of prospectus and thereby employed a deceptive device constituting fraud under Rule 10b-5. In *In re College Bound Consolidated Litigation*[291] the court held that "even though an underwriter cannot be held primarily liable for false statements it did not actually make, such liability could be based on the dissemination of false statement made by others".

In *In re MTC Electronic Technologies Shareholder Litigation*[292] case (hereinafter – *MTC*) plaintiffs alleged the material misdisclosure in the registration statement and prospectus and a research report issued by the underwriter. The underwriter was also charged with failing to correct materially false and misleading statements which it knew to be false at the time they were issued. The court held that "in light of the central role underwriters play in the issuance of securities and the special reliance placed on them by prospective

[289] *SEC v Dain Rauscher, 254 F. 3d 852 (9th Cir. 2001).*

[290] *In re U.S.A. Classic Securities Litigation, 1995 WL 363841 (S.D.N.Y.).*

[291] *In re College Bound Consolidated Litigation, 1994 WL 172408, 1994 U.S. Dist. LEXIS 5756 (S.D.N.Y. May 4, 1994)* (n.d.).

[292] *In re MTC Electronic Technologies Shareholder Litigation. 898 F. Supp. 974 (E.D.N.Y. 1995) and 993 F. Supp. 160 (E.D.N.Y).*

investors, they are simply not secondary actors with respect to statements in the registration statement or prospectus". The court recalled the decision in *Chris-Craft Industries, Inc,. v Piper Aircraft* which recognized that although "an underwriter or dealer-manager for a securities issue does not actually prepare the registration material…<…> by participating in an offering [the underwriter] constructively represents that statements made in the registration materials are complete and accurate. The investing public properly relies upon the underwriter to check the accuracy of the statements and the soundness of the offer; when the underwriter does not speak out, the investor reasonably assumes that there are no undisclosed material deficiencies. The representations in the registration statement are those of the underwriter as much as they are those of the issuer".[293] According to the *MTC* court, this reasoning applies to the underwriter liability under Rule 10b-5. Therefore, the specific relationship between the underwriter and the issuer allows distinguishing it from the other secondary actors, such as auditors and lawyers. The court stated that while other professionals "must literally "make" the allegedly false statements in order to be liable under Rule 10b-5", the statements in the prospectus are automatically attributed to the underwriter.

The decisions cited above tend to suggest that at least some courts recognize the underwriter gatekeeping duties beyond the traditional prospectus liability. Upon closer look, the position is not so strong. First of all, those are mostly district courts decisions which are not precedents according to the American doctrine. Secondly, the only underwriter-related decision having a power of precedent – S*oftware Toolworks* is not supported by the majority of other Circuits. Therefore, this case-law has no strong authority and can easily be overruled based on the general case-law on the primary liability of the secondary actor. Finally, these decisions mostly applied to the misdisclosures in the official offering documents but not in all cases covered by the Rule 10b-5.

Moreover, the discussed above *Tambone*[294] tends to deny underwriter duties under Rule 10b-5 when the statements are not directly attributable. Although this decision caused a lot

[293] *Chris – Craft Industries, Inc,. v Piper Aircraft, Corp., 480 F.2d 341 (2d Cir.) cert denied, 414 U.S. 910, 94 S. Ct. 231, 38 L. ed. 148 (1973);.*

[294] *SEC v Tambone, 597 F.3d 436 (1st Cir. 2010).*

of controversy both within the judiciary[295] and academia[296] for the time being it is the main precedent in the field.

Recently there was a move to resolve this issue on the legislative level. In 2009 several bills were introduced which proposed to extend private liability to anybody who knowingly or recklessly provides substantial assistance to primary actors who engage in securities fraud.[297] This would have confirmed the underwriter secondary liability under Rule 10b-5. The idea was to include this proposal into the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter – Dodd-Frank Act). Professor Coffee also proposed to place a ceiling on liability for secondary defendants of 2 million dollars for individuals and 50 million for corporations, subject to the further provision that the award should not in any event exceed the greater of ten percent of the defendant's average income, net worth, or market capitalization.[298] However, these provisions seem to be abandoned as they did not make it to the adopted law. Instead, it was decided to confer the authority to bring such cases on the SEC.

Besides the questions of scope, Rule 10b-5 is also very different from Section 11 and 12(a)(2) as regards the required level of care and evidentiary burdens. The standard of care is much lower as Rule 10b-5 prohibits only intentional or reckless misconduct. As regards the meaning of intentional misconduct, plaintiffs need to show that the defendant has acted

[295] Judge Lipez issued the strong dissent with the majority's opinion supporting the SEC's position that "by virtue of his role in the securities market and his statutory duties, a defendant may make an implied statement without actually uttering the words in question".

[296] See Eric H Franklin, "How to Avoid the Constraints of Rule 10b-5 (b): A First Circuit Guide for Underwriters.," *ExpressO*, n.d., http://works.bepress.com/eric_franklin/1. arguing that if liability is only imposed in cases where the underwriter explicitly participates in the drafting of prospectus, any underwriter using a prospectus containing a misrepresentation may sell securities free from liability as long as it had no drafting responsibility. The liability can be easily avoided by splitting the functions – one financial intermediary may take responsibility for drafting and other just underwrite.

[297] On July 30 2009 Senator Arlen Specter introduced a bill Nr. S.1551, entitled The Liability for Aiding and Abetting Securities Violations Act of 2009, which proposes to extent private liability to anybody who knowingly or recklessly provides substantial assistance to primary actors who engage in securities fraud. In April 2010, Representative Maxine Waters separately introduced a House version of essentially the same bill Nr. H.R. 5042. On the May 4th Senator Arlen Specter also suggested that his proposal can also become a part of Restoring Financial Stability Act of 2009-the main legislative initiative stemming out of financial crisis. Nevertheless, these proposals did not make it into adopted Frank-Dodd Act.

[298] John C. Coffee, "'Evaluating S.1551: The Liability for Aiding and Abetting Securities Violations Act of 2009', Testimony Before the Subcommittee on Crime and Drugs of the United States Senate Committee on the Judiciary", September 17, 2009, http://judiciary.senate.gov/pdf/09-09-17%20Coffee%20Testimony.pdf.

with scienter.[299] The scienter requirement does not require a showing that the defendant actually desired to mislead or harm investors. It is sufficient to demonstrate that the defendant appreciated the misleading nature and consequences of its words and actions.[300] There is a great number of definitions of recklessness as developed by courts, such as "<…> those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence but an extreme departure from standards of ordinary care, [presenting] a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it",[301] "<…> carelessness approaching indifference"[302] or when defendants "had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts although they could have done so without extraordinary effort".[303] Courts tried to make it clear that recklessness should be significantly different from negligence: "not just a difference in degree, but also in kind".[304] Nevertheless, commentators note that now it is similar to the European style gross-negligence standard.[305] It is claimed that it is highly indeterminate.[306]

In other cases, the court held that the standard of care for an underwriter of municipal offerings is one of reasonable prudence. However, in order to become subject of Rule 10b-5 the departure from that standard has to be "extreme" in order to satisfy the element of scienter.[307] In order to succeed in its claim the investor must show that the underwriter

299 *Ernst & Ernst v Hochfelder, 425 U.S. 185 (1975)* (n.d.).

300 *SEC v Falstaff Brewing Co., 629 F. 2d 62, 76 (D.C. Cir. 1980)* (n.d.).

301 *Broad v Rockwell International Corp., 642 F. 2d 929, 961-962 (5th Cir.), cert. denied, 454 U.S. 965 (1981)* (n.d.).

302 *Hoffman v Estbrook & Co., 587 F 2d 509, 516 (1st Cir. 1978)* (n.d.).

303 *Kiernan v Homeland Inc., 611 F. 2d 785, 788 (9th Cir. 1984)* (n.d.).

304 *Sanders v John Nuveen & Co, Inc., F.2d 790 (7th Cir. 1977).*

305 Paul Davies, *Davies Review of Issuer Liability: Final Report*, June 2007, pg. 12.

306 Langevoort, Cox, and Hillman, *Securities Regulation*, pg. 650.

307 *SEC v Dain Rauscher, 254 F. 3d 852 (9th Cir. 2001).*

conduct was especially wrongful. In other words, the case law creates a rather low standard of underwriter care under Rule 10b-5.

Unlike both Sections 11 and 12, in Rule 10b-5 evidentiary burdens are not reversed. Investors have to allege that the defendants: (1) made a misleading material misrepresentation or omission; (2) investors relied upon defendants actions; (3) plaintiffs suffered damages caused by fraudulent acts; (4) defendants acted with scienter.

The proof of reliance or transaction causation is one of the trickiest questions in establishing the liability under Rule 10b-5. The general rule following the so-called "fraud-on-the-market" theory is that reliance is assumed given that the markets are efficient. This theory states that on the efficient market the security's price reflects all material information. Therefore, when investors make their investment decision based on the market price they indirectly rely on all the information. The misleading information, however, disrupts the functioning of this price formation.[308] To cite the Court the market "is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of stock is worth the market price." If investors base their decisions on the market price it is useless to impose on them the burden to demonstrate that they relied on the information.

The Fourth Circuit has applied the "fraud-on-the-market" theory in the context of proving reliance on statements by a secondary actor. The Court stated that "a plaintiff seeking to rely on the "fraud-on-the-market" presumption must ultimately prove that interested investors (and therefore the market at large) would attribute the allegedly misleading statement to the defendant". To establish the reliance a court should plausibly infer that "interested investors would have known that the defendant was responsible for the statement at the time it was made, even if the statement on the face is not directly attributed to the defendant".[309] This decision would suggest that the reliance requirement in cases against secondary actors would not be as automatic as it is normally. However, even in this case it will not be required for investors to prove that they have actually read and relied on the misstatement.

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[308] This theory was developed by the Supreme Court in *Basic Inc. v Levinson.*

[309] *In re Mutual Funds Investment Litigation, 566 F.3d. 111 (4th Cir. 2009).*

Secondly, investors also have to establish that there is a casual link between the misrepresentation or omission and investor's injury, *i.e.* loss causation. In lines with *Dura Pharmaceuticals, Inc. v Broudo*[310] it must be shown that any losses resulted from the fraud itself and not other market forces such as investor expectations, market conditions, or developments within the company.[311] Different circuits apply tests which range from strict to very lax loss causation.[312] Determination of damages is a complicated question which often becomes a "battle of experts" where each party presents expert econometrical evidence to prove or deny the loss causation.

Finally, the duty to prove scienter rests on the investor. In addition, there are elevated requirements on what investors need to show. According to the PSLRA the action cannot go forward, and the plaintiff cannot obtain discovery, unless and until the plaintiff can plead with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind (*i.e*., an intent to defraud in the case of Rule 10b-5 cases). In the case of the primary violator, this level of intent can often be shown without the engaging in discovery. For example, it can be shown that the executive has suddenly sold most of his stock after he learned of undisclosed negative information. But in the case of a secondary actor such as an underwriter, it is extremely difficult to plead such facts without discovery. A plaintiff cannot simply allege that the underwriter serving as an advisor to the issuer suggested fraud or illegality. Rather, she must plead such a claim with particularity before it can obtain any discovery. This serves as a big obstacle to hold secondary actors liable for securities fraud as in most cases they will be able to obtain early dismissals of the case.[313]

4. PROCEDURAL RULES IN THE USA

American law allows for the collective litigation of claims for damages within one proceeding, known as a class action. Class actions are regulated by the Federal Rule of Civil Procedure 23 and are set in their entirety in Key Rules of Court and Statutory

[310] *Dura Pharmaceuticals, Inc. v Broudo, 544 U.S. 336 (2006)* (n.d.).

[311] Ibid.

[312] Ann Morales Olazábal, "Loss Causation in Fraud on the Market Cases Post-Dura Pharmaceuticals," *SSRN eLibrary* (n.d.): pg. 339-340, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1435447.

[313] Coffee, "Testimony."

Authority. Specific rules applicable to securities class actions are further stipulated in Private Securities Litigation Reform Act of 1995 (hereinafter – the PLSRA) and Securities Litigation Uniform Standards Acts of 1998.

Class action is a representative collective litigation mechanism where all cases are treated as one.

In principle, any individual investor can bring a class action for damages on behalf on all others similarly situated. In practice, however, the majority of securities class actions are initiated and financed by securities lawyers and are lawyer-driven.

The USA law allows contingency fees. According to this arrangement the lawyer is paid a percentage of the recovery in case of winning the case and gets nothing if the case is lost. The contingency fee is usually around 20-30%.[314] This means that the lawyers have incentives, which can sometimes become perverse, to initiate private litigation as they can cover their expenses from their contingency fee.

In addition, there is also no "loser pays" rule, *i.e.* each side to a lawsuit bears their own costs, regardless of who wins. As a result, the securities lawyers risk almost nothing expect their own expenses and time in case of failure and thus have strong incentives to initiate securities class actions.

Some safeguards are provided against the lawyer's abuse of litigation.

First of all, the court has to select a lead plaintiff. Under the PSLRA the presumptive lead plaintiffs are investors with the greatest financial interest, even though they cannot be mentioned in the initial filing. Usually, big institutional investors become lead plaintiffs as this provides them with the opportunity to somewhat control the development of the case. The lead plaintiff also selects the lead council who is further responsible for handling the case. The lead plaintiff provision has not eliminated the strong interest of class lawyer's in the initiation of securities class actions, so that they remain lawyer-driven notwithstanding the PSLRA. This is because class counsel appointments depend upon who is selected as the lead plaintiff. Thus, the lead plaintiff provision encourages a competition among

[314] Theodore Eisenberg and Geoffrey P Miller, "Attorney Fees in Class Action Settlements: An Empirical Study," *Journal of Empirical Legal Studies* 1, no. 1 (March 1, 2004): 27-78.

lawyers to identify themselves with investors whose losses are so significant that they may qualify them as the most adequate plaintiff.[315]

Secondly, the court has to review the class action on its merits and can impose sanctions on frivolous litigation. Thirdly, the court must also review lawyers' fees to determine if they are reasonable. Finally, the law allows the discovery process in securities cases to begin only after the motion to dismiss has been superseded.

An American class action is an opt-out mechanism. At the outset, the court does not need to know the identity of every class member. Moreover, the individual investors do not need to take affirmative action to become members of the class. However, in order to get certified as a class several requirements, such as commonality[316], typicality[317], fairness and adequacy[318], numerosity[319], must be satisfied. Although the decision whether to certify a class is not supposed to involve a determination of the merits of the claim, as a practical matter it is a decision whether the claim will proceed at all.[320]

After the class has been certified the notice to potential class members must be published. Identified class members receive individual notice while others are informed by advertising or other practicable means. The notice informs class members that the action is pending, that they have the right to choose not to be part of the class, and if they do not opt-out, to enter an appearance by counsel if they wish. They must also be informed that if they do not opt-out, they will be included in the class.[321]

After the class is certified, single investors may opt-out of the class if they are not satisfied with the setting of the case or if they are otherwise not interested in pursuing the claim. All members of the class are bound by the settlement or decision of the court.

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[315] Cox and Thomas, "Leaving Money on the Table," pg. 858-859.

[316] There must be questions of law or fact common to the class, but it is not required that every question is common to all class members.

[317] Claims of the representative parties must be typical of the claims of the class.

[318] Representative parties must fairly and adequately protect the interest of the class.

[319] The class must be so *numerous* that joinder of all members is impracticable.

[320] Alexander, "An Introduction to Class Action Procedure in the United States," pg. 6.

[321] Ibid., pg. 8.

If the case goes to the court it is tried by jury. Jury trial is known to often result in unexpected and at times controversial outcomes. Jury members are often subject to the popular sentiment. Therefore, this adds to the pressure to settle the cases.

In practice only a small fraction of cases undergoes the full procedure. After the class action has been filed with the court, the great majority of cases are settled out of court. However, the law states that a class action may not be dismissed or settled without notice to the class and the approval of the court. Thus, after the parties reach a proposed settlement, they present it to the court for a determination that it is fair and adequate. Class members have the right to attend that hearing and to be heard. It is not uncommon for judges to insist on modifications to the proposal before giving approval. Additionally, in most large class actions, the trial judge or a settlement judge is actively involved in the settlement negotiations, and so has a role in shaping the terms of the proposed settlement. Only after this "fairness hearing" is the settlement finally approved.[322]

Once the case is settled the settlement amount is put in an escrow account and the settlement administrator is appointed who has to take all reasonable efforts to give potential claimants notice of the settlement, explain how they can submit their claims so as to be eligible to participate in a settlement and finally distribute the settlement.[323] At this point, investors need to take an active action to actually receive their compensation. Cox and Thomas (2002) show that there is a difference between retail and institutional investors. Retail members of the class have a *right* to claim compensation. On the other hand, institutional members of the class have a fiduciary *duty* to do so (as long as benefits of doing so exceed costs). They argue that for an institutional investor "a reasonable course of action should be guided again by comparing the costs to submit the claim with the expected award from the settlement". As on this stage of the case "the benefits of filing and perfecting these claims are much more concrete", it can be expected "this to be a one-sided calculation in favor of filing for any actively trading institution".[324] The money put

[322] Janet Cooper Alexander, "An Introduction to Class Action Procedure in the United States" (presented at the Debates over Group Litigation in Comparative Perspective, Geneva, Switzerland,, July 21, 2000), pg. 9, http://www.law.duke.edu/grouplit/papers/classactionalexander.pdf.

[323] For more information see Cox and Thomas, "Leaving Money on the Table," pg. 867-869.

[324] Ibid., pg. 867.

on the escrow account is further distributed among those investors who submitted their requests for compensation.

5. LIMITATION OF LIABILITY

5.1. Disclaimers and limitations

American law limits underwriter possibilities to modify or opt-out of the federal liability regime. Most of the methods of limiting the liability were deemed either by statute or by courts as not consistent with the aim of securities regulation.

First of all, Section 14 of the Securities Act and Section 29 (a) of the Securities Exchange Act stipulate that any condition, stipulation or provision, binding any person to waive compliance with any provision of these Acts or any rule of the SEC, are void. Therefore, disclaimers or waivers of liability by underwriters are explicitly prohibited already in the statutory law.

5.2. Indemnification and contribution

"Indemnification clauses" of underwriting agreements between the issuer and the underwriter present a more interesting case. The situation with indemnification clauses is rather strange. The SEC "has not opposed the inclusion of indemnification clauses as regards underwriters".[325] As noted by Loss, Seligman and Paredes "this special treatment of underwriters apparently has a historical explanation in the fears expressed during the early days of the Act that underwriters would be unwilling to assume the full risks of § 11, with attendant danger to the country's economic recovery".[326] Indeed, as a practical matter indemnification clauses are being inserted in all underwriting agreements.

Courts, however, have often declared these indemnification clauses void. The leading case *Globus v Law Research Service, Inc.*[327] declared indemnification void both in case of fraud (Rule 10b-5) and negligence (Section 11 and 12 (a) (2)). The courts held that such

325 Langevoort, Cox, and Hillman, *Securities Regulation*, 127.

326 Loss and Seligman, *Fundamentals of Securities Regulation*, 4629.

327 *Globus v Law Research Service, Inc.418 F 2nd 1276 (1969), cert. denied, 397 US (1970)* (n.d.).

indemnification clauses are contrary to the laws' underlying policies because they undermine the underwriter role as an investigator and public advocate.

The only possibility to limit the liability exposure for underwriters allowed by courts is by using contractual "contribution clauses". Courts held that, in general, contribution clauses are valid and can be enforced.

6. LIABILITY THREAT POSED BY THE USA SYSTEM

Having described different elements constituting the underwriter liability regime in the USA, it is now time to assess what is the deterrent threat posed by the combination of all legal rules described in this Chapter. To answer this question one has to examine not only the combined effect of legislative provisions but also the outcomes of real life litigation.

6.1. Law on books

a). Section 11

Section 11 and supporting procedural rules have all prerequisites to make the underwriter liability quite extensive.

First of all, the underwriter is explicitly included in the circle of potential defendants and defined by the law. This relieves any doubts as to whether the financial intermediary can be held liable if it failed to conduct careful investigation of the issuer.

Secondly, the definition of potential plaintiffs and therefore the extent of damages, at least as regards initial offerings, is quite extensive as it covers both primary and secondary market buyers of the issued securities. At the same time the size of damages does not become uncontrollable because only buyers of that particular issue of securities are included. Also in cases of initial distributions, the limitations on the size of damages do not allow the liability to reach the levels exceeding the full offering amount. Therefore, the maximum potential damages are always predictable.

The problem can only be encountered in the context of the SEO where it is very difficult for investors to prove the tracing requirement. Only a small group of investors may be able to participate in the case which will limit the magnitude of damages claimed in the case. It is also argued that traceability requirement provides perverse incentives to underwriters to limit the amount of IPO securities and offer more substantial amounts shortly afterwards.

By doing this they can make it more difficult for investors to trace back their securities because there will be already outstanding securities of the same class on the market. Thus they limit the Section 11 liability. Consequently, the tracing requirement can be seen as an element which unnecessarily limits the scope of liability so that "the deterrent and remedial purposes of the Securities Act have been severely limited".[328]

Thirdly, the allocation of evidentiary burdens also contributes to extending the liability. The general principle of civil litigation in tort cases is that the plaintiff has to prove their allegations. Section 11 changes this principle and excuses plaintiff investors from most of the evidentiary burdens. This makes filing and litigating the case much easier for investors and therefore makes the liability threat more profound.

Finally, the American liability regime can be very strong as disclaimers and limitations of liability are not allowed. While both indemnification and contribution clauses are allowed, they provide limited protection for the underwriter because quite often the issuer is already bankrupt by the time the liability issue is raised. Therefore, they cannot be regarded as an effective means of limiting liability.

The only limiting feature of the American Section 11 is the definition of damages which are described as "out-of-pocket" losses and capped by the offering price. Moreover, damages cannot exceed the total underwritten and distributed amount. Therefore, they represent the maximum possible gain the underwriter can receive from cheating or shirking in its monitoring. In addition, the damages are relatively standardized. While they may vary depending on the individual stake or the moment of purchase or sale, they do not take into account other circumstances such as trading patterns or individual investment circumstances. Therefore, statutory damages in the USA can be smaller than in some other jurisdictions which will be analyzed further in this book.[329]

Procedural rules also have all necessary features to lead to high levels of enforcement. First of all, the combination of class action mechanisms, the contingency fees and no "loser pay" rule provides lawyers with incentives to launch class actions. Though the individuals' damage is often too small to make a lawsuit worthwhile, a class action can aggregate many claims so that there is a significant total amount at stake – enough to make litigation

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[328] Sale, "Disappearing Without A Trace.", pg. 431.

[329] See Chapter VI.

economically feasible. Given that contingency fees are allowed, the potential class recovery is large enough to cover lawyers' expenses and bring profit. Thus, it becomes profitable for lawyers to specialize in class action litigation, and a plaintiffs' bar of "entrepreneurial lawyers" emerges. The lawyers' stake in the action, their fee, is large enough for them to search out potential class claims and to bring suit on behalf of the class. Thus, the combination of these rules can create a market for private enforcement of the law.

Once the class action is launched, underwriters have two options. One is to litigate the case in the court. The other one is to settle with all class members. Between these two, going to trial is the least attractive because the underwriter may be forced to pay full statutory damages. Moreover, the underwriter can be sure that if he will not settle, investors will proceed to the trial. Their costs of doing so are relatively low. All claims are settled in one single procedure. Costs do not need to be spent on finding and informing or getting consents of all parties *ex ante* but the case proceeds on the opt-out basis. The opt-out feature of the American class action also ensures that the majority of the class members will participate in the case. As participating in the case costs nothing while opting-out entails some costs, only those who value their damages more than the amount offered *via* settlement plus individual litigation costs will choose to opt-out. Moreover, major burdens of proof are reversed.

In sum, the probability of enforcement will be high because lawyers are motivated to file a case in which it is pretty certain that the underwriter will settle with all class members in anticipation that otherwise investors will definitely go to court and will be awarded damages of the amount equal to the price drop.

The problem which is often voiced about the American class action, mostly advocated by the European commentators but also supported by some US studies,[330] is that the US litigation system can become excessive and abusive and produce the following negative consequences:[331]

- No cost-benefit analysis by claimants on bringing litigation;

[330] For example see Committee on Capital Markets Regulation, *Interim Report 2006*; Michael R. Bloomberg and Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*, 2007.

[331] Hodges, *The reform of class and representative actions in European legal systems*, pg. 131-132.

- Excessive volume of litigation, particularly unmeritorious claims;
- Capture of litigation by lawyers pursuing their own interest;
- Conflicts of interest between lawyers and clients, particularly as regards the settlement amount;
- Too high litigation costs;
- Disproportionate lawyer's fee;
- Possibility of blackmail settlements due to the high pressure;
- The overall costs of the litigation are too high and impose significant unnecessary burden on the economy.

Among these mostly relevant in this context is that the USA system, one the one hand, can generate a too high enforcement level and at the same time too low settlement sizes.

The enforcement frequency can be too high because the class action mechanism, American rule of cost-sharing and contingency fees cumulatively provide class representatives or their lawyers with too high incentives to file cases. In addition, the ability to diversify their case portfolio allows taking risks of failure. Therefore, lawyers may be much more risk preferring than investors on questions of initiating suits. At the same time, many class members are small retail investors who have insufficient stakes to engage in close monitoring of lawyers' actions. Lawyers possess significant autonomy from investors. Therefore, lawyers are free not to perform the cost-benefit analysis of the merits of the case and file also cases which do not deserve to be launched. In turn, the economic pressure of litigation will trick defendants into settling such cases. This can cause overenforcement.

The possibility to make litigation decisions in accordance with own economic interests rather than those of the class, may also provide class attorneys with incentives to agree on early and low settlements in cases where it is worthwhile to pursue a large settlement. The literature on this topic explains that lawyers are not interested in demanding high compensation for their clients for two main reasons. First of all, as regards the size of settlement they are rather risk-averse. Once they invested their time and resources in the case, they have a lot at stake in case of failure. Therefore, they would choose a smaller but certain settlement over the higher but more risky one. Secondly, there is a threat that they can collude with the underwriter for low settlement in return of higher fees. To cite Coffee

(1983) "the parties can find a variety of means by which to trade low settlement for a high attorney fee, once the clients becomes only a distant bystander".[332]

Both problems are well-known and attempts were furthered to mitigate them. The PSLRA introduced several measures. Firstly, it required the court to invite class members to seek the position of the lead plaintiff and select the most suitable candidate as a lead plaintiff. When there are few competing candidates to become lead plaintiffs, the party with the most substantial losses is assumed to be the best suitor for this position. As a result, big institutional investors would become lead plaintiffs. This would provide them with the opportunity to somewhat control the development of the case and select the lead counsel who is further responsible for handling the case. Secondly, the court was instructed to scrutinize both the merits of the complaint as well as the reasonableness of attorneys' fees which would lower the expected return to the plaintiffs' attorneys from bringing a class action and thus would curb the excessive litigation. The court was also given a duty to impose sanctions on frivolous litigation. Finally, the PSLRA imposed a stay of discovery process until a motion to dismiss has been superseded. This measure was introduced because there was a concern that lawyers abused the discovery process by filing cases alleging bald violations, gaining access to defendant's documents and if those revealed that there was indeed a violation, amending the already filed claim with details learned through discovery. The stay on discovery was supposed to increase lawyers' costs of determining the presence of specific misleading statements and omissions and the materiality of such misstatements and omissions and thus to discourage the excessive litigation. As regards the size of settlement, the court was required to approve the settlement. These measures should have increased investors' control over the case and the reasonableness of the settlement amount.

Given that the concerns about the drawbacks of the American system are well-known and some action was undertaken to mitigate them, any strong conclusions about the current state of the litigation can be drawn only by analyzing the empirical data precisely in that particular area.

b). Section 12(a)(2)

[332] Coffee, "Rescuing the Private Attorney General," pg. 230-232.

It should be noted that in general the analysis of the deterrent effect of Section 12(a)(2) should be in line with what has been just discussed as regards Section 11. However, Section 12 has one considerable difference – it requires the privity between the plaintiff and the defendant. This highly limits investors' possibilities to use this device for the enforcement of underwriter gatekeeping duty. This means that the circle of potential plaintiffs and thus the size of estimated damages on the basis of Section 12(a)(2) is quite limited and does not pose serious deterrence to underwriters.

In addition, underwriter liability for oral statements and other communications related to the distribution will often not arise as these types of disclosure will not be considered to have materially affected the investor's perception. Thus, as long as information in the prospectus will be correct, investors will be expected to rely on the prospectus rather than on other types of information.

As a result, one can clearly see that Section 12(a)(2) is of secondary importance as an instrument of enforcement of the underwriters' gatekeeping duty in the USA legal system.

c). Rule 10b-5

As was discussed in this Chapter, Rule 10b-5 can be used against underwriters in two main cases. First of all, it can be used in cases where Sections 11 and 12 do not apply. In this case it is the only source of liability underwriters could face.

One can see that in such a case Rule 10b-5 cannot be considered a good example of underwriter liability. To start with, Rule 10b-5 is intentionally very broad and is considered to be the universal antifraud provision. It imposes the liability for reckless or intentional conduct, *i.e.* fraudulent rather than negligent behavior. As underwriter actions usually amount only to negligence, this provision will allow many cases of gatekeeping failure go uncovered.

Application of Rule 10b-5 is also problematic to underwriter fraudulent behavior. First of all, there is a considerable uncertainty whether underwriters as secondary actors fall under the liability coverage. Rule 10b-5 is applicable only to the primary violator, *i.e.* only the "maker" of the misleading statement. Whether the underwriter is "making" a statement when it simply participates in the preparation of the statement or distributes securities is not completely settled. Some case-law, such as *Software Toolworks* and *MTC*, emphasizes the special position of the underwriter in drafting offering documents and recognizes the mere participation in drafting of those documents as making of the statement within the meaning of Rule 10b-5. Other courts, such as *Tambone*, think the opposite. The Supreme Court will have another chance to finally resolve the puzzle as it will rule on *Mutual Funds* case. The legislative developments, *i.e.* the refusal to grant private right of action for aiding and abetting in the Dodd-Frank Act, however, point in the direction of limiting such underwriter liability.

In addition, litigating the fraud case against the underwriter is quite difficult. The duty to prove underwriter fault lays on the plaintiff. In addition, the fault must be pleaded with particularity. In case of underwriter liability this can be very difficult to prove. Investors also must prove both the reliance and loss causation. Scienter and reliance have proved to be highly controversial elements which cause a lot of uncertainty in the court practice. Therefore, investors face considerable hurdles in litigating the case against underwriters under Rule 10b-5. This suggests that Rule 10b-5 is of very limited use as a tool to foster the enforcement of underwriter gatekeeping duty and would not cause considerable deterrent incentives for underwriters.

As a result, it can be predicted that the impact of this provision for underwriter liability both in negligence and in fraud will be very limited.

6.2. Law in practice

There is very little empirical evidence about the real liability threat posed by the USA underwriter liability system. To start with, it must be stressed out that usually the discussion concerns not the underwriter liability in particular but rather the USA securities litigation in general or the even wider category of the USA private litigation. Thus, there are almost no studies focusing exclusively on underwriter liability for issuer's disclosures.

In general, it is widely acknowledged that the USA securities environment is quite litigious. Empirical evidence certainly suggests that each year there is a significant amount of cases brought and settled. Table 1 shows that within the period between 2002 and 2009 on average 189 class actions were filed per year and 104 settlements were reached. Fewer than one or two securities class action suits were tried in any year.[333] The average total

[333] Cox and Thomas, "Letting Billions Slip through Your Fingers," pg. 418.

amount of settlements per year for this period was 6,357 billion dollars with average settlement of 61,06 million dollars.

Table 1. Private securities litigation in the USA 2002-2009

Category/ Year	2002	2003	2004	2005	2006	2007	2008	2009	Av
Number of fillings	224	192	228	182	119	177	223	169	189
Number of settlements	111	94	110	119	90	109	97	103	104
Total settlement (million $)	2074	2960	3568 ,00	1001 8	1829 5	7363	2753	3830	6357
Average settlement (million $)	18,6 8	31,4 9	32,4 4	84,1 8	203, 28	67,5 5	28,38	37,18	61,0 6
Median settlement (million $)	7,40					9,30	8,00	8,00	8,18

Source: Cornerstone Research, Securities Class Action Settlements 2009 Review and Analysis and Securities Class Action Filings 2009: A Year in Review

Several influential reports were quick to name such figures excessive and affecting the competiveness of the USA securities markets.[334] However, the mere number of cases does not tell much about the probability of enforcement. To make such judgment one should at least compare it with the number of offerings per year and, ideally, the number of violations (which is by definition unknown). An example of such evaluation is a study by Alexander (1991) which examines a group of securities class actions alleging fraud in IPOs of computer related companies. This study found that suits were filed against every company in the industry and its underwriter whose stock declined significantly and these cases were settled for approximately one quarter of the potential damages. This constituted 9 out of 17 hi-tech companies which went public during the sample period. Based on these

[334] Bloomberg and Schumer, *Sustaining New York's and the US' Global Financial Services Leadership*; Committee on Capital Markets Regulation, *Interim Report 2006*.

empirical findings (certain decrease in price, same law-firm and similar damages) the author claimed that the probability of enforcement in IPO cases was very high and, in fact, this is the case of overenforcement or inappropriate enforcement because the settlement process in these cases did not take the merit of cases into account and some of these cases were totally meritless.[335]

On the other hand, there are many studies which show that the USA private enforcement system performs rather well. For example, studies following Alexander (1991) have "demonstrated time and time again that this was an overly hasty conclusion that is unsupported by any existing large sample study of securities fraud class action settlements".[336] For instance, a study by Choi (2002) showed that the PSLRA was effective in limiting both regular and frivolous litigation.[337] It also increased the dismissal rates as demonstrated by the empirical study by Pritchard and Sale (2005).[338] It was also showed that the participation of a big institutional investor as a lead plaintiff leads to the higher settlement.[339] Thus, it can be concluded that even if prior to the PLSRA there was some frivolous litigation, the empirical literature tend to suggest that the situation has greatly improved ever since and the amount of litigation is justified by the merits of cases.

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335 Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," *Stanford Law Review* 43, no. 3 (February 1, 1991): 497-598.

336 James D. Cox and Randall S. Thomas, "Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law," *SSRN eLibrary* (March 30, 2009): pg. 7, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1370508.

337 Stephen J. Choi, "Do the Merits Matter Less After the Private Securities Litigation Reform Act?," *Journal of Law, Economics, and Organization* 23, no. 3 (October 1, 2007): 598 -626.

338 A. C. Pritchard and Hillary A. Sale, "What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act," *Journal of Empirical Legal Studies* 2, no. 1 (March 2005): 125-149.

339 Stephen J Choi, Jill E Fisch, and A. C Pritchard, "Do Institutions Matter - The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act," *Washington University Law Quarterly* 83 (2005): 869; Michael A. Perino, "Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions," *SSRN eLibrary* (October 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938722; Ellen M. Ryan and Laura E. Simmons, *Securities Class Action Settlements 2009 Review and Analysis* (CORNERSTONE RESEARCH, n.d.), www.cornerstone.com.; James D. Cox, Randall S. Thomas, and Dana Kiku, "Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions," *Columbia Law Review* 106, no. 7 (November 1, 2006): 1587-1640; James D Cox, Randall S Thomas, and Lynn Bai, "There are Plaintiffs and... There are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements," *Vanderbilt Law Review* 61 (2008): 355.

Moreover, it should be made very clear that this data is not illustrative of litigation which is most relevant to the topic of this book, *i.e.* litigation on the basis of Section 11 and 12(a)(2) and of litigation against underwriters. The empirical literature usually does not focus on third party defendants such as underwriters and auditors. In their extensive study of empirical research on securities fraud, Cox and Thomas (2009) state that empirical investigation of the impact of securities class action on third party defendants is still relatively undeveloped.[340] In the similar context of auditor's liability they state that in fact what matters "among the missing facts that need to be gathered is a crisp assessment of the true risk faced by Big Four, so-called second-tier accounting firms, and all other accounting firms".[341] This statement is even more true as regards the underwriter liability.

As will be demonstrated immediately below, cases under Section 11 and cases against underwriters constitute only a part of the overall litigation activity. During the period from 2002 to 2009 underwriters were named as defendants, on average, in 7.9% of all cases that is in 8 to 14 cases per year.[342] Unfortunately, there is no data available on what kind of cases are brought against underwriters (Section 11 or Rule 10b-5). Anecdotal evidence, however, shows that cases are brought under both causes of action, Rule 10b-5 often being cited side-by-side with Section 11 or 12. This means that although on paper Rule 10b-5 should be almost irrelevant to underwriters as regards their gatekeeping duty, in practice it provides some deterrent effect on underwriter monitoring behavior.

There is some general data as regards all class actions based on Section 11 but not specifically related to underwriters. Loss and Seligman (1993) state that during the first 35 years after the adoption of the Section 11 only 2 adjudicated recoveries and 6 reported decisions approving settlements of class action resulted out of 30.000 filed registration statements. After the landmark decision in *Escott v BarChris Construction Corp* the number of cases has increased, however, it would never reach the extent of litigation on the basis of Rule 10b-5.

340 Cox and Thomas, "Mapping the American Shareholder Litigation Experience," pg. 28.

341 Ibid., pg. 30.

342 Based on the data from *Securities Class Action Filings 2009: A Year in Review* (Cornerstone Research), http://securities.cornerstone.com; Ryan and Simmons, *Securities Class Action Settlements 2009 Review and Analysis*.

The recent data for the period 2002-2008 demonstrates that Section 11 claims still constitute a fraction of the total securities litigation activity (see Table 2). Within this period Section 11 claims constituted, on average, 14.5% of all securities class actions.[343] In real numbers this is, on average, only 15-27 cases per year. Purely Section 11 and/or 12(a)(2) claims constituted even smaller fraction of overall caseload – only 4.1% of the cases or 4-8 cases in real numbers.

As a result, it is fair to conclude that while it is impossible to make strong claims about the real probability of enforcement against underwriters, it can be stated that the majority of these cases are not frivolous and the number of such cases is not excessively large. It can also be seen that both Section 11 and Rule 10b-5 are used as causes of action although the exact proportion of different types of cases is unknown.

Table 2. Private litigation in the USA 2002-2009

Case category/Year	2002	2003	2004	2005	2006	2007	2008	2009	Av
Section 11	11%	9%	7%	9%	12%	19%	23%	26%	14,5%
Section 12 (a) (2)	9%	4%	5%	5%	9%	11%	19%	24%	10,8%
Rule 10b-5	87%	91%	87%	91%	87%	80%	75%	66%	83%
Only Section 11 and 12(a)(2)	4.1%								
Underwriter defendant	5%	2%	1%	5%	4%	11%	17%	18%	7,9%

Source: Cornerstone Research, Securities Class Action Settlements 2009 Review and Analysis and Securities Class Action Filings 2009: A Year in Review

The second trend is that although misstatement cases are being brought, the full amount of statutory damages is never obtained. This happens because the parties do not go to trial but prefer to settle in order to avoid significant litigation costs.

343 This also includes overlapping cases where both Section 11 and Rule 10b-5 are mentioned as a cause of the action.

One can clearly see that in misstatement cases settlements usually constitute just a fraction of statutory damages. Within the period from 1996 to 2009 the relationship between the amount of settlement and estimated damages was the lowest for purely Rule 10b-5 cases, increasing for Section 11, 12 and Rule 10b-5 cases and was the highest for purely Section 11 and 12 cases. Still, even for purely Section 11 and 12 cases this constituted a mere 9.5% of estimated statutory damages.[344] The median amount of settlement as a percentage of estimated statutory damages in cases against underwriters (all cases) is higher than in cases against other capital market participants. Still, on average, this constitutes only 5.4% of the estimated investors' statutory damages.[345]

To put these numbers in perspective one has to understand that this is a just a percentage of estimated statutory damages. Statutory damages in the USA are equal to the price drop caused by the misstatement. This amount lays somewhere between zero and the full offering amount. Thus, statutory damages will be equal to the full offering amount only in exceptional cases when the price drops to zero. On average, they will be smaller than the offering amount. Therefore, 5.4% or 9.5% should be calculated not from the total offering amount but from a smaller sum equal to the price drop.

It is easy to see that the damages of this amount are quite low. Often they will be even lower than the minimum gain the underwriter receives from engaging in the offering, *i.e.* underwriting fee. The underwriting fee is usually equal to 7% of the underwritten amount. The lead underwriter is usually allocated with around 60% of the offering. Thus, the underwriter normally receives an income equal to 4.2% of the offering amount.[346]

This leads to the conclusion that the settlement damages underwriters pay in misstatement cases will exceed their official gains from engaging in the offering only in cases when the settlement will be higher than 4.2% of the offering amount which will happen only if price drops dramatically so that the basis for the calculation of damages is very high. If we allow for the possibility for some side-payments from the issuer to the underwriter, the deterrent effect of the damages of this magnitude is even more uncertain.

[344] Data calculated on the basis on Figure 8 in Ryan and Simmons, *Securities Class Action Settlements 2009 Review and Analysis*, pg. 9.

[345] Ibid. Note, however, that the cases against underwriters can include other than Section 11 cases.

[346] The lead underwriter usually distributes around 60% of the offering.

One has to acknowledge that despite this general result, the empirical studies show that the PLRSA had some impact on the size of settlement. It was shown that the participation of a big institutional investor as a lead plaintiff leads to the higher settlement. Thus, apparently the PLRSA had an impact so that the probability of opportunistic behavior by class attorneys became somewhat limited. However, PLRSA did not manage to completely eradicate the problem.[347]

7. CONCLUSIONS

Chapter IV was dedicated to an extensive legal analysis of the USA federal regulation of underwriter gatekeeping duty and liability.

The main conclusions of this Chapter is that out of three discussed causes of action – Section 11 of the Securities Act, Section 12(a)(2) of the Securities Act and Rule 10b-5 adopted under the Exchange Act, the former one is the most relevant instrument with respect to underwriter activities. Section 11 is a specialized provision of securities law which applies to underwriters' liability for misdisclosures in the official registration statement and prospectus. It was seen that the standard of liability and the structure of liability rule under Section 11 is very investor-friendly. The analysis showed that the only limitation of this provision is that in case of seasonal equity offerings it can be used only by a limited number of investors. Nevertheless, it was shown that in practice the liability threat is quite limited as settlements are usually quite low and often do not even exceed what the underwriter has formally gained by providing underwriting services. Thus, one should carefully weigh the statements claiming that liability in the USA is excessive. At least as regards underwriter liability under Section 11, this does not seem to be true.

In addition, this Chapter allowed concluding that as regards underwriters' liability for misleading statements outside the registration statement, two causes of action can be distinguished. Section 12(a)(2) can be applicable in cases against underwriters for oral misstatements related to distribution and for types of prospectuses other than the official registration statement. The standard of care under this provision and the structure of liability are almost identical to Section 11 with the difference that it applies only to the

347 Choi, Fisch, and Pritchard, "Do Institutions Matter - The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act"; Perino, "Institutional Activism Through Litigation"; Ryan and Simmons, *Securities Class Action Settlements 2009 Review and Analysis*; Cox, Thomas, and Kiku, "Does the Plaintiff Matter?"; Cox, Thomas, and Bai, "There are Plaintiffs and... There are Plaintiffs."

seller-purchaser relationship. In addition, types of disclosures covered by Section 12(a)(2) do not, as a rule, change investor's perception sufficiently enough to trigger the imposition of liability. Therefore, this Section is of limited use as regards the enforcement of the underwriter gatekeeping duty.

On the other hand, Rule 10b-5 promulgated under Section 10 (b) of the Exchange Act of 1934 can be used as a basis to claim liability against the underwriter in all other cases not covered by the two previously mentioned causes of action. It is a general anti-fraud provision which imposes the liability for reckless or intentional conduct. However, in this case the standard of care required from the underwriter is much lower and it is much more difficult for investors to litigate their case. The analysis showed that the case-law relevant to underwriters under Rule 10b-5 is very unclear and unpredictable. Therefore, it was concluded that Rule 10b-5 can only be regarded of secondary importance for the issue of underwriter liability and likely to create more costs than contribute to real deterrence.

CHAPTER VI. EUROPEAN LEGAL FRAMEWORK

1. GENERAL REMARKS

The EU law relevant to the question of underwriters' gatekeeping duty and liability differs significantly from its American counterpart. Chapter IV has shown that federal and state securities regulations co-exist as two parallel systems. The issuer has to satisfy both the requirements of the federal and state regulation. Similarly, investors can base their claims both of federal and state causes of action. Public enforcement is also available both on the federal level in the hands of the SEC and on the state level in the hands of local authorities.

The law applicable to securities offerings in the EU can also be described as consisting of two levels: the harmonized EU regulation and national regulations. Nevertheless, this system is very different from the USA dual system.

First of all, harmonized EU legislation has a supremacy over national Member States regulations. This means that national laws cannot contravene the EU legislation and in the case of conflict – the European law would have primacy. This allows creating the common core of European regulation which is equally applicable in all Member States.

Another difference from the federal US regulation is that the EU securities law is mainly contained in directives, which usually stipulate not the precise operational rules but only high-level principles. Directives are normally not directly applicable and should be implemented into national laws. Individuals, as a rule, cannot base their claims on provisions of directives.[348] Therefore, while the common principles of the EU securities regulation become part of national laws, national authorities have full discretion as to how to implement the framework principles of the EU directives as long as they are in line with these principles. Consequently, national laws of EU Member States can be described as having a common core, but differing in details.

EU securities law directives are usually referred to as maximum rather than minimum harmonization measures. This means that they set common standards to be implemented by Member States as opposed to the minimum standards leaving Member States to impose

[348] European law has developed multiple exceptions from this general rule. Under certain conditions Directives can be both vertically and horizontally directly applicable.

superequivalent requirements or, in other words, goldenplate the provisions of directives. Nevertheless, on some issues EU securities law directives explicitly allow Member States to expand the coverage of some provisions.

As a result, the parties in Europe in practice do not face the double regulatory regime but have to comply only with national laws which, in turn, implement the European rules. Investors can directly rely only on causes of actions established by the applicable national law.

Moreover, the EU does not have the EU level authority similar to the American SEC. Gatekeeping duties in EU Member States, are thus subject only to the national public enforcement system.

2. UNDERWRITERS' GATEKEEPING DUTIES AND LIABILITY WITHIN THE EU REGIME

2.1. Requirement to disclose information

The topic of civil liability for misleading information in prospectuses is dealt with in the EU Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC as amended by the Directive 2010/73/EU (hereinafter – Prospectus Directive). The Prospectus Directive imposes the requirement to publish the prospectus in all cases of public offerings as defined in the Directive. Article 5 provides the general principle that such "prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities". The documents implementing the Prospectus Directive further provide a list of minimum elements to be included in the prospectus. Similar to the American solution, this means that complying with these minimum requirements is not enough to satisfy the general requirement of Article 5. In addition, it mush be ensured that the whole complex of information leads investors to make an "informed assessment".

2.2. Basis for liability

To ensure the compliance with the requirement to disclose information Article 6 (2) of the Prospectus Directive stipulates that Member States shall ensure that their laws, regulation and administrative provisions on civil liability apply to those persons responsible for the information given in a prospectus. Thus the Directive demands not any kind of responsibility but specifically civil liability as an enforcement tool. Enforcement *via* criminal or administrative law or supervisory rules would, thus, be insufficient to satisfy the requirements of the Prospectus Directive.[349]

2.3. Possible defendants

However, at this point American and EU regulations start to differ. The American law names numerous parties, including explicitly the underwriter, as persons who can be held liable for the violation of the requirement to provide non-misleading information in a registration statement. Article 6 of the Prospectus Directive states that responsible for the content of the prospectus at the minimum should be the issuer *or* its administrative, management or supervisory bodies, the offeror, the person asking for the admission to trading on a regulated market or the guarantor, as the case may be. Therefore, the European law requires the responsibility to be mandatorily attached only to the issuer. Undoubtedly, this requirement of the European law is only the minimum, *i.e.* Member States are free to widen the circle of responsible persons by their national law. However, limiting the prospectus liability to apply only to the issuer would also be consistent with the EU law.[350]

As can be seen, the Prospectus Directive does not explicitly name the underwriter as one of the persons which Member States could make responsible for the prospectus. Moreover, the EU law does not even have a formal definition of the underwriter similar to the one in USA law. It seems that the European regulator is reluctant to recognize underwriters as main actors in European securities markets and to place on them the gatekeeping function and adequate enforcement devices.

[349] Susanne Kalss, "Recent Developments in Liability for Nondisclosure of Capital Market Information," *International Review of Law and Economics* 27, no. 1, International Review of Law and Economics (2007): pg. 83.

[350] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 492.

In addition, the Prospectus Directive requires that the persons responsible for prospectus are clearly identified in the prospectus by their names and functions. Moreover, responsible persons have to include in the prospectus an explicit declaration that "to the best of their knowledge, the information contained in the prospectus is in accordance with the facts and that the prospectus makes no omission likely to affect its import". Arguably, by inserting mentioned provisions in the Prospectus Directive the drafters pursued the goal to improve legal certainty and foster the responsibility. Nevertheless, these provisions have an unexpected negative effect. They limit the possibilities, at least within the statutory law, to extend the liability to other parties who have not explicitly accepted the liability. In contrast, the US law does not have the similar requirement. Of course, the parties participating in the distribution have to be named also in American prospectuses. However, they are not required to make a declaration. In other words, for the liability to attach there is no requirement of the express acceptance of liability, while the reading of the European law tends to suggest so.

This being said, it is also clear that the EU Prospectus Directive does not prohibit the underwriter prospectus liability. First of all, underwriters could come under the scope of Article 6 of the Prospectus Directive if they fall under the definition of "the offeror" or "the person asking for the admission to trading" and given that a Member State included this in its national law. Offeror is described quite tautologically as a legal entity or individual which offers securities to the public.[351] In turn, the public offer means a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities. This also applies to the placing of securities through financial intermediaries. It can be argued that the underwriter can come under the definition of the offeror, especially if it buys the securities from the issuer and further distributes them to investors, *i.e.* participates in the transaction as the principal. It can also be contemplated that the underwriter can be the person asking for the admission to trading as it is often the case that the underwriter takes care of the listing process.

Secondly, the notion of underwriter is also not completely unknown to EU law. One can come to this definition by referring to the list of financial services provided in the Annex 1 of the EU Directive 2004/39/EC on Market in Financial Services (hereinafter – the MiFID

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[351] Article 1(a)(i) "person making an offer" (or "offeror") means a legal entity or individual which offers securities to the public.

directive). The MiFID states that both "underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis" and "placing of financial instruments without a firm commitment basis" are considered as investment services. Therefore, financial service providers who engage in various types of underwriting are underwriters and come under the scope of the MiFID directive. The MiFID, however, has limited significance for the topic of underwriter liability.[352] Moreover, underwriters are also explicitly mentioned in Annex III of Commission Regulation (EC) 809/2004[353] which details the Prospectus Directive as regards information contained in prospectuses. These rules require that the prospectus provides names and addresses of the coordinator(s) of the global offer and of single parts of the offer as well as entities agreeing to underwrite the issue on a firm commitment as well as entities agreeing to place the issue without a firm-commitment or under best-efforts arrangements. Thus, the systemic analysis demonstrates that the institute of an underwriter is recognized by the EU law. The underwriting activities are "worth" regulating as financial services and the information about the underwriter is considered important enough to be required to be mandatorily included in the prospectus.

In summary, the European harmonized regulation on the issue of prospectus liability does not, as such, impose on underwriters the duty to monitor issuer's disclosure in the

[352] The Mifid directive regulates the provision of financial services. It has two sets of rules: rules which apply to a financial service provider in general and special rules governing the relationship between the financial service provider and its clients. According to the MiFID, investments services can only be provided by the entities authorized by the home Member State designated competent authority. Therefore, underwriters need to get authorization of the local authority in order to be able to engage in underwriting activities. Moreover, they are subject to specific MiFID rules as regards the organization, relationship with the authorities, etc.

Part of MiFID rules, such as the obligation to provide „fair, clear and not misleading information", to act with integrity in relation to information provided to clients or to take act in the best interests of its clients, apply only within the relationship of the financial service provider with the client. Individual investors, as a rule, do not fall under the definition of clients under the MiFID because underwriters will usually not be considered as providing any investment services to them. This is because underwriting services are provided to the issuer rather than to investors. The underwriter also does not qualify as providing investment advice because marketing of securities to the general public does not fall under the scope of investment advice which is understood as personal rather than general recommendations to a client.

In fact, mentioned MiFID rules will also not be applicable in respect of the underwriter-issuer relationship because the issuer will most often be considered as a professional client. According to the Annex II, large undertakings, such as issuers, meeting certain size requirements are considered to be professional clients. Professional clients are assumed to possess the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur. Consequently, underwriter relationship with the issuer will also be out of the scope of certain MiFID rules.

[353] Commission Regulation (EC) 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements.

prospectus and does not hold the underwriter liable. In addition, it imposes the requirement for each person to explicitly declare themselves as accepting the liability. This limits the extension of the liability to those who have not done so. Nevertheless, underwriters can become subject to the liability if they act as an offeror of securities or if they introduce such securities to trading. Moreover, nothing precludes underwriters from explicitly accepting the liability. Finally, individual Member States have a right to expand the liability coverage so to include underwriters.

2.4. Beyond prospectus liability

In addition, Article 15 of the Prospectus Directive also states that the information contained in an advertisement shall not be inaccurate, or misleading. This information shall also be consistent with the information contained in the prospectus, if already published, or with the information required to be in the prospectus, if the prospectus is published afterwards. The advertisement shall state that a prospectus has been or will be published and indicate where investors are or will be able to obtain it. In any case, all information concerning the offer to the public or the admission to trading on a regulated market disclosed in an oral or written form, even if not for advertising purposes, shall be consistent with that contained in the prospectus. However, the Directive does not impose or demand Member States to impose any liability for the violation of this requirement.

Other types of liability for misdisclosure in capital markets are regulated by the EU Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (hereinafter – Transparency Directive) which states that Member States have to ensure that the issuer or its administrative, management or supervisory bodies shall be responsible for violation of the periodic and *ad hoc* disclosure obligations of the Transparency Directive. The liability does not have to exist under civil law and administrative and criminal sanctions are sufficient.[354] It is quite clear that these provisions do not cover underwriters. As a result, underwriters' liability for disclosures outside the prospectus as well as the liability not related to the distribution is not regulated by the EU law. However, they may arise from the causes of action embedded in national law.

[354] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 492.

2.5. Unfair Commercial Practices Directive

The basis for the underwriter's duty to ensure that the information in the prospectus is not misleading can also be derived from Directive 2005/29/EC concerning unfair business-to-consumer commercial practices in the internal market (hereinafter – Unfair Commercial Practices Directive).[355]

The main goal of the Unfair Commercial Practices Directive is to protect consumers against unfair commercial practices. Article 5 states that a commercial practice is unfair if it is contrary to the requirements of professional diligence and if it materially distorts or is likely to materially distort the economic behaviour of the average consumer. In particular, Article 6 stipulates that a commercial practice is unfair if it is misleading, *i.e.* if it contains false information or deceives the average consumer and causes or is likely to cause him to take a transactional decision that he would not have taken otherwise. Article 7 also prohibits misleading omissions. The solicitation of investors using misleading prospectus could be regarded as an unfair commercial practice and thus banned by the Directive.

However, the Unfair Commercial Practices Directive has some limitations for it to be a powerful base for the underwriter liability. First of all, this Directive applies only to the business to consumer relationship. The notion of consumer covers only natural persons who are acting for purposes which are outside their trade, business, craft or profession. Thus, the Unfair Commercial Practices Directive applies only to the underwriter and the retail investor relationship. This means that institutional investors or any other entities, who often constitute a significant part of overall investors, are not covered by its protection.

Secondly, the arsenal of remedies foreseen by this Directive is quite limited. Article 11 imposes a general requirement for Member States to ensure that adequate and effective means exist to combat unfair commercial practices in order to enforce compliance with the provisions of the Directive in the interest of consumers. However, to implement this requirement the Directive only requires Member States to authorize persons or organisations

[355] Directive 2005/29/EC of the European Parliament and of the Council of 11 May 2005 concerning unfair business-to-consumer commercial practices in the internal market and amending Council Directive 84/450/EEC, Directives 97/7/EC, 98/27/EC and 2002/65/EC of the European Parliament and of the Council and Regulation (EC) No 2006/2004 of the European Parliament and of the Council,

regarded under national law as having a legitimate interest in combating unfair commercial practices, including competitors, to take legal action in court or/and before an administrative authority. Thus, the Directive does not grant a broad right of action to single consumers but relies on the enforcement by the authorized persons. Furthermore, the Directive provides courts or administrative authorities in unfair commercial practices cases with quite limited remedies. The Directive states that they should be entitled to order the cessation of unfair commercial practices or the prohibition of the practice. In addition, they can require publication of that decision or publication of a corrective statement. The Directive, however, does not speak about the possibility to grant damages to consumers.

Obviously, the fact that the Unfair Commercial Practices Directive does not provide for the possibility of compensation of damage does not prevent the Member States from regulating this question by their national laws. However, the private right of action can hardly be derived from the provisions of the Directive. However, the general requirement to ensure that adequate and effective means exist to combat unfair commercial practices could be interpreted very widely. Thus, the Unfair Commercial Practices Directive can be regarded as a good starting point for formulating the underwriter's gatekeeping duty. However, it does not provide for the use of civil liability as its enforcement tool.

3. PROCEDURAL LAW IN EUROPE

While there is some harmonization of substantive rules of securities law on the EU level, the common procedural EU law does not exist. The only clue on this subject the Prospectus Directive provides is that Member States shall ensure that civil liability applies to those persons responsible for the information given in a prospectus. Moreover, from the general jurisprudence of the European Court of Justice and from the recitals of the Directive itself it follows that sanctions of duties have to be effective, proportional and dissuasive. This duty is derived from the principle of loyalty of Member States enshrined in the treaties. Thus, it can be argued that not any form of civil liability would be in compliance with the EU law but only such civil liability which is effective, proportional and dissuasive. Each Member State is, however, free to choose which kind of procedural rules will be used to impose civil liability.

It is often claimed that most of the jurisdictions lack the proper mechanism for the consolidation of individual cases which is necessary to make civil liability in securities cases effective. While national procedural laws are very different, one can single out those main tendencies.

First of all, differently from the USA, EU Member States have the "loser pay" rule. Moreover, Hodges (2008) even states that the "loser pays" rule is so firmly embedded "in the psyche and architecture of European civil justice systems" that its removal is simply unthinkable.[356]

Secondly, in Europe there are no mechanisms totally adequate to pure the US type class action. However, different forms of collective actions exist in Europe that serve the same purpose of grouping individual claims for damages, such as joinder actions, representative actions and test cases, where a case brought by one or more persons leads to a judgment that forms the basis for other cases brought by persons with the same interest against the same defendant.[357]

Thirdly, the majority of representative actions (except for the UK) grant the right of standing not to the individual member of the group but rather to representative organizations or arms of the state government.[358]

Finally, existing European collective litigation systems are mostly opt-in and there is a lot of reluctance to introduce opt-out systems. Such reluctance is mainly explained by constitutional and human rights concerns, as well as "legal culture, adherence to the fundamental right of access to the courts, fear that the importation of the American type of class actions would lead to a flood of cases and so on".[359]

Nevertheless, it is also noted that there is an actual trend to move into the direction of facilitation of bringing suits in misdisclosure cases. Sweden, France, Spain, Germany,

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356 Hodges, *The reform of class and representative actions in European legal systems*, pg. 47.

357 Stuyck, *An Analysis and Evaluation of Alternative Means of Consumer Redress Other Than Redress Through Ordinary Judicial Proceedings*, pg. 260.

358 Ibid., pg. 281.

359 Ibid., pg. 321.

Norway and the Netherlands have each adopted reforms that remove some of the traditional roadblocks to the US style class actions.[360]

4. CONCLUSIONS

Chapter VI discussed the harmonized EU regulation in the field of misstatement liability. First of all, it was noted that differently from the USA law where federal and state laws are on equal footing, the EU law has precedence and superiority over national laws of Member States. It sets minimum requirements expressed as general principles from which Member States cannot deviate. However, individual Member States have discretion as regards how the EU rules can be implemented in national law. On some occasions Member States can also "goldenplate" European rules by adding additional requirements.

However, the role of gatekeepers as monitors of issuer's disclosure is not emphasised on the EU level. There are no explicit provisions which would provide for the enforcement mechanism to make underwriters comply with their gatekeeping duties. Moreover, the reading of the European law tends to suggest so that the prerequisite for the imposition of prospectus liability is for the persons responsible for the prospectus to be named in the prospectus as such and to make a declaration of acceptance of liability. This may result in the limitation of possibilities to hold underwriters liable unless they explicitly accept the liability. At the same time, there is nothing in the EU law which can formally preclude Member States from imposing the liability on underwriters.

The EU law does not regulate the procedural aspects of underwriter liability. This is left for the discretion of individual Member States. In general, European procedural laws are also perceived as not particularly supporting private enforcement. This is because most of them have the "loser pays" rule, do not allow American-style class actions, existing collective procedures are initiated by representative organizations rather than by members of the class and they are opt-in rather than opt-out.

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[360] Merritt B. Fox, "Civil Liability and Mandatory Disclosure," *SSRN eLibrary* (n.d.): pg. 250, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1115361.

CHAPTER VII. UNDERWRITER CIVIL LIABILITY IN THE NETHERLANDS

The Netherlands is a traditional civil law country. However, it's regulation of the topic of prospectus liability, in general, and underwriter liability, in particular, is very peculiar if not unique. This peculiarity is a feature both of substantive and procedural rules.

1. PROSPECTUS LIABILITY. SECTIONS 6:193 A, 6:194 AND 6:195

1.1. Requirement to disclose information

As regards the rules on the offering of securities to the public in the Netherlands there is nothing new. The main regulatory instrument is the Dutch Financial Supervision Act (Wet op het financieel toezicht) and implementing orders. This act mainly reflects the provisions of the Prospectus Directive. It prohibits any offerings of securities to the public or any prior announcement of such an offer in advertisements or documents unless an adequate prospectus is or will be made. A prospectus should contain all information which is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer. More detailed content requirements and the minimum information items that must be included in the prospectus are derived directly from the EU Prospectus Regulation. Compliance with the requirements of the Prospectus Rules does not automatically guarantee that informational duties are satisfied. It should additionally be assessed whether a prospectus contains *all* information relevant for investors. The prospectus has to be approved by the Netherlands Authority for the Financial Markets (Autoriteit Financiële Markten, hereinafter – AFM). Similar to other jurisdictions the approval by the AFM does not involve verification of information.

1.2. Basis for liability

The particularity of the Dutch law appears when one looks at the rules concerning prospectus liability. In comparison to other legal systems discussed in this book, Dutch law has no specific rules on prospectus liability. However, there are two different sets of rules – misleading advertising rules and unfair commercial practices rules, which can be used as a basis for prospectus liability. In general, these two sets of rules are very similar. The main difference between them is that one can be used as a basis for liability by private investors (those not acting in the course of their business) and the other one only by professional ones (those acting in the course of their business).[361]

It should be noted that chronologically misleading advertising provisions are much older than the unfair commercial practices regulation which entered into force only in 2008. Until 2008 all types of investors would use misleading advertising provisions as their cause of action in all prospectus misdisclosure cases. Therefore, the case law on prospectus liability in general and on underwriter liability in particular is mainly based on the misleading advertising cause of action. It is likely that the main principles of misleading advertising litigation will be reiterated in unfair commercial practices cases. It is also fair to predict that consumer related claims will have their specifics due to some small differences in the statutory text and the specific nature of retail customers.

The first set of rules is laid down in the Unfair Commercial Practices Act of 2008 (Wet op de oneerlijke handelspraktijken) and is focused on protection of consumers. It adds Section 6.3.3 A dedicated to unfair commercial practices to the Dutch Civil Code (hereinafter – the DCC). Section 6:193b states that a trader acts tortuously to a consumer if she commits an unfair commercial practice. A commercial practice is unfair if a trader acts contrary to the requirements of professional diligence and if the practice materially distorts or is likely to materially distort the capability of the average consumer to take an informed decision to make a transactional decision that she would not have taken otherwise. A commercial practice is specifically unfair if the trader commits a commercial practice that is misleading or aggressive.

Publication and distribution of the prospectus is regarded as a commercial practice which is directly related with the promotion, sale or supply of a product to consumers. Consequently, publication and distribution of a misleading prospectus can be considered as an unfair commercial practice when the misleading prospectus materially distorts or is likely to materially distort the capability of an average investor to take an informed decision to make a transactional decision that she would not have taken otherwise. Section 6:193j (2) provides that in case a customer suffers a damage as a result of the trader acting tortuously, the trader is liable for the damage caused.

361 G.P. Roth and M. van Eersel, "Litigation and Securities Law," in *Financial law in the Netherlands* (Alphen aan den Rijn: Kluwer Law International, 2010), pg. 492.

The second set of rules is focused on protection of professional investors who do not fall under the definition of a consumer.[362] In the underwriter – professional investor relationship the prospectus is treated as advertising. The main mechanism to ensure the correctness and completeness of information in advertising, and thus in the prospectus, is the liability for misleading advertising stipulated in Sections 6:194 and 6:195 of the DCC. Section 6:194 provides that a person commits a tort if she makes public or causes to be made public a misleading statement regarding goods or services which she, or the person for whom she acts offers in the conducting of a profession or business. Section 6:195 (2) states that if an investor suffers a damage as a result of misleading advertising, then “a person who has entirely or partially determined or caused to determine the content and presentation of the announcement” is liable for the damage caused as a result.

1.3. Potential defendants

Following the Prospectus Directive the Financial Supervision Act requires the issuer to accept responsibility for the prospectus by making a statement. On the other hand, underwriters are not explicitly obliged to accept responsibility and make a responsibility statement. Thus, the underwriter is not explicitly recognized as a responsible person by the specialized securities law. Consequently, it may be concluded that the Dutch prospectus regulation closely follows underlying EU rules.

However, the Dutch Supreme Court already in its 1993 landmark decision in the *COOP* case[363] recognized that the underwriter, in general, influences what information will be included in the prospectus to such an extent that the underwriter should be deemed as determining the entire contents and presentation of the prospectus. The Court acknowledged that although a prospectus is a compilation of information from various sources and with varying nature, it nonetheless constitutes a document which is presented to the public as one integrated whole. The average investor, when deciding whether or not to invest, mainly relies on the prospectus, and that, because the lead manager attaches its name to the issue, the average investor will and may reasonably expect that the lead

[362] Before the entry into force of the unfair commercial practices provisions all claims were based on misleading advertising provisions.

[363] *ABN AMRO v The Association for the representation of the interests of Coopag Finance BV HR 2 December 1994, NJ 1996, 246* (n.d.).

manager has not done so without proper diligence. The underwriter has its own responsibility because it prepares, signs and distributes the document.[364]

In a more recent decision in the *World Online* case[365] the Supreme Court elaborated that lead underwriters have a special duty of care towards investors, given their central role, irrespective of their official title such as "global coordinator" or "lead manager". The duty of care in the context of an offering on the Dutch market applies irrespective of whether the leading underwriter is Dutch or foreign.

Note that the coverage of unfair commercial practices rules is somewhat broader than misleading advertising rules. In misleading advertising cases in order to hold the underwriter liable it is crucial to determine whether it has determined the content and the presentation of the prospectus. In unfair commercial practices cases the trader is responsible independently whether it has determined the content and the presentation of the prospectus or not. A trader is defined as any natural or legal person who is acting for purposes relating to her trade, business, craft or profession and anyone acting in the name of or on behalf of a trader.[366] This includes all types of underwriters. This allows expanding the unfair commercial practices cases also to syndicate members other than the lead underwriter.[367] As it will be seen below, this could also negate the possibility for the lead underwriter to disclaim the liability for the parts of the prospectus. The unfair commercial practices case is thus somewhat similar to Section 12(a)(2) of the USA Securities Act which stipulates the liability of the seller of securities.[368] However, this does not mean that all kind of underwriters will be subject to the same duty of care. It is plausible that the standard of care will be higher for lead underwriters than for other

[364] F. Graaf, "Risks for lead managers in The Netherlands," *International Financial Law Review* 12, no. 12 (1993): pg. 32. It should be noted that in this case the prospectus did not disclose which parts were prepared by whom.

[365] *VEB et alia v. World Online, ABN AMRO and Goldman Sachs, VEB et alia v. World Online, ABN AMRO and Goldman Sachs, LJN: BH2162, Hoge raad 07/11104* (n.d.).

[366] Article 6:193a of the DCC.

[367] T.M.C. Arons and A.C.W. Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," in *Financial law in the Netherlands* (Alphen aan den Rijn: Kluwer Law International, 2010), pg. 455.

[368] See discussion of Section 12 (a)(2) in Section 3.1 of Chapter V.

members of the underwriting syndicate.[369] Sticking to the core of this book, further the attention will be mostly dedicated only to the gatekeeping function of the lead underwriter.

1.4. Potential plaintiffs

As it was mentioned above, retail investors can claim damages on the basis of unfair commercial practices provisions while professionals can use a misleading advertising cause of action. A consumer is defined as any natural person who is acting for purposes which are outside his trade, business, craft or profession.[370] Retail or private investors thus are covered by this definition. This encompasses also experienced and qualified investors as long as they are not acting for purposes related with their trade, business, craft or profession.[371]

However, the question on whether these are primary market or/and secondary market investors has no clear answer. There is no case law on this question. Some commentators claim that the liability provisions are available for both primary and secondary market investors provided that the prospectus is misleading with respect to information which has lasting importance. There is also no tracing requirement. Hence both the buyers of the new and the outstanding securities of the same kind can launch the claim. The possibility to bring the claims ends when the investor finds out or should have found out that the prospectus is defective. Others limit the circle of potential plaintiffs only to the purchasers on the primary market. Secondary market investors would still have a claim but only on the general tort law provision of Section 6:162 of the DCC.[372]

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[369] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 455.

[370] Section 6:193a of the DCC.

[371] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 455.

[372] Klaus Hopt, *Prospekt- und Kapitalmarktinformationshaftung: Recht und Reform in der Europäischen Union, der Schweiz und den USA* (Tübingen: Mohr Siebeck, 2005), pg. 795-794.

1.5. Liability standard

The standard of liability under both sets of rules is negligence with a reversed burden of proof. The underwriter has a duty of care in respect of all the information in the prospectus. Similar to American law the Supreme Court made it clear that the underwriter role in the distribution and issuance of securities does not consist merely in gathering information in order to draft the prospectus. It also imposed on the underwriter a duty to take an autonomous position *vis-a-vis* the issuer and carry out an independent investigation.

There is no formal division in respect of expertised and non-expertised portion of statements. For example, in the *COOP* case the court stated that there is no general rule that the underwriter can blindly rely on the accuracy and completeness of financial statements merely because they have been certified by auditors. The underwriter must determine whether the information stated in an expertise portion contains information that an average Dutch investor would expect.[373] The Court noted that the underwriter must at least enquire with the issuer and the financial world, in particular with banks involved in the issuer's business.[374] The standard of reasonableness will likely to differ depending on the type of information in question. Thus, the contents of the due diligence investigation will most probably not be as demanding for the expertised portion of statements as compared to non-expertised statements. It will be also depend on the type of underwriter. The most demanding standard will apply to the lead managers. A less demanding standard will apply to other syndicate members.

1.6. Burdens of proof

The specificity of Dutch procedural law which can be applicable in prospectus liability cases is that the questions of the commission of tort and of damages are often, although not necessarily, separated.[375] The main reason for such separation is that the only available

[373] H. Cornelis and T. Nederveen, "Civil Liability for Prospectus Misstatements under Dutch Law," *International Financial Law Review* 14, no. 12 (1995): 50-53.

[374] Graaf, "Risks for lead managers in The Netherlands," pg. 32.

[375] This book mostly focuses on the possibilities of collective litigation in prospectus liability cases. It still remains possible to file an individual prospectus liability case. In such situation questions of commission of tort and of damages will be discussed at the same time.

remedy in a collective representative action relevant for prospectus liability cases is a declaratory judgment, *i.e.* judgment acknowledging that the prospectus is misleading to the average investor.[376] Claims for damages can be pursued only on an individual basis. Therefore, evidentiary burdens in declaratory cases and damages cases will be dealt with separately.

a). Burdens of proof at the declaratory judgment stage

Normally, the first step in misstatement litigation in the Netherlands involves a representative action to declare that the tort was committed. It is rather easy for investors to litigate such cases. A representative association files a claim seeking to declare that the prospectus is misleading to the average investor.[377] Section 6:193j (1), in case of unfair commercial practices, and Section 6:195 (1), in case of misleading advertising, provide that in such cases investors simply need to make a motivated claim that the information in the prospectus was incorrect or incomplete. Arons and Pijls (2010) argue that investors also need to show that because of its incorrectness and incompleteness the prospectus was misleading. While the question of incorrectness and incompleteness is factual, the evaluation of whether it was also misleading is subjective. The prospectus is misleading "if the falseness and/or incompleteness of the prospectus is such that one can reasonably expect that the average consumer would not have acquired the securities at all or at a lower price if he was aware of their falseness and/or incompleteness".[378] Thus, the court has to make a hypothetical assessment of the case taking as a reference an average consumer and the circumstances of a particular case. This assessment has a causation element; however, it is of a very general nature. Investors do not need to prove individual reliance on the statement or any other element of the case.

The reading of Section 6:193j (1) also suggests that to prove that the tort is committed it is enough to prove that the statement was misleading.[379] This would mean that whenever

[376] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 445.

[377] Ibid.

[378] Ibid., pg. 468.

[379] Ibid., pg. 463.

there is a misleading statement, the defendant, including the underwriter, would be recognized as having committed a tort without questioning their fault (violation of duty of care or non-performance of the due diligence). This conclusion would follow from the fact that the determination of whether the information was misleading involves evaluation of whether the statement is incorrect/incomplete and whether the average consumer would be affected by such information, as described above, but it does not encompass the question of the defendant's fault.

Moreover, differently from Sections 6:194 and 6:195, to hold somebody liable under Section 6:193j (1) it is not required to prove that the defendant "has determined the content and presentation of information". In my view, in both *COOP* and *World Online* cases for the declaratory judgment under Section 6:194 the discussion of the negligence was based exactly in relation of proving whether the underwriter can be recognized as a person who "has determined the content and presentation of information". If this interpretation is correct, in cases under Section 6:193j underwriters would be in the same position as issuers in declaratory cases – *i.e.* it would be kind of strict liability. The recognition that the tort was committed does not in itself make underwriters liable for losses to investors. However, it makes the pursuance of declaratory cases against underwriters very easy for investors.

The only defence available for the underwriter in a declaratory case under unfair commercial practices rules is that the information (or facts) was correct and complete or that even if it was incorrect or incomplete it was not misleading. It is suggested that the rationale for such reversal of proof is that it is generally easier for the person who is responsible for the content or the presentation of a statement to prove the accuracy.[380] In addition, on the basis of misleading advertising rules they could also argue that they have not determined the content and the presentation of the statement. However, given the prevailing case-law such a defence will unlikely to be successful.

b). Burdens of proof at the stage of the award of damages

As has already been mentioned, the award of damages in prospectus liability cases is possible only on an individual but not a collective basis. Assuming that it has already been established that the underwriters committed a tort by publishing or distributing misleading

[380] Hopt, *Prospekt- und Kapitalmarktinformationshaftung: Recht und Reform in der Europäischen Union, der Schweiz und den USA*.

prospectus, to succeed in their claim for damages investors need to show the individual causation.

There are no specific statutory rules on causation tailored either to misleading advertising cases or unfair commercial practices cases. This leads to the conclusion that the ordinary provisions of the DCC concerning causation which apply in case of any negligent act should be used.[381] Under Dutch law causation requires proving two types of relationship. First, it must be established that a tort was a necessary condition (*condition sine qua non*) for the harm. Secondly, it must be determined that the harm was a *reasonable* consequence of the tort (legal cause or attribution). As it was already described when discussing the USA legal system, causation can be further classified into transaction causation and loss causation. In Dutch law, transaction causation means that “but for” the tort the transaction would have occurred at a more favorable market price *or* would not have occurred at all. Loss causation means the link between the tort and transaction and the resulting harm. “But for” causation and legal cause normally have to be established for each kind of loss.[382]

The case law, however, points at the specificity of proving causation in prospectus liability cases. The Supreme Court in the *World Online* case[383] stated that it is quite problematic for investors to prove a *sina qua non* relationship between the misleading information and damages because there might be numerous other factors affecting the investors’ investment decision, investors might often not even read the prospectus. Therefore, the reliance should be presumed. It stated that in case of a misstatement in a prospectus, it can be assumed that an investor on the primary market would not have purchased the security, and that an investor on the secondary market would either not have bought the security or would have bought it on different terms.[384] Thus, transaction causation seems to be assumed in the

[381] Ibid., pg. 795.

[382] B de Jong, *Schade door Misleiding op de Effectenmarkt: Een Onderzoek naar de Vereisten van Causaal Verband en Schade bij Schadevergoedingsacties van Beleggers Wegens Misleiding door Beursvennootschappen, met* (Deventer: Kluwer, 2010), pg. 399–400.

[383] *ABN AMRO v The Association for the representation of the interests of Coopag Finance BV HR 2 December 1994, NJ 1996, 246.*

[384] de Jong, *Schade door Misleiding op de Effectenmarkt: Een Onderzoek naar de Vereisten van Causaal Verband en Schade bij Schadevergoedingsacties van Beleggers Wegens Misleiding door Beursvennootschappen, met*, pg. 406.

absence of proof to the contrary. The underwriter can rebut this assumption by showing that no connection exists between the investor's decision and the misleading statement. This would be specially the case when the investment decision was made before the misleading information was released.[385] Also, professional investors are also less likely to get misled by the misstatements.[386] Interestingly, the Supreme Court acknowledged that the relaxation of transaction causation requirement is required in order to comply with the requirements of the Prospectus Directive to ensure the effective civil liability regime for prospectus misdisclosures.

Notably, investors *may* choose not to make use of this presumption and prove individual reliance as it could permit them to demand the bigger damages, for example, also the losses sustained by not investing in an alternative investment project.[387] In this case they need to provide evidence of reliance. However, courts seem to accept that they are not obliged to do so.

In both cases (whether transaction causation is assumed or not) investors need to show the losses and loss causation. For this they have to present the event study showing the mode and extent of the price move. Moreover, they have to provide information about purchases and sales during and after the timeframe of the study, their investment patent and profile.[388]

Investors do not need to prove underwriter negligence as a part of claim for damages. However, the underwriter can protect itself from liability by proving that he cannot be held accountable for the tort committed.

[385] *VEB et alia v. World Online, ABN AMRO and Goldman Sachs, VEB et alia v. World Online, ABN AMRO and Goldman Sachs, LJN: BH2162, Hoge raad 07/11104*.

[386] Ibid.

[387] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 477.

[388] Jong, *Schade door Misleiding op de Effectenmarkt: Een Onderzoek naar de Vereisten van Causaal Verband en Schade bij Schadevergoedingsacties van Beleggers Wegens Misleiding door Beursvennootschappen, met*, pg. 407.

1.7. Definition of damages

In the Netherlands there is no clear statutory definition of damages similar to one in the USA. The main principle is that compensable damages should be equal to the actual damages. However, what constitutes "actual" damages depends very much on how the claim if formulated and judges have broad discretion when estimating damages. In principle damages are established by comparing the wealth position as it is with the wealth position that would have resulted in the hypothetical case that the tort had not occurred. Potentially, it can cover the "out-of-pocket" losses, lost profits, interest, transaction costs etc.

If the investor argues that "but for" the fraud she would have bought the security at a lower market price, the amount of damages is equal to the artificial inflation of the price. In this case damages will be approximated to the "out-of-pocket" loss. However, it is noted that the investor will also have to provide information about purchases and sales during and after the timeframe of the fraud. It will matter whether the investor ordered a certain number of the security[389] or invested a certain sum[390].

However, if the investor argues that "but for" the fraud the purchase have not have occurred at all (even at the lower price), the amount of damages would depend on the hypothetical assessment by the court about what the investor would have done instead of buying a security. To estimate these kinds of damages the court may require the investor to provide information about her general pattern of investment and his investment profile. As regards retail or incidental investors the court may assume that the funds would have been simply put into savings account.[391] In addition, interests, dividends and fees paid can be included in the calculation of damages.

Therefore, damages in Dutch misstatement cases are not standardized as in the USA and may vary significantly in individual cases.

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[389] In this case the damages are equal to the artificial inflation at the moment of purchase multiplied by the number of securities. Ibid., pg. 400.

[390] In this case the damages are equal to the amount of money needed to buy the net incremental number of securities that would have been obtained but for the fraud or a market value of the securities that were not received. Ibid., pg. 401.

[391] Ibid., pg. 407.

2. BEYOND PROSPECTUS LIABILITY

The Dutch law imposes some duties on the underwriter also as regards the information contained in sources other than the official prospectus but directly related to the distribution. Case-law[392] on misleading advertising and commentaries on unfair commercial practices[393] confirm that underwriter gatekeeping duty and liability also extend to statements using other means of communication, including press announcements and statements made during press conferences or in media interviews.

In the leading *World Online* case underwriters were held liable for *inter alia* failing to rectify impressions given to investors and the public in press conferences and interviews by the CEO and other officers of the issuer that were inconsistent with information in the prospectus and for failing to guide the issuer in order to prevent it from giving too optimistic an impression in press releases before and directly after the IPO. The court stated that underwriters owe a duty of care towards investors to take a proactive role, ensuring that investors and the market as a whole are properly informed. The Supreme Court confirmed that if public statements are made at the same time as an IPO and relate to the business of the issuer, sensitivity is heightened and the issuer and lead managers must take into account the impact that such statements may have on potential investors (using the average investor as a benchmark). Such statements must be consistent with the information in the prospectus and may not create false impressions or unfounded expectations in respect of the issuer's existing business or future prospects. If a misconception or lack of clarity results from statements made by or on behalf of the issuer or representatives of the issuer (whether before or after publication of the prospectus), the issuer must provide clarification. If the issuer fails to act, the underwriters may have to issue a press release. The obligation to clarify remains even if the prospectus contains true and complete information that is not misleading.

Underwriters also argued that they should not be held liable because there was a disclaimer in the prospectus which stated that potential investors should not rely on information outside the prospectus. The Supreme Court ruled that this does not exclude potential

[392] *VEB et alia v. World Online, ABN AMRO and Goldman Sachs, VEB et alia v. World Online, ABN AMRO and Goldman Sachs, LJN: BH2162, Hoge raad 07/11104*.

[393] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 457.

liability, as investors generally do rely on such outside information in certain circumstances.

The burdens of proof in cases of misdisclosure beyond prospectus are regulated by Sections 6:193j and 6:194-195 in the same manner as discussed above.

3. PROCEDURAL RULES IN THE NETHERLANDS

In the Netherlands, differently from the USA, claims for damages cannot be pursued in a collective action. The Dutch court in *Vie d'Or* case has ruled that claims for damages lack the necessary extent of generalization and therefore they cannot be considered of the similar or common interest. The rationale for such restriction is that actions for damages, specifically the nature and extent of damage and causation, require individual assessment of the claims.[394]

To mitigate this problem, the Dutch usually use a two step procedure. First of all, the representative collective action on the basis of Section 3:305a (1) of the DCC is launched seeking to achieve the declaratory judgment that the prospectus is misleading to an average investor. Next, investors can either launch follow-on individual claims, assign their case to a third person, negotiate a private settlement(s) with the underwriter or the representative organization can negotiate the collective settlement with the underwriter as prescribed in the Collective Settlement of Mass Damage Act of 2005 (hereinafter – collective settlement).[395]

Dutch representative action is a mechanism which allows a foundation, association or other non-profit organization, to initiate legal proceedings to protect the collective interests of a group of claimants in accordance with the objects described in its articles of association. This can be an established consumer or investors' organization. In the securities field the Vereniging van Effectenbezitters (hereinafter – the VEB) is the most important permanent interest group which launches proceedings on behalf of investors. It could also be a specialized entity set up for this particular purpose. For example, Stichting Investor Claims

[394] Willem H. Van Boom, "Collective Settlement of Mass Claims in the Netherlands," *SSRN eLibrary* (n.d.), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456819.

[395] Wet van 23 juni 2005 tot wijziging van het Burgerlijk Wetboek en het Wetboek van Burgerlijke Rechtsvordering teneinde de collectieve afwikkeling van massaschades te vergemakkelijken (Wet collectieve afwikkeling massaschade), Staatsblad 2005, no. 340.

against EADS foundation was incorporated under Article 3:305a of the DCC with the purposes to protect the interests of all investors in European Aeronautic Defence and Space Company.[396] Often, a collective action is the result of a coordinated effort by an established organization and one set up specifically in connection with the litigation. There also can be two or more organizations bringing separate collective actions in respect of the same issue if they are both found by the court to protect the interest of the group in accordance with the objects described in their articles of association.[397]

Similarly to the USA model where individual members do not have to take any explicit action to become members of a class, to show that it is representative, an organization must be able to identify its members but it is not necessary that class members come forward individually to opt-in. However, differently from the USA the representative organization starts a collective action in its own name and the judgment binds only the organization and the defendant, but not individual class members. Class members can still sue in their own right. Thus, the Dutch representative action cannot be characterized as a real representative procedure. It should rather be conceived as a test case. In representative litigation it is not required that possible class members are informed of the initiation of the litigation. In practice, however, the representative organizations seek to provide a lot of information and they seek publicity for their activities.

After the declaratory judgment has been obtained investors have various possibilities to seek compensation of their damage. The first possibility to receive compensation after the declaratory judgment has been delivered is for individual investors to launch individual follow-on claims. In individual proceedings investors will seek to declare that the defendant is liable to individual investors and determine the amount of damages. The litigation process in individual claims will follow the general rules of civil procedure with certain particularities which arise on the basis of Sections 6:193j or 6:195. The main hurdle for investors will be a requirement to show the causal connection between the misleading statement and their damages. However, it is suggested that the court will not apply overly strict causation requirements and will presume reliance.

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[396] For more information see http://www.investorclaimsagainsteads.com/index.php.

[397] Ianika Tzankova, *Netherlands Class Actions, Group Litigation and Other Forms of Collective Litigation (2)*, Global Class Actions Exchange (Stanford Law School, n.d.), pg. 5.

In principle, investors can also assign their claims or give a mandate to the foundation which will initiate a civil procedure on behalf of investors. Assignment of claims for compensation is broadly accepted under Dutch law although there is no fixed procedure how this can be done. However, it does not change the nature of individual cases and even in this case each claim will be treated individually. This can cause significant logistical problems because in each case the claimant must show a number of specific circumstances.[398] This is especially problematic as regards the causal link between the misleading statement and damages.[399] Although reliance is presumed an underwriter may try to rebut this presumption which would hinder the joinder of claims. Moreover, the estimation of damages will vary dependent on the way the claim is formulated and may require individualized proof.[400] Thus, such voluntary pooling arrangements can sometimes fail.

Alternatively, investors can negotiate settlements with the underwriter. These can be either private settlements or the representative organization may negotiate a voluntary collective settlement.

There are no special rules on private settlements and they are considered purely a private matter in which courts do not intervene.

In contrast, the collective settlement procedure is regulated. In 2005 the Netherlands has adopted a set of rules which provides for the court approval of an opt-out collective settlement. Given that the parties agree to settle the case out of court, they can apply to the Amsterdam Court of Appeal to declare the settlement fair and binding even on absent parties, on an opt-out basis. Investors can opt-out from the settlement by providing a written notice if they do not wish to be bound. Once the court approves the settlement and the time for opt-out expires, the settlement becomes binding on all class members.

[398] Willem H. van Boom, "Collective Settlement of Mass Claims in the Netherlands," *SSRN eLibrary* (n.d.), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1456819.

[399] Arons and Pijls, "Prospectus Liability in the Netherlands: Consequences of the Unfair Commercial Practice Rules (Wet Oneerlijke Handelsprakijken, Wet OHP)," pg. 479.

[400] de Jong, *Schade door Misleiding op de Effectenmarkt: Een Onderzoek naar de Vereisten van Causaal Verband en Schade bij Schadevergoedingsacties van Beleggers Wegens Misleiding door Beursvennootschappen, met*, pg. 408.

Investors have to be informed about the collective settlement twice. The first notice, upon courts approval, may be by advertisement only, if the court approves this. The second one can be given by ordinary mail.

The Amsterdam Court of Appeal has exclusive jurisdiction in first and final factual instance over collective settlement cases, and in this way can develop case management expertise in this field. It will consider several points concerning the substantive and procedural fairness and efficiency of the settlement.

De Jong (2010) reports that damages in collective settlement cases are usually calculated with the use of expert opinion regarding the artificial inflation for the relevant period. However, the court does not assess individual investor's motives for purchasing a security. Therefore, the damages for all investors are pretty uniform. It is admitted that "it would be very costly to investigate the actual loss for each investor, whereas the gain in precision is relatively modest compared to the more standardized approach".[401]

The allocation process of payments resulting from out-of-court approved collective settlements is an aspect that has to be considered by the court when it decides about the fairness of the settlement.[402]

Representative actions or settlements are usually financed by the relevant representative organization collecting an advance financial contribution from the individual group members. For example, in the *Dexia* case, investors paid a 45 euro voluntary donation to a foundation and this funding was used to start a collective action. The VEB finances its actions from membership fees and donations. A clear trend is that the media and, more specifically, consumer oriented television programmes are playing an increasing role in the initial phase in which contact is made between group members and lawyers and other legal service providers.[403]

A contingency fee arrangement is formally prohibited for members of the Dutch Bar but a success fee is allowed, including a percentage of the damages or settlement sum.[404]

[401] Ibid., pg. 409-410.

[402] Ianika Tzankova, *Netherlands Class Actions, Group Litigation and Other Forms of Collective Litigation*, Global Class Actions Exchange (Stanford Law School, 2007), pg. 18.

[403] Ibid., pg. 19.

[404] Roth and van Eersel, "Litigation and Securities Law," pg. 501.

Moreover, it is not prohibited for other third parties to fund a collective action or settlement on the basis of a contingency fee arrangement.

The “loser pays” rule is in place but it is also not very “biting”. Under the Dutch regime the “loser” pays only a small portion of the actual costs incurred. The amount awarded is based on figures fixed by courts and based on the amount in dispute and the number of court-related activities. Moreover, lawyers' fees and the costs of litigation in general are substantially lower in the Netherlands than they are in the US. This is due in part to the more limited discovery procedures available and the lack of a jury system. Court fees depend on the amount claimed and are capped at 5,916 euro. In sum, the amount the loser has to pay is limited and rather small as compared to the actual litigation costs and should not serve as a big hurdle to the litigation.

In the Netherlands there is no US or English style discovery. There are limited possibilities to obtain documents. Only specific documents may be requested and certain other conditions must be met. However, information can be obtained from witnesses (including expert witnesses) through a preliminary procedure akin to a pre-trial deposition. In certain corporate disputes, it may be possible to gather information through what are called inquiry proceedings (enquête-procedure).

There is no jury trial. The Dutch judges are appointed and not elected.

There are no punitive damages. Parties are, however, entitled to statutory interest on damages, on late payment of a principal amount, from the date on which the wrongdoing took place. This provides an incentive for parties to settle a claim.

4. LIMITATIONS OF LIABILITY

4.1. Disclaimer and limitations

The decision of the Dutch Supreme Court in the *COOP* case seemed to impose very wide gatekeeping duties on the underwriter. At the same time, the Court acknowledged that if the underwriter clearly states in the prospectus that certain statements were not made by him and that the underwriter does not guarantee their correctness, burdens of proof (in particular the burden to prove that the underwriter has determined the content of the statement and was negligent in doing so) are not reversed and rests on investors. Thus, in contrast to the USA where the limitation of liability is explicitly prohibited, the Dutch

Supreme Court allowed a kind of partial limitation of liability by underwriters. However, the consequence of such waiver or disclaimer is not the automatic limitation or exclusion from liability. It also does not affect the underwriter duty to perform the due diligence investigation.[405] It only results in the reversal of the burden of proof, making it more difficult for the investor to launch and litigate the case.

In addition, courts apply strict requirements to the form and contents of disclaimers. To be effective they had to be clear and printed in prominent place and manner. They had to clearly state which parts of the prospectus they refer to.[406]

It should be noted that the decision of the Supreme Court gave rise to a lively debate on the effect of the disclaimer, given that the due diligence has been performed. Due diligence was not performed in the *COOP* case. Thus the Supreme Court did not discuss this case in its decision. Commentators point at the discrepancy between the role of the underwriter in the offering and the possibility of fragmentation of liability. Timmerman cited by Hopt (2005) noted that once the underwriter performs a due diligence "it would become impossible, or at least illogical to declare in the prospectus that only the issuing company is responsible for the largest part if the information included in the prospectus".[407] Such statement by the underwriter would even be "misleading because of the fact that the lead manager has verified material parts of the prospectus while carrying out obligatory due diligence investigation".[408] Winter cited by Hopt (2005) also is of the same opinion stating that the reversal of burden of proof should apply to the prospectus as a whole.[409]

The validity of disclaimers is also attacked under unfair commercial practices provisions. In comparison to Section 6:195 of the DCC Section 6:193j does not require that the burden of proof is reversed only when the content and presentation of information in question was determined by the trader. Therefore, insertion of the disclaimer does not reverse the burden of proof because provision of information by the defendant is no longer required for the

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405 Cornelis and Nederveen, "Civil Liability for Prospectus Misstatements under Dutch Law."

406 Graaf, "Risks for lead managers in The Netherlands.", pg. 33.

407 Hopt, *Prospekt- und Kapitalmarktinformationshaftung: Recht und Reform in der Europäischen Union, der Schweiz und den USA*, pg. 789.

408 Ibid., pg. 790.

409 Ibid.

application of 6:193j of the DCC as long as it is proven that the information was misleading.

It is reported that since the *COOP* case IPO prospectuses in the Netherlands began to contain explicit limitations of liability by the underwriters. Dutch prospectuses often state that the IPO firm and its top managers are solely liable for the contents of the prospectus. According to Nederveen cited by Hopt (2005), these kinds of statements do not meet the requirements of the *COOP* case and will not have an impact on the reversal of proof.[410] Indeed, as can be seen from the *World Online* case the limitation of liability in the prospectus was not even discussed.

4.2. Indemnification and contribution

Dutch underwriting agreements similarly to the American ones contain indemnification clauses which allow a shifting of liability risks from the underwriter to the issuer. Commentators state that also under Dutch law the enforceability of such indemnification is doubtful, especially where the underwriter had actual knowledge of misstatements in prospectus.[411] In addition, usually the issuer is already insolvent by the time the question of indemnification arises. Thus, it cannot compensate the underwriter.

Contribution clauses are not discussed in the literature and the case-law.

5. LIABILITY THREAT POSED BY THE DUTCH LEGAL SYSTEM

5.1. Law on books

The analysis of substantive provisions of the Dutch law on underwriter prospectus liability shows that despite the differences in formulation there are few important similarities to American Sections 11 and 12.

First of all, while underwriters are not explicitly named as potential defendants in prospectus liability lawsuits, they are clearly recognized as such by the court practice.

[410] Ibid., pg. 794.

[411] Cornelis and Nederveen, "Civil Liability for Prospectus Misstatements under Dutch Law."

Thus, there is no doubt that underwriters are considered the main defendants in case of misstatements surrounding equity offerings.

Secondly, the position as regards the circle of potential plaintiffs is not completely clear but many agree that it will not be strictly limited to the primary market buyers. Thus, a relatively large circle of investors has a right to file a suit which theoretically creates conditions for high cumulative damages.

Thirdly, the standard of conduct is also very similar to the USA where underwriters are required to undertake a diligent investigation of offering documents. In a sense underwriters' gatekeeping duties in the Netherlands are even more extensive than in the USA as the underwriter has a duty to correct evidently misleading public statements made by the issuer's officers.

Finally, Dutch law also reverses the burden to prove negligence from the plaintiff to the defendant. Recent case law also suggests that the presumption of reliance will be applied in cases of misstatements. This highly facilitates a filing of claims by investors.

However, from here on the two systems start to differ. These differences are interconnected and determine and support each other.

To start with, there is no precise definition of statutory damages. They can vary in individual cases and include consequential damages, interests, dividends. On the one hand, this could lead to damages in the Netherlands exceeding American ones. This would happen because most of investors would claim only "out-of-pocket" damages while some would claim also other damages. On top, everybody would claim interest. On the other hand, this also means that the damages have to be assessed individually. Individual assessment of damages is possible only in individual cases. This goes in line with the provisions of Dutch procedural law which does not allow collective claims for damages.

However, the probability that *all* or even the majority of individual cases for damages will be brought is rather small. Investors in misstatement cases are usually dispersed and have minor stakes. Therefore, they are subject to rational apathy and free-riding problems. It is likely that often their costs of launching claims on individual basis will be lower than expected gains. Thus, investors' participation can be ensured only if their litigation costs are somewhat reduced.

In the Netherlands, prior declaratory judgment in a representative action can be seen as one of devices to reduce the costs of individual litigation and thus improves investors' incentives to sue. While a decision in the representative action does not have a formal *res judicata* power, it is very unlikely that courts in follow-on cases will deviate from the representative decision. Therefore, it makes it easier for investors to pursue their individual cases because they do not need to prove *de novo* that a tort was committed. Still, this is likely not to be enough to completely overcome rational apathy and free-rider problems of all investors to enable them to claim individual damages. Therefore, although potentially investors could argue that their individual damages exceeded the artificial price inflation, only few will be willing to litigate this question. As a result, one cannot expect the statutory damages in the Netherlands to exceed the damages in the USA.

Secondly, the number of investors participating in the case in the Netherlands can be expected to be much lower than in the USA. As mentioned before, the Dutch do not have a mechanism for collective litigation of claims for damages comparable to the American class action. Therefore, claims for damages have to be litigated either on an individual basis or by using some case joining techniques. It can be expected that, even with the prior declaratory judgment in place, individual cases will be launched only by investors with sufficiently large stakes.

The only possibility for ensuring the participation of a minor investor is that they assign their claims or give a mandate to the representative organization which will initiate a civil procedure on their behalf. However, such voluntary pooling arrangements can be disrupted by the need to assess individual issues of damages and causation. In addition, in order to become a party to a case, investors have to become active. In a sense, assignment of claims is kind of opt-in collective procedure. It is well established that opt-in procedures increase participation rates as compared to individual litigation but result in a lower rate of participation than the opt-outs. Thus, the assignment of claims to an organization would improve investor's participation as compared to the basic scenario. However, it cannot approach the scope achieved in the American class action procedure.[412]

Summing together the problems related with the individual litigation and litigation *via* assignment of claims, it is fair to claim that the number of investors participating in a case in the Netherlands will be lower than it would be in the USA where all members of the

[412] Collective litigation is likely to settle for a substantially larger amount of money in total than would have been expended to settle claims had individual litigation prevailed. D. R. Hensler, "The Globalization of Class Actions: An Overview," *The ANNALS of the American Academy of Political and Social Science* 622, no. 1 (March 2009): pg. 10.

class are automatically included in the case. This will lead the low prospective cumulative damages to be awarded even in case investors win.

Misstatement cases get finally resolved in courts only in exceptional cases. Most often they get settled in the anticipation of the trial. This would apply to the Netherlands as well.

It has been just shown that going to court in the Netherlands will likely lead to damages lower than in the USA. The magnitude of statutory damages is often cited as one on the main determinants of the settlement amount. As in the Netherlands the magnitude of damages in case investors go to court is not expected to be very high, this should affect investors' bargaining power in settlement negotiations preventing them from agreeing on high settlements amounts.

The Dutch litigation system is not likely to lead to high settlement amounts also for another reason. In short, while in the USA defendants are *obliged* to settle with all members of the class, in the Netherlands they have a *right* to do this. Thus, underwriters may choose not to exercise this right and settle only with a small group of investors who are likely to go to court.

In the USA once the class action is launched, there are two choices – either to go to court or settle with *all* class members. In the Netherlands, there are three options. The choice will largely depend on the costs of each of these regimes. First of all, the parties can go to court. Secondly, they can settle *via* a collective settlement procedure. In this case the settlement applies to all class members and is binding just as it is in the USA. However, this procedure is not obligatory. Thirdly, parties can negotiate purely private settlements. In this case the settlement binds only the settling parties while it does not preclude other investors from bringing their own claims. The court is not involved and the settlement is not finale.

Simple economic logic suggests that parties will prefer the cheapest solution. Litigation in court is traditionally associated with the highest litigation costs. Although, in the Netherlands these costs are lower than in the USA as the American-style class actions are not allowed, this argument still holds because there is always a prospect of individual litigation or assigned collective litigation. Moreover, in the Netherlands the declaratory decision may be used by investors as an additional argument to force the underwriter to settle either privately or collectively. By making it easier to file the individual claims for damages, the declaratory judgment increases the scope and threat of individual litigation.

The threat of litigation serves as an incentive to settle. Therefore, both parties will be willing to forego the option to go to court. The major choice is then between the private settlement and the collective settlement.

Let's first look at the choice of the underwriter. On the one hand, the underwriter has reasons to prefer the collective settlement. This is because the underwriter would save costs of negotiating and litigating individual claims. The settlement would be achieved in one procedure and once and for all. Indeed, Van Boom (2009) mentions that it is the desire to achieve the finality that has inspired tortfeasors to lobby for the adoption of the Collective Settlement of Mass Damage Act.[413] On the other hand, agreeing to the collective settlement means that the underwriter has to compensate all injured investors including those who have not yet expressed their willingness to participate in legal proceedings. By increasing the number of participating parties the collective settlement can increase expected damages. Thus, the underwriter faces a trade-off between the finality and higher settlement amount. It would choose the collective settlement only if this is the cheapest way to finalize the case.

When is it cheaper for the underwriter to go for individual settlements than for collective settlements? It is cheaper when the representative organization seeking the settlement has relatively few members. In this case, the underwriter will be better-off by simply settling with such organization on a private basis. Arguably, other small investors who are not members of an organization will not initiate individual proceedings because it is not cost efficient for them. The underlying logic is that if those minor investors have not chosen to participate by assignment of claims to the representative organization or becoming members of such association, it is unlikely that they will participate individually. Thus, the underwriter will have incentives to settle collectively only if the representative organization has a large number of members. Let me briefly note that high value investors or investors with large stakes do not matter in this calculation because the underwriter knows that they will need to be compensated anyway – either as a part of the collective settlement or by satisfying individual claims or settlements.

Now, if we look at incentives of a representative organization to choose between the collective settlement and the private settlement, we will see that it also has incentives to prefer a private settlement. Representative organizations are usually financed by the

[413] van Boom, "Collective Settlement of Mass Claims in the Netherlands," pg. 8.

membership fee. Therefore, they will have questionable reasons to protect interests of anybody else other than their members. Extending the number of investors to be compensated can be costly to the organization. First, the collective settlement procedure is relatively more costly than a normal settlement. It requires the parties to notify all interested parties and to stand before the court. Moreover, there is a threat that if the number of investors increases, the underwriter may not be willing to compensate the damages in full. Thus, by sharing the amount with other investors, members of representative organization are risking to decrease their compensation as a percentage of damages. As a result, while the representative organization may be interested in attracting new members, it has little incentives to seek for a collective settlement.

On the other hand, the Dutch system does not suffer from the principal-agent problems which affect the settlement amount as a percentage of total damages. Representative organizations do not operate on contingency fee basis and do not risk much in case of the failure of the settlement. Thus, they are not as risk-averse as lawyers in the USA. Their activities are also widely publicized. High settlements, therefore, attract new members with their membership fees. Therefore, representative organizations have all incentives to bargain for high settlements for their members within the private settlement framework.

As a result, on the one hand, there is a possibility that the settlement will cover only a fraction of injured investors. This points that the total settlement amount will be smaller than in the USA. On the other hand, the settlements per share or as a percentage of statutory damages can be higher than in the USA. The final outcome will largely depend on which of these two powers will prevail. The precise amount of damages in Dutch underwriter liability cases can be shown only on the basis of the empirical data.

It is important also to determine the probability of enforcement which the Dutch legal rules create. Incentives of representative organizations to initiate cases can be expected to be quite high. As mentioned before, in the Netherlands only the representative organization has an authority to initiate both representative actions for declaratory judgments and collective settlement negotiations. On the positive side, this allows overcoming the problem of rational apathy as compared to individual investors. Associations can rely on the shared funding. Moreover, s representative organization is less risk-averse than an individual investor. On the negative side, incentives of the representative organization to file a claim are not aligned with economic incentives of its members. Therefore, the incentives of a representative organization become very similar to the incentives of a public enforcer.

Salaries of agents of the representative organization are not aligned with the outcomes of the cases. Therefore they have weak incentives to actively search for cases of misdisclosure. Moreover representative organizations have limited resources both in terms of the budget and staff. Finally, the enforcement of the underwriter liability case maybe just one of many responsibilities of the representative organization which might not be its political priority. The selection of cases might also be one-sided. Representative organizations are likely to choose more prestigious cases or cases with high media coverage in order to attract new members[414] and raise their political importance. Therefore, they may not be able and willing to deal with all cases brought to their attention. In addition, there might be path-dependence. After the enforcement process has begun, there might be a trend to find the underwriter liable so to justify resources invested in litigating the case.

The incentives of a representative organization to seek for the collective settlement are as questionable as they are in the first case. Nevertheless, in case of collective settlement the organization may be motivated if it covers its expenses from the settlement amount.

However, there are prerequisites to expect that lawyers and other third party funders will be interested in either approaching an established organization or establishing the *ad hoc* organizations to commence litigation. This is because although a contingency fee arrangement is formally prohibited for members of the Dutch Bar, a success fee is allowed, including a percentage of the damages or settlement sum.[415] Moreover, it is not prohibited for other third parties to fund a collective action or settlement on the basis of a contingency fee arrangement. In addition, the "loser pays" rule is limited in magnitude.

The conclusion which follows is that while incentives of representative organizations to launch misstatement cases can be questionable, there is a possibility for third party funders to take advantage of Dutch procedural rules to initiate cases. Thus, although the probability of enforcement is not likely to reach the American dimensions, there is a chance that a significant number of cases will be brought.

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[414] Keske, *Group Litigation in European Competition Law*, pg. 128.

[415] Roth and van Eersel, "Litigation and Securities Law," pg. 501.

5.2. Law in practice

Reasonable efforts did not allow collecting any aggregate data as regards litigation in misstatement cases. However, there is information on separate cases. Declaratory judgment mechanism has been used in several misstatement cases, most prominently in *Philips*[416], *COOP* and *World Online.* There are also several examples of collective settlements in misstatement cases such as *Shell* and *Converium.*[417] Two cases can be used as an illustrative case-study. The *World online* case was settled privately. In the *Shell* case the collective settlement procedure was used.[418]

In the *World Online* case, the estimated investors' damage was close to 3 billion euro. The price drop was also pretty dramatic. Around 150,000 investors were injured. After the declaratory judgment was issued, the representative organization has reached a private settlement with underwriters. The total amount of settlement was 110 million euro. It was distributed only among 12,000 members of the representative organization. While this amount constituted 3.6% of the estimated statutory damages, each of participating investors received more that full compensation of their damages. In fact, it was claimed that this amount was even higher than the full "out-of-pocket" loss. This is mostly achieved due to the calculation of interest.[419]

[416] Supreme court, November, 1997, NJ 1998/268. The investors of Philips NV sued Philips because the financial forecast was not as positive as stated by Philips. The court held that Philips acted wrongfully by advertising the way it did.

[417] *Converium Holding AG, Hof Amsterdam (tweede meervoudige burgerlijke kamer) 12 november 2010, nr. 200.070.039/01, LJN BO3908, RF 2011/8* (n.d.). As in the Shell case, prior to the Dutch collective settlement two class actions were settled in the USA. These class actions did not include non-USA investors. The Court used the Shell decision as a precedent. The court assumed jurisdiction to declare an international collective settlement binding in a case where none of the potentially liable parties and only a limited number of the potential claimants were domiciled in the Netherlands. The decision is recognized in all European Members States, Switzerland, Iceland and Norway under the Brussels I Regulation and the Lugano Convention. Thus, it can be seen that the Dutch collective settlement is being used for settling international mass claims, irrespective of whether any (class action) litigation has taken place in the Netherlands. Nevertheless, it is still not clear what are the incentives leading defendants to agree to settle collectively. For more information see Helene van Lith, "Internationale bevoegdheid Nederlandse rechter WCAM-zaak," *Ondernemingsrecht 2011* 3 (maart 2011): pg. 117-122.

[418] *Shell* case was not directly related to the share distribution but concerned disclosures in the secondary market. Therefore, it cannot be directly compared to the World online case. However, it is useful as an illustration of the magnitude of damages in a similar case.

[419] http://www.veb.net/content/HoofdMenu/Acties/WorldOnline/ActieWorldOnline.aspx.

The amount of the underwriting fee underwriters have received in this case is not disclosed. However, normally the underwriting fee is around 3-4% of the underwritten amount. The offering amount was 12 billion euro.[420] The settlement involved all major underwriters, so it can be assumed that they have underwritten the biggest part of the offering. Thus, it is fair to predict that the underwriting fee could easily constituted 400-480 million euro in this case. Comparing the amount of settlement with the underwriting fee, one can clearly see that the settlement was considerably lower than the underwriting fee. Therefore, in this particular case it can be claimed that only a small fraction of investors participated in the case and the settlement amount constituted only a fraction of statutory damages which was even lower than the underwriter gain.

In the *Shell* case, investors had estimated damages of approximately 3.6 billion euro. After the settlement of the class action in the USA, the several Dutch representative organizations collectively settled with Shell (not the underwriters) for the total sum of 381 million euro. Almost all investors, except for a few who opted-out, received compensation. However, the proposed settlement constituted only 9.5% to 12.8% of estimated damages.[421] There are two perspectives to assess this amount. On the one hand, this magnitude of compensation is much higher than one normally achieved in similar cases in the USA.[422] It is also higher than in cases of private settlement. On the other hand, this is incomparable to the amount achieved per share in private settlement mentioned above.

6. CONCLUSIONS

Chapter VI focused on the regulation of underwriter liability in the Netherlands. It was noted that the Dutch system is particular because the issue of liability is regulated by the general Civil Code rather than by the specialized securities law statute. Negligent misstatement is considered either as a misleading advertising or as an unfair commercial practice. Despite the generality of the statutory provisions, Dutch courts have developed

[420] According to the information on http://en.wikipedia.org/wiki/World_Online.

[421] http://www.shellsettlement.com/index.php?page=settlement.

[422] According to the information provided by the representative organizations in cases that are the most comparable to the proposed settlement, median settlements were just 1.6% of estimated damages for cases settled through 2004 and just 0.6% for cases settled in 2005. Cornerstone research for the period 2002-2008 estimates them somewhat higher – between 2.3% and 4 %.

the case-law which clearly sees the underwriter as one of the main subjects of prospectus liability. Thus, the substantive content of liability provision is very close to the USA Section 11 with two significant exceptions – the statutory damages are not defined, limited and standardized and the burden to prove loss causation is not reversed. Therefore, investors have to prove losses in each individual case.

Procedural Dutch law is, however, significantly different from American law. The most important difference is that collective actions for damages are not permitted. However, the Dutch deal with this problem by using a two step procedure involving a representative collective action for a declaratory statement that a tort was committed followed by follow-on individual litigation, assignment of claims or private or collective settlements. The Dutch collective settlement procedure allows achieving the compensation of damages for all members of class on an opt-out basis. However, it is voluntary.

More in-depth analysis demonstrated that despite seemingly wide measure of damages, on average, the statutory damages in the Netherlands will not exceed the American damages. In addition, it can be expected that a smaller number of investors will launch their claims for damages. Thus, "the shadow of the law" in the Netherlands is expected to be less threatening than it is in the USA. This can be one argument why investors bargaining power in the settlement negotiations in the Netherlands can be lower than in the USA which can lead to low settlements. Moreover, in contrast to the USA where underwriters can only settle with the whole class, in the Netherlands collective settlement is not obligatory. Thus, the underwriter may choose to settle just with a certain group of investors. It is intuitive that the number of participants in the settlement has an impact on the total size of settlement. Thus, the analysis shows that the Dutch law is unlikely to lead to high settlement amounts in misstatement cases. This is illustrated by two recent settlements where settlement amounts approximated those usually achieved in the USA class action.[423]

The analysis also showed that incentives of representative organizations to litigate misstatement cases can be equaled to those of public enforcers. Nevertheless, there is a scope for third-party funders to initiate misstatement cases. Therefore, although the probability of enforcement in the Netherlands is not likely to reach the USA levels, the

[423] See Sections 6.2 and Conclusions of Chapter V.

Dutch underwriter liability regimes can and has already produced some significant outcomes.

CHAPTER VIII. UNDERWRITER CIVIL LIABILITY IN THE UK

1. PROSPECTUS LIABILITY. SECTION 90

1.1. Requirement to disclose information

The rules on the offering of securities to the public in the UK are contained in the special securities law statute.[424] Similar to the Prospectus Directive, the Financial Service and Markets Act of 2000 (hereinafter – the FSMA) states that the prospectus must contain all the necessary information which investors would require to make an informed assessment of the securities.[425] Implementing legislation adopted by the Financial Services Authority (hereinafter – the FSA) further stipulates the list of items to be included in the prospectus. Thus, although there are some minimum requirements as regards the quantity of information, a subjective judgment should also be made in order to satisfy the requirements as regards the completeness and correctness of information. Moreover, the information should be presented in a form which is comprehensible to analyze.[426]

1.2. Basis for liability

Section 90 of FSMA is rather similar to its American equivalent. It is a provision of the specialized securities law which provides that investors have a private cause of action against "the persons responsible for prospectus or the listing particulars" if they suffer damages as a result of any untrue or misleading statement or the omission in the prospectus. This liability attaches both to the official prospectus which is required in cases of public distribution in a sense of the Prospectus Directive as well as the listing particulars – an offering document which is published when the official prospectus is not required. Some offering documents, such as the admission document for an Alternative Investment Market listing are, however, not included in this coverage.[427]

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[424] It should be noted that I use the term UK law to refer to the UK statutory law and English common law. Scottish law also forms part of the UK law, however, I do not analyze it. I think that a choice to focus on the English law is justified given that the core of capital market activities takes place precisely in London.

[425] Section 87 A (1) (b) of the FSMA.

[426]Alastair Hudson, *Securities Law* (Sweet & Maxwell, 2008), pg. cvi.

[427] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 493.

1.3. Potential defendants

FSA Prospectus Rules provide a list of persons who can be responsible for the content of prospectus. In contrast with the US law and similarly to the Prospectus Directive, this list does not explicitly include underwriters. However, this list *inter alia* consists of persons "who accept responsibility for the content of prospectus", persons "who have authorized the contents of the prospectus" and persons who offer the securities.[428] These categories seem wide enough to potentially include underwriters. Nevertheless, in practice underwriters generally avoid the liability under the Section 90 of FSMA.

First of all, following the formula developed in the Prospectus Directive the British prospectus regime requires that responsible persons are named in the prospectus and they must make a declaration stating that "having taken all reasonable care to ensure that the information contained in the prospectus is, to the best of their knowledge, in accordance with the facts and contains no omissions likely to affect its import".[429] A person who accepts responsibility for the terms of a prospectus may declare that they accept responsibility only for a part of the prospectus and that they are liable only to that extent. Thus, underwriters can become included under the first group if they explicitly accept responsibility and make a declaration. It is noted, however, that it is customary that only the issuer and its directors accept responsibility.[430] In turn, as a rule, underwriters include various disclaimers of liability in underwriting agreements.

Secondly, the prevailing opinion is that mere participation in the preparation of prospectus does not constitute authorization. Even when the underwriter acts also as a sponsor, it will not be regarded as authorizing the content of the prospectus.[431]

Underwriters often act as offerors, *i.e.* make an offer to the public.[432] However, par. 5.5.7 of the Prospectus Rules provides that if the issuer is responsible for the prospectus, the

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[428] Prospectus Rules 5.5.3.

[429] Prospectus Rules App. 3.1.1., Annex 1, 1.1/1.2 and Annex III, 1.1/1.2.

[430] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 494.

[431] Ibid.

[432] At least when acting on a firm-commitment basis.

prospectus was drawn up primarily by the issuer, or the offeror is making the offer in association with the issuer, the offeror is excluded from liability. Moreover, the Prospectus Rules stipulate that a person shall not be responsible solely by giving advice in a professional capacity.[433] Two consequences follow. First of all, this provision can be interpreted as to exclude underwriters who do not underwrite the securities in the traditional sense but only provide advice, *eg.* the best-effort underwriting.[434] Secondly, as there is no guidance of what constitutes "primarily" drawing up of prospectus, it is also disputable under what conditions underwriters will fall under this provision even in firm-commitment underwriting. However, taken together with the fact that the issuer always explicitly accepts the authorship and responsibility for the prospectus, it is likely that in most cases the underwriters will enjoy the safe harbor provided by this exception.[435]

1.4. Potential plaintiffs

The category of potential plaintiffs under Section 90 includes any person who has acquired some of the securities to which the defective offering documents relate. The prevailing opinion for the long time has been that only persons to whom the statement was explicitly directed can sue the responsible persons. *Peek v Gurney*[436] gave a right of action only to the primary market investors. So did *Al-Nakib Investments (Jersey) Ltd v Longcroft*.[437] On the other hand, *Andrew v Mockford*[438] states that the prospectus can be issued with a view to inducing purchasers in the aftermarket as well as initial subscribers.[439] *Possfund Custodian Trustee Ltd v Diamond*[440] can also be interpreted as providing the right of action

[433] Prospectus Rules 5.5.9.

[434] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 494.

[435] Ibid., pg. 494-495.

[436] *Peek v Gurney (1873) L.R. 6 H.L. 377* (n.d.).

[437] *Al-Nakib Investments (Jersey) Ltd v Longcroft (1990) 3 All E.R. 321* (n.d.).

[438] *Andrew v Mockford (1896) 1 Q.B. 372* (n.d.).

[439] Geoffrey Morse, *Palmer's Company Law: Annotated Guide to the Companies Act 2006* (Sweet & Maxwell, 2007), pg. 5224.

[440] *Possfund Custodian Trustee Ltd v Diamond (1996) 2 All E.R. 774* (n.d.).

to purchasers in the after-market who sought to rely on the terms of the prospectus.[441] Latter case-law is interpreted as a changing recognition that prospectuses (as opposed to other documents such as documents related to takeovers) are intended to be relied upon by the public at large.[442] Nevertheless, there is no commentary how the question of tracing is resolved in the English legal system.

1.5. Liability standard

The FSMA provides the standard of liability similar to that of the USA Section 11. It is a negligence standard, the content of which varies depending on the nature of the statement. To avoid the liability for non-expertised statements defendants need to show that they reasonably believed (having made inquires they should reasonably have made) that the statement was true and not misleading. For statements prepared by experts, defendants need only to demonstrate that they "reasonably believed that the other person was competent to make or authorize the statement, and had consented to this inclusion in the form and context in which it was included". This is a much less stricter requirement than the one imposed by the American law, because it does not require the defendant to believe that the content of the expertised statement was correct. There is no case-law with regard to the further content of the duty of care.

1.6. Burdens of proof

In parallel to its American counterpart, Section 90 also shifts some burdens of proof from investors to defendants.

Investors do not need to prove the defendant's negligence. However, the defendant can use the performance of due diligence as a defense.

Commentators also claim that investors are also not required to prove reliance and investors can claim damages even if they have never seen the prospectus. Hudson (2008) suggests that it would be consistent with the spirit of the law that "to establish a claim the claimant does not necessarily need to show that they have read and relied on the particular

[441] Morse, *Palmer's company law*, pg. 5238-5239; Hudson, *Securities Law*, par. 24-44 - 24-52.

[442] Morse, *Palmer's company law*, pg. 5239.

misstatement in the prospectus, or even that they read the prospectus containing the misstatement at all. Rather the requisite causation may be established if the price at which the claimant acquired the securities was materially affected by the misstatement, or the omission, or the failure to correct it by the persons responsible for it".[443] However, the defendant may protect itself by showing that an investor knew about the statement being false.[444] Nonetheless, there is still no case-law confirming this position. Therefore, one shall be careful about relying too much on the presumption of reliance.

In contrast to American law, however, investors need to demonstrate the causal link between the misstatement and the loss. However, it is not clear whether or not that loss must have been foreseeable or whether there was simply some causal connection between the misleading statement and the loss which resulted from it. The proof of causation can become problematic to prove for investors the more time passes between the misdisclosure and its revelation which causes damages as it increases the likelihood of new factors which affect the price.

1.7. Definition of damages

According to the British law, in misstatement cases the measure of damages is that appropriate to claims in tort. It can be roughly described as "out-of-pocket" losses, although the definition is not as precise as in the USA. In general terms, the claimant is entitled to be placed in the position which he would have occupied if the misrepresentation had not been made. This is usually equal to the amount obtained by deducting from the price paid the actual value of the securities at the time of acquisition. In assessing this value, the market value may provide guidance but it is not a strict measure for damages. Courts in some cases can compensate consequential damages. However, they are reluctant to extend the ambit of consequential loss too widely.[445]

2. PROSPECTUS LIABILITY. COMMON LAW CAUSES OF ACTION

[443] Hudson, *Securities Law*, par. 23-15 - 23-16.

[444] QC Ross Cranston, *Principles of Banking Law*, 2nd ed. (OUP Oxford, 2002), pg. 350.

[445] Hudson, *Securities Law*, par. 24-8.

The basis for underwriters' prospectus liability can also be sought within common law causes of action. The most relevant are the torts of fraudulent misrepresentation and misleading representation. Contractual liability may arise out of breach of contract and the Misrepresentation Act of 1967. However, as the law stands now there are also very limited possibilities to hold the underwriter liable.

2.1. Tort of fraudulent misrepresentation

The main principle of the fraud liability is that a person who has been induced by the fraudulent misrepresentation either to subscribe for securities or to purchase them may recover damages for any loss sustained from the persons responsible for the misrepresentation.[446] However, there is a burden on investors to demonstrate several elements.

First of all, they need to show a fraudulent state of mind of the defendant. In *Peek v Derry*[447] it was ruled that liability for fraud at common law required either knowledge that the statement was false or that the maker of the false statement should have made it not caring whether it was true or false. However, a statement will not be fraudulently made if the maker reasonably believed in its truth or accuracy. It is not enough to prove the defendant's gross negligence or that it was made without any reasonable grounds for believing it to be true.[448] Intention or recklessness is needed for liability in fraud. In this way fraud in the British doctrine is a much stricter standard than Rule 10b-5 which has been interpreted by the courts as including cases of gross negligence, whereas an honest, even if unreasonable, belief in the truth of the statement prevents a finding of fraud in English law.[449]

Moreover, English law in the case of fraud requires that the statement of case alleged fraud clearly and that allegation must be supported with particulars, which are capable of supporting the allegation of fraud. Fraud cannot be pleaded generally. In addition, under

[446] Morse, *Palmer's company law*, pg. 5224.

[447] *Peek v Derry (1887) 37 Ch. D. 541, CA* (n.d.).

[448] Hudson, *Securities Law*, par. 24-26.

[449] Paul Davies, *Davies Review of Issuer Liability Liability for misstatements to the market: A discussion paper by Professor Paul Davies QC*, March 2007, pg. 45.

the Bar Council's Code of Conduct a barrister may not draft a statement of case making any allegation of fraud unless he has clear instructions to make such allegation and has before him reasonably credible material which as it stands establishes a *prima facie* case of fraud. Otherwise, the case gets rejected. As a result, it is very difficult for a claimant who does not have evidence of fraud to get past the strike-out stage.[450] Taken together with the strictness of the substantive standard, this creates considerable hurdles in using this cause of action against underwriters.

Secondly, it must be shown that the false statement was addressed to the investor in order to induce him to acquire the securities. Investors need to rely on the statement, *i.e.* they need to show that the statement induced them to acquire the securities. The question when it is reasonable to assume that the investor will rely on the statement is discussed in the case-law. It seems that the important factor for this decision is the context in which the prospectus is being put into circulation.[451]

Commentators note that in a case of secondary liability, such as underwriter liability, it is basically impossible to prove the secondary actor's (underwriter) intent to defraud. As a result, these requirements preclude any effective use of the tort of fraudulent misrepresentation as a cause of action against the underwriter. As it has been noted before, underwriter misconduct usually is not fraudulent but only negligent.

2.2. Tort of negligent misrepresentation

The tort of negligent misrepresentation, as interpreted by courts, is also not a very powerful tool in the hands of investors.

In *Hedley Byrne & Co. v. Heller and Partners Ltd*[452] the court established that the liability for negligent misrepresentation may arise where there is the necessary proximity between the representor and representee. Three conditions have to be satisfied. There should be a "special relationship" between the plaintiff and the defendant. This includes contractual as well as non-contractual relationships. Secondly, it should be foreseeable that the recipient

[450] Ibid.

[451] Hudson, *Securities Law*, par. 24-27.

[452] *Hedley Byrne & Co. v. Heller and Partners Ltd, [1964], A.C.465* (n.d.).

of the statement may rely on that statement. Finally, the defendant should in fact rely on the statement and as a result suffer a loss.[453]

In *Caparo Industries Plc v Dickman & Others* decision[454] (hereinafter – *Caparo*) the court held that the special relationship exists if (1) the advice is required for a purpose whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given, (2) the adviser knows, either actually or inferentially that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose, (3) it is known, either actually or inferentially, that the advice so communicated is likely to be acted upon by the advisee for that purpose without independent inquiry and (4) it is so acted on by the advisee to his detriment.[455]

Applying these criteria to the auditors' liability for the misleading audit prepared in connection to the takeover the *Caparo* court held that auditors do not owe a duty of care to investors who might rely on the audited accounts when buying securities in company (not related to a takeover). Auditors have no duty of care neither to the new investors nor to existing shareholders. The court concluded that even though "auditors are obliged by law to report to the general body of shareholders, there is no sufficient proximity between auditors and individual shareholders as the purpose of the auditor's report is not to allow individual shareholders to be better informed so that they could increase their stake in the company, but rather its purpose is to provide them with information as a general body so that they can better exercise control over the affairs of the company".[456] This decision has often been cited as to exclude the liability of third parties such as auditors and underwriters for misleading statements.

However, there is the ambiguity whether this is a correct interpretation of *Caparo*. The point is that *Caparo* was related to the specific context of a takeover and not the offer to the public at large. In this case, it was fair to conclude that auditors could not reasonably foresee that investors would rely on their audit to make unrelated transactions. Arguably,

[453] As developed in Ibid.

[454] *Caparo Industries Plc v Dickman & Others (1990) 2 A.C. 605* (n.d.).

[455] Hudson, *Securities Law*, par. 24-34.

[456] Dermot Cahill, *Corporate Finance Law* (London: Sweet & Maxwell, 2000), pg. 143.

this logic would change because in contrast to the takeover setting, in public offering the preparation of a prospectus is obligatory. Moreover, the prospectus is intended to be a statement made to the investing public on which such public can rely. Thus, *Caparo* would not preclude the liability of the third parties participating in the preparation of prospectus.[457] Some commentators point that "while it is not a position that has yet been confirmed explicitly by the courts, it is possible that an investor could argue that the sponsors and underwriters have a duty of care to investors to avoid misrepresentations in the prospectus".[458] At they same time they note that "given that the issuer clearly assumed responsibility <…> and given that sponsors and underwriters will generally expressly disclaim such responsibility, it is unlikely that such parties would be found liable for negligent misstatement solely on the content of the prospectus".[459]

Moreover, to succeed in their claims investors need to prove each ingredient of liability. This includes proving reliance and that they believed that the defendant intended them to act upon the misrepresentation.[460] This significantly increased the investors' burden of proof and discourages them from filing the cases.

2.3. Contractual liability

The only significant exposure to liability for underwriters may come on a contractual basis. Contractual liability is prescribed both by the statutory law, namely the Misrepresentation Act, and the common law breach of contract provisions. Contractual liability is available only against the contracting party. It has been held that other persons, such as the contracting party's agents, cannot incur liability under the Misrepresentation Act.[461] Thus, such liability can arise only when the underwriter acts as a principal (*eg*. in firm-commitment underwriting) and investors acquire securities from them directly. In such case, there is a contractual relationship between the underwriter and the investor. As a

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[457] Hudson, *Securities Law*, par. 24-41 - 24-43.

[458] Raj Panasar and Philip Boeckman, *European Securities Law* (OUP Oxford, 2010), pg. 297.

[459] Ibid., pg. 297;.

[460] Gerner-Beuerle, "Underwriters, Auditors, and other Usual Suspects," pg. 499.

[461] Morse, *Palmer's company law*, pg. 5223.

result, investors can use contractual remedies against the underwriter.[462] When the underwriter acts as an agent for the issuer (*eg.* best-effort underwriting) misrepresentations by the underwriter, within the scope of its actual or apparent authority, are attributable to the issuer even though the brokerage or placement agreement forbids such behavior. In such case investors can request rescission or compensation from the issuer who, in turn, can ask the underwriter to compensate him under the indemnification agreement.

3. BEYOND PROSPECTUS LIABILITY

It seems that in the UK the underwriter is more exposed to the liability for statements beyond the prospectus. Such liability may arise on these three main occasions: while using the “pathfinder” prospectus, when making statements during the marketing process and by issuing the “deal research”.

In a first case, a pathfinder, *i.e.* an unapproved draft prospectus, is considered as an advertisement. Therefore, it has to comply with the regime established by the Prospectus Rules for advertisements. In short, these rules require that such prospectus explicitly states that investors should subscribe for any securities only in the basis prospectus. They also require that the pathfinder prospectus is consistent with the information required to be included in the prospectus. Pathfinder prospectus also comes under the rules related to the financial promotion. According to Section 21 of the FSMA it is prohibited to communicate an invitation or inducement to engage in investment activity unless the content is approved by the authorized person. Underwriters are authorized persons and as such are allowed to make financial promotion and they are allowed to authorize issuer’s communications. Therefore, they may be sought by the issuer to authorize the pathfinder prospectus and thus accept responsibility for it. It might be the case that changes will have to be made to the pathfinder before it becomes approved. In this situation the underwriter may find itself in need to draw the changes to the attention of potential investors who have seen the pathfinder.[463]

Secondly, other communications during the marketing process may be attributed to the underwriter. Again, such communications come under the financial promotion regime. The

[462] Cranston, *Principles of Banking Law*, pg. 338.

[463] Panasar and Boeckman, *European Securities Law*, pg. 298.

FSMA and implementing regulations impose various requirements as regards the content and form of different types of financial promotion communications, including the duty to perform a due diligence. By approving the issuer's communication an underwriter is assuming responsibility for its contents. Similarly, if an underwriter issues a communication itself, it must comply with relevant rules. Courts may also deduct that by making comments during the road shows etc. the underwriters assume responsibility for such statements and thus should be subject to a duty of care under the common law.

Finally, when the underwriter also produces the research reports on the underwritten company it can get itself exposed to the liability.

In these situations the liability would be asserted on the basis of the common law liability for fraudulent or negligent misstatements. As discussed before, there are considerable evidentiary hurdles in respect of common law causes of action as investors are required to prove all elements of action. Indeed, commentators note that, although, theoretically there are various grounds for the liability to arise, it remains "very unusual in the United Kingdom for any party connected with a prospectus to be sued under any heads set out above".[464]

4. PROCEDURAL RULES IN THE UK

In the UK currently there are two mechanisms for multi-party litigation. However, only one of them is currently used in misstatement cases.

The first mechanism is the so-called representative rule which, at the first glance, resembles the USA class action. In the UK a representative action may be brought by one or more persons who have the same interest in a claim as representatives of any other persons who have that interest. The representative claimant does not need to be approved neither by the court nor by represented parties. Any judgment or order given is then binding on all persons represented but can only be enforced by or against a person who is not a party to the claim with the permission of the court. However, some elements on this action were interpreted very narrowly. Most importantly, limitations are placed on the award of damages. Damages cannot be awarded without reference to the particular loss suffered by members of the class. Therefore, each participant needs to be individualized

[464] Ibid., pg. 300.

and losses carefully calculated. This have been said to be the reason why "the English representative action remains a procedural blackwater rather than flourishing style of multi-party litigation".[465]

One can easily notice the similarity between the Dutch representative action and the British representative rule as regards their ban on processing claims for damages. However, while this ban does not make the Dutch to completely abandon the representative action which is still being used in order to obtain the declaratory judgment, in the UK this opportunity so far has not been explored.

The second type of collective litigation mechanism is a Group Litigation Order (hereinafter – GLO) as stipulated in Section 19.III of the Rules of Civil Procedure. It can be mostly described as a joinder procedure. A GLO is issued by a court when there is a number of similar claims that give rise to common or related issues of fact or law.

This is an opt-in mechanism. Upon the issuance of the GLO the Group Register is set up which lists all claims which have become part of the order. In contrast to the US system where all investors are included automatically in the class and have to take action in case they do not want to participate, in the UK investors need to take individual action. Investors willing to participate in the case need to explicitly to be added to the Group Register which they can do by submitting their individual claim before the court-imposed deadline. Individual submission is somewhat facilitated because the court appoints the lead solicitor who assists all investors in preparing and filing to join the official register. In fact, the lead solicitor usually takes initiative to identify the full range of class claimants and seeks to obtain the permission of as many of them as possible to join in the litigation and have their claims entered on the register.

A GLO can be issued upon request of either party to a case or by the court *ex officio*.[466]

The UK has the so-called "loser pays" rule which requires a plaintiff to pay the costs of the successful defendant. This raises investors' expected costs and thus deters them from lodging claims.[467]

465 Edward F Sherman, "Group Litigation under Foreign Legal Systems: Variations and Alternatives to American Actions," *DePaul Law Review* 52 (2003 2002): pg. 422.

466 Hodges, *The reform of class and representative actions in European legal systems*, pg. 55.

Contingency fees are not allowed, but conditional fees are. A conditional fee is an arrangement when the lawyer gets nothing in case of failure, but in case of victory he gets a success fee in the form of an additional percentage based on an hourly rate or a flat fee. The UK Law Society advises to limit the success fee to a maximum 25% of the amount received by the client.[468] As a result, British lawyers have fewer incentives to file claims than American ones.

Group and representative actions are still rare in the UK.[469]

5. LIMITATION OF LIABILITY

5.1. Disclaimers and limitations

British law's approach to the limitation of liability is rather interesting. The main principle is that limitation of liability is allowed in most cases arising from common law causes of actions but it not allowed for statutory causes of action unless it is explicitly allowed.[470]

The analysis above has demonstrated that the underwriter is neither forced to accept responsibility for the prospectus nor is considered as a person authorizing the content of the prospectus. The only real exposure can come in a very specific case, being if the underwriter falls under the definition of an offeror and the exceptions do not apply. However, even in this case Section 90 of the FSMA allows parties to accept the responsibility only for a part of the prospectus. As a result, the underwriter is allowed to limit his liability only to some parts and not to the whole prospectus. In practice, the

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[467] Hawes (2009). pg. 220-221. However, it is noted that this problem can be solved by the so-called after-the-event insurance which covers plaintiffs loser pays obligations. Third-party funding in the UK is already becoming a competitive market which "could give class action activity in the UK and Europe a boost". While it is still not a solution for a small investor in England, it can be an effective solution for the funding problems of institutional investors. In fact third-party funding of litigation is considered somewhat superior to the lawyer driven US style litigation. US class actions are lawyer driven while European style third party funded litigation is plaintiff driven.

[468] *Faure et al* in Mark Tull, *New Trends in Financing Civil Litigation in Europe: A Legal, Empirical, and Economic Analysis* (Edward Elgar Pub, 2011), pg. 44.

[469] Clare Canning and Ruth Malone, "Securities and Banking Litigation Arising out of the Financial Crisis in the United Kingdom," in *Global financial crisis: navigating and understanding the legal and regulatory aspects*, n.d. in Eugenio Bruno, *Global Financial Crisis: Navigating and Understanding the Legal and Regulatory Aspects* (London: Globe Law And Business, 2009), pg. 448.

[470] Cranston, *Principles of Banking Law*, pg. 340.

underwriter would take the responsibility only for the parts of prospectus which were prepared by the underwriter such as information about the distribution model. Arguably, this is not the kind of information likely to contain misleading information. Therefore, the FSMA allows underwriters to effectively protect themselves from liability.

5.2. Indemnification and contribution

Contractual indemnification provisions between the issuer and the underwriter are permitted. Indemnity can extend to all loss incurred by the underwriter with the exception of the loss resulting from its own negligence.[471] British indemnity provisions are even wider than the American ones. In addition to the usual "disclosure indemnity" under which the issuer promises to indemnify the underwriter in case of liability for misleading statements, British underwriting contracts provide for the indemnity in case of an actual or alleged breach of any of the company's representations, warranties or undertakings. For instance, the company might breach some securities law representations which can lead to regulatory sanctions for underwriters but not entail private civil liability. Moreover, British underwriting agreements often provide for a "transaction indemnity" which requires the issuer to indemnify the underwriter against all losses arising out of the services performed by the underwriters in connection with the offering unless there is gross negligence of the underwriter.[472]

Contribution is allowed under Section 1 of the Civil Liability Contribution Act 1978. The right of contribution arises when the other person is also held liable on whatever basis. The amount of contribution is determined by the court based on the other person's responsibility and may reach the full indemnity.[473]

[471] Morse, *Palmer's company law*, pg. 5241.

[472] Panasar and Boeckman, *European Securities Law*, pg. 142-143.

[473] Morse, *Palmer's company law*, pg. 5241.

6. LIABILITY THREAT POSED BY THE BRITISH SYSTEM

6.1. Law on books

The analysis in this Chapter shows that the British prospectus liability regime as applied to underwriters differs significantly both from the USA and the Netherlands.

On the one hand, it was found that the British have a specialized statutory prospectus liability provision modeled after American Section 11. However, underwriters usually simply do not fall under its coverage. The underwriter is not explicitly mentioned as a possible defendant. In addition, limitations of liability are allowed. Therefore, underwriters often use different disclaimers to further protect themselves against liability. As a result, the possibility for underwriter to become a subject to liability under Section 90, unless it explicitly accepts such liability, is rather low.

The analysis, however, did not limit itself to the assessment of statutory law and further looked at common law causes of action. It was seen that the tort of fraudulent misrepresentation covers only the most serious violations and requires proving all elements of the case. The tort of negligent misrepresentation covers also negligent behavior. However, as the case-law stands now, it seems to preclude the liability of secondary actors. Nevertheless, commentators see the possibilities that in the future the interpretation of the case-law will change. Nevertheless, this cause of action still requires the plaintiff to prove negligence, reliance and other elements of the case which will remain a considerable hurdle for private litigation.

This section will go further. It will seek to analyze the possibility of enforcement in the UK *assuming* that underwriters fall under the definition of a potential defendant. This could happen either in case underwriters would voluntary accept the liability, if it would fall under one of the categories of potential defendants mentioned in Section 90 or if the legal doctrine would change and courts would recognize them as potential plaintiffs. As currently this is not the case, further analysis is very hypothetical. Nevertheless, it is useful as it can show the potential for underwriter liability as a deterrence mechanism given that the problems of the definition of the potential defendant are fixed.

a). As compared to the USA

In the UK statutory damages are not defined very precisely as is the case in the USA but will in most cases be equal to "out-of-pocket" loss. Thus, they could be somewhat larger than in the USA because they are not capped by the offering amount. However, they would be somewhat lower than in the Netherlands where consequential damages can also be included in the definition of damages. This, however, only means that an individual investor *can* ask for damages of this magnitude. It does not mean that the full damages of this magnitude *will* be obtained. Therefore, in order to evaluate the overall magnitude of damages one should look at the expected level of participation of individual investors.

In the UK it is fair to expect a lower level of participation of individual investors in misstatement liability cases than in the USA. As was explained in the previous sections, misstatement cases in the UK can be litigated either on an individual basis or *via* the GLO procedure.

It has been mentioned on various occasions that individual litigation is only feasible when the individual stake is rather significant. Otherwise, it is too costly for investors to bring their claims. On the other hand, it is claimed that big institutional investors in the UK tend to settle misstatement problems by other means rather than litigation.[474] These sophisticated parties are accustomed to exert influence *via* informal, reputational and market mechanisms and do not regard private litigation as an important control tool.[475] Thus, one cannot expect a vibrant individual litigation.

The only possibility of a collective procedure is the GLO. The GLO allows somewhat reducing the individual costs for a plaintiff because the case is usually led by the lead solicitor who identifies investors, contacts them and arranges the filing of the case on their behalf. Nevertheless, if one looks at the economic incentives of lawyers to become lead solicitors, it is clear that these incentives in the UK are lower than in the USA. First of all, the contingency fee is not allowed. The conditional fee can be used but it is quite limited. Secondly, the "loser pays" rule is in place which makes it more risky for a lawyer or any other third party funder to start the litigation. Thirdly, the requirement to prove individual losses may highly complicate the collective resolution of the case and thus discourage the

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[474] Panasar and Boeckman, *European Securities Law*, pg. 300.

[475] Eilis Ferran, "Are US-style Investor Suits Coming to the UK?," *Journal of Corporate Law Studies* 9, no. 2 (October 2009): pg. 19.

lawyers from starting it in the first place. As a result, cases can be expected not to be brought with the sufficient frequency. Consequently, the total damages in case the misstatement case goes to the court can be expected to be rather small.

b). As compared to the Netherlands

If one compares the British situation with the Netherlands, one can clearly see that in both countries, besides the individual litigation, to achieve compensation of damages in court individual investors have to take some active action. In the Netherlands they have to assign their claims to a representative organization, a lawyer or other third party. There is no structured statutory procedure for doing so. However, the prior declaratory judgment procedure increases the chances of success of individual cases and therefore provides incentives to joining the case.

In the UK, investors can join the GLO which is a more structured way to bundle individual cases together than the Dutch assignment of claims. On the one hand, a structured and well-developed procedure in the UK can facilitate and lower the costs of litigation. However, it is difficult to see and moreover quantify how much more efficient is this mechanism as compared to the simple assignment of claims. On the other hand, the British do not have a prior declaratory judgment. Thus, the question whether a tort was committed still has to be resolved in the GLO. Thus, while the mechanism of bundling of individual cases maybe more developed and structured in the UK than in the Netherlands, joining the GLO litigation is more uncertain for investors in the UK than assigning claims in the Netherlands. It is hard to predict which of these two effects would prevail.

c). Predicting the size of settlements in the UK

As has been mentioned before, misstatement cases rarely go to trial. Thus, in order to evaluate the real liability threat one should evaluate the possible settlements in the UK.

First of all, as the number of participants in the case and the size of damages which investors are likely to obtain by going to court is rather low, also the bargaining position of a plaintiff in settlement negotiations is very weak. Therefore, one cannot expect high settlements in misstatement cases in the UK.

Secondly, in contrast to the USA and similarly to the Netherlands, there is no mechanism in the UK which would force the underwriter to settle with all members of the class. Moreover, there is not even a voluntary arrangement such as the Dutch collective settlement procedure which would allow the underwriter to settle with all injured investors. Thus, it is fair to predict that settlements will only be reached on a private basis with investors included in the GLO.

d). Probability of enforcement

The probability of enforcement can also be expected to be rather low. On the one hand, individual investors face too high costs to initiate cases independently. On the other hand, as was discussed in the previous section, lawyers and other third party funders do not face enough economic incentives to ensure that the complex GLO procedures are commenced with sufficient frequency. At the same time, representative organizations are not granted with either a right or a duty to initiate cases on behalf of investors. Thus, it is likely that private enforcement in misstatement cases will take place only sporadically in the most clear and egregious cases. It is fair to predict that the probability of enforcement in the UK will be much lower than in the USA and maybe even lower than in the Netherlands.

6.2. Law in practice

For the reasons explained above private enforcement of misleading disclosure cases is very low in the UK. Between 1990 and 2006 there was only one reported case on the statutory basis and two cases under the common law alleging misstatements in prospectuses.[476] None of these cases listed the underwriter as a defendant. Citing Ferran (2009) the current British situation can be characterized "by the near-absence of shareholder actions on the basis of non-disclosure or misleading disclosure".[477]

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[476] Those were *Axa Equity & Law Life Assurance Society plc v, Natianal Westmisnter Bank, [1998] C.L.C. 1177*; *Al-Nakib Investments (Jersey) Ltd v Longcroft (1990) 3 All E.R. 321*; *Possfund Custodian Trustee Ltd v Diamond (1996) 2 All E.R. 774*. See John Armour et al., "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States," *Journal of Empirical Legal Studies* 6, no. 4 (December 2009): pg. 714.

[477] Ferran, "Are US-style Investor Suits Coming to the UK?".

7. CONCLUSIONS

Chapter VII analyzed the underwriter liability for misstatements surrounding the distribution of securities in the UK. Four potential causes of actions were identified. The statutory liability provision embedded in Section 90 of the FSMA was characterized as very similar to the American Section 11. However, the main problem was that it simply did not include underwriters under its coverage. Common law causes of action were also analyzed and it was concluded that they are interpreted very narrowly as to include secondary actor liability. In addition, they set too demanding evidentiary requirements which make cases against underwriters virtually impossible.

The analysis also showed that solving the problems of substantive law would not, however, solve the problem. Even if problems of the definition of a plaintiff or the deficiencies of common law causes of action were resolved, the expected liability threat would remain rather low. The main identified problem is that the mechanism for collective dispute resolution does not allow achieving high rates of investor participation and thus does not create the expected sanction of the sufficient magnitude. Moreover, the complexity of procedure, on the one hand, and weak economic incentives to initiate cases, on the other hand, result in a low probability of enforcement. Thus, one can expect that in the UK misstatement cases would neither attract many plaintiffs nor would be initiated with sufficient frequency.

It is clear that private enforcement is not being used in the UK as the mechanism of enforcement of the underwriter gatekeeping duty. However, the mere acknowledgement that there is no private enforcement, does not allow making any judgment as regards the efficiency of the British system. This assessment will be performed further in this book in Chapter X.

PART THREE. UNDERWRITERS. CIVIL LIABILITY: POLICY IMPLICATIONS

PREFACE

Parts I and II can be considered as a gradual build-up of the case for underwriter liability. Part One has positioned underwriters within the capital markets and described them as the main intermediaries between investors and the issuer. It also provided an economic justification for using underwriters as gatekeepers of issuer's disclosure and explained how civil liability can be used as one of the tools to enforce the gatekeeping function of the underwriter. However, Part One does not argue that the civil liability is a superior enforcement mechanism.

Part Two has looked at how the civil liability is structured in real life liability regimes and how it functions in practice. Two examples of underwriter liability, in the USA and in the Netherlands, were found and thoroughly analyzed. It was shown that simply looking at the "law on books", the liability threat in the USA seems to be quite extensive. However, in practice there are not so many cases against underwriters and the size of settlements in these cases constitutes just a small fraction of estimated statutory damages. The settlement barely reaches the size of underwriter fees. In the Netherlands, it was found that the structure of both certain substantive and procedural legal rules imply that the liability threat is rather limited. Few anecdotal practical examples confirmed that finding. There are just a few cases brought and the size of settlements also amounts to a small percentage of estimated damages. Thus, Part Three allowed concluding that in both countries where underwriter liability is used as an enforcement device, the expected liability underwriters face hardly equals the fee they receive for their services. On the other hand, it was also found that in the UK the civil liability is not used. Moreover, in the UK the current procedural rules even prevent the potential use of liability in the future.

The goal of this Part Three is to propose possible solutions for the drawbacks of existing underwriter liability systems. It consists of two Chapters. Chapter IX covers two countries where civil liability is actively used as an enforcement regime for underwriter gatekeeping function – the USA and the Netherlands. Chapter X explores the situation in the UK. Chapter IX analyzes the Law and Economics literature as regards the optimal structure of underwriter liability. The most of attention is dedicated to the analysis of the choice between negligence and strict liability. After the short review of the academic debate on this issue, I analyze the choice of a liability standard within the framework developed by

Shavell. I check whether underwriter liability can be treated as a unilateral or a bilateral accident. I investigate the effect of mistakes on the choice of the liability regime. Finally, I look at the impact of the liability regime on the level of activity at capital markets. Going outside the Shavell framework, I also assess the deterrent threat resulting from the current negligence liability in the USA and the Netherlands. I argue that strict liability is preferable both according to Shavell criteria and based on my assessment of the current situation.

Based on my analysis I propose some modifications to the current underwriter liability regimes. First of all, I suggest switching from negligence to strict liability. I also propose that in order to temper frivolous litigation the burden of proof of general loss causation should be placed on investors. Finally, I argue that damages in underwriter liability cases should be capped at the amount of underwriting fee.

Chapter IX further explains how this solution can be implemented in the USA and in the Netherlands. To achieve the desired outcome in the USA the legislator should change the liability standard, reverse the burden of proof and cap damages. In contrast, in the Netherlands there is no need to reverse the burden of proof as it is already on the investor. However, the definition of damages needs to be standardized and the mechanism of proving loss causation modified.

Chapter X is the final Chapter of this book. Its goal is quite intriguing – to resolve the mystery surrounding the UK case. It is found that in the UK underwriters face a very low formal enforcement threat coming both from civil liability and alternative enforcements mechanisms which are analyzed in depth in this Chapter. However, it is also found that underwriters are important players on British capital markets performing the same role as in other analyzed countries. In addition, British capital markets do not lag behind others.

The success of low intensity enforcement in the UK is explained by the peculiarities of the market. It is composed of sophisticated institutional investors, it is socially and geographically concentrated, and it is at the growth stage of development. As a result, informal market enforcement mechanisms such as reputation provide sufficient deterrence. The reader should be cautioned that this situation may change as the market develops and in the future there may be a place for civil liability. However, in its current form the UK civil liability regime is not able to generate effective enforcement. As a remedy, Chapter X proposes to apply a solution along the lines of the one suggested for the US and the UK.

CHAPTER IX. PROPOSAL FOR IMPROVEMENT OF UNDERWRITER CIVIL LIABILITY REGIMES IN THE US AND THE NETHERLANDS

1. UNDERWRITER LIABILITY AS A TORT

The economic analysis of underwriter liability should start from a clarification of the nature of this liability relationship. As it was discussed before, the particularity of underwriter liability is that it is based on tort rather than on the contract. This is because there is no direct contract between the underwriter and the investors. The underwriter has a contractual relationship only with the issuer to whom it owes contractual as well as fiduciary duties. However, while executing their contract with the issuer, the underwriter can inflict harm to the third parties – investors.

The harm, also known as pure economic loss,[478] consists of a decrease of the value of a security due to the disclosure of previously made material misstatements or omissions of information. It is assumed that in securities markets investors make their investment decisions based on the information disclosed. Hence, if there are material misstatements or omissions in such disclosure, investors will either underprice or overprice the securities. Later, when the misdisclosure would be revealed to the market, the price of securities would change reflecting the new information. If the securities were overpriced, and upon the revelation of the misstatement the price has fallen down, investors would suffer a loss equal to the difference between the price that they have paid for the security and the price for which they can sell the security after revelation of the misdisclosure. In its essence, the misdisclosure causes a transfer of wealth from investors to issuers. Besides pure distributional consequences, such transfer can lead to market failure in the form of adverse selection. Appreciating such transfer of wealth, investors will discount *ex ante* all the shares based on an average probability of misdisclosure. This can drive high-quality issuers out of the market. In the extreme scenario adverse selection can lead to the complete unraveling of the market.[479]

[478] See, for example, van Boom, Koziol, and Witting, *Pure economic loss*.

[479] See, for example, Frank H. Easterbrook and Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors," *Virginia Law Review* 70, no. 4 (May 1, 1984): 669-715; Ronald J Gilson and Reinier H Kraakman, "The Mechanisms of Market Efficiency," *Virginia Law Review* 70 (1984): 549.

Underwriter liability is a third-party liability strategy. This means that the underwriter is held liable for violations of a disclosure duty by the issuer. Therefore, there are two parties responsible for the harm (injurers): the issuer who commits the actual misstatement and the underwriter who owes a duty to monitor and prevent the misstatements by the issuer. Thus, the underwriter violates not by making a misstatement, but by failing to prevent it. A related point is that the primary goal of the imposition of underwriter liability is not to eliminate misstatements, but to provide the underwriter with incentives to exercise an optimal level of care in gatekeeping, consisting of monitoring of issuer's disclosure.

2. NEGLIGENCE VS STRICT LIABILITY

2.1. Academic debate on negligence vs strict liability

Although the details of underwriter liability regimes differ greatly between jurisdictions, the most common structure of underwriter liability is negligence. Normally, the underwriter liability rule is based on an underwriter duty to monitor the issuer's disclosure with a reversed burden of proof of underwriter negligence. Given the overwhelming prevalence of negligence rule, one would expect that there are some strong reasons why negligence is chosen over another type of liability standard – particularly, strict liability.

Indeed, the Law and Economics literature dedicated some attention to the question of choosing the right standard of gatekeeper liability. However, there is no much consensus on the optimality of underwriter liability standard. Three views can be distinguished. One prefers negligence as the optimal liability standard. Another view states that none of the regimes is superior *ex ante*, but there are circumstances under which one can be preferred to another. The last view supports strict liability as the optimal standard for underwriter liability.

The most prominent proponents of negligence as the optimal liability standard are Kraakman (1986) and Sher (2005). The seminal work on gatekeeper liability by Kraakman (1986) does not discuss the choice between negligence and strict liability at length, but only hints that the main reason negligence is preferable to strict liability is that "the residual risk [of strict liability] might easily overshadow the gatekeeper's performance costs: that is, gatekeepers will be penalized for a much wider range of misconduct than they can actually deter".[480] Interpreting this statement, one could argue that the rationale for preferring negligence regime is related to the underwriter imperfect ability to prevent misdisclosure and the resulting residual liability risks. It is assumed that there is some certain optimal level of monitoring where any additional monitoring effort brings more costs than benefits. Negligence liability provides the underwriter with optimal incentives to monitor. However, strict liability goes further. It punishes the underwriter also in cases where they could not prevent disclosure even if they exercised such an optimal level of monitoring. Therefore, strict liability includes insurance from misdisclosure, which the underwriter would provide to investors. In this perspective, the choice of a negligence rule implies the assumption that investors are better off bearing the residual risks themselves rather than shifting such risks to underwriters.

Sher (2005) presents the choice between negligence and strict liability from another perspective. According to Sher (2005) one of the biggest advantages of a liability regime is that the adjudication by courts "provides a credible threat of revealing a leader's [(e.g. underwriter)] actions to the investors. When the share price drops and the investors suspect their leader of not having exerted an optimal effort, they may turn to the courts where the leader's actual behavior can be reviewed".[481] Thus, legal liability allows investors to distinguish the reason why the price of the security has fallen down and then punish the responsible party. This should make it "much easier and cheaper to convince company executives to opt for the proper disclosure strategy. The reason for that is that the law causes the leader to opt for a strategy of exerting optimal effort in due diligence. Therefore, it becomes unprofitable for the executives to opt for a different strategy".[482]

Assessing the choice between strict liability and negligence within this framework, Sher (2005) argues that subjecting the underwriter to strict liability only allows investors to determine whether the price drop was caused by the misleading information or by unrelated reasons. It does not provide information on underwriter actual effort in preventing the misstatement. The uncertainty about underwriter actual fault in causing the

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[480] Reinier H Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy," *Journal of Law, Economics, and Organization* 2, no. 1 (March 20, 1986): pg. 76.

[481] Noam Sher, "Negligence versus Strict Liability: The Case of Underwriter Liability in IPO's," *DePaul Business & Commercial Law Journal* 4 (2006 2005): pg. 470.

[482] Ibid.

violation has a negative effect on the reputation mechanism. Sher (2005) states that under strict liability “investors will not be able to rely, *ex ante,* on the leader's presentation that he has harnessed her reputation to the task. The leader will not be able to convince investors that their having hired her reputation means that he risks her reputation for conducting optimal due diligence. This is because, given a strict liability rule, it will not be reviewed *ex post”.*

The neutral view is represented by Hamdani (2003). Hamdani (2003) specifies the conditions under which each of these regimes works best. Gatekeepers should face strict liability “when they can either (1) price-discriminate among prospective clients based on their likelihood of engaging in misconduct, or (2) take steps that would eliminate wrongdoing by all clients”.[483] On the other hand, gatekeepers should be subject to negligence liability “when the government possesses the information necessary for specifying the due level of gatekeeper policing and determining whether gatekeepers have complied with the specified level of policing”.[484] Hamdani (2003) also points at the higher residual liability risks associated with strict liability.

The supporters of strict liability are Partnoy (2001) and Coffee (2004). Partnoy (2001) argues that – particularly in the USA context – a negligence-based regime forces underwriters to “follow [certain] procedures to obtain a due diligence benefit regardless of whether they otherwise would choose to follow those procedures”. In addition, because “there is little case-law and only few pointers from the SEC”, underwriters can rely on a successful due diligence defense when “they satisfy all the minimum standards specified by the industry, courts, and regulator”.[485] Therefore, a negligence-based underwriter liability regime provides a “regulatory license” to underwriters – “valuable property rights which are granted independently of the underwriter investment in reputational capital”.[486] In this way, the negligence liability weakens the reputational incentives of the underwriter because it induces to perform monitoring procedures not in order to preserve the reputation for quality, but just to avoid being found negligent under a fuzzy legal standard. Given this

[483] Assaf Hamdani, “Gatekeeper Liability,” *Southern California Law Review* 77 (2004 2003): pg. 102.

[484] Ibid., pg. 103.

[485] Frank Partnoy, “Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime,” *Washington University Law Quarterly* 79 (2001): pg. 513–514.

[486] Ibid., pg. 506.

circumstance, and the fact that some liability costs will be passed on to the issuers, under a negligence regime there are few incentives for the underwriter to perform an optimal monitoring of the issuer's disclosure. In sum, according to Partnoy (2001) negligence imposes unnecessary costs without providing efficient incentives to underwriters. In this way it causes under-enforcement of underwriters' gatekeeping duties.

Coffee's (2004) criticism of negligence liability is partly similar to Partnoy's, although it differs in one important aspect. According to Coffee, negligence is not the optimal liability standard for gatekeepers because it provides an opportunity for underwriters to shift to managers the blame for misstatements. As it was discussed, there is a lot of uncertainty surrounding the disclosure practices of the issuer and the exact monitoring practices by the underwriter. Therefore, in negligence regimes the underwriter will have incentives to claim that it was deceived by the management. Negligence-based liability provides incentives "to rationalize or overlook fraud or irregularity and later assert, on its discovery, that they were deceived by management".[487]

Having concluded that negligence leads to under-enforcement, both Partnoy (2001) and Coffee (2004) argue that strict liability would solve the problem. Partnoy (2001) states that in contrast to negligence, strict liability would not completely eradicate reputational incentives to monitor. The underwriter would have incentives to preserve the reputational capital in order to obtain the lowest premium in the reinsurance market. Arguably, also the issuer would be interested to hire the underwriter based on their reputation for quality. This choice would imply a lower liability risk and thus a lower cost of capital for the issuer. Therefore, reputational incentives are expected to work better under the strict liability than under the negligence rule. Coffee (2004) states that differently from negligence, under strict liability "[the gatekeeper] would know that it sinks or swims with its client; hence, half-hearted or *pro forma* monitoring, which may be a rational strategy under a negligence or fault-based legal regime, no longer protects the gatekeeper".[488]

However, both Partnoy (2001) and Coffee (2004) acknowledge that unlimited strict liability can create excessive residual liability threats, which can seriously distort underwriting markets. Thus, both authors propose to limit strict liability by applying a cap

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[487] John C. Jr Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms," *Boston University Law Review* 84 (2004): pg. 306.

[488] Ibid.

on damages. Partnoy (2001) proposes to subject the underwriter to strict liability regime but to provide him with the possibility to contractually limit the size of compensable damages. The damages can be limited by specifying the percentage of the total damages. Coffee (2004) also argues for the cap on underwriter strict liability. However, according to Coffee, this cap should be set by law and take form of a multiple of the highest annual revenues received by the gatekeeper from its client over the last several years.

To sum up this review of literature on the choice of gatekeeper liability standard, it is fair to state that there is no general agreement that negligence is the optimal standard of underwriter liability. Moreover, although most of the articles follow Law and Economics methodology, none of the discussed papers is consistently based on the standard analytical framework as developed by Shavell.[489] This framework is often used for the analysis of tort liability. Thus, in order to contribute to the negligence *vs* strict liability debate, the following section will analyze the underwriter liability using Shavell's framework.

2.2. Application of Shavell framework to underwriter liability

The major criteria for determining the optimality of a liability standard used by Shavell are:

- whether the accident is unilateral or bilateral;
- the allocation of information about the conduct;
- the level of activity.

The following sections will analyze underwriter liability according to these criteria.

a) Unilateral vs bilateral accident

The first test in determining the optimal liability standard is to establish which party should be provided with incentives to take care. The economic literature states that both strict liability and negligence are efficient in case of unilateral accidents. Negligence is preferable only when the precaution is bilateral. A unilateral accident is a case when only activities of the injurer(s), in our case, the issuer and the underwriter, determine the

[489] Steven Shavell, *Economic Analysis of Accident Law* (Harvard University Press, 2007); Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press, 2004).

probability of the harm, *i.e.* misdisclosure. In unilateral accidents, under strict liability the underwriter will bear all investors' losses from the misdisclosure and therefore will internalize all the costs of its activity. As a result, it will adopt a level of care which minimizes the expected social costs. Such a level of care will be equal to the optimal level of care. In a negligence-based regime the underwriter will avoid the liability if it performs diligent monitoring. If such level of monitoring is set to equal the socially optimal level of due care, the outcome will be socially desirable.

In my opinion, in constructing an underwriter liability regime it is necessary to analyze the case as a unilateral accident. This assumption is quite realistic within the securities market framework. To understand why this is the case, one should look at whether investors who become victims of securities violations are capable of taking precautions.

As it was discussed before, securities offerings are usually bought by two types of investors. Primary buyers are usually institutional investors. They are informed, knowledgeable, sophisticated and they are active participants in financial markets managing portfolios of securities. They should be able to take precautions by investigating the issuer on their own. They actually do so by participating in bookbuilding.[490] The incentive to investigate the issuer and thus to take precaution comes from the structure of bookbuilding method of pricing and allocating securities. Recalling the discussion in previous Chapters, during the bookbuilding institutional investors are approached by the underwriter and asked to place a bid for the securities. To be able to make a bid institutional investors need to collect information and evaluate the issuer. The underwriter encourages investors to collect and disclose information by the discretion the underwriter exercises in pricing and allotting securities. Thus, in a sense, the bookbuilding already forces institutional investors to take precautions in the form of collecting information. As a result, there is no need for an additional tool to induce these sophisticated investors to take precautions.

However, it was also discussed in Section 3.4 of Chapter I that institutional investors tend to immediately sell off securities which are allocated to them (flipping). Thus, the securities end up with retail investors. As a rule, those retail investors become the real victims of misstatements as the damage usually materializes only by the time when the securities are in their hands. However, the capabilities of this group of investors to take

[490] See Section 2.6 of Chapter I and Section 3 of Chapter III.

precaution are very low, if not inexistent. Both the financial and the legal literature typically describe retail investors as uninformed investors. Uninformed investors make decisions with limited information both on the nature of financial claims and the information on fair value of securities. They cannot be expected to take any care in assessing the quality of the information. Therefore, retail investors are assumed to be unable to influence their exposure to the misdisclosure involved with the securities offerings.

Summing up, the analysis shows that within the context of securities offerings one group of potential victims, who is able to take precautions, already faces incentives to take care with respect to the quality of disclosure. These are the institutional investors, who do not need additional incentives to take care. On the other hand, another group – the retail investors – is simply unable to take precautions against misdisclosure. Therefore, it can be concluded that the case of underwriter liability should be analyzed as a unilateral accident.

Treating the case of misdisclosure as a unilateral accident leads to the conclusion that – from the perspective of providing incentives to a certain party in order to minimize social losses – the design of the liability rule should be mostly concerned with targeting the incentives of underwriters, not investors. In this respect, there are no reasons why negligence liability should be preferred to strict liability.

b) The effect of mistakes

To distinguish further between the two regimes one should take into account the mistakes and the uncertainty surrounding various elements of the liability regime. The Law and Economics literature states that strict liability is preferable when a court can assess damages more accurately than standards while the negligence should be favored when the court possesses the necessary information, *i.e.* the court can accurately specify the efficient level of monitoring and fully observe the actual level of monitoring that the underwriter has adopted. The efficiency of the strict liability regime can be easily undermined by court errors in setting damages and court errors in failing to hold injurers liable. In contrast, under the negligence rule, the incentives for the injurer's precaution is not affected by modest court errors in setting damages or in determining who caused an accident or injurer's modest errors in predicting such damages. The efficiency of the negligence standard can, however, be easily affected by court errors in setting the legal standard of due care. In these cases, negligence can lead either to over or under-deterrence. If the due care standard is too strict, then negligent liability would penalize the underwriter for violations that they could not prevent efficiently. Similarly, random errors in the legal standard imposed by a negligence rule cause the injurer to increase precautions above the efficient level. On the other hand, when the standard is set at a too low level, underwriters will have incentives to take less care than it would be optimal, which implies that misdisclosure is underdeterred.

Assessing gatekeeper liability from this angle, one can clearly see that in the case of misdisclosure of information in securities offerings, damages are relatively easy to estimate. They are usually defined as a decrease of securities price due to the revelation of misstatements. With the use of econometric tools and financial data, this is a relatively simple exercise.

On the other hand, setting of the appropriate negligence standard can be a pretty difficult task, especially in the absence of established business practices. Indeed, even Kraakman (1986) who generally supports the negligence-based regime of gatekeeper liability, notes that the negligence regime is successful in the USA mainly due to the presence of "a community of legally sophisticated gatekeepers" who "can tell courts or administrators what due care ought to mean by developing informed criteria on their own".[491] In this case, the content of the monitoring duty is simply deduced from the established business practices. The rulings of the court, thus, "enshrine illustrative procedures indirectly by imposing liability for ignoring a range of previously informal monitoring practices".[492] In a way, the imposition of the negligence liability means the incorporation of business practices in law. In the case of underwriters, this is exactly where the problem of underdeterrence of negligence liability stems from. Recalling both Partnoy (2001) and Coffee (2004) arguments,[493] while the presence of a powerful underwriting industry facilitates the setting of due care standards, it also creates the danger that this industry would lobby for less stringent standards in order to avoid liability or use existing business practices as an entrenchment device for incumbent gatekeepers. Similar concerns are

[491] Reinier H Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy," *Journal of Law, Economics, and Organization* 2, no. 1 (March 20, 1986): pg. 80.

[492] Ibid.

[493] See Section 2.1 of this Chapter.

voiced by Choi (1998) who is worried that underwriters may attempt to influence the courts to install costly procedures that provide intermediaries with large amounts profit, but hardly any incentive to accurately assess the quality of issuer's disclosure. According to Choi (1998) "although the securities bar and underwriters provide expertise, they also bring a desire to maximize their importance and role in securities offerings".[494]

The situation becomes even more complicated when we consider that the court can also make mistakes in comparing underwriter actual activities with the applicable legal standard. The monitoring by the underwriter is usually unobservable and might also be not documented. Therefore, it is difficult to see exactly which actions did the underwriter perform in order to fulfill its duty of care.

The relative advantage of courts in assessing damages compared to setting a due care standard and assessing compliance with it in misdisclosure cases leads to the conclusion that the underwriter strict liability should be preferred to a negligence standard for the misdisclosure cases.

c) Level of activity and residual liability risks

The next step in the choice of an optimal liability regime is to consider the impact of the imposition of liability on the level of activity. In this case, the level of activity means the level of underwriting activity. However, given that it is almost impossible for the issuer to distribute securities without the participation of the underwriter, the level of activity translates also in the issuance of shares to the public by the issuer.

The Law and Economic literature explains that it might be desirable to limit the level of activity in potentially harmful conducts. Applying the argument to our case, the higher the level of activity, the higher the probability of misdisclosure. It is desirable that the issuer and the underwriter take the level of activity and associated harm into account when deciding respectively to issue and to underwrite securities. The level of activity should be set at some optimal level where marginal benefits are equal to the social harm caused by such activity. The optimal level of activity is achieved when the issuer is made to internalize the full social costs associated with his misconduct.

[494] Stephen Choi, "Market Lessons for Gatekeepers," *Northwestern University Law Review* 92 (1998 1997): pg. 949.

The choice of the liability standard has an impact on the level of activity. This is associated with the residual liability risks, *i.e.* liability risks that occur even when the underwriter has taken due care and the latter corresponds with efficient level of precautions. The residual risks cannot be avoided by taking due care, but they can be minimized by adjusting the level of activity. To protect themselves from the residual liability risks, the underwriters can either refuse to underwrite the most risky companies or increase the underwriting fees.[495] In the latter case the underwriters would shift some liability costs to the issuer. The underwriting fee increase would increase the issuer's cost of capital. Therefore, this would exclude some companies from the market and thus limit the level of issuing activity in the market.

Strict liability has a direct impact on the level of activity. Residual risks arise under strict liability because the underwriter is held liable independently of his fault and because he cannot entirely prevent misstatements. Therefore, even if he takes due care, this will not totally protect him from liability. The underwriter will incorporate the residual liability risk when setting the underwriting fee. Normally, such effect is considered desirable because the increase of underwriting fee helps to achieve the goal of tort liability – the internalization of social costs of misconduct. Indeed, strict liability would force both the underwriter and the issuer to take the social costs of issuer's misconduct into consideration.

However, Hamdani (2003) correctly notes that there is a difference in applying strict liability in primary actor liability setting (*eg*. issuer liability) and applying it in the case of gatekeeper liability (*eg.* underwriter liability). In a gatekeeping setting, strict liability may cause serious disruptions in capital markets. The problem is that the underwriter cannot distinguish *ex ante* the probability of misstatement of individual companies. Therefore, the increase of underwriting fees will not be individualized but rather based on the average probability of misstatement in the market. In other words, all issuers will pay the same price for different securities. This can cause adverse selection in the market. At the same time, the liability threat can also lead the underwriters to adopt risk-limiting strategies, which can foreclose a market entry for some risky but still law-abiding companies.

[495] The literature points out that the refusal by one underwriter to underwrite a certain issuer usually precludes the issuer from entering the market. Other underwriters will interpret such refusal as a sign of bad quality and would not bid for the underwriting.

In contrast, a perfectly enforced negligence does not cause residual liability risks (because residual losses are always borne by the victims) and thus it does not have any impact on the level of activity via the underwriters' fees. Under negligence liability, once the underwriter takes due care, they are not liable. Thus, because there are no residual liability risks, there is no increase of underwriting fees and the level of activity in security markets is not affected by adverse selection.

However, residual liability risks have an impact on the level of activity when the imperfections in the enforcement of negligence liability are taken into account. Residual liability risks arise because courts, investors or underwriters may make mistakes in interpreting a vague negligence standard or the actual behavior of the underwriter. The increase of the underwriting fee under the negligence regime does not reflect social costs of a misstatement, but rather the problems created by imperfect implementation of negligence as a liability standard. Therefore, the effect on the level of activity is ambiguous and may not be socially beneficial.

In sum, both strict and negligence liability regimes are associated with residual risks and have an impact on the level of activity. Both are not perfect in controlling the level of activity, although for different reasons. Thus, the task is to choose the second best solution.

It is often argued that negligence is preferable simply because the residual costs of strict liability are higher than the residual costs of negligence. But are the costs of residual liability risk under strict liability higher in the real world? In my view, a fair reply to this question is that it depends. On the one hand, the magnitude of residual liability risks of strict liability depends on the underwriter monitoring ability. If the latter is high, the residual risks are rather low and *vice versa*. On the other hand, the magnitude of residual costs of negligence depends on parameters such as the level of uncertainty surrounding the definition of due care, the experience of all parties in estimating the outcome of the case, and the parties' risk attitudes. Thus, it is not for granted that residual risks of strict liability will be significantly higher than residual risks of negligence liability. In my assessment, there are reasons to believe that in case of underwriter liability for misstatements during securities offerings, the residual risks of strict liability are not much higher than those of a negligence liability regime.

First of all, the residual liability risks under strict liability can be expected not to be particularly high because underwriters can be assumed to be quite efficient in monitoring issuers and thus effectively prevent deceiving issuers from entering the market. Indeed, in

Chapter II it has been argued that in the context of primary distributions and especially as regards the disclosure in the official offering documents the underwriter ability to monitor the issuer can be expected to be quite high. This is because of the special role the underwriter plays in preparing the offering and drafting of the prospectus. Thus, when we move from negligence to strict liability, the increase of the fee should not be very high. In addition, it can be argued that due to its experience in the underwriting business the underwriter might be able to screen issuers and price discriminate among them, which will allow to at least partially avoid adverse selection scenario. In fact, Hamdani (2003) himself is ready to admit that in the context of the primary market liability the underwriting fee increase "would approximate the discount in the price that investors would have paid for the securities of a company going public in the absence of gatekeeper liability. Thus, even the most expansive form of gatekeeper liability would arguably not make issuers worse off than they would have been under a regime of primary liability. In other words, assuming that the expected costs of fraud are generally reflected in the price investors are willing to pay for the securities offered to the public, the introduction of strict gatekeeper liability would have virtually no adverse impact on capital market".[496]

On the other hand, the magnitude of residual risks of the current negligence liability is already quite high. Some empirical studies sought to relate the liability risks to the level of underpricing. The findings seem to confirm that at least in the USA, negligence liability is associated with an increase of underpricing.[497] Therefore, negligence liability as it is now creates significant residual liability risks.

Putting these findings together, it turns out that the magnitude of the fee increase caused by the residual risks of strict liability may be not as large as it is usually pictured, especially compared to the negligence liability regime currently in place. Therefore, there is no strong reason to prefer negligence to strict liability also according to this criterion.

d) Problem of frivolous litigation

Additional problem usually associated with strict liability is that strict liability can cause or worsen the problem of false positives (*i.e.* liability is wrongfully imposed on the

[496] Assaf Hamdani, "Gatekeeper Liability," *Southern California Law Review* 77 (2004 2003): pg. 112.

[497] See Section 3.2 of the Chapter III.

underwriter). Given that it is relatively easier for the plaintiff to file the case and to prevail under strict liability than under negligence, too many weak and frivolous cases will be filed and unjustified settlements will be achieved. In fact, what is feared is that lawsuits will be filed not only in cases where the misstatement causes a price drop but also in all other cases whenever the price of securities drops for unrelated reason.

A frivolous suit is a claim which is filed not because of its merits but expecting that the underwriter will settle in order to avoid the distraction of litigation, high attorney fees, and the negative publicity surrounding a securities lawsuit. In contrast to normal settlements, settlements of frivolous suits do not reflect the merits of the case. They decrease social welfare as they encourage the filing of more and weaker suits while under-compensating actual victims of securities violations. If the settlement does not take into account the merits of the case, the functioning of liability rules as a deterrence mechanism can be endangered. In fact, frivolous litigation can even lead the liability system turning into a "form of insurance against large stock market losses by giving investors".[498] This danger is particularly relevant in the case of underwriters, who are often the deep pockets of securities lawsuits. It is widely accepted that this form of insurance is not desirable in securities markets as it contradicts the underlying logic of investment in securities.

In my view this is quite a legitimate concern, especially as regards the USA legal system. The most worrisome element is that, currently, Section 11 places the burden to prove loss causation – the causal link between the misstatement and losses, on the defendant, *i.e.* the underwriter. More precisely, this is formulated as a negative defense that the underwriter can use against the plaintiff's allegations. Thus, as the law stands now, cases can proceed even before this question is resolved. Therefore, the filing of cases for investors or their lawyers is very easy and not costly. If this is coupled with the strict liability standard, the plaintiffs' costs of filing the claim would become negligible, which may lead to a huge inflow of litigation, including weak and frivolous cases.

However, it should be noted that under negligence liability the issue of frivolous litigation arises as well. This is again a practical consequence of the uncertainty associated with the negligence standard. The definition of a frivolous suit differs between negligence and strict liability. Under negligence the suit can be frivolous for two reasons: if the suit is brought

[498] Janet Cooper Alexander, "Do the Merits Matter? A Study of Settlements in Securities Class Actions," *Stanford Law Review* 43, no. 3 (February 1, 1991): pg. 501.

when the underwriter has, in fact, been diligent or if the price drop was not caused by the misstatement. In contrast, under strict liability the suit can only be frivolous if the second condition holds. Thus, perhaps counterintuitively, negligence liability by definition creates more opportunities to file weak or frivolous cases than strict liability.

Summing up, both strict and negligence liability regimes can cause a problem of frivolous litigation. While we cannot estimate how serious this problem can be under strict liability, there is some data with regards to the negligence regime in the USA. As it was discussed in Chapter V, the most prominent study in this field is Alexander (1991). This study showed that under the current USA negligence regime, frivolous litigation is a big problem. The article analyzed the filings against computer and computer-related IPO companies during the first half of 1983. It found that each complaint named as defendants the issuer, its directors and high officers, and the underwriters of the IPO. The article claimed that at least a part of these claims were meritless. Suits alleging securities violations were filed under the negligence regime "whenever the stock price declined sufficiently following the IPO to support an award of attorneys' fees that would make it worthwhile to bring a case. Since significant price declines were to be expected for some proportion of these stocks irrespective of whether there were securities violations, it seems reasonably certain that the lawsuits filed against the sample companies varied as to the strength of the plaintiffs' case on the merits, unless one is prepared to believe that every company in the industry that did poorly was also a securities violator – and to the same degree".[499] These findings point towards the conclusion that the current negligence liability exposes the underwriters to significant risks of frivolous litigation.

2.3. Liability regimes and low settlement size

In addition to the arguments discussed in this Chapter, at various junctures the analysis carried out in this book suggests that negligence liability regimes in their current form result in underenforcement of the gatekeeping duties of the underwriter. In Part Two of this book it has been found that in countries that employ civil liability as an enforcement tool for underwriter gatekeeping duty – the USA and the Netherlands – the liability threat is existent, but in practice it seems to be quite limited.

[499] Ibid., pg. 513.

Although it is impossible to estimate the actual probability of enforcement in misstatement cases, it is clear that lawsuits are brought with some high frequency. In the USA a few underwriter liability cases are settled every year.[500] In the Netherlands these suits are less frequent. Nevertheless, there are some high-level precedents in the field capable of performing a deterrent function.[501] Therefore, one could not argue that the current liability systems completely fail to generate litigation activity that can provide deterrence.

The main problem with underwriter liability cases is rather the size of damages obtained in those cases that are brought and settled. It was shown that the amount of settlement in most cases constitutes just a fraction of the statutory damages. This amount is typically lower than the gain to the underwriter from committing a violation, as illustrated below.

Becker (1974) famously claimed that in order to discourage the violator from engaging in unlawful conduct, the liability threat should exceed the gains associated with such misconduct.[502] The liability threat is given by the amount of sanction multiplied by the probability of its application. The maximum gain for the underwriter in case of a failure to provide diligent gatekeeping is determined by its income – the underwriting fee – because in this hypothesis the underwriter incurs no gatekeeping costs. Thus, focusing on the extreme case in which the probability of enforcement is 1, the minimum liability necessary for underwriter deterrence should be equal to the underwriting fee. Accordingly, the liability system is *never* effective in providing deterrence if the expected liability threat is *lower* than the underwriting fee.

If one evaluates underwriter liability systems based on this criterion, one will clearly see that even assuming that the probability of enforcement is equal to 1 (in reality it is likely to be lower), the average size of damages awarded in reality makes the expected liability threat fall under the threshold required for deterrence. Thus, one can argue that both in the USA and in the Netherlands the current liability system leads to systematic underenforcement of the underwriter gatekeeping duty. This means that the current negligence liability systems, even though they generate some litigation activity, fail to

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[500] See Section 6.2 of Chapter V.

[501] See Section 5.2 of Chapter VII.

[502] Gary Becker, *Essays in the economics of crime and punishment* (New York: National Bureau of Economic Research distributed by Columbia University Press, 1974).

perform their economic function, which is to provide incentives for the underwriter to exercise efficient care in monitoring the issuer's disclosure.

It should be analyzed why the size of settlements is so low. The answer can be found looking at the link between the liability standard and procedural law.

In the USA class action lawyers have incentives to agree on early and relatively low settlements. On the one hand, the lawyers are rather independent from the plaintiffs. Therefore, they can take procedural decisions pursuing their own goals rather than the goals of the class. Personally, lawyers are rather risk-averse and thus prefer smaller but certain settlements over higher but riskier ones. Lawyers could also collude with the underwriter for a lower settlement in return for higher fees or other side-payments. On the other hand, Section 11 features a negligence liability standard with reversed burdens of proof on almost all elements of the case. This means that while it is relatively easy for securities lawyers to file a suit, taking a case to the trial stage is associated with the risk of losing the case if the underwriters manage to defend themselves. In other words, at the trial stage there is a great uncertainty surrounding most elements of the case, especially as regards the underwriter actual behavior.

It was seen in Section 2.6 of Chapter V that the definition of what constitutes underwriter negligence is well developed in the USA case law. However, as monitoring is a highly circumstantial activity, it still remains unclear whether certain activities will be or will not be considered to satisfy the due care requirement. Thus, the plaintiff's lawyer is never sure that if she goes to trial she would win the case. Given the lawyers' independence from the plaintiff and their risk aversion, such uncertainty provides the lawyer with incentives to agree to a lower but earlier settlement.

In the Netherlands the main cause of relatively low settlement amounts is different from the USA. There is no mechanism of collective litigation of claims for damages. However, there is a two-stage procedure involving a declaratory judgment and, subsequently, individual litigation. The declaratory judgment stage involves a declaration of misconduct on some sort of strict liability basis (although there is no damage award at this stage). In addition, the pursuit of a declaratory judgment against underwriters is very easy for investors. However, at the second stage, when individual or assigned litigation takes place and actual damages are awarded, the situation is completely different. First of all, investors need to prove individual damages and loss causation. Moreover, while investors do not need to prove underwriter negligence, the underwriter can and will claim due diligence as a defense from liability. Therefore, each individual case is difficult to litigate and will involve some uncertainty about the outcome. Many investors may choose not to engage in litigation for this reason. The uncertainties associated with the outcome of the case would also lead to the weakening of the bargaining position of those plaintiffs who decide to participate in settlement negotiations. Consequently, the Dutch system leads to a rather weak “shadow of the law” which affects the size of settlements.

In addition, the Dutch law has no mandatory collective settlement procedure. The existing collective settlement procedure is purely voluntary. Therefore, there will be cases when settlements will involve only a fraction of harmed investors, which of course diminishes the size of the cumulative damage award.

The Dutch system of underwriter liability is also based on a negligence standard with a reversed burden of proof. In the same way as in the US, this creates uncertainty about the outcome of individual cases. While in the USA this uncertainty affects the incentives of lawyers to fight for higher settlements, in the Netherlands it is one of the reasons why individual investors may not file liability suits *at all.* The uncertainty about the outcome of the case reduces the number of investors willing to initiate and participate in cases and thus the expected amount of damages that the underwriter faces. Such a weak “shadow of the law” affects the average amount of settlement investors are able to extract from underwriters. In other words, while in the USA the negligence standard does not affect the filing rates and the number of participating investors, but has a direct impact on settlement negotiations, in the Netherlands negligence liability affects the number of individuals participating in the cases, which indirectly influences the size of settlements.

There can be two solutions to the problem of low settlement size. One is to cure the identified problems of procedural law. However, the problem with general procedural law is that it applies not only to underwriter liability, but also to the whole bunch of other liability relationships. Therefore, while these arrangements can lead to underenforcement in case of underwriter liability, they can function well in other circumstances. As a result, solving the problem of underwriter underdeterrence by adjusting the rules of procedure can have long-ranging perverse effects on other fields of law and can be undesirable. On the other hand, it is practically impossible to change the procedural rules only as far as underwriter liability is concerned.

Another solution is to reduce the uncertainty surrounding the outcome of the case. The simplest way to do this is to get rid of the negligence requirement in underwriter liability cases, *i.e.* to shift from negligence liability standard to strict liability whereby the underwriter is held liable independently of its fault. Strict liability would reduce the uncertainty surrounding the outcome of the case and therefore increase the potential award of damages if the case goes to trial. In turn, this would strengthen the investors' position in settlement negotiations or their lawyers' incentives in a litigation process. Both circumstances would lead to higher settlements amounts.

3. PROPOSAL FOR A CHANGE

3.1. Switch to strict liability

The arguments discussed in the previous sections provide additional support to the hypothesis, initially introduced by Partnoy (2001) and Coffee (2004), that strict liability may be a more efficient regime of underwriter liability than negligence. The current outcome seems to be not only theoretically flawed, but also producing suboptimal results in practice. However, I think that a few changes in the law can considerably improve on the current situation.

The most important modification to the current regime is the change from negligence to strict liability. Under this regime underwriters would be held liable for damages as soon as it is shown that there is a causal link between the misstatement and the decrease of price, independently of their actual fault in causing such a misstatement. As discussed above, such a change would not only be in line with basic economic criteria, but would also solve the problem of underenforcement currently observed in the USA and the Netherlands.

3.2. Solving the problem of the excessive residual liability risk: the cap on damages

In line with Partnoy (2001) and Coffee (2004), my analysis also showed that there might be reasons to limit the size of damages in underwriter liability cases. The need to cap damages under strict liability is associated with the problem of residual risks. As was discussed in Section 2.2 above, residual liability risks can become too high. This could have a negative impact on the level of activity in capital markets, particularly the issue of new securities, which may become lower than it is optimal. However, this concern can easily be addressed by reducing the size of statutory damages under strict liability.

Capping of damages is not uncontroversial. The basic Law and Economics tradition posits that in order to achieve optimal deterrence the damages in misstatement cases should be at least equal to the full social harm caused by such misstatement. The reason why normally damages should equal the full social harm of misconduct is that by taking care the injurer lowers the probability of the accident and thus reduces the accident losses. The optimal level of care is achieved when the marginal benefits of taking care are equal to marginal costs of taking care. Thus, only when damages are equal to the full social harm caused, the injurer is made to fully internalize the negative externalities it has caused.[503]

Assuming perfect enforcement, such liability threat will be determined by the sanction or damages the underwriter has to pay. There are two options how to calculate such a sanction. It can be calculated on the basis of the total harm caused to investors or the benefits derived by the injurer from the violation. Law and Economics, as a rule of thumb, suggests that the harm is a better measure because otherwise the court risks underestimating the gains. Thus, in this perspective, a liability threat based on the underwriter gain could result in insufficient deterrence.[504]

Usually, deviating from these rules by capping the damages below the full social cost of misstatement would mean that the underwriter would not internalize the full social costs of issuer's misconduct and thus would not get the right incentives. However, there are reasons to believe that this reasoning does not apply to underwriter liability.

First of all, it should be noted that there is a difference between the primary liability of the wrongdoer and gatekeeper liability. The goal of primary liability is to make the injurer internalize the full social costs of his conduct. To achieve this goal it is reasonable to require that the damages reflect the total social harm. However, the goal of gatekeeper liability is in a sense more modest. Because the gatekeeper is supposed to stop the harmful activity by denying access to the potential wrongdoers, the purpose of gatekeeper liability is to provide monitoring incentives to underwriters and to discourage them from monitoring negligently. This can be simply achieved by setting the liability threat slightly higher than the gains from underwriter "failing to close the gate" when this would be

[503] Michael Faure, *Tort Law and Economics* (Edward Elgar Publishing, 2009), pg. 156. referring to Richard A. Posner, *Economic Analysis of Law* (Aspen Publishers, 2003), pg. 192; Robert Cooter and Thomas Ulen, *Law and Economics* (Pearson Addison Wesley, 2004), pg.312 and 323; Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press, 2004), pg. 236.

[504] Faure, *Tort Law and Economics*, pg. 170.

efficient and by adjusting this sanction to the probability of enforcement. However, to achieve this goal there is no need to require that the damages caused by the issuer be compensated in full.

Secondly, in Chapter II it was concluded that some deterrent effect is already caused by market enforcement mechanisms, especially reputational sanctions and enforcement by stock exchanges. The deterrent threat caused by market mechanisms is very difficult to quantify. However, there are indications that it can be substantial. In the related field of issuer liability Karpoff *et al* (2008) estimated that the loss of reputation of the firms involved in balance sheet misstatement cases constituted 66.56% (if estimated using means) or 92.09% (if estimated using medians) of the total loss. This means that the threat posed by market mechanisms cannot be disregarded and it should be added to the threat of legal liability. Accordingly, the size of damages in liability cases should be adjusted downwards. Therefore it could be optimal to set the levels of underwriter liability lower than the total harm caused by the misstatement.

Thirdly, full compensation of harm may induce overinvestment in securities.[505] According to Schwartz (1997), liability payments are transfers of resources from gatekeepers to investors. These transfers perform an insurance function independently of the liability standard. If investors can affect the amount of these payments by altering their investment levels, then the legal regime may distort the efficiency of their investment decisions. If damages are measured based on actual investments, investors can increase the expected liability payments by over-investing. Thus, the potential transfer of wealth from gatekeepers to investors can lead to an over-investment in risky assets, relative to a socially optimal level, even with a high-quality gatekeeping. Conversely, removing the association between actual investments and liability payments can induce a socially optimal level of investment. In addition, according to Schwartz (1997), combining strict liability with a damage measure independent of the actual investment provides gatekeepers with optimal incentives to monitor.

Having concluded that basing the threat of legal liability on the total harm would not be optimal, one has to search for other ways to determine the optimal liability threat. Partnoy and Coffee debated about which way of capping the damages is better. Partnoy (2001) and

[505] Rachel Schwartz, “Legal Regimes, Audit Quality and Investment,” *The Accounting Review* 72, no. 3 (July 1, 1997): 385-406. The cited article concerns the liability of auditors, however, its intuition is equally valid for underwriters.

Partnoy (2004) argue that it is better to link the amount of damages to the total damage, *i.e.* the underwriter would have to pay a certain percentage of the full damages. In this way the damages would still be proportionate to the total social costs of the violation and will be increasing in the severity of the harm. In addition, Partnoy (2004) argues that the percentage of the social harm is a better method of capping the damages because it can be quite complicated to estimate the revenues of certain gatekeepers.

In contrast, Coffee (2004a) and Coffee (2004b) propose to set the damages as a multiple of the highest annual revenues received by the gatekeeper from its client (the primary wrongdoer) over the last few years. According to Coffee (2004b), this measure is preferable simply because it is less likely to lead to gatekeeper bankruptcy and would be more politically feaseable.

My analysis also indicates that it is the fees, but not the full social harm, which should be used as a benchmark for setting the damages. First of all, as it was discussed above, the full social costs are mostly irrelevant for the goals of the imposition of underwriter liability. As the goal of underwriter liability is to provide incentives to monitor the issuer efficiently and given the assumption that the probability of enforcement is equal to 1, in order to achieve deterrence the liability threat should be equal to the underwriter gains from the issuer in question. Assuming there is no bribery (*i.e.* excluding the cases of fraud), the maximum gain for the underwriter is thus equal to the underwriting fee received from the issuer. Therefore, it is logical to base the damages faced by underwriters in liability cases on the underwriting fee.

Secondly, the underwriting fees are easy to determine. They are usually indicated in the underwriting agreement and the prospectus as a percentage of the total amount of offering. In the USA this usually amounts to 7% of the underwritten amount. In Europe underwriting fees are on average 3-4%.[506]

In should be noted that, in the real world, the probability of enforcement is typically lower than 1. It might be necessary to introduce some multiplier of the proposed size of damages in order to correct the underdeterrence effect stemming from a probability of enforcement lower than 1. However, the problem of using a multiplier is that it is very difficult to estimate a general probability of enforcement of underwriter liability. The probability of

506 London Stock Exchange, “Aim Rules for Nominated Advisers,” pg. 4.

enforcement varies depending on the institutional context. In particular, the relative importance of private enforcement varies from country to country, and nowhere in the world it seems to be comparable to the USA.[507] The relevance of private enforcement is also supposed to change over time. In this perspective, a relatively low multiplier or none at all would be required in the USA legal system, while in the Netherlands a higher multiplier might be needed.

The optimal size of the damage multiplier, however, can only be determined after having determined the average amount of settlements once the proposed modifications to the system of underwriter liability have been implemented. This would be an interesting avenue for future empirical research.

3.3. Solving the problem of frivolous litigation: the shift of the burden to prove loss causation

The previous discussion of the choice between negligence and strict liability also emphasized that strict liability can exacerbate the problem of false positives, whereby the underwriter may be forced to settle an unfounded liability suit. Given that it is relatively easier for the plaintiff to file a case and to prevail under strict liability than under negligence, too many weak and frivolous cases could be filed and unjustified settlements might be achieved. In fact, what is feared is that lawsuits will be filed not only in cases where the misstatement causes a price drop, but also in all other cases whenever the price of securities drops for unrelated reason.

As acknowledged before, this concern is legitimate and thus it should be addressed. To avoid the proliferation of frivolous litigation under strict liability, this dissertation suggests a rather straightforward solution that might allow balancing the effect of the imposition of strict liability. It is proposed to impose the burden to prove loss causation, *i.e.* the causal link between the misstatement and the losses, back to the plaintiff as it is common in normal tort cases. In this situation only those cases where plaintiffs can prove a link between the misstatement and the price drop will be able to proceed to trial. This would prevent plaintiffs and their lawyers from filing frivolous cases in the first place. In this way it can be made sure that the underwriter will have to pay a considerable sum in all cases

[507] Reinier H. Kraakman, *The anatomy of corporate law: a comparative and functional approach* (Oxford University Press, 2009).

when misstatement causes a price drop, also independently of its actual fault. However, the need for the plaintiff to prove loss causation would protect underwriters from frivolous litigation.

It should be noted that the requirement to prove loss causation can be formulated in two different manners. It can be understood as a duty to show a general link between the misstatement and the loss (general proof of loss causation). This can be achieved by providing an expert opinion showing that the price of a certain security was affected by the misstatement and the extent of such price move. The expert would usually use an econometric regression analysis of the price behavior within a certain time frame.[508] Although such type of analysis definitely requires certain skills and expertise, as well as sufficient data, it can be performed once and then it would be applicable to all the investors involved.

A second method is to require proving the link between the misstatement and individual losses of each investor (individual loss causation). Proving the individual loss causation is a quite specific and complicated process. It requires the assessment of individual circumstances of the case. Under the requirement to prove individual loss causation, each investor is typically supposed to provide specific information about such circumstances as their purchases and sales during and after the timeframe of the violation, the general pattern of investment and their investment profile.

The requirement to prove general loss causation is beneficial because it ensures that investors do not file meritless lawsuits, *i.e.* claim damages whenever there is any significant price drop or when there is a misstatement, but there is no market reaction to such a misstatement. However, individual loss causation may go too far in limiting litigation, *i.e.* it can prevent not only frivolous litigation but also worthy cases from being brought. This is because a focus on individual loss causation significantly complicates the litigation of misstatement cases, creating unnecessary hurdles to the litigation. In turn, this can affect the average size of settlements.

In addition, assuming the same loss causation across different investors in a certain security is justified according to the postulates of the efficient capital market hypothesis

[508] This econometric analysis would involve an event study that covers the period during which the market was misled. First of all, the event window is defined. Secondly, an abnormal return on stock is calculated taking into account economy-wide, industry and firm-specific information. Finally, the statistical significance of the abnormal return is tested. Ibid.

(hereinafter – ECMH) and fraud-on-the-market theory. ECMH states that in efficient markets the securities price reflects all the available public information.[509] This means that given that distribution markets are efficient the misstatements and omissions contained in the registration statement affect the market price of the security. Markets are efficient when the information is timely incorporated in the price. There are reasons to claim that primary markets are indeed efficient in a sense that they reflect all the information disclosed in the prospectus. In primary markets the incorporation of prospectus information into the price happens, first of all, *via* the bookbuilding process. During the bookbuilding procedure the preliminary prospectus is distributed to institutional investors who submit their bids on the basis of such information. Bids inform the company about the market demand for the securities and allow setting the offering price. It is claimed that the particularities of the bookbuilding process ensure that the revealed price is a fair and honest estimate of the disclosed information.[510] Once the security enters secondary market trading, the information in the prospectus continues to be the only source of information for the price formation in the market. The price emerges as a result of the negotiations between the buyers and sellers on what is considered to be the "true" value of the security. In this way, the prices set by primary markets are efficient at the time of the offering and for some time after the offering, at least until new information becomes public.

Because markets are efficient, an information misstatement determines a "fraud on the market". All investors can be assumed to rely *equally* on the information in the prospectus. The fraud-on-the-market theory claims that in open and developed securities markets, the price of a security is determined by the available material information. Misleading statements will hence defraud investors even if they do not directly rely on the misstatements. Therefore, it is unnecessary to require investors to show individual reliance and that they in fact read and analyzed the information themselves. In other words, the issue of reliance can be considered common to all investors.[511]

[509] See, for example, Gilson and Kraakman, "The Mechanisms of Market Efficiency."

[510] For further discussion see Section 3 of Chapter III.

[511] This theory was endorsed by the US Supreme court in *Basic Inc. v Levinson.*

In turn, the revelation of the misstatement is considered as an event which triggers the realization of losses. The efficient capital market hypothesis provides a basis to claim that in primary markets it is likely that a material misstatement will initially inflate the price whereas the revelation of true information will lead to a price decrease. This situation determines the same loss for each individual investor (naturally adjusted for the size of holdings and other individual factors). This approach suggests that individual misstatement cases are rather standardized. Therefore, assuming that the loss causation is the same for all the affected parties can lead to considerable cost savings without increasing the expected error costs.

In sum, while the requirement to prove general loss causation is useful as a mechanism for filtering-out frivolous cases, the requirement to prove individual losses may be too burdensome. Such a requirement can have a chilling effect on worthy litigation. In addition, mainstream modern finance theories suggest that it is cost-effective to assume the same loss causation for all investors.

4. APPLICATION TO THE USA LEGAL SYSTEM

Currently, in the USA, Section 11 is formulated as a negligence liability standard with reversed burdens of proof on almost all elements of the case. Applying the proposed modifications of underwriter liability regime to the USA legal system would require the following changes.

First of all, Section 11 should be changed in a way that the due diligence defense is removed for underwriters. Thus, the underwriter would become subject to strict liability, as it is currently the case for the primary wrongdoer – the issuer.

Secondly, the burden to prove general loss causation, *i.e.* the causal link between the misstatement and the losses, should be placed on the plaintiff, as it is common in normal tort cases.

Finally, the damages in underwriter liability cases should be capped at the size of the underwriter fee received by the issuer. Given the relatively high level of private enforcement due to the USA procedural law, the probability of enforcement may be quite close to 1 and thus there may be no need at all to introduce a multiplier in order to correct for underdeterrence.

5. APPLICATION TO THE DUTCH LEGAL SYSTEM

In the Netherlands underwriter liability also takes the form of negligence liability with the burden to prove due diligence imposed on the underwriter. The other burdens of proof are mostly on the plaintiff. To implement my proposal in the Netherlands, the legal system would require the following modifications.

As in the USA, the due diligence defense should be removed. This would make the underwriter strictly liable for any misstatements of the issuer which result in a price drop.

Secondly, it should be noted that the problem of frivolous litigation usually associated with strict liability is not as important in the Netherlands as it is in the USA. This is related to the fact that collective claims for damages are not allowed and that the right to initiate collective cases for a declaratory judgment is granted only to representative organizations. Even though these can be *ad hoc* organizations, the absence of contingency fees and the "loser pays" rule limits considerably the perverse incentives to launch frivolous cases in the Netherlands.

In addition, the burden to prove damages and loss causation is already on the plaintiff in the Netherlands. According to the current Dutch law the question of loss causation and damages arises only at the stage of individual or assigned follow-on litigation. At this stage, it is not required to prove that each of the individual investors relied on the prospectus in making its investment decision (reliance or transaction causation). However, the plaintiff is required to prove individual damages and that the misstatement caused losses (individual loss causation).

The proof of damages and individual loss causation in the Netherlands is normally rather specific. It depends on individual circumstances and how investors formulate their claims. Thus, there is no standardized definition of damages and there is no standardized way to prove them. Usually, the proof of loss causation involves investors providing an expert opinion showing that the price of security was affected by the misstatement and the extent of such price move. Disgruntled investors also have to provide specific information about circumstances such as purchases and sales during and after the timeframe of the fraud, the general pattern of investment and their investment profile.

As discussed above, such approach to loss causation can place an unnecessary burden on plaintiffs and thus discourage worthy litigation. Therefore, the outcome can be improved by making several amendments to the Dutch rules on loss causation. First of all, I would recommend introducing a statutory definition of damages in misstatement cases, along the lined detailed below. In addition, it should be sufficient for investors to prove that there is a general link between the misstatement and the drop of price following its revelation. This would require the plaintiff to present an expert opinion showing the effect of the revelation of the misstatement on the price.

If the burden of proof is based on the general link between the security price and the disclosure of information, the requirement of Dutch law that plaintiff prove loss causation would be preserved. However, it would be possible to get rid of unnecessary and unjustified individual assessment of damages. The damages in the Netherlands would be made uniform for all investors and investors would be freed from the need to prove individual circumstances. This would facilitate individual litigation or assigned litigation of claims for damages, so that more and more investors could participate in the case. As a result, the cumulative threat of litigation in the Netherlands would increase providing a stronger “shadow of the law.” This would likely lead to an increase in the average amounts of settlements in the Netherlands.

An even more advanced step would be to resolve the question of general loss causation not at the second stage of follow-on litigation, but already at the first stage of declaratory judgment. In my view, as soon as the general loss causation is introduced, it becomes a rather common question that is suitable to be resolved in representative proceedings. At this stage the court could either acknowledge or deny the link between the misstatement and the reduction of firm capitalization following the revelation of misstatement. For example, De Jong (2010) proposes that the court could determine by what amount the price was artificially inflated for each day of the class period. This would provide an important step in easing the determination of causation.[512] The question of individual losses could still be left for the follow-on litigation where the court would assess matters such as the apportioning of individual losses. In these cases, investors would present evidence of their investment behavior within the set timeframe in order to calculate the exact amount of compensation. However, investors in individual cases would be relieved from the duty to prove the general loss causation *ex novo*.

[512] Ibid., pg. 409.

The introduction of general criteria to prove loss causation would also entail the modification of the definition of damages in the Netherlands. Currently, in the Netherlands there is no statutory definition of damages in misstatement cases. Depending on the formulation of the claim, damages may be defined as "out-of-pocket" loss or they can include lost profit or consequential losses. The damages are also not limited and they can vary significantly depending on individual circumstances.

The current situation is not efficient for two reasons. First of all, investigation of the actual loss borne by each investor is very costly and it creates unnecessary hurdles in individual and assigned litigation. As it was already discussed, the efficient enforcement of underwriter liability is associated with collective litigation mechanisms. To be effective such mechanisms should allow for some sort of collective litigation of damage claims. This can only be possible when damages are somewhat standardized and the court does not need to assess each and every individual circumstance of the case. While "out-of-pocket" losses are pretty uniform for all investors, the other damages can be very individual. Therefore, it is optimal to limit the compensable damages in misstatement cases to "out-of-pocket" loss in order to facilitate the functioning of collective litigation systems. The gain in precision when using individualized measures of damages is also unlikely to be as significant to justify the costs of such individualized approach. Thus, in order to facilitate both individual and assigned litigation a more standardized measure of damages is desirable.

Secondly, there are strong economic reasons to limit the compensation of losses in misstatement cases only to direct monetary losses depending on the price drop (*i.e.* "out-of-pocket" losses) while excluding other types of damages. Easterbrook and Fischel (1985) authoritatively argued that that further damages, such as consequential damages, should not be allowed in securities cases because there is no direct link between those damages and the misstatement. In other words, there is no connection between the decision to invest in an alternative project and the way the funds to finance such project are obtained. If an alternative project is indeed that attractive, the investor needs not to obtain the sources to finance this project by refusing to invest in the securities offering in question. Instead, the investor could have borrowed the funds. Therefore, the change of the price of the security by itself does not create an economic injury on top of "out-of-pocket" injury.[513]

[513] Easterbrook and Fischel, "Optimal Damages in Securities Cases," pg. 633.

Two more arguments point in the direction of limiting the damages in misstatement cases to "out-of-pocket" losses. The first argument is based on the idea that the measure of damages influences the parties' investment in information verification. If the measure of damages includes consequential or any other damages, they can highly exceed the total offering amount.[514] The damages will also be very uncertain because the underwriter cannot predict the consequential damages of all possible plaintiffs. The uncertainty will push investments in precaution even further. As a result, underwriters will invest in information verification much more than is socially optimal.

In addition, when discussing the USA scenario it has been argued that the compensation of "out-of-pocket" losses under a strict liability regime should be capped at the amount of the underwriting fee. The same arguments should apply in the case of the Netherlands.

As a result, in order to improve the misstatement litigation in the Netherlands it is necessary to modify the damages in the following manner. The first move is to introduce a statutory definition of damages for prospectus liability cases. This would help to standardize the misstatement litigation and make it easier for investors to formulate and bundle their claims. Compensable damages in the Netherlands should be limited to "out-of-pocket" losses. Consequential or lost profit damages should not be compensated. This would place the damages in the Netherlands more in line with economic insights. Damages can be defined in an USA-style manner, as the difference between the purchase price and the price attributed to and resulting from the revelation of the misstatement. Moreover, coupled with the imposition of strict liability, the damages should be limited by the amount of underwriter gain from the negligent misstatement, *i.e.* the underwriting fee received by the issuer. This would provide underwriters with the right incentives to gatekeeping without overly increasing the overall costs of issuing securities.

6. CONCLUSIONS

This part aimed to analyze the Law and Economics literature regarding the construction of an optimal liability regime for underwriters. First of all, it was shown that there is a debate in the academic literature with regard to the optimal liability standard. To contribute to this

[514] Ibid., pg. 620-621.

debate underwriter liability was analyzed, first of all, applying the economic criteria developed by Shavell. It was found that the case of underwriter liability should be analyzed as a unilateral accident. Next, it was established that it is easier to determine damages in misstatement cases than to set the optimal level of due care. In addition, it was shown that both negligence and strict liability lead to significant residual liability risks and this can have a negative impact on the level of activity in capital markets. Finally, it was suggested that both liability regimes can cause frivolous litigation. This analysis showed that there are no strong reasons to prefer negligence to strict liability. The latter can function equally well if not better.

Secondly, the discussion was expanded outside Shavell framework. The actual liability threats under current negligence liability regimes in the USA and the Netherlands were analyzed. It was found that the current negligence liability regimes fail to provide effective incentives for underwriters to act as reliable gatekeepers. It was found that, as a rule, the sizes of settlements in underwriter liability cases are lower than the average gains the underwriter derives from providing underwriting services, *i.e.* the average underwriting fee. Thus, even assuming the highest possible probability of enforcement ($p = 1$), such a low sanction is unable to provide sufficient incentives to monitor.

This Chapter then proceeded to search for a solution to this problem. The core of the proposal developed herein is to shift from the current negligence-based liability to strict liability. This step would allow reducing the uncertainty surrounding the outcome of individual cases. In turn, in the USA this would affect securities lawyers' incentives to fight for higher settlement amounts. The same logic can be applied to the Netherlands, where the move from negligence to strict liability would encourage more investors to participate in misstatement cases, increase the "shadow of the law" and thus increase the settlement amounts.

To counterweight the threat of frivolous litigation usually associated with strict liability, this Chapter also proposed to place the burden to prove loss causation on the investor. However, it was argued that such proof of loss causation should not vary across investors, but instead be general, consisting of showing the general link between the misstatement and the decline of market capitalization of the company. This solution requires a uniform definition of damages in misstatement cases and precludes individualization of losses. Requiring the plaintiff to prove loss causation would protect the underwriter from being sued whenever the price drops significantly even though such a price drop is attributable to factors other than a misstatement. It would also discourage claims whenever there is a misstatement that does not affect the price. However, a general determination of loss causation would not create individual hurdles for the collective resolution of claims for damages.

To implement this proposal in the USA, where causation in securities fraud is typically determined on standardized terms, this Chapter proposed to simply shift to the plaintiff the requirement to show loss causation. In the Netherlands the burden to prove loss causation is already on the plaintiff. However, in this jurisdiction the proof of loss causation is currently very individualized. Thus, to implement this proposal, Chapter IX has suggested adopting a statutory measure of damages defined as “out-of-pocket” loss (capped by the amount of underwriting fee). This would allow making the formulation of individual claims easier and more standardized thus paving the way for a simpler collectivization of claims. In the Netherlands, it was suggested that the question of general loss causation could be resolved within the representative action for declaratory judgment, which is the first stage of enforcement of a typical underwriter liability case.

It was also acknowledged that the adoption of strict liability can cause significant residual liability risks, which may overly reduce the activity levels on capital markets and thus be inefficient. To avoid this outcome it was suggested to cap the statutory damages in underwriter liability cases at the amount of the underwriting fee received from the issuer. The deviation from full compensation of losses is also justified by the fact that underwriters already face some market-based reputational losses in case of a liability suit. Also, capping the liability exposure of underwriters reduces the latter’s role as insurers of the investing public, thereby limiting the problem of overinvestment stemming from gatekeeper liability.

CHAPTER X. THE CURIOUS CASE OF THE UK

1. NO PRIVATE ENFORCEMENT

Part Two of this book has demonstrated that although there are strong arguments for the use of civil liability as an enforcement device for underwriter gatekeeping duty, not all countries use it. Chapter VIII showed that in the UK the underwriter gatekeeping function is generally not subject to private enforcement. Neither statutory nor common law causes of action position the underwriter under civil liability threat. In addition, the particularities of collective dispute resolution mechanisms and weak economic incentives to initiate cases prevent vivant civil litigation activity in this field.

Nevertheless, one cannot claim that underwriters do not perform a gatekeeping function in the UK. Underwriters are commonly used. All types of underwriting are present, although the terminology varies significantly. “Direct offers”, “offers for subscription” or “prospectus issues” are cases when the issuer publishes the prospectus itself and sells the shares directly to investors. This involves best-efforts or stand-by (or in English parlance – underwritten) offerings. Most of the direct offers are underwritten on a stand-by basis.[515] In “offers for sale” the underwriter agrees to purchase all the securities from the issuer for further resale to the public or selected investors (so-called placing). An offer for sale is equivalent to the American firm-commitment underwriting. It is a usual method of public issue for securities listed on the Main List of the London Stock Exchange (hereinafter – the LSE).[516]

As a rule, the underwriter assists the issuer in preparing a prospectus. This document in many cases is drafted by the underwriter and its advisers or at least is heavily influenced by the underwriter. To do this the underwriter conducts the due diligence investigation which involves “the issuer disclosing to the underwriter, almost without limitation, information relating to its internal operations, as well as its strategic challenges and future prospects”.[517] The issuer provides minutes of its board and committee meetings and those

515 Hudson, *Securities Law*, pg. 47.

516 Ibid., pg. 42.

517 Andrew Tuch, “Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts,” *SSRN eLibrary* (n.d.): pg. 56, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=989891.

of its subsidiaries, all major contracts to which the company or its subsidiaries is a party, and any other information. The underwriter also interviews issuer's officers and other employees about matters such as business plans and financial performance. In contrast, to the USA where the process of due diligence is rather informal, in the UK there is a clear focus on formal verification procedures. During the due diligence the issuer produces verification notes. Verification notes comprise a number of questions based on every sentence in the prospectus to which the answers must be provided by the responsible parties. Each answer must contain an appropriate reference to the evidence or the source of information. The verification notes are, first of all, reviewed by the underwriter and its lawyers and only then the final version is reviewed and approved by the board of directors.[518]

In addition, it seems that the British approach to the civil enforcement of underwriter gatekeeping duty does not affect the quality of its capital markets. The UK markets are not lagging behind others where the liability is used. In case of IPOs, the USA market has been for the long time considered the biggest and the most active IPO market. However, since 2001 London managed to overtake the US as regards the number of listings. In recent years London was the biggest market in Europe representing 38% of total money raised on the EU-regulated markets in 2010.[519]

Table 3. IPO activity

<table>
<tr><th>Country/Year</th><th>1995</th><th>1996</th><th>1997</th><th>1998</th><th>1999</th><th>2000</th><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>Total</th></tr>
<tr><td>Belgium</td><td>1</td><td>3</td><td>13</td><td>18</td><td>17</td><td>7</td><td rowspan="4">36</td><td rowspan="4">15</td><td rowspan="4">14</td><td rowspan="4">20</td><td rowspan="4">800</td></tr>
<tr><td>France</td><td>22</td><td>59</td><td>82</td><td>226</td><td>68</td><td>76</td></tr>
<tr><td>Netherlands</td><td>6</td><td>7</td><td>15</td><td>22</td><td>17</td><td>9</td></tr>
<tr><td>Portugal</td><td>16</td><td>5</td><td>7</td><td>10</td><td>5</td><td>4</td></tr>
</table>

[518] Valerie Ford Jacob, "The Due Diligence Process From The Underwriter Perspective," in *Conducting due diligence in M&A and securities offerings, 2008* (New York NY: Practising Law Institute, 2008), pg. 105.

[519] http://www.pwc.com/pl/en/ipo-watch-europe/IPO_Watch_Europe_2010.pdf

UK	285	347	217	169	161	366	236	219	194	413	2607
US	458	675	474	284	477	382	80	66	63	174	3133

Source: For USA data - Jay Ritter, Some Factoids about the 2008 IPO Market

For non-USA data – Gajewski and Gresse, A survey of the European IPO Market, 2006

At the same time, in the UK misstatement cases seem very rare and it has largely avoided Enron-type corporate scandals.[520]

Given the success of the UK capital markets and the fact that underwriters are being used and that they perform the same functions as elsewhere, one cannot claim that civil liability is indispensable for the successful capital markets. However, this also does not mean that underwriters do not face compliance incentives from other sources. Indeed, there may be other enforcement mechanisms in place. The following sections will look into such possible alternatives to private enforcement in the UK.

2. ALTERNATIVE ENFORCEMENT MECHANISMS

2.1. Overview of historical development: LSE and FSA

The enforcement of the underwriter gatekeeping duty in the UK was traditionally left for the self-regulation by the stock exchange, namely the LSE. Until 2000 the LSE had a substantial authority to regulate activities of its members.

Historically the LSE had a single market for all companies – the Main market. It contained two separate market segments – Primary and Secondary listing markets. Primary listing market was the main market for all UK companies. Secondary listings were available only

[520] One could argue that the paucity of reported cases in the UK does not necessarily mean that there is a problem with the enforcement. It can also be the case that claims are successfully settled out of court. However, I doubt that this is the case in the UK. This conclusion follows from the fact that according to my analysis the possibility to bring and win misstatement case in the UK are limited. Thus, there is no "shadow of law" which would encourage the settlements. In addition, it would be logical to expect settlements only after some important cases get resolved. These do not exist in the UK.

More realistic hypothesis for the paucity of misstatement scandals in the UK is that there is the general compliance in the market. I am more in favor of this hypothesis which will be discussed in more details in Section 3 of this Chapter.

to overseas companies. Primary and secondary markets differed as regards the strictness of their listing requirements, those of the Primary market being considerably more stringent. One of the specific requirements for the listing on the Primary market was for the company to have a sponsor. The role of the sponsor, usually the lead underwriter, was to ensure that the Stock exchange receives all the information and documents to support the application for listing, to provide assurance to the LSE that responsibilities of the issuer under the Listing rules were met, to guide the company while acting with due care and skill. The sponsor had to be registered with the LSE and the LSE could exercise enforcement powers in case the sponsor failed to perform its duties. Lead underwriters would usually become sponsors for the companies they underwrite.

At the time it was argued that the requirements for Primary listing on the LSE were too burdensome for small and medium local companies. Thus, in 1995 the LSE established the separate market – the Alternative Investment Market (hereinafter – the AIM) which admitted small and medium companies and relieved many of the requirements of Primary listing. However, the requirements applicable to the gatekeeping function of the underwriter were not abandoned. To the contrary, the AIM introduced the institute of the nominated advisor or so-called nomad whose functions were even wider than those of sponsors.

A nomad has to approve the appropriateness of the offering, its terms and all related disclosures. It also decides what the company has to disclose. A nomad must act with due skill and care at all times. It is responsible to the LSE for advising and guiding an AIM company on its responsibilities under the AIM Rules for Companies not only in respect of admission but also in respect to its continuing obligations on an ongoing basis. A nomad must be available to advise and guide AIM companies for which it acts at all times.[521] In fact, according to Coffee (2006) a nomad possesses "probably the greatest discretionary authority given to gatekeeper: someone who oversees all of the terms and disclosure decisions for clients companies that lack the experience or reputation to be trusted to make such decisions themselves. In turn, a Nomad is monitored by the stock exchange that approved it".[522]

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[521] London Stock Exchange, "Aim Rules for Nominated Advisers."

[522] Coffee in Yasuyuki Fuchita and Robert E. Litan, *Financial Gatekeepers: Can They Protect Investors?*, illustrated edition. (Brookings Institution Press, 2006), pg. 176.

The LSE has the following monitoring and enforcement powers in respect to nomads. First of all, it may subject a nomad to a formal review to ensure that it has fully discharged its responsibilities. A nomad has to fully co-operate fully with the LSE and answer any questions. It must also allow access to its records and business premises. Secondly, the LSE has a say as regards the suitability of nomads' employees. Finally, if the LSE considers that a nomad is either in breach of its responsibilities or that the integrity and reputation of AIM has been or may be impaired as a result of its conduct or judgment, the LSE may take one or more of the following actions:

- issue a warning notice;
- levy a fine;
- issue a censure; or
- remove the nominated adviser from the register; and
- publish the action the Exchange has taken and the reasons for that action.

Thus, until 2000 all lead underwriters would be subject to the enforcement only by the stock exchange. This shows that it was recognized that market incentives were not enough to provide deterrence for underwriters to serve as gatekeepers. However, it was believed that stock exchanges were able to ensure compliance.

Significant changes occurred in 2000 when the LSE has undergone the process of demutualization and became a publicly listed company. Probably pursuing the belief that demutualization created conflicts of interest in performance of the exchange regulatory and monitoring functions,[523] the listing responsibilities were transferred from the LSE to the public body – the Financial Services Authority (hereinafter – FSA), which became responsible for listing and aspects of enforcement, including the authorization and supervision of sponsors. Nomads, however, remained completely under the supervision of the LSE.

There are two bases for public enforcement against underwriters in the UK. First of all, there is a general authority of the FSA to investigate and enforce violations of requirements imposed by the FSMA. It can subject the violator to the public censure which

[523] See some discussion in Section 4.2 d) of Chapter II.

is assumed to have a serious effect on the censored person's business or reputation.[524] It can also impose penalties and determine the amount of a penalty at its discretion. The FSA is entitled to issue or to apply to the court for the restitution order against a person who has contravened the FSMA or against any other person who was knowingly concerned in the contravention when profits have accrued to the person as a result of the contravention or persons suffered loss. This provision, theoretically, allows the FSA to reach underwriters as secondary actors. As an *ultima ratio* the FSA may proceed with revoking its authorization required under the FSMA for the underwriter to be able to pursue underwriting activities. This is an extreme remedy which is likely to be considered excessive for the cases of negligent misstatement.

Secondly, Listing rules[525] also state that if the sponsor violates its duties under the Listing rules, the FSA can exercise its disciplinary powers as mentioned above, *inter alia* the cancelation of sponsor's approval. Therefore, statutory enforcement powers of the FSA in respect of underwriters are rather wide and it possesses a big range of instruments to ensure compliance.

Some changes relevant to the enforcement regime in respect of underwriters have taken place recently. In 2010 the LSE has reformed its listing categories for the Main market. Primary listing was renamed into Premium listing while Secondary became Standard. The requirements for Premium listing remained similar to the Primary listing, including the requirement for the issuer to have a sponsor who is authorized and supervised by the FSA. However, the Standard (former Secondary) listing category became available also for the local issuers. Companies applying for the Standard listing have to follow only the minimum EU requirements and *inter alia* are not required to have either a sponsor or a nomad. This change is supposed to increase flexibility for the London market, providing more options for small and medium companies either to downgrade to Standard (requiring a 75% resolution from shareholders) or, for new applicants, by offering a simpler and cheaper route to listed status.[526] However, as of 2011 Standard listing category has not

524 *Financial Services: Investigations and Enforcement*, 2nd ed. (Tottel Publishing, 2005), par. 7.29 - 7.30.

525 Listing rules have statutory power in the UK.

526 "Shake-Up In LSE Listings", n.d., http://www.growthbusiness.co.uk/channels/raising-finance/flotation/1092342/shakeup-in-lse-listings.thtml.

been particularly popular. Premium listing was the most common listing standard – there were twice as many companies with Premium listing than with the Standard one.

In sum, currently the company planning to publicly issue securities in the UK has three possibilities. It can apply to:

- the Standard listing on the Main market which has no enforcement in respect of underwriters;
- the AIM which features the nomad regime enforced by the LSE;
- the Premium listing on the Main market which features the sponsor regime enforced by the FSA.

Therefore, one can see that the UK system of enforcement of gatekeeper function has developed from purely self-regulatory system which was mandatory for all local companies to a multi-level mixed enforcement system which is rather flexible and provides a lot of choice for issuers.

2.2. Enforcement by the FSA in practice

Despite the arsenal of remedies at the FSA's disposal, according to the information available to my knowledge there were no cases where underwriters were subject to the general enforcement by the FSA (but there were cases when solicitors and other agents were held responsible). The data shows that also, in general, enforcement by the FSA is indeed of a very low intensity. Between 2002 and 2005 the FSA imposed sanctions in respect of disclosure failures against only eight issuers and no secondary actors. The highest sanction was 17 million pounds, but the next largest fine was 450000 pounds.[527] Coffee (2007) provides data on the percentage of the regulator's budget spent on enforcement activity. Over the period between 2004 and 2007 the enforcement expenditure of the FSA ranged between only 12.4% and 13.2% of its total budget.[528]

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[527] Kathryn Cearns and Eilis Ferran, "Non-Enforcement-led Public Oversight of Financial and Corporate Governance Disclosures and of Auditors," *Journal of Corporate Law Studies* 8, no. 2 (2008): 191-224.

[528] Jr. Coffee, "Law and the Market: The Impact of Enforcement," *University of Pennsylvania Law Review* 157, no. 2 (December 2007): 229-311.

Cases of enforcement against sponsors are also very rare. In fact, the first and the only enforcement action against a sponsor took place quite recently – in 2011 when the FSA censured a sponsor – BDO LLP for failing to comply with the Listing Rules.[529]

This is not surprising given that the UK securities regulation is known to be not an "enforcement-led" mechanism. It is mostly principle-based, meaning that "the regulator defines policies and goals, cooperates with the regulated industry in determining how those goals are to be achieved, and leaves room for industry to innovate whilst still being accountable for its actions".[530] Rather, UK securities regulation mostly relies on a range of compliance-promoting strategies.[531] As a result, the British public enforcement is of a very low intensity.

The enforcement is also risk-based in as sense that it prioritizes the areas that pose the biggest threat to the regulator's regulatory objectives. The FSA has stated its policy when it will take formal disciplinary action, it will consider a number of factors, including the seriousness of the violation, cooperation of the violator with the FSA and similar actions already taken. It will also consider if the firm has taken steps to compensate consumer losses, to discipline staff involved and to address any systemic failures. However, it is clear that it is not the FSA's role to secure compensation in every case where there has been a regulatory breach. Therefore, in most cases the FSA will proceed in an informal way by issuing an informal private warning.[532]

The facts presented above lead to the conclusion that although in the UK there are all preconditions for the public *ex post* enforcement of underwriter gatekeeping duties, the underlying enforcement philosophy determines that such enforcement is not pursued. Whether such an approach is successful is difficult to estimate. Although London markets

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529 See Jack Humphrey, "Lax Advisory Services Invite Censure Against BDO LLP", June 2, 2011, http://inaudit.com/regulatory/lax-advisory-services-invite-censure-against-bdo-llp-6501/. It should be noted that the violation was not related with disclosure in the context of securities distribution but rather a merger. Therefore, there are no cases of enforcement against underwriters in their misstatement gatekeeping capacity.

530 Eilis Ferran, "Principles-based, Risk-based Regulation and Effective Enforcement," in *Perspectives in company law and financial regulation: essays in honour of Eddy Wymeersch* (Cambridge UK; New York: Cambridge University Press, 2009). in Michel Tison et al., *Perspectives in Company Law and Financial Regulation*, 1st ed. (Cambridge University Press, 2009)., pg. 428.

531 Ferran, "Principles-based, Risk-based Regulation and Effective Enforcement," pg. 429.

532 *Financial Services*, pg. par. 7.7 - 7.26.

performed relatively well in the first years of existence of the FSA, the FSA is a relatively young agency. Therefore, it is difficult to evaluate its enforcement policy and whether the FSA caused that success. However, there are signs that it has not been particularly efficient. In fact, the recent financial crisis led to harsh criticisms of the FSA and to a possible shift to a tougher approach to supervision and enforcement.[533]

2.3. Enforcement by the LSE in practice

There is no information about formal enforcement activities of the LSE when it still had an authority over activities of sponsors.

Cases of enforcement against nomads are also exceptional. The only case I was able to identify took place in 2006 after the discovery of fraud by Langbar International. Following this scandal the LSE launched a review of nomad activities, resulting in a regulatory "handbook" for nomads. It also fined the nomad of the company – Nabarro Wells 250000 pounds and publicly censured them for acting without due skill and care. The LSE also questioned the firm's systems and controls, and ruled it had failed to undertake the necessary level of due diligence to assess the appropriateness of certain companies for admission to AIM. During the review of Nabarro Wells files, the LSE found problems with five out of seven securities issues involving the firm. The LSE, however, refused to disclose the problematic issues.[534]

Thus, one can also see that formal enforcement by the LSE is also of a very low intensity, although there are some exemplary cases.

2.4. Summing up

This Section has clearly demonstrated that the enforcement of the underwriter gatekeeping duty is not left entirely to the market mechanisms. The applicable enforcement regime depends on the choice of listing venue within the LSE. Therefore, the company has some

533 "FSA at bay: As the City crumbles, can Britain's financial watchdog fix the system?", March 18, 2009, The Economist edition, http://www.economist.com/node/13315523.

534 Robert Lea, "Nabarro Wells censured by LSE over listing", October 29, 2007, http://www.thisismoney.co.uk/money/markets/article-1615177/Nabarro-Wells-censured-by-LSE-over-listing.html.

flexibility in choosing the underwriter liability regime (although this is not entirely a free choice as it comes as a part of a much wider bundle of applicable rules. It is far from clear what the importance is of this particular criterion in the firm's decision where to list). The possible enforcement regimes are no-liability for Standard listing, enforcement by the stock exchange for AIM listings and public enforcement for Premium listing. However, it was seen that although both the LSE and the FSA have wide enforcement powers on paper, they have been following a light-touch, non-enforcement led approach rather than an aggressive enforcement. Thus, UK underwriters do not face a strong enforcement threat also from these sources of enforcement.

3. PARTICULARITIES OF THE UK MARKET

Is there a way to reconcile the findings about the UK situation with the theoretical background developed in Chapter II? In fact, they match comfortably given the particularities of the UK financial markets and community which enable the peculiar British approach to regulation of financial markets to be successful.

First of all, Chapter II argued that market-based enforcement mechanisms are usually not capable of providing enough compliance incentives to underwriters. Thus, there is a need for some sort of legal enforcement mechanisms. The existence of a set of formal enforcement regimes suggests that this holds also in the UK. It can also be seen that the more prestigious listing categories (Premium listing) are associated with stricter (at least on paper) enforcement (enforcement against sponsors by the FSA). This means that the market acknowledges and gives premium for the credible enforcement against underwriters.

Secondly, Chapter II argued that the deterrent threat comes from several sources: market-based enforcement mechanisms and legal tools. It was stated that the legal threat is only necessary when and to the extent market-based incentives fail to work. To rephrase, British-style light-touch formal enforcement may be enough to ensure optimal deterrence only when market incentives perform well.

In fact, there is some research which argues exactly that, *i.e.* that the structure of British financial markets provides conditions for reputational mechanisms to operate relatively well. It features the British business community which is based on the relational club-like environment where informal enforcement measures play an important role.[535] As a result, historically there was no need for more aggressive enforcement.

To begin with, the UK has been characterized, on the one hand, by restrictive personal taxation and, on the other hand, by a safe harbor to invest in capital markets for pension funds. This meant that collective investment vehicles got very well developed and institutional investors became the main players in capital markets in the UK since a very long time. Around two-thirds of the shares in UK listed companies are owned by institutional investors. This ownership is also quite concentrated – top five shareholders own approximately 30-35% of the equity. In addition, these shareholders do not have the regulatory hurdles to communicate between each other and with the company.[536] These factors make it easier for British investors to form coalitions who could "publicly pressure a company to make wise corporate governance decisions".[537] These players are also considered sophisticated and knowledgeable enough to be trusted to govern themselves. Institutional investors "can fend for themselves effectively with the legal and extra-legal tools at their disposal, and are diversified enough to absorb the remaining risk from lesser transparency. Given that, it makes sense to lighten up on regulatory requirements <…> so as to let issuers experiment with different approaches to corporate governance and disclosure without one-size-fits-all demands".[538]

In addition to containing sophisticated players, the London market is characterized by the high level of geographical and social concentration. In this context the article by Armour and Skeel (2007) provides important insights. They point at a specificity of the British investment community: "in the United Kingdom, the self-regulatory system was orchestrated principally by the community of investment bankers and institutional investors, all of whom regularly rub shoulders in the "City," the one-square-mile district where London's business community is located. <> In London, City professionals – in

535 See Armour et al., "Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States."

536 In contrast, in the USA Rule 13d-1 of the Exchange Act requires the disclosure of any arrangements between shareholders. Investors are often unwilling to make such filings and there are unable to act collectively.

537 Kerry Shannon Burke, "Regulating Corporate Governance through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom," *Journal of Corporation Law* 27 (2002 2001): pg. 370.

538 Donald C Langevoort, "SEC, Retail Investors, and the Institutionalization of the Securities Markets, The," *Virginia Law Review* 95 (2009): pg. 1075.

particular, institutional investors avoided the need for *ex post* litigation by developing a body of norms, which eventually gave rise to the Takeover Code. These norms were, and still are, enforced by reputational sanctions such as the threat of exclusion from the London Stock Exchange, which ensured that contentious issues were resolved *ex ante* without the need for court involvement".[539]

These two factors, the presence of sophisticated actors and the significant concentration of markets, created conditions for the market incentives to be powerful enough to relieve the need for the stricter forms of regulation and supervision. Such interpretation is also supported by professor Langevoort (2009) who provides an important comparison between the UK and the US market. He argues that low intensity enforcement and informal sanctions work well in geographically and socially proximate communities and in growing rather than mature industries. More closely interconnected social networks generate mimetic behavior because tighter networks facilitate the transmission of both ideas and norms. In turn social networks correlate with geographic proximity. Therefore, to the extent that there are greater social network affinities between the regulator and the regulated, informal suasion should be more potent.

According to Langevoort (2009) the UK can be characterized exactly as a concentrated but a growing industry. It can sustain low intensity enforcement because: "(1) institutional investors themselves are better able to exert various forms of pressure on managers that lessen the need for post hoc litigation; and (2) the issuer community is smaller and more concentrated, so that formal and informal sources of suasion by regulators are more potent". Therefore, it enables working of less intrusive enforcement mechanisms. In comparison, the USA market is both dispersed geographically and is very mature. Thus, it needs more formal and stricter enforcement tools.

Mayer (2008) also points at the importance of the geographical concentration of securities market. Historically in the UK "to reduce information problems and fraud, securities were traded in the city in which most investors resided. <…> companies were very dependent on local shareholders to raise finance. Their reputation amongst local investors was therefore critically important to allow access to external sources of finance. <…> In other words their dependence on local investors for future expansion acted as a commitment

[539] John Armour and David A. Jr Skeel, "Who Writes the Rules for Hostile Takeovers, and Why - The Peculiar Divergence of U.S. and U.K. Takeover Regulation," *Georgetown Law Journal* 95 (2007 2006): pg. 1730-1731.

device".[540] This type of the market was based mainly on trust and did not require regulation. Later, firms expanded beyond their local markets which triggered the need for regulation. However, as regards financial intermediaries, they still remain centered in geographically proximate areas which should ensure the reliability of reputational incentives.

4. MEANS TO INCREASE LIABILITY THREAT IN THE UK

4.1. Is there a need for civil liability in the UK?

Does the finding that the current UK system performs relatively well make my proposal regarding the design and role of civil liability system useless in the UK legal system? I do not think so.

First of all, scholars agree that the current British solution is only sustainable given the prevailing market structure. Once it changes, trust mechanisms appear to break down and more formal investor protection becomes necessary.[541] The more markets will become globalized and dispersed, the bigger there will be a need for more formal enforcement mechanisms. Therefore, the particularity of the British market which enabled to sustain the current system will likely disappear.

To countermine these changes currently the British regulator can only change its enforcement attitude and shift to more intensive public enforcement. However, as has been explained in detail in Chapter II, there are at least three strong arguments against the system which relies exclusively on public enforcement. First of all, public enforcers have a natural informational disadvantage as compared to private parties. Secondly, they lack sufficient financial resources to investigate and launch all cases. Thirdly, public enforcers may face internal agency problem, ranging from simple human laziness to the extreme form of bribery. Moreover, it would cover only companies listed on the Premium segment of the LSE. Other companies would be either totally left out of the enforcement system or would have to rely on the enforcement by the stock exchange which cannot be fully

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[540] Colin Mayer, "Trust in Financial Markets," *European Financial Management* 14, no. 4 (September 1, 2008): pg. 623.

[541] See, for example, Mayer, "Trust in Financial Markets"; Langevoort, "SEC, Retail Investors, and the Institutionalization of the Securities Markets, The," pg. 1074..

reliable.[542] In this context, the civil liability can serve as an important compliment if not a substitute for current types of enforcement.

However, the analysis of Chapter VIII showed that current substantive and procedural rules eliminate any effective civil liability threat in the UK. Thus, cosmetic changes such as the inclusion of the underwriter into the circle of potential defendants will not result in a significant increase of the liability threat. As a result, unless some radical changes are introduced, the current UK system is doomed to lead to a low level of enforcement and low sanctions in misstatement cases. In this context, the introduction of capped strict liability with a reversed burden of proof could be seen as a way to counterweight problems created by the British procedural rules.

4.2. Application of my proposal to the UK legal system

As mentioned before, in order to introduce underwriter liability in the UK, underwriters should be recognized as defendants in cases under Section 90 of the FSMA. As in the other two countries discussed in this book the current UK system of misstatement/prospectus liability is based on a negligence-based standard with a reversed burden of proof. The uncertainty about the outcome of the case affects the size of settlements in a same way as in the Netherlands – it may discourage some investors to launch individual cases for damages or participate in the GLO proceedings. Therefore, the uncertainty about the outcome of the case reduces the number of investors participating in the case and thus the total sanction for the underwriter. Thus, negligence can be considered as one of the causes for the weak "shadow of law" which is then turned into low amounts of settlement.

The shift from the current negligence liability standard to strict liability will reduce the uncertainty about the outcome of the case and make it easier for individual investors to pursue individual claims for damages. Thus, the size of damages in case the lawsuit goes to court will increase thus increasing the "shadow of law". This should lead to the increase of settlement sizes in the UK.

Similarly to the Netherlands, the problem of frivolous litigation linked to strict liability is not as important in the UK. US-style collective claims for damages are not permitted and

[542] See the discussion in Section 4.2 d) of Chapter II.

frivolous GLO litigation is restrained by the ban on contingency fees and the "loser pays" rule.

Moreover, currently the British approach to the proof of causation is such that the transaction causation in normally assumed while the burden of proof of the loss causation is on the plaintiff. Within the GLO procedure those are the questions which the court does not consider common and that have to be resolved at an individual level. As it is the case also in the Netherlands, the losses are not statutorily defined, may vary and have to be proved individually.

As I have already argued in the case of the Netherlands, the requirement to show losses and prove loss causation has its advantages and disadvantages. It is positive because it prevents baseless claims. It is harmful because together with preventing frivolous litigation it also chills down real cases.

However, this outcome can be avoided if the losses are standardized for all investors and only the general proof of loss causation is required (see the discussion in Section 5 of Chapter IX). In the UK the GLO mechanisms could easily accommodate such a solution. In the GLO procedure the court joins together and formulates common questions for a group of similar cases leaving individual issues for further individual resolution. Thus, it is proposed that, given that the losses are standardized, the court recognizes a question of general loss causation as a common question to all investors and resolves it for all cases. The questions concerning the precise size of each investor's part of the damages could be left for further individual resolution. Thus, the requirement of the British law for the plaintiff to prove loss causation is preserved although in this modified form.

As in the Netherlands in the UK there is no statutory definition of damages in misstatement cases. Thus, although usually they will be equal to "out-of-pocket", the court can also award lost profit or consequential losses.

The arguments as regards the definition of damages developed in respect to the USA and the Dutch situations apply equally to this case. On the one hand, there is a need to limit residual risks of strict liability. On the other hand, a non-standardized and wide definition of damages is economically unjustified and creates hurdles for collectivization of claims. Given these arguments, the UK underwriter liability system would also benefit from a statutory definition of damages along the lines of this proposal.

5. CONCLUSIONS

The goal of Chapter X was to explain the puzzle presented by the unique situation as regards underwriter liability in the UK. In Chapter VIII it was concluded that there is no civil liability for underwriters. This Chapter also looked at alternative enforcement mechanisms such as public enforcement by the FSA and enforcement by the stock exchange. It was found that although on paper these enforcers have wide enforcement powers, in practice they follow a low intensity enforcement approach. Nevertheless, it was established that underwriters are present on British markets, that they perform the same functions as elsewhere and that the British capital markets are well-developed. Therefore, one has to acknowledge that the absence of intensive enforcement did not cause significant problems in the UK.

However, this Chapter has also suggested the explanation why such approach was successful in the UK. This was due to the particularities of the British market – the presence of sophisticated institutional investors, social and geographical concentration and the maturity of the market. These features enabled working of market mechanisms, especially reputation, and thus relieved the need for the more intensive enforcement.

This Chapter also cautioned that the current British situation is not stable – any change in the market structure could reverse the balance of powers and the reputational mechanisms may start failing. In this context there may be a place for civil liability to act as the additional enforcement mechanism. However, even if underwriters would start to be recognized as potential defendants in misstatement liability suits, current substantive and procedural rules are not likely to lead to vivant litigation activity which could provide meaningful enforcement. Thus, also in the UK some changes need to be implemented in order to improve civil liability. It was argued that the solution proposed on the previous Chapter would also work in the UK.

The major change would be the shift from a negligence-based liability to a strict liability standard. It would also be necessary to standardize the losses and loss causation in underwriter misstatement cases and to start resolving the question of general loss causation as a common question in GLO proceedings. In order to avoid overenforcement, it is also suggested to cap damages in underwriter misstatement cases by the amount of the underwriting fee.

CONCLUSIONS

1. MAIN FINDINGS

1.1. Underwriters and their main functions

This book focused on one of the main participants in the process of raising capital *via* financial markets – securities underwriters. It started by a description of what exactly an underwriter does in the process of securities distribution. It was shown that the underwriter is hired by the issuer to provide advisory, sale intermediation, gatekeeping, underwriting and price discovery (bookbuilding) services during the offering process and provision of liquidity, stabilization, analyst coverage and other services after the distribution is completed. It was concluded that although the underwriter participation in the distribution is not required by law, in practice the underwriter is an indispensable figure in the process of securities offering and it plays a central role.

Further this book reviewed the economic thought which sought to explain what the rationale for employing the underwriter in the capital raising process is. It turned out that the mostly cited explanation is that the underwriter has a superior ability to bridge the information gap between the issuer and outside investors. It can act as an efficient gatekeeper on capital markets – monitor the issuer's public statements as regards their correctness and completeness and prevent material misdisclosure of information. It was also pointed out that the underwriter has incentives to depart from being a credible gatekeeper. Thus, it was concluded that there must be some market-based and/or legal enforcement devices to induce the underwriter to do its job well.

Against this background the main question posed in this book concerned the role of civil liability as an enforcement device for the underwriter gatekeeping duty. To answer this question the discussion considered the following three subtopics:

1). What is the rationale for using civil liability as an enforcement device? Does it have any advantages or disadvantages over other enforcement mechanisms?

2). How is civil liability used in practice? What are the applicable legal rules? What is the real deterrence created by the existing liability regimes? Do the existing civil liability regimes achieve their deterrent function?

3). Is there a need to improve or modify the current civil liability systems? If yes, by what means?

The following sections will summarize the answers to these questions and provide some suggestions for further research in this field.

1.2. Positioning civil liability among other enforcement mechanisms

In this dissertation initially it was argued that the underwriter faces powerful market incentives based on reputation to act as a gatekeeper. However, both theoretical and empirical arguments were found to state that the reputation alone could often be insufficient to ensure compliance. Thus, the need for legal enforcement devices was recognized.

It was concluded that *ex post* enforcement is a superior form of enforcement as it closely mimics the working of reputational mechanisms and is more suitable given that (1) gatekeeping is a complex and highly circumstantial activity thus *ex ante* regulation can be very burdensome and is likely to result in errors, (2) it is cheaper to use *ex post* sanctions to punish monitoring violations and the resulting harm rather than preventing violations from happening in the first place and (3) the underwriter has sufficient assets to sustain *ex post* enforcement.

Three main types of *ex post* enforcement were distinguished: public enforcement by the market supervisor, enforcement by the stock exchange and private enforcement *via* civil litigation. It was concluded that all of these mechanisms could be effective in providing the underwriter with incentives to monitor. In addition, they all can enhance the performance of other functions attributable to the underwriter, *i.e.* (1) improve the overall quality of advisory services and (2) provide additional incentives to exert optimal effort in extracting the information from informed investors. However, civil liability has some relative advantages as compared to other enforcement mechanisms. These are: (1) better information about the violation and losses, (2) positive effect of compensation on the level of investment and (3) saving of public costs of enforcement. At the same time, private enforcement (1) depends crucially on the procedural rules for collective litigation and (2) is not motivated by the social but rather by the private welfare maximization goal. Thus, it can easily lead to both under and over deterrence. In addition, private enforcement can result in the duplication of investigative and litigation efforts by individual investors. In the absence of efficient rules to mitigate the duplication of individual litigation costs, private enforcement can cause higher administrative costs. Thus, while there are strong reasons to recommend using civil liability as an enforcement tool, one should be aware of the unavoidable complications associated with this choice.

1.3. Civil liability in selected jurisdictions

To further investigate the role of civil liability as an enforcement device this book looked at how it is used in a few real-world legal systems. The legal regimes in the USA, the EU, the Netherlands and the UK were assessed. The analysis of liability systems was based on the premise that there are numerous aspects of liability rules that have to be evaluated in order to estimate the deterrence of underwriters. In addition, liability threat cannot be assessed in isolation from the relevant procedural rules. It was concluded that the following five main aspects are the most relevant to the determination of the liability threat: potential parties to a dispute, liability standard, measure of damages, procedural rules and the nature of the liability rules.

As regards the USA regulation of underwriter liability the following conclusions were made. There are three main causes of action – Section 11 of the Securities Act, Section 12(a)(2) of the Securities Act and Rule 10b-5 adopted under the Exchange Act. Section 11 is the most relevant instrument with respect to underwriter activities and it is applicable to underwriters' liability for negligent misstatements in the official registration statement and the prospectus. According to the "law on the books", Section 11 creates conditions for quite a broad liability threat. The analysis of this dissertation showed that the only limitation of this provision is that in case of seasonal equity offerings, Section 11 can be used only by a limited number of investors. However, in practice the liability threat is limited because the amount of settlements in these cases is normally rather low and never exceeds the underwriting fee. Therefore, this book came to the conclusion that, as far as Section 11 is concerned, the threat of underwriter liability in the USA can hardly be called excessive. On the contrary, one can even argue that it leads to the systematic underenforcement.

As regards two other causes of action, it was concluded that Section 12(a)(2) is of limited use for the enforcement of the underwriter gatekeeping duty because it features a seller-purchaser privity requirement. In addition, the types of disclosures covered by Section

12(a)(2) usually do not alter investor's perception sufficiently enough to trigger the imposition of liability. On the other hand, the general anti-fraud prohibition contained in Rule 10b-5 is problematic to activate because it is applicable only to reckless or intentional conduct. In addition, it is much more difficult for investors to litigate their case. Moreover, Rule 10b-5 is applicable only to primary violators and underwriters are usually not considered such. Thus, Rule 10b-5 is of secondary importance for the purpose of underwriter liability and it is likely to create more costs than contribute to effective deterrence.

The analysis of the harmonized EU law in the relevant field allowed concluding that such law is largely irrelevant to the subject of underwriter liability. The main document in the field – the Prospectus directive, sets the minimum requirements for prospectus liability leaving it to the Member States to adopt the implementing measures. On the one hand, the gatekeeping role of the underwriter is not emphasized. On the other hand, there is nothing in the EU law that can limit Member States discretion as regards the imposition of liability on underwriters. There is no harmonization also with respect to the procedural rules that are generally perceived as not particularly supporting private enforcement. This is because most EU jurisdictions have the "loser pays" rule and do not allow American-style class actions. In other words, existing collective procedures in Europe are initiated by representative organizations rather than by members of the class and they regulate investors' participation based on opt-in rather than opt-out.

Consistent with the conclusions as regards the EU law, the analysis of two European jurisdictions showed considerable differences in the regulation of underwriter liability within the EU and as compared to the USA. The Netherlands and the UK were analyzed.

It was shown that the particularity of the Netherlands is that the issue of underwriter liability is regulated by the general Civil Code rather than by a specialized securities law statute. Nevertheless, the substantive content of liability provision is very close to the USA Section 11, with two important differences – the statutory damages are not defined, limited and standardized and the burden to prove loss causation is on the plaintiff. As regards the procedural law, the Dutch do not have the American style class action but rely instead on a two step procedure consisting, first, of a representative collective action for a declaratory statement that a tort was committed. Afterwards, a follow-on individual litigation, assignment of claims or private or collective settlements may occur.

The review of how these rules work in practice has shown that the Dutch underwriter liability regime can and has already produced some significant outcomes. However, the requirement to show individual loss causation coupled with stringent procedural rules resulted in a weak "shadow of the law" in the Netherlands – a low probability threat and size of damage award by courts and thus in relatively low settlements "in the shadow of the law". This circumstance made the size of settlements in such cases in the Netherlands comparable to the relatively low settlements in the USA. Thus, it was concluded that also in the Netherlands the expected liability threat is likely to be insufficient to encourage meaningful compliance by the underwriter.

This book also showed that, in contrast to the USA and the Netherlands, in the UK the underwriters do not generally face civil liability. Although there are four potential causes of actions within the statutory and the common law, the main problem is that the underwriter is simply not recognized as a potential defendant and that evidentiary requirements are too demanding to spur any meaningful litigation. In addition, the current mechanism for collective dispute resolution does not allow achieving high rates of investor participation and thus does not create expected sanction of a sufficient magnitude. Moreover, the complexity of procedure, on the one hand, and weak economic incentives to initiate cases, on the other hand, result in a low probability of enforcement. Thus, there are no cases of underwriter liability in the UK.

In sum, the legal analysis showed that approaches to the enforcement of underwriter gatekeeping duty differ significantly. Some countries see civil liability as the main enforcement device; others do not use it at all. Moreover, it was shown that in those countries that employ civil liability, it often fails to achieve its main goal – the deterrence of underwriter negligence.

The following Table 3 briefly summarizes the main elements of underwriter prospectus liability provisions in three national jurisdictions.

Table 4. Underwriter liability in the USA, the Netherlands and the UK

Country	USA	Netherlands	UK
Source of liability provision	Securities law (Sec. 11)	DCC (Sec. 6:193 A, 6:194 and 6:194)	Securities law (Sec. 90)

Underwriter as a potential defendant	Explicitly mentioned and precisely defined by the statute	Not mentioned, defined by the case-law	Not mentioned Not defined Could fall under one of categories, but rarely does
Potential plaintiffs	Primary investors Secondary buyers if tracing requirement is satisfied	Unclear	Primary market investors Secondary buyers
Liability standard	Negligence	Negligence	Negligence
Burdens of proof:			
Negligence	Reversed	Reversed	Reversed
Reliance	Reversed	Reversed by the case-law	Reversed by doctrine
Loss causation	Reversed	On plaintiff but not very strict	On plaintiff but not very strict
Definition of damages	"Out-of-pocket" losses capped at the offering price	Can also include consequential damages, dividends, interest etc	Mostly limited to "out-of-pocket" loss
Procedural law:			
Compensation of damages	Allowed, class action procedure	Allowed only on an individual basis or *via* assignment of claims	Allowed only on an individual basis or *via* a GLO procedure
Collective procedures	Class action	(a) Representative action for declaratory judgments (b) Assignment of claims (c) Voluntary collective settlement	(a) Representative rule (not used in practice) (b) GLO
Cost-sharing rule	Each party bears its own costs	"Loser pays" but limited	"Loser pays"
Contingency fee	Allowed	Prohibited for lawyers Success fee allowed	Allowed but very limited Limited success fee allowed

1.4. The proposal for a change

The analysis of American and Dutch underwriter liability systems allowed concluding that in these countries the expected liability for underwriters hardly reaches the average underwriting fee they receive for providing underwriting services. Therefore, one can observe a systematic underenforcement. The identified cause of this problem in the USA was the lawyers' incentives in the settlement process. In the Netherlands both substantive rules and procedural rules were reported to determine a low level of settlements.

In order to increase the amounts of settlements this book proposed the following solution. It was suggested that the current negligence liability regimes should be changed to strict liability. In addition, the burden of proof of loss causation should be placed on the plaintiff and damages capped by the amount of the underwriting fee. These measures should have a double impact. On the one hand, the change of liability standard should decrease the uncertainty surrounding the outcome of the case and thus cause higher settlements in cases that are being brought. On the other hand, the positioning of the burden of proof of loss causation on the plaintiff should discourage filing of frivolous suits. The standardization and limitation of damages should further contain the costs that strict liability imposes on deals. As a result, the proposed changes should manage to correct two kinds of errors currently associated with underwriter liability cases: increase the deterrent effect in worthy cases (type I error) but limit the occurrence of weak and frivolous litigation (type II error).

This dissertation concluded that the proposed changes are suitable in order to improve the situation in all the three legal systems discussed. However, there are some particularities of their implementation. In all three jurisdictions the statutory liability standard should be changed from negligence-based liability to strict liability. However, in the USA the burden of proof of loss causation should be reversed from the defendant to the plaintiff. In the Netherlands and in the UK there is no need to reverse the burden of proof of loss causation as it is already on the plaintiff but there is a need to modify the way the damages are defined and the loss causation is being proved. In these two countries it was suggested that the standard statutory definition of damages should be adopted along the lines of the American "out-of-pocket" measure of losses. The proof of loss causation should be of a general nature, consisting of the proof the causal link between the misstatement and the behavior of the securities' price. It was suggested that in the Netherlands this question could ideally be resolved already at the stage of the declaratory judgment. In the UK the same issue could be resolved as a common question during the GLO procedure. In all three countries the damages should be capped at the amount of underwriting fee.

2. LIMITATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

As acknowledged from the beginning of this dissertation, the ultimate goal of gatekeeping is to improve the quality of disclosure in primary securities markets. However, this book looked at how this goal can be achieved only *via* one particular mechanism – underwriter corporate liability. For practical reasons other important aspects were left out of the scope of this work.

First of all, in this book underwriters were considered as a corporate entity without looking at what is happening inside the firm's "black box". However, in reality the decisions as regards the precise monitoring actions and effort are taken by real people – employees of the underwriter who are subject to their own utility maximization functions. These factors can seriously affect the effectiveness of the corporate liability regimes. Thus, a more profound research into how the decisions are taken at the company level and on the mechanism to align the interests of corporate agents with those socially efficient would contribute to a better understanding of the reasons why violations occur and what can be done to discourage them.

Secondly, this book discussed underwriters in isolation from other gatekeepers that take part in the securities distribution process such as auditors, lawyers, credit rating agencies and others. Although underwriters differ significantly from both auditors and lawyers, they all in one way or another contribute to the monitoring of issuer's disclosure and, depending on the legal system, face some enforcement threat. Thus, in order to assess the overall quality of disclosure in securities offerings, it would be useful to determine the relationship between the subject of underwriter liability and the regulation of these other actors. The finding of this analysis can also bring some light on the efficiency of having multiple gatekeepers in the market.

In addition, it would be interesting to investigate whether the conclusions as regards the real liability threat underwriters face are the same with respect to other gatekeepers, *e.g.* whether the civil liability of auditors also fails to reach its deterrence targets. Moreover, it would be valuable to see whether the solution aimed to increase the liability threat proposed in this book would also be applicable with respect to other gatekeepers.

Thirdly, this book mostly focused on one particular enforcement device – civil liability and largely ignored other enforcement mechanisms with respect to underwriters such as enforcement by the securities regulator and by the stock exchange. While such limitation was justified, taking into account the scope of this book, a deeper analysis of the relationship between civil liability and these other forms of *ex post* enforcement would allow drawing a more complete picture of the deterrence that underwriters face.

The research in those three fields would both provide us with a better understanding of the functioning of the underwriting industry and contribute to the general debate on how the quality of corporate disclosure can be improved.

In addition, this book revealed that there is a lack of data and empirical research concerning certain aspects of underwriting. It should be acknowledged that there is quite extensive empirical research in certain specific domains. For example, there are numerous studies as regards the underpricing phenomenon, bookbuilding techniques, underwriting fees etc. However, as regards the aspects of underwriter liability there is very little data and even less of its empirical assessment. Thus, although we know quite a lot about securities litigation in general, there is a stunning lack of specific empirical research on the litigation against underwriters. We can only estimate a rough number of cases brought against underwriters in their role as gatekeepers and predict their outcomes. More research efforts are needed to in this particular domain in order to determine with more precision the exact liability threat underwriters are facing.

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ENGLISH SUMMARY

This book is dedicated to the Law and Economics analysis of civil liability of securities underwriters for the damage caused by material misstatements of corporate information by securities issuers. It seeks to answer a series of important questions. Who the are underwriters and what is their main role in the securities offering? Why there is a need for legal intervention in the underwriting market? What is so special about civil liability as an enforcement tool? How is civil liability used in a real world and does it really reach its goals? Finally, is there a need for a change and, if so, by what means?
Answering these questions is important because nowadays securities underwriters are main and indispensable participants in the process of raising capital *via* public financial markets. They provide important services to the issuer and investors both during the offering process and after the distribution. The analysis of the economic theory shows that the main explanation for such a wide use of underwriters is that they are good in correcting the informational asymmetry between the issuer and outside investors. Economic theory also postulates that underwriters can act as efficient gatekeepers in capital markets – they can monitor the correctness and completeness of issuer's public statements and thus prevent misstatements of the material information. It is socially beneficial that the gatekeeping by the underwriter is accurate and reliable as long as costs of gatekeeping and its enforcement are lower than benefits.

This book acknowledges that there are market incentives, such as reputation, which encourage underwriters to perform their gatekeeping function well. However, alone these market enforcement mechanisms are insufficient to ensure compliance. Therefore, some form of legal intervention is needed. It is analyzed which form of legal intervention fits the underwriting setting best. It is concluded that e*x post* legal intervention is superior to *ex ante* legal intervention. Further, all mechanisms of *ex post* legal intervention – public enforcement by the market supervisor, enforcement by the stock exchange and private enforcement *via* civil litigation, can be effective in providing the underwriter with incentives to monitor. In this setting, civil liability is just one of the types of legal intervention which has its advantages and disadvantages.

The legal analysis of the USA, the EU, the Netherlands and the UK performed in this book shows that there is no uniformity in the use of civil liability as a tool to provide monitoring incentives to underwriters. Civil liability is used quite widely in the USA and in the Netherlands while in the UK underwriters face almost no liability threat. It is also shown

that both in the USA and the Netherlands in practice the liability threat is limited because the amount of settlements in these cases is normally rather low and never exceeds the underwriting fee. It is suggested that in these countries the expected liability threat is likely to be insufficient to encourage meaningful compliance by the underwriter and there might be a systematic underenforcement of underwriter gatekeeping function.

The last Part of this book is dedicated to the search of a remedy for the problem of low settlement size in underwriter civil liability cases. As a possible solution it is proposed to switch from the current negligence liability to strict liability. This should be coupled with the positioning of the burden of proof of loss causation on the plaintiff and capping of damages by the amount of the underwriting fee. These measures should, respectively: decrease the uncertainty surrounding the outcome of the case and thus cause higher settlements in cases that are being brought, discourage filing of frivolous suits and contain the costs that strict liability imposes on deals.

NEDERLANDSE SAMENVATTING

Dit boek gaat over de rechtseconomische analyse van de civiele aansprakelijkheid van Lead managers voor schade als gevolg van gebrekkige informatie door emittenten van aandelen. Het beoogt een aantal belangrijke vragen te beantwoorden. Wie zijn de Lead managers en wat is hun hoofdtaak bij aandelenemissies? Waarom is er behoefte aan regelgeving in de markt? Wat is er zo bijzonder aan civiele aansprakelijkheid als middel om naleving af te dwingen? Hoe wordt civiele aansprakelijkheid in de praktijk gebruikt en worden de doelstellingen daadwerkelijk bereikt? Ten slotte, dienen er wijzigingen te komen en zo ja, welke?

Het antwoord op deze vragen is van belang omdat Lead managers belangrijke en onmisbare deelnemers zijn in het proces van kapitaal aantrekken op financiële markten. Ze leveren belangrijke diensten aan de emittent en investeerders zowel tijdens het emissieproces als na de verdeling. Analyse van de economische theorie toont aan dat de belangrijkste verklaring voor de wijdverbreide inzet van Lead managers is dat ze goed zijn in het corrigeren van de informatieasymmetrie tussen de emittent en investeerders. Economische theorie stelt ook dat Lead managers kunnen optreden als efficiënte poortwachters- ze houden toezicht op de juistheid en volledigheid van de openbaarmakingen van de emittent en op die manier voorkomen ze dat er onjuiste verklaringen worden gedaan. Het is nuttig vanuit maatschappelijk oogpunt dat de poortwachteractiviteiten van de Lead manager nauwkeurig en betrouwbaar zijn zo lang de kosten van het poortwachten en naleving lager zijn dan de opbrengsten.

In dit boek wordt erkend dat er marktprikkels zijn, zoals het in stand houden van een goede reputatie, die ervoor zorgen dat de Lead managers hun poortwachterfunctie goed uitoefenen. Deze marktmechanismen alleen zijn echter niet voldoende om nakoming af te dwingen. En daarom is enige vorm van regelgeving noodzakelijk. Vervolgens wordt geanalyseerd welke vorm van regelgeving het meest passend is voor de markt. De conclusie is dat regelgeving gericht op achteraf ingrijpen beter voldoet dan regelgeving waarmee vooraf wordt ingegrepen. Bovendien, alle mechanismen van regelgeving voor achteraf ingrijpen, handhaving door een markttoezichthouder, handhaving door de beurs en zelfregulering via de burgerlijke rechter kunnen als aansporing dienen om de Lead manager ertoe aan te zetten zijn taak als controleur waar te maken. In deze context is civiele aansprakelijkheid slechts één van de mogelijkheden om naleving van regelgeving af te dwingen, civiele aansprakelijkheid heeft echter zowel voor- als nadelen.

De juridische analyse van de situatie in de Verenigde Staten, de Europese Unie, Nederland en het Verenigd Koninkrijk in dit boek toont aan dat er geen eenduidigheid is in het gebruik van civiele aansprakelijkheid als middel om Lead managers aan te sporen hun taak als controleur te vervullen. Civiele aansprakelijkheid wordt meer gebruikt in de Verenigde Staten en Nederland, terwijl Lead managers in het Verenigd Koninkrijk nauwelijks iets te vrezen hebben van civiele aansprakelijkheid. Maar het boek toont ook aan dat in de praktijk de dreiging, zowel in de Verenigde Staten als in Nederland, van civiele aansprakelijkheid gering is omdat het aantal schikkingen in dit soort zaken nogal laag is en nooit hoger is dan de vergoeding die de Lead manager heeft ontvangen. Dit zou erop kunnen duiden dat de verwachte dreiging voor aansprakelijkheden te laag is om daadwerkelijke nakoming door de Lead manager af te dwingen. Er kan dus sprake zijn van een systematisch tekort in de handhaving van de poortwachterfunctie.

Het laatste deel van het boek gaat over het zoeken naar een oplossing voor het probleem van de lage omvang van schikkingen in civiele aansprakelijkheidszaken met Lead managers. Er wordt voorgesteld om de huidige schuldaansprakelijkheid om te zetten in een risicoaansprakelijkheid. Dat dient gepaard te gaan met het opleggen van bewijslast over de oorzaak bij de eiser en het maximeren van de schade op het bedrag van de vergoeding van de Lead manager. Deze maatregelen dienen de onzekerheid betreffende de uitkomst van een rechtszaak te beperken en daarmee tot hogere aantallen schikkingen leiden in zaken die aanhangig worden gemaakt, chicanes uit te sluiten en de kosten beperken die risicoaansprakelijkheid met zich meebrengt.