

Strict liability makes no sense in today's capital markets.

Is it Time to Wind Up the Securities Act of 1933?

BY JAMES SPINDLER

University of Southern California Law School

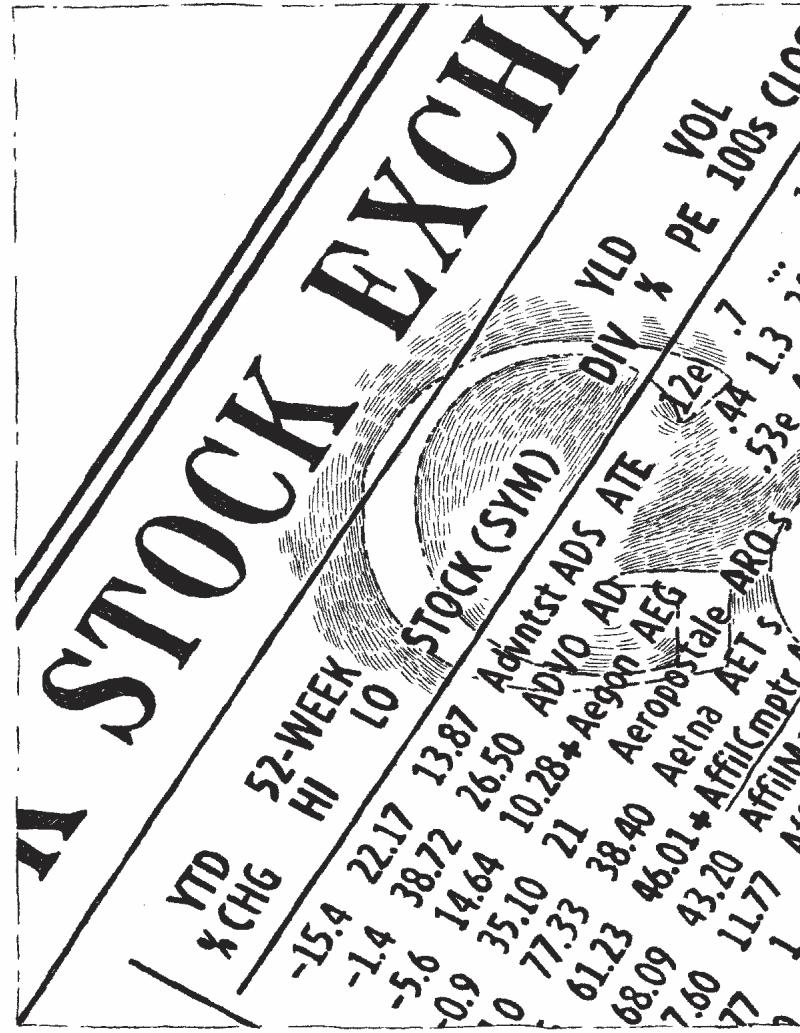
Mandatory disclosure rules are often perceived as a no-lose quick fix. After all, what is the harm in simply requiring, say, a seller to give a prospective buyer information that the seller already has in her possession? It appears to promote fairness with little, if any, overall social cost.

Based largely on this premise, disclosure rules are a popular choice among academics and legislators. But information is costly to obtain and certainty may be impossible to achieve. The disclosure rules create hidden costs: when information is incomplete or uncertain, the party burdened with making accurate disclosure is made to bear the risk that those disclosures will prove incorrect.

Take a recent example of the costs of disclosure in the corporate compensation realm. The Securities and Exchange Commission recently scrapped part of a new proposal that would have required disclosure of compensation contracts for very highly paid non-executives of public firms. The proposal had come to be known as the "Katie Couric Clause" because it would have required compensation disclosure regarding such entertainment luminaries such as Couric, Jay Leno, and Brad Grey.

Why did the SEC scrap the proposal? The short answer is that Hollywood voiced fierce resistance, claiming it would compromise the privacy of both the studios and the stars themselves. But the more complete answer lies in the nature of what would have been disclosed. Suppose Tom Hanks is being paid with a

James Spindler is an assistant professor of law and business at the University of Southern California Law School. He may be contacted by e-mail at jspindle@law.usc.edu.



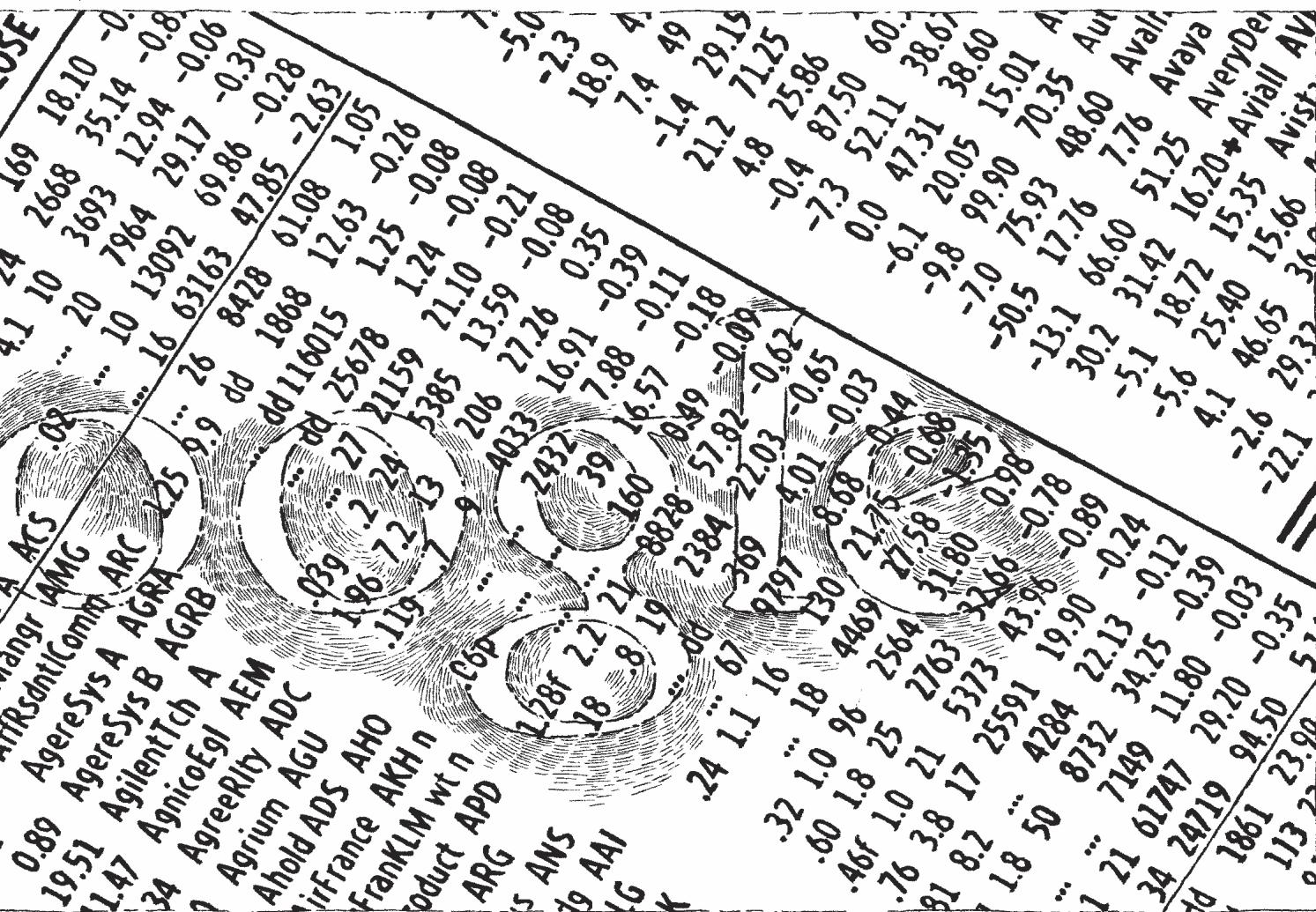
cut of box office receipts, DVD sales, European licensing, and product merchandising. Full disclosure of Hanks' compensation would require disclosure of those projected amounts. That is, the Hollywood studios would be charged with telling investors what Hanks is going to make in the future based on projections for how their core business projects are going to perform. Guess too low and Hanks' compensation would be wrong— and perhaps fraudulently— underreported. Guess too high and the firm may wrongly— and fraudulently— overstate the amount of money that it is going to make on its upcoming big-tent film project.

One can imagine that, at the margin, the Couric clause could have affected the way in which compensation contracts are structured—that is, the way that firms choose to pay their employees. One might imagine that this would also affect whether certain employees choose to work for public firms in the first place.

Even though Couric and Leno are now safe, the SEC is charging ahead with the rest of the compensation disclosure proposal, and variable or performance-based compensation is therefore becoming a risky proposition. Full and complete disclosure creates potential liability where compensation is based on fuzzy measures of success or failure. Just ask Dick Grasso who, after a by-all-accounts successful tenure at the New York Stock Exchange, now faces prosecution for his going-away

compensation package. Or ask any of the reported 100-plus firms under investigation (as of the time of this writing) for stock options backdating. In hindsight, it can be difficult to distinguish compensation for a job well done from stealing from the till.

The current stock options backdating scandal, which ostensibly involves 29.2 percent of all publicly traded companies, is the same problem writ larger. Were the directors and executives who authorized the backdated awards trying to mislead shareholders as to the intrinsic value of such compensation in order to make it look like option grants were the product of hard bargaining rather than a wink and a handshake? Were the executives who received such backdated awards failing to fully inform the compensation committees about what the awards themselves were? From the outside and in retrospect, it is simply hard to say. But if you require full disclosure regarding these sorts of intrinsically unclear things, and if you make failure to fully and truly disclose punishable by personal civil liability or, under Sarbanes-Oxley, 25 years of jail time, you can expect executives and boards to get a bit jittery. After all, we are living in a post-Enron world where even the presence of equity-based compensation—even assuming it was fairly granted—becomes evidence of an executive's motive to commit fraud in order to cash out at an inflated price. For some firms and executives, this is the "last straw" and they are leav-



ing the public markets (witness the recent departure of GE's top star, David Calhoun, for the greener and more lucrative pastures of the private equity world).

But in the grand scheme of things, this is relatively small potatoes, worth mentioning mostly because of its currency in the headlines. Compensation disclosure is only a drop in the bucket of extant securities law, yet another incremental cost that an already beleaguered public capital market must bear. There are bigger issues, by far, and they concern the ability of the public markets to fund productive ideas so that they may blossom into the Microsofts, General Electrics, and Googles of tomorrow. The way such companies grow has traditionally been with public market money, and the public capital markets are accessed through a process known as the initial public offering (IPO). IPOs are governed by statute and rules, the core of which is the Securities Act of 1933. And while we have had plenty of time to get used to the Securities Act, its effects upon the U.S. capital markets are profound and far-reaching.

THE SECURITIES ACT OF 1933

When a firm issues securities to the public, the Securities Act and the Securities Exchange Commission police the information that the firm discloses to the public as well as the manner in which the firm discloses it. All the firm's information, especially for a first time issuer (an "IPO" issuer), has to be channeled into what is called a "registration statement," which is roughly the same thing as the familiar informational "prospectus" that purchasers of public offerings are required to receive under law. In an IPO, the Securities Act strongly prohibits any disclosure outside of the prospectus, with few exceptions. (Of recent note, the SEC liberalized disclosure via "free-writing prospectuses" in 2005, a welcome step in the right direction. However, the practical use of this in IPOs has been limited so far.) Illegal disclosures, whether they be something as seemingly innocuous as a telephone call, the exchange of a business card, or an interview in a magazine, can result in draconian liability: any person who views or receives the disclosure and who purchases securities in the public offering has the right to sell those securities back to the issuer at the offering price. While firms and their underwriters may attempt fairly elaborate mechanisms to make disclosure outside of the prospectus, such as utilizing informal networks of contacts, by and large the only information about an IPO issuer will be what is in the prospectus. This is all part of an attempt to insure that all investors have equally good access to the relevant information about the firm, and that all the information that the firm discloses to investors is on-the-record and is fully subject to liability for false disclosure under the Securities Act.

Just what is the liability that a firm faces in a public offering of securities? Fraud is of course proscribed, but many successful securities class action lawsuits involve not even an allegation of fraud. This is because fraud is not a prerequisite to liability under the Securities Act. Rather, a firm issuing securities is *strictly* liable for material misstatements or omissions, without regard to whether those misstatements

or omissions were intentional or even negligent. Underwriters, managers, and directors are liable for material misstatements or omissions, too, but they have a defense called the "due diligence" defense. This means that they can escape liability by affirmatively demonstrating that they were duly diligent in reviewing the information that the firm discloses, i.e., proving that they were not negligent. The issuer, however, is on the hook no matter what, without regard to its intentions or efforts.

Consider what this means. Suppose we have a responsible firm that really tries to do the right thing. Notwithstanding its best efforts and good intentions, the firm is liable for false disclosures, even if the firm believed those disclosures to be true. The firm is also liable for omissions, even if the firm did not know it was omitting anything. Sounds pretty harsh, but how hard is it, really, to disclose correctly? After all, the firm should know what its profits were last year, whether any of its managers are crooks, how many employees it has, and so on, should it not? The problem is that not all things can be known with certainty, even what we think of as concrete, historical facts such as what the firm's sales were in the last three years.

We might suppose that the firm would attempt to limit its information to only absolutely cold, hard facts, but this is not possible for two reasons. First, the rules require disclosure of some things that are inherently forward-looking and uncertain. When a bank must make a required disclosure regarding its loan loss reserves, for instance, those reserves reflect the bank's judgment of what the future will look like — namely, how much of its loan portfolio is going to go bad. If this estimate is too low, the bank has painted too rosy a picture, and if more loans than expected do go bad such that the bank's initial estimate appears unreasonable, the bank may well find itself liable. More generally, in modern times the SEC has begun to mandate disclosures of a firm's plans, expectations, and recent trends (often found in the "Manager's Discussion and Analysis" section of a prospectus). If a firm is not forthcoming with this information, the SEC can delay or deny effectiveness of the registration statement, preventing the public offering from occurring.

Second, the firm's ability to limit disclosure is bounded by its need to raise capital from investors. Suppose an investor is considering whether to invest in a firm that is doing its IPO. The investor is only willing to pay as much for the security as the information he has indicates it to be worth. Because the Securities Act prohibits disclosure outside of the prospectus, the only information that the investor receives is in the prospectus. (IPO issuers with a high degree of name recognition, such as Google or Vonage, are rare exceptions, and both of those offerings, which attempted to rely on customer-generated buzz, were severely botched.) Therefore, the investor is only willing to pay as much as the prospectus suggests the firm is worth. Omitting positive information, while it can limit liability, does so at a prohibitive cost.

The fact that omissions, as well as affirmative misstatements, are actionable means that, given a certain background expectation about the firm's future performance, the firm will

be liable if it fails to disclose facts or risks that may affect that future performance. For instance, disclosure of an upward trend in profits perhaps implies in the minds of investors that the trend will continue into the future. If there is some reason why that trend will not in fact continue, and the firm does not disclose it in the prospectus, the firm may be liable for an omission. Thus, while a firm can, to a degree, limit its positive forecasting of what the future will be, it cannot avoid its duty to disclose why it is that things might get worse. This gives rise to the reams of “risk factor” disclosure that fill prospectuses in an attempt to catalog every conceivable problem that might surface: valued employees quitting, tie-ups with suppliers or clients disintegrating, even acts of God, terrorism, and war.

GOING TO COURT These restrictions give rise to the common situation in which a firm goes public, does not do as well as expected, and subsequently receives a barrage of class action securities lawsuits alleging that the firm misstated or omitted information pertaining to its likelihood of success. How is a court to evaluate such claims under the Securities Act’s strict liability provision?

sometime in the past, by the time of the lawsuit), direct examination is no longer possible — just in the same way that a court cannot generally examine directly the past workings of an operating company.

So, the court is left with something of a problem. The resulting bad performance was quite unlikely if the coin was as represented (five tails should only occur once in 32 times), but it is not impossible. Thus, the court would have to engage in what is known as Bayesian Analysis — the court would determine a prior estimate of how likely it was that the entrepreneur was truly and correctly stating its estimate of the coin’s fairness, which would involve looking at the entrepreneur’s experience (is she generally competent?), coin flipping expertise (was this a new and untested project?), prior track record (how have similar past ventures turned out?), history of truthfulness (is there any reason to believe the entrepreneur may have been lying?), and so on. Then, given the prior estimate and the result that actually occurred, the court can calculate whether it is likely or not that the entrepreneur’s disclosure at the time was an accurate statement of the coin’s qualities.

If the entrepreneur in this case is someone like Warren

Not all things can be known with certainty, even what we think of as concrete historical fact such as what the firm’s sales were in the last three years.

To start simply, suppose we have an entrepreneur who sells a security based on the flips of a coin. If the coin returns heads, the entrepreneur will pay the holder of the security a dollar. If it does not, the entrepreneur pays the security holder nothing. If the security entitles the holder to the results of five flips of the coin, and if the entrepreneur represents that this is in fact a fair coin (i.e., the likelihood of heads and tails are equal at 0.5), we would expect that an investor would be willing to pay \$2.50 to purchase this security. Sometimes, we would expect the coin to return all heads (a windfall to the investor), sometimes all tails (a total loss), and sometimes something in between, all of which when multiplied by the probability of occurring and summed together, equals \$2.50, the expected value of the security.

Now, suppose the investor purchases the securities for \$2.50 and the coin flips return all tails, such that the entrepreneur tells the investor, “tough luck.” The investor, feeling that he has perhaps been snookered, takes the entrepreneur to court on the theory that the entrepreneur was either lying or incorrect when she stated that the coin was fair. (Recall that the Securities Act makes inadvertent falsehoods, in addition to fraud, actionable.) A court would ideally want to examine the coin to determine whether it is fair or not. But supposing the actual coin can no longer be identified (this all happened

Buffett — a person with an impeccable reputation for competence and honesty — the court will probably decide that this was, in fact, a simple case of bad luck. But if the defendant does not have such a sterling reputation, the court may conclude that it is more likely than not that the statement that the coin was fair was incorrect. In such a case, the Securities Act allows the investor to recover his money from the firm.

Note that it becomes more likely that a material misstatement or omission occurred as the performance gets worse and worse. Suppose that instead of issuing a security for five coin flips, the entrepreneur sells the investor a security for 100 coin flips. What happens when the entrepreneur returns 100 tails in a row? The odds against this occurring with a fair coin are so infinitesimal that it approaches near certainty that the coin flips were not fair and the entrepreneur’s disclosure was inaccurate. Even if it is Warren Buffet who made the disclosure, the only reasonable conclusion would be that he was wrong, perhaps because he had an off day or had been bamboozled himself (the Bernie Ebers defense). Then he must pay.

In the case of an actual operating company being sued under the Securities Act, the court engages in an analogous inquiry. If a firm discloses information that leads investors to pay \$30 per share but the price subsequently

tanks to \$22, this creates a rational suspicion that the firm's disclosure was inaccurate at the time made. (This suspicion would be quite a bit stronger if, on the same facts, the price had dropped all the way to \$0.) In order to determine whether the information disclosed was correct or not, the plaintiff might provide evidence of managerial carelessness or dishonesty, call an expert witness to dispute the appropriateness of the accounting or forecasting methods that the entrepreneur utilized, and so on. The defendants would counter by citing records of competence and integrity, presenting experts who approve of the methods used, etc. But at the end of the day the court is left to decide whether, given the results that occurred, it was more likely than not that the disclosure was accurate and complete.

Of course, as in the rest of life, absolute truth is unobtainable in securities class action proceedings and civil courts operate on the standard of the preponderance of the evidence. This means that sometimes — perhaps even quite often — unlucky firms that committed no fraud, inaccuracies, or omissions will nevertheless be punished, while malfeasant firms will go unpunished, provided they are lucky. This is more so under the Securities Act's strict liability regime than it would be under a simple fraud regime where a plaintiff would have to affirmatively show that the defendant was lying. And as such, we might ask (as we will in a few moments) if this does not have a negative effect on entrepreneurial activity.

A POTENTIAL BENEFIT?

Before getting to negative effects, it must be pointed out that there is a potential salutary effect to such a liability standard. Firms doing IPOs (and, to a lesser extent, non-initial public offerings) are incentivized by the Securities Act to expend a great deal of effort in making sure that their disclosure is as accurate as possible and no more rosy than is conservatively justified.

To see how this works and why it might be a good thing, consider one more example. Suppose our entrepreneur owns and manages a firm that is working on a medical device that, while promising, is largely untested. She faces the choice of doing more research to determine more accurately whether it will be profitable or not, or simply going ahead and selling the firm as-is to the public through a public offering of securities.

In the absence of the securities laws, we might suppose that the risk-averse entrepreneur would greatly prefer the immediate public offering of the firm. Suppose that the entrepreneur estimates that the device at the present time has an expected value of \$10. She estimates that doing more research will reveal the device's value more accurately, i.e., that research will reveal that the project is worth either \$0 or \$20 with a probability of 0.5. The problem with doing more research is that, while it is great if it turns out to be worth \$20, the entrepreneur would be stuck with a complete dud if it turns out to be worth \$0. Therefore, we can expect that our entrepreneur would prefer to remain behind the "veil of ignorance" and sell the firm immediately to the public, which should not care about the risk because it can diversify.

To see the problem with this course of action, assume that

the sale goes through and the entrepreneur is left managing a firm of other people's money. What happens when the entrepreneur subsequently performs the research to determine whether the device is marketable or not? If it turns out to be worth \$20, that is terrific; start building the factories, hiring the sales force, and so on. But if it is worth \$0, that is a problem; the ideal thing to do would be to cut losses, liquidate, and distribute the firm's assets to its shareholders. But why would the entrepreneur want to do this? After all, it is not her money anymore. From her perspective, because she enjoys managing and collecting a paycheck every week, she should vow to shareholders that the firm will "overcome" this "set-back," keep managing, and perhaps diversify into another line of business in order to counter the bad results.

This is what economists would call a "holdup" problem. The ability to cut one's losses, to prevent good money from chasing bad, is lost because one cannot trust management to return money once it is given over. While this problem can be particularly acute for new issuers with short operating histories whose projects may be largely unproven, they also occur among mature public firms whose shareholders are too diffuse to serve as a check upon management. Consider, for example, R. J. Reynolds, which faced declining business prospects from a diminishing market, legal liability, and new product failures. Rather than wind up the firm and distribute cash to shareholders — which probably would have been in the best interests of shareholders at the time — the company diversified its holdings by acquiring a food producer. That way, the ongoing company, RJR Nabisco, could keep operating and managers could keep their jobs. However, because tobacco and food are not exactly synergistic industries, this was likely bad for shareholders, even though it was good for managers.

We might suppose that shareholders could exercise their voting franchise to compel managers to wind up a failed company. But a proxy contest to remove incumbent management is a long and uphill battle. Particularly, shareholders have difficulty in coordinating their efforts and it behooves any single shareholder to sit idly on the sidelines and let others do the hard work. A buyout of the firm may be possible (as ultimately happened with RJR Nabisco) because the buyer could make gains by liquidating a company whose assets are worth more than the going concern. But because of the amount of risk and capital involved, such a buyer may not always exist and the buyer may face a risk that the price rises on the news of the acquisition attempt. More directly, even, a buyout may fail if management entrenches itself through practices such as staggered boards of directors (meaning that incumbent directors cannot be removed for a period of years), dual-class voting stock (meaning that management or management's friends hold a disproportionate amount of voting power), or a more recent invention, the "poison pill," a sort of Dr. Strangelove doomsday machine that causes the firm to implode spectacularly upon a successful change of control.

But here it seems, at least at first, that the Securities Act might play a useful role. If the entrepreneur goes ahead with the sale of the firm in an IPO, purchasing shareholders will

likely have a right of recovery against the firm (and hence the entrepreneur) in the event that the project turns out to be a dud. This is because the entrepreneur, if she blithely states that the firm is worth \$10 and nothing more, has failed to disclose the risks that might lead the project to pay off less than expected. Note that there is no real fraud here: the shareholders pay \$10 for a firm that is expected to be worth \$10, but there is still a right of recovery under the Securities Act's strict liability provision when risk materializes. The Securities Act gives shareholders the ability to claw back their investment from the entrepreneur, preventing her from wasting value on a dud project. It must be noted, though, that the Securities Act does this in the clumsy, expensive, and prone-to-abuse form of an investor class action.

We might suppose that, anticipating this, the entrepreneur would choose to disclose all sorts of risks about the failure to test the product. While this is to some extent a pro-

the Securities Act can prevent the destruction of value resulting from holdups with immature companies. But is this something that we really need a federal statute to accomplish? As it turns out, in today's sophisticated markets, the venture capital industry accomplishes the same task in a much more efficient fashion.

IS THE SECURITIES ACT NECESSARY TODAY?

The Securities Act of 1933 is very much a product of its time. As one might imagine, the context of the 1920s stock market collapse and the ongoing Great Depression would greatly affect the character of any regulation. Furthermore, the financial world of the United States in 1933 was a very different place. The lack of data processing ability, national and global communication conduits, and modern financial theory made for a capital markets environment that was, by today's standards, parochial and primitive.

The Securities Act may protect against the holdup problem, but it does so in the clumsy, expensive, and prone-to-abuse form of an investor class action.

phylactic against liability, it is an incomplete one because the Act and SEC rules require risk factor disclosure to be specific; merely stating that the project or company is untested – and thus subject to unknown risk – does not cut it. To be safe, the entrepreneur must be able to name the risk that ultimately surfaces. And if the entrepreneur's firm is subject to more risk than is the background norm in the industry, the entrepreneur must correct the reasonable assumption that investors would otherwise draw (i.e., that the firm is similar to others in the industry) or else risk liability for a false omission. Moreover, the SEC can decide not to allow effectiveness of a registration statement or prospectus that is overly vague and that does not disclose certain specified information.

Of course, to the extent that the entrepreneur makes such statements about risk, her credibility is diminished and investors are willing to pay less for the firm's shares. This is why companies that have stable and mature earnings prospects, such as Kraft, may choose to make relatively few risk factor disclosures (Kraft's IPO prospectus is notable for this) – they have nothing to hide and wish to signal their high degree of confidence in their future prospects.

Therefore, the Securities Act does two things: First, from an *ex ante* perspective, it encourages the entrepreneur to undertake the requisite testing and investment in information to avoid a subsequent holdup problem. Second, from an *ex post* perspective, it can avoid the entrepreneur's waste in a holdup situation by allowing shareholders to claw back their money.

Taking all this into account, it seems that in some instances

The institutional landscape was quite different, too. If one wanted to raise cash for, say, a factory to manufacture a revolutionary new type of buggy whip, there was nothing like today's venture capital and private equity markets to provide needed financing through an equity stake. Rather, apart from public capital financing, innovators of the day often had to pony up the cash themselves, find a way to borrow it, or, if they were lucky, make friends with rich people who were willing to take a risky ownership position. Because rich friends are a rare commodity, entrepreneurs had to face the twin privations of high risk and low liquidity: if the entrepreneur is entirely invested in a buggy whip factory, her very survival may depend on the business's success and she may have little opportunity to cash out some or all of her ownership stake.

Thus, many entrepreneurs turned as quickly as they could to the public offering of securities. By embodying fractional ownership rights in pieces of paper known as stock certificates and selling them to the public, a firm could have owners as numerous as the stars in the sky. The owners, who could own very small investments in the firm relative to their overall wealth, could hold shares of the firm with relatively little cost of risk-bearing. That is, while buying all of IBM presents an unacceptable amount of risk to a single investor, buying one share of IBM stock does not because the investor can diversify.

Thus, many of the companies that sold securities to the public in the boisterous markets of the Roaring Twenties were probably not vetted as well as they should have been because venture capital, as we know it, did not exist to serve as incubators for speculative fledgling businesses. All in all, this may

have been destructive of value. The Securities Act could have an ameliorating effect in such a case because it forces entrepreneurs to invest in information up front and makes immature offerings more expensive.

Today, however, venture capital largely solves this problem. The venture capitalist ponies up money for an equity stake, and thus relieves the entrepreneur of much of the risk that she would otherwise face. However, the venture capitalist does not stand idly by and passively watch his money get spent. Rather, through a series of contractual conditions and covenants, the venture capitalist retains the right to claw back his money if the project appears to be headed south. The ven-

portfolio. Thus, the Securities Act negates the value-adding benefits of risk-diversification. At the same time, the Securities Act forces the entrepreneur to serve as an insurer of the purchasing shareholders' returns. It is as though every share, particularly every IPO share, comes with an insurance policy attached to it.

Because insurance is valuable, this ought to inflate the price of the firm's shares at the time of the public offering. Over time, as the statute of limitations under the Securities Act approaches, this initial inflation ought to disperse, and it would appear as though IPO shares exhibit long-term underperformance compared to their peers. We can use existing

It may be advisable to retain a rule against fraudulent conduct, but strict liability makes no sense in today's sophisticated and deep capital markets.

ture capitalist conditions funding on continued good performance and benchmarking. So, if the buggy whip prototype performs poorly in market testing, for instance, the venture capitalist's contract gives him the right to remove his money from the firm. Thus, this justification for Securities Act liability appears to be obviated by today's sophisticated and deep financial markets.

TODAY However, much like an errant entrepreneur who selfishly sails a business with diminished prospects toward the ultimate shores of insolvency rather than winding things up for the benefit of shareholders, Congress and the SEC have refrained from rolling up the Securities Act and calling it quits, even though the septuagenarian statute appears largely obsolete. What effects, then, does the Securities Act have today?

Some very bad effects, as it turns out. Consider again the plight of an entrepreneur who faces strict liability for securities offering disclosure. When the purchasing shareholders sue the firm, the result is the same as if the judgment were coming out of the entrepreneur's pocket. Suppose the entrepreneur retains 30 percent of the firm's ownership (a not-uncommon figure); when the 70 percent of shareholders who bought securities successfully sue for rescission, the firm pays out the judgment or settlement, which dramatically reduces the value of the firm's shares. Because the entrepreneur is the only shareholder who does not participate in the award, it is as though the entrepreneur pays out herself.

This means that the entrepreneur can never, with finality, divest herself of her risk in the firm. This is so even though both the risk-neutral shareholders and risk-averse entrepreneur would find such an arrangement to be optimal: the entrepreneur receives lower risk and increased liquidity, while shareholders receive a security that is expected to pay dividends in the future and that can be placed in a diversified

data on the rates of suit and settlement and the typical settlement payout in order to calculate the expected effect. According to a 1996 *University of Pennsylvania Law Review* article by James Bohn and Stephen Choi, the largest quintile of IPOs (accounting for about half of IPO volume) get sued 9.1 percent of the time. Philip Drake and Michael Vetsuydens, in a 1993 *Financial Management* article, find that issuers settle for 31.7 percent of post-offering declines on average, and that shareholders receive (after attorneys' fees and other costs are taken out) about 79 percent of that, for approximately 25 percent of post-offering decline. Making some assumptions about the variance of firm returns and crunching the numbers, we find that these figures could readily lead to initial price inflation (and consequent underperformance) of 2.3 percent.

Indeed, as it turns out, IPO firms do tend to underperform non-IPO firms: Jay Ritter and Ivo Welch, in a 2002 *Journal of Finance* article, report 5.1 percent underperformance. Additionally, this reported underperformance appears to be concentrated before the one-year and three-year anniversaries of the IPO, which correspond to the running of the statute of limitations for the strict liability Securities Act claim. (Before Sarbanes-Oxley, shareholders could sue no later than one year after the discovery of the violation, and no more than three years after the offering; Sarbanes Oxley has extended these periods to two and five years, respectively.) Securities Act liability may therefore help to explain the otherwise puzzling phenomenon of persistent IPO underperformance.

Effects of Securities Act liability may go even further. Because the entrepreneur is in charge of the firm until (and perhaps after) its IPO, the entrepreneur has great leeway in deciding how the firm will be set up. If the entrepreneur is going to be subject to increased risk, she may decide to take steps that, though costly, serve to insulate her against the for-

tunes of the firm. It is likely or probable that these actions are, overall, destructive of value even though they serve to make the entrepreneur better off.

Perhaps the most costly option, from a societal point of view, is that the entrepreneur may eschew risky projects in favor of less profitable but less risky ventures. For the economy as a whole, this may have dramatic consequences. Many of the most valuable companies, such as high-tech firms like Microsoft, Intel, or Google, necessarily entail a great deal of risk at startup. While we are lucky to have the startup culture that we have in the United States, it is conceivable that our securities liability structure retards our innovation and development. For example, Michael Perino reported in a 2003 *University of Illinois Law Review* article that nearly every tech firm that went public toward the end of the late 1990s bubble faced lawsuit. It is impossible to say how much this litigious environment is hurting us, but it seems likely that the damage is significant. Other manifestations of this phenomenon include firm-level diversification and investment in hedging transactions or insurance, which reduce risk but may do so at the expense of overall shareholder profits.

Alternatively, our entrepreneur might seek to entrench herself in power so shareholders can never vote her out of office. While this might lower the price that shareholders are willing to pay for the firm *ex ante*, it may still make sense to do so from a risk-alleviation perspective: while the entrepreneur faces the possibility of liability, at least she will be able to retain her job and extract private benefits from the company. This is a way of hedging against potential liability. Indeed, Robert Daines and Michael Klausner, in a 2001 *Journal of Law, Economics and Organization* article on IPOs, find a positive correlation between management stake and anti-takeover protections. Thus, it may be that where the manager/entrepreneur is unable to cash out of the firm, she will invest in anti-takeover technologies that effectively hedge her risk.

Another alternative is that, if the entrepreneur fears having her stake in the firm wiped out by liability, she may, *ex ante*, decide not to invest as much in the firm in the first place. In some cases, she may continue to hold assets personally or in a separate, non-public company in order to shield them from shareholder lawsuits. This exacerbates holdup costs because the entrepreneur, not the shareholders, owns the productive assets; if the entrepreneur finds a better deal elsewhere, she can take her assets and walk away, leaving shareholders with a relatively worthless shell.

Finally, and perhaps most commonly, prohibitive disclosure liability reduces the amount of positive disclosure that

entrepreneurs are willing to make. For instance, a bank with a promising new business line in consumer credit may not make much by way of positive disclosures about it because if it fails, shareholders could later sue (and possibly win) for a misstatement or omission. Reduced positive disclosure means that shareholders are willing to pay less for a firm's shares; thus, liability can distort the allocation of capital. If risky projects cannot be disclosed, risky projects will tend to be underfunded relative to the social optimum. While it is not clear that the phenomenon of first-day "pops" — the amount that an IPO rises on the first day of trading — is necessarily related to Securities Act liability, many practicing lawyers do believe that this is the result of intentional underpricing as a way of insuring against lawsuits. If that is even partly true, first-day pops — which represent on average 15 percent of the value of securities offered for all issuers and 18 percent for more risky tech companies — represent a tremendous loss of capital for productive enterprise in this country: up to 18 percent of the value of a public company.

However, it may be that the market can provide some limited ways to contract around the recalcitrant Securities Act provisions. For one, entrepreneurs will seek alternative methods to communicate their information to the marketplace. They can do this by hiring (and paying a premium for) reputable underwriters who maintain a network of dealers and clients who stand ready to buy what the underwriters have to sell them. Or they may rely heavily on some of the limited exceptions that the Securities Act allows, such as the oral offers exception during the waiting period, most commonly manifested in the traveling "road show" where underwriters and the issuer make presentations to institutional buyers. Or they may, in effect, hire research analysts to promise to shill for the issuer. (See "Communication by Other Means," Fall 2005.) In all of these cases, however, these are costly disclosure mechanisms. Not only is there a direct cost involved (paying the underwriters, for instance), but the quality of the information is necessarily degraded by being forced through such clumsy and imprecise conduits.

It would be far better, then, to remove the main obstacle to effective direct disclosure: the strict liability provisions of the Securities Act. While it may still be advisable to retain a rule against fraudulent conduct, strict liability simply makes no sense in today's sophisticated and deep capital markets. R

Readings

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