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SHELF REGISTRATION, INTEGRATED DISCLOSURE, AND UNDERWRITER DUE DILIGENCE: AN ECONOMIC ANALYSIS

Merritt B. Fox*

In a recent article,¹ Professor Barbara Banoff mounted a spirited defense of the Securities and Exchange Commission’s decision to adopt permanently Rule 415² under the Securities Act of 1933 (Securities Act).³ Rule 415 permits the registration of securities that an issuer intends to “put on the shelf” rather than sell immediately.⁴ By having a block of “shelf registered” securities available, an issuer avoids the delay of the registration process once the decision is made to proceed with a sale. Shelf registration also gives an

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⁴ Rule 415 is a departure from the traditional position of the SEC not to permit an issuer to register securities that it does not intend to sell immediately. The position was based on an interpretation of the language of § 6(a) of the Securities Act, 15 U.S.C § 77f(a) (1982), and reflected a policy against the sale of securities on the basis of stale information. See In re Shawnee Chiles Syndicate, 10 S.E.C. 109 (1941).

Rule 415 is limited to issuers qualified to use form S-3 (the short form registration statement). See infra note 8. Under Rule 415, registered securities can be offered on a delayed or continuous basis during a two year period following the effective date of the registration statement. The issuer need not amend the registration statement during the two year period unless there has been a fundamental change in the reported information that has not been disclosed in a subsequent report to the SEC. See infra note 8. The effect of Rule 415 is to permit an issuer that wishes to sell some or all of the registered securities at any point during the two year period to contact the several managing underwriters named in the registration statement, determine which underwriter will give it the best terms, and offer the security to the market through that underwriter in a matter of hours.

1005
issuer the flexibility to seek bids from a group of competing underwriters and bypasses the traditional method of negotiating a fixed price in advance of sale with just one underwriting syndicate.

A major criticism of Rule 415 is that this speed and flexibility impede an underwriter's ability to perform "due diligence," its statutorily induced investigation of the accuracy of the information contained in the registration statement. Professor Banoff uses

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5 An underwriter is an intermediary, usually an investment bank, that purchases an issuer's offering and then sells it to the public. Most corporations use underwriters in their public offerings. SEC Monthly Statistical Rev., Apr. 1984, at 29. Section 11(a) of the Securities Act provides that any person acquiring a security whose registration statement contains "an untrue statement of a material fact or [omits] to state a material fact required to be stated therein or necessary to make the statements therein not misleading" may sue every underwriter of the security for damages. 15 U.S.C. § 77k(a) (1982). To avoid liability, the underwriter must show that "[h]e had, after reasonable investigation, reasonable ground to believe and did believe" that the registration statement did not contain such an untrue statement or omission. Id. § 77k(b)(3)(A) (1982). The investigation and review of the registration statement motivated by these sections is known as "due diligence."

Though Section 11 imposes liability on a variety of participants in a public offering, including the issuer, its directors, and certain of its top officers, underwriter liability is a crucial part of the legislative plan. See Greene, Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System, 56 Notre Dame Law. 755, 767-70 (1981). There are good reasons to believe that such imposition of liability results in the underwriter, because of its independence, playing a somewhat adverse or "devil's advocate" role in the drafting of the registration statement. Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 886 (S.D.N.Y. 1968). Because an underwriter participates in numerous public offerings each year and the management of an issuer does so just occasionally, an underwriter is much more likely to develop the resources and skill necessary to perform a thorough investigation than is the management of an issuer. Feit, 332 F. Supp. at 581; Folk, Civil Liabilities Under the Federal Securities Acts: The BarChris Case, 55 Va. L. Rev. 1, 54 (1969). Furthermore, the issuer might find that the gains to be reaped in a successful offering outweigh the risks of liability for damages for being less than forthright or shading the truth, but the underwriter has little to gain from taking such risks. See Comment, BarChris: Due Diligence Refined, 68 Colum. L. Rev. 1411, 1421 (1968).

modern finance theory to argue that this concern is misplaced because the improvements in information reaching the market through underwriter due diligence do not benefit investors in a worthwhile fashion. Due diligence, she asserts, is therefore unnecessary.

The significance of Professor Banoff's argument extends beyond the question of whether shelf registration is desirable. Her argument applies equally to the desirability of "short form registration," another recent SEC reform. The SEC, recognizing that publicly held corporations are required under the Securities Exchange Act of 1934 (Exchange Act)\(^7\) to file periodic reports containing financial and other information of interest to prospective securities purchasers, now permits a large class of issuers to use a short form Securities Act registration statement that provides for this information to be incorporated by reference rather than repeated. Together, short form and shelf registration constitute the heart of the SEC's program of "integrated disclosure," the most important set

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* Banoff, supra note 1, at 176-84.


The S-3 form allows an issuer to incorporate by reference into his registration statement the information provided in the 10-K, 10-Q, and 8-K filings. The only information relating to the affairs of the issuer that must actually be set out in the registration statement is, in most cases, the use of proceeds and a description of any material change since the last 10-K not already described in a subsequent 10-Q or 8-K. Under the eligibility requirements for form S-3, the registrant must be organized under the laws of, and have its principal place of business in, the United States (although some foreign private issues may qualify as well). The registrant must also have regularly filed the reports required under the Exchange Act for the prior three years and must not be delinquent in its financial obligations. Finally, the aggregate market value of the voting stock held by nonaffiliates of the registrants must be at least $150 million, or $100 million with an annual trading volume of at least three million shares. Id. at 11,384, reprinted in [1937-1982 Accounting Series Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328, at 62,997. Louis Loss estimates that 2000 firms are eligible to use form S-3. L. Loss, Fundamentals of Securities Regulation 144 (1983).
of changes in the regulation of the sale of new issues since the passage of the Securities Act.\(^9\)

The theory behind both parts of the integrated disclosure program is the efficient market hypothesis.\(^{10}\) The hypothesis suggests that all information contained in an issuer's periodic reports is immediately reflected in the price of the issuer's securities. Short form registration is justified because repetition of information already expressed in the price of an issuer's securities serves no useful purpose.\(^{11}\) Shelf registration is justified because the statement registering a securities offering need not be current if the price at which the securities will be sold reflects information contained in periodic reports filed between the time the registration statement becomes effective and the time of the offering.\(^{12}\)

Short form registration has been subject to the same criticism as shelf registration—that it impedes due diligence—and largely for the same reasons.\(^{13}\) Professor Banoff apparently realizes that her argument, if correct, is an effective response to criticism of both parts of the integrated disclosure program. She suggests that the SEC exempt underwriters from their due diligence obligations for "all offerings into an efficient market, whether or not the offering is shelf registered."\(^{14}\)

This article examines whether modern finance theory demonstrates that the information improvement resulting from due diligence produces no social benefit. It suggests that given a properly

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\(^{10}\) See infra note 17 and accompanying text.


\(^{14}\) Banoff, supra note 1, at 185 (footnote omitted).
broad view of the role of the market for securities in our economy, the opposite is the case. It then examines the issue that Professor Banoff has largely avoided: the effects of short form and shelf registration on underwriter due diligence. It finds that the effects are negative, and concludes that the SEC should develop ways to put the same kinds of pressures on issuers when they prepare Exchange Act periodic reports as underwriters historically placed on them when the issuers prepared Securities Act registration statements.

I. THE BENEFITS OF INFORMATION DISCOVERED BY UNDERWRITER DUE DILIGENCE

Professor Banoff does not claim that underwriter due diligence fails to improve the quality of information about an issuer reaching the market, but argues only that the improved information produces no worthwhile benefits. The validity of her argument depends on the range of functions that one believes the market for securities plays in our economy. The narrowest view is that the securities market is simply a place to speculate, a Las Vegas for a more respectable group of individuals. A second, somewhat broader view is that many investors purchase securities for the same reason they deposit money in a savings bank—not because they expect to profit from price fluctuations but because they expect on average to earn a positive rate of return on their investment. The third and broadest view sees the market not just as an institution to serve the needs of its participants but as an instrument of social control influencing real economic events: choosing which proposed investment projects to implement and how to use the economy's existing productive capacity.

The first view leads, by application of the efficient market hy-

15 Banoff, supra note 1, at 180-81. Some commentators question whether due diligence has this effect, and suggest that to believe it does is inconsistent with the efficient market hypothesis. See, e.g., Pickholz & Horahan, The SEC's Version of the Efficient Market Theory and Its Impact on Securities Law Liabilities, 39 Wash. & Lee L. Rev. 943, 947 (1982). Professor Banoff correctly rejects that view. Banoff, supra note 1, at 180. Unless there is truth to the generally rejected "strong form" of the efficient market hypothesis, see infra note 19, some information known or available to insiders of the corporation is not reflected in the price of the issuer's securities. The potential liabilities imposed upon an underwriter in connection with the public offering of securities creates a strong incentive for the underwriter to uncover some of this information and disclose it to the market.
pothesis, to the conclusion that information improvements resulting from due diligence are of no importance because the market is as fair a game with or without improved information. The second view, implicitly held by Professor Banoff, leads to the same conclusion. Information improvements resulting from due diligence increase the accuracy of the prices of individual securities, but accuracy is unneeded. If one holds a portfolio of inaccurately priced securities, the inaccuracies tend to cancel each other out. The third view leads to the opposite conclusion. Information improvements resulting from due diligence produce benefits—increased accuracy in the prices of individual securities influences the decisions of corporate management in ways that increase the efficiency with which scarce resources are allocated.

A. The Securities Markets as Las Vegas

The Las Vegas analogy suggests that an investor who purchases a security believes, based on faith in his luck or in his superior ability to predict the future, that the price of the security is less than its "actual value"—the aggregate future stream of income accruing to its holder discounted to present value. The seller believes the opposite. This sort of trading is a zero-sum game because whatever one party gains—the purchase of a bargain or the sale of an overpriced security—the other loses.

The efficient market hypothesis, most broadly stated, is that the market price of a security "fully reflects" all information available at the time in question. The term "fully reflects" is not clearly

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16 This definition of "actual value" requires an ex post view to be operative. The "actual value" of a security at a given point in time, t₀, cannot be determined until some point in the future, after the security has paid out its last distribution. In the case of a bond where the issuer has not defaulted, that future point would be after the date of its maturity. In the case of a share of common stock, that future point would be after the date of the issuer's dissolution. A perfectly informed investor would be able to predict the future with certainty, and could at t₀ accurately determine the actual value of the security. A real world investor, using the imperfect knowledge available to him at t₀, must guess what its actual value is as of that date.

defined in the relevant literature, but appears to mean that, given any particular model of individual investor behavior and of the resulting equilibrium prices aggregated from that behavior, the market acts "as if" every investor knew the information.18

The implication of the empirical studies supporting the efficient market hypothesis19 is that the average investor need not know any particular bit of information to participate in the market on a "fair" basis with other outsiders. As best anyone who had all the information available to outsiders would be able to tell, the actual value of a security is as likely to be above as to be below market price. In statistical terms, the price is "unbiased."20 Every outside buyer or seller buying or selling the security at the market price is in the same position. Knowing particular information will not help spot a winner or a loser because the significance of such information has already been reflected in the security's price.

The efficient market hypothesis suggests, assuming no trading on inside information, that whether the level of information available to the market is high or low, it is a fair game for all participants. Information improvement resulting from underwriter due diligence will not make the game fairer. If the hypothesis is correct, the policy implications of the view of the market as Las Vegas

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18 Fama, supra note 17, at 388; Gilson & Kraakman, supra note 17, at 554-55.
19 A considerable number of empirical studies are consistent with this hypothesis to the extent that it applies to bits of publicly available "hard data," such as earnings reports, the decision of a firm to split its stock, and the decision of a firm to set its level of dividends. See K. Garbade, Securities Markets 249-59 (1982); J. Lorie & M. Hamilton, supra note 17, at 83-87; Fama, supra note 17, at 405-09. Once such a bit of information becomes available to anyone outside of the corporation's insiders, the studies suggest that it is very quickly fully reflected in the price of the security. These tests of the speed at which market prices adjust to obviously relevant publicly available information constitute what Fama refers to as the "semi-strong" test of the efficient market hypothesis. Fama, supra note 17, at 388. Importantly, the hypothesis has not been confirmed by what Fama labels "strong form" tests of its validity—tests aimed at determining whether market prices also fully reflect nonpublic information. Id. See Finnerty, Insiders and Market Efficiency, 31 J. Fin. 1141 (1976); Jaffe, Special Information and Insider Trading, 47 J. Bus. 410 (1974); Lorie & Niederhoffer, Predictive and Statistical Properties of Insider Trading, 11 J.L. & Econ. 35, 52-53 (1968). Due diligence can be viewed as part of a federal regulatory scheme to make the nonpublic information that these studies suggest is not reflected in the market prices of publicly traded securities public, so that the prices will reflect all information.
20 A price is unbiased when $E(\text{price} - \text{actual value}) = 0$, where $E$ is the expected value operator based on all publicly known "hard" information. If this is true, the market is a "fair game" in the sense that no one can expect systematically to make trading profits (profits above the normal expected return from an investment in a security of this risk category) using any of this information. Fama, supra note 17, at 384-85.
are clear. The maintenance of fairness is the only obvious role, if there is any, for government regulation of a zero-sum game not affecting anyone who does not play. There is therefore no justification for legal rules that induce underwriter due diligence.\textsuperscript{21}

B. The Securities Market as a Place to Store Savings

Some investors buy securities as an alternative to Las Vegas, but clearly others, believing the efficient market hypothesis and having no special faith in their luck, buy securities because it is a way to store their savings that historically has produced, on average, a positive rate of return.\textsuperscript{22} Much modern finance literature focuses exclusively on this type of investor, and recommends strategies for indentifying a portfolio of securities that, given the individual investor's tastes, will have the optimal combination of risk and return. In her analysis of why the information improvement induced by underwriter due diligence produces no benefits, Professor Banoff implicitly embraces this view of the role of the securities markets in the economy.\textsuperscript{23}

Professor Banoff's argument is an apparently straightforward application of portfolio choice theory.\textsuperscript{24} Even assuming that the

\textsuperscript{21} Underwriter due diligence could be viewed as a means of supplementing direct prohibitions on insider trading. The more information that the federal securities laws force to be disclosed, the less inside information exists to tempt potential insider traders. Under this view, due diligence could be justified even if the market is considered simply as a substitute Las Vegas.

\textsuperscript{22} From 1926 to 1974, the annual inflation-adjusted rate of return on a representative sample of common stocks was 6.1%. Ibbotson & Sinquefield, Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns (1926-1974), 49 J. Bus. 11, 39 (1976).

\textsuperscript{23} Banoff, supra note 1, at 182-83.

\textsuperscript{24} Portfolio choice theory traces its origins to an article by Markowitz in 1952 that prescribed how an investor, given his tastes concerning the tradeoff between expected return and risk, should construct an optimal portfolio using the expected return, variance, and covariances of each available security. Markowitz, Portfolio Selection, 7 J. Fin. 77 (1952). See also H. Markowitz, Portfolio Selection: Efficient Diversification of Investments (1959); Tobin, Liquidity Preference and Behavior Towards Risk, 25 Rev. Econ. Stud. 65 (1958). In 1961 Sharpe developed a simplified version of the Markowitz model in which the investor constructs his optimal portfolio on the basis of expected return, the portion of the variance of the return of the security that is perfectly correlated with the return on the market as a whole (i.e., systematic or "beta" risk), and the portion of the return of the security that is independent of the return on the market as a whole (i.e., unsystematic or "alpha" risk). Sharpe, A Simplified Model for Portfolio Analysis, 9 Mgmt. Sci. 277 (1963). For straightforward expositions of these theories, see J. Lorie & M. Hamilton, supra note 17, at 171-210; W. Sharpe, Portfolio Theory and Capital Markets 96-101 (1970). The exact number of se-
price of a security is the result of the operations of an efficient market, she observes that investment in the security is risky in the sense that its actual value may be above or below its price. There are two components to this risk: unsystematic risk, which is company- or industry-specific, and systematic risk, which is common to the market as a whole. The information improvement that results from underwriter due diligence is company-specific information and only reduces the unsystematic risk associated with an investment in the company’s securities. Reducing unsystematic risk in this fashion involves real costs ultimately passed on to investors. Unsystematic risk can be eliminated from an investor’s portfolio more cheaply by diversification. Legally induced due diligence thus results, Banoff contends, in a needless expenditure of resources for which investors would not willingly choose to pay.

Professor Banoff’s conclusion is that no increase in the expected accuracy of the price of any single security resulting from an improvement in information about its issuer is worthwhile. A price is relatively accurate if it is relatively close, whether above or below, to a security’s actual value. When a price has a high expected accuracy, on average the deviation of the price from the actual value is small. As Kenneth Arrow has said, “uncertainty is . . . the complement of knowledge,” so if less is known about an issuer, the price of its securities will have a lower expected accuracy than if more is known. Although the efficient market hypothesis assures

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25 Due diligence involves the time of many highly-paid executives, lawyers, and accountants.

26 This conception of expected accuracy can be put in statistical terms. Price is a random variable generated by a distribution function that, because price is unbiased, has a mean equal to actual value. The variance of this distribution—the expected value of the square of deviation of price from actual value—is the measure of the expected accuracy of the price. Definitions for these statistical terms can be found in R. Hogg & A. Craig, Introduction to Mathematical Statistics 16-28, 34-40 (2d ed. 1965).

27 Arrow, Control in Large Corporations, 10 Mgmt. Sci. 397, 404 (1964).

28 The connection between the level of information in the market and the expected accuracy is aptly stated by Stigler: “[p]rice dispersion is a manifestation—and, indeed, it is the measure—of ignorance in the market.” Stigler, The Economics of Information, 69 J. Pol.
an investor that, whatever its accuracy, the price of each security is unbiased, a risk averse investor holding just one or a few securities would be happier if they were relatively accurately priced. Professor Banoff argues that risk averse investors can avoid this problem by spreading their investment dollars over a diversified portfolio of securities. Then, even if little is known about each issuer, so that the price of each security can be expected to be relatively inaccurate, the inaccuracies will have little impact on the investor because they will be independent of each other. In some cases the price will be inaccurately high and in some inaccurately low; the inaccuracies will tend to cancel out each other.

This second view of the market would be sufficiently broad for the purpose of making policy if the market consisted only of secondary trades of previously issued securities, stock purchases were never based on a desire to acquire control of the issuer, and executive compensation was never affected by stock price. In such a hypothetical world, what happens in the market would have no effect on real economic events. Participants in the market would simply be trading rights to autonomously supplied streams of shareholder distributions. The welfare of the participants in the market would be all that mattered, and would be determined by the characteristics of their portfolios, which if properly composed, would not be affected by any inaccuracies in the prices of individual securities caused by a lack of company-specific information. In such a world, the use of portfolio theory to prescribe changes in securities law might be valid.

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Econ. 213, 214 (1961).
29 See supra note 20.
30 Even then, it might not be valid. There are two serious problems with using portfolio theory to prescribe changes in securities law even in this hypothetical world. First, a significant number of investors do not fully diversify their portfolios. The risk averse among them would be hurt as a result of a decrease in the accuracy of the prices of individual securities. Professor Banoff's advice to these persons is essentially "let them diversify." She believes their preference to be insured by underwriter due diligence should not be respected because they do not bear the full burden of the cost of this insurance. Banoff, supra note 1, at 183 n.229. Perhaps the fact that they do not bear the full burden should be attributed to the shareholders who do diversify and decide not to take advantage of the insurance. Many of the people who do not diversify are small investors who cannot economically diversify except through the purchase of a managed or unmanaged mutual fund. To tell them to diversify is to tell them that they cannot purchase stocks on the basis of their best guesses as to their future prices. The efficient market hypothesis does not assure us that their efforts are futile. Whether they are futile depends on the information the investors use to base their
C. The Securities Market as a Nerve Center for the Real Economy

The problem with the preceding view, however, is that this hypothetical world is not the real one. The broadest view of the securities market reveals an additional function. The securities market monitors and structures the allocation of scarce resources in the economy: it decides which proposed investment projects are implemented and how the economy's existing productive capacity is used. Most of these choices are made, at least in the first instance, by the management of existing corporations. Security prices and the information that is used to establish them are central to the working of three mechanisms that limit the discretion of management faced with these choices: the cost of capital to individual corporations, the market for corporate control, and stock price based management compensation schemes. Given this third, broadest view, there are benefits from the increase in the expected accuracy of the prices of individual securities as a result of information improvements from underwriter due diligence.

1. Cost of Capital

Real investment is the use of resources such as skilled labor, machinery, bricks, and mortar to create new capacity in the economy to produce a particular good or service. Purchasing these resources usually requires spending more money than the new project can be expected to generate in the near future. The funds to cover this deficit might come from the net revenues of current operations, from a loan, or from the sale of new equity or debt securities. Each
of these methods of funding will eventually result in a diversion of money that would otherwise be distributed as dividends, so the expenditure inevitably involves a cost to existing shareholders.\(^3\) This is the "cost of capital,"\(^2\) the figure that a management dedicated to maximizing shareholder welfare\(^3\) must weigh against the benefits of the new capacity. Although corporate finance scholars disagree to some extent on how to measure a firm's cost of capital, most believe that a firm's share price is relevant to the calculation.\(^3\)

If the market prices of securities are inaccurate, a misallocation of resources for real investment can occur.\(^3\) Consider two firms, X and Y, which are identical, apart from the following exceptions. X shares are priced inaccurately high and Y shares are priced inaccurately low. Each is considering a new investment project of equal cost and equal risk, but anyone who knows the details of each project would conclude that Y's project has a higher expected return than X's. Assume for a moment that the only way each of the firms can provide funds for its project is by issuing new shares. X's cost of capital will be less than Y's because X will need to issue fewer new shares to raise the same amount of money. Under these circumstances, after weighing the costs and benefits of implementing their respective projects, X may decide to go ahead,\(^3\) and Y

\(^3\) A reduction in future dividends decreases the current actual value of a security. See supra note 16 and accompanying text.

\(^2\) This idea that the cost of a project is the opportunity cost to shareholders of not receiving funds is presented in D. Farrar & J. Meyer, Managerial Economics 63-67 (1970).

\(^3\) See infra note 42 and accompanying text.


\(^3\) There is a theoretical argument that the overpricing of X shares should have no effect on X's decision whether to implement the project. If management of a firm with overpriced shares determines that the rate of return on the project is below what shareholders could earn if they received an amount of dividends equal to the cost of the project and reinvested them, the firm should sell additional shares anyway, but instead of investing the proceeds in the project, should pay them out as additional dividends. Fischel argues along these lines in defense of the proposition that a firm's dividend decision is independent of its investment policy. Fischel, The Law and Economics of Dividend Policy, 67 Va. L. Rev. 699 (1981). There is little evidence, however, that corporations behave this way.
may decide not to proceed. Because of inaccurate security prices, scarce resources would be used to implement X's project, even though Y's project is superior.

Generally, of course, a sale of a new issue of shares is not the only way to provide funds for a project. But that fact does not make share price irrelevant to a firm's cost of capital and its decision whether to implement a particular project. First, for X, overpriced shares mean that it will probably finance the project by a sale of shares even if other sources are available. Second, the misinformation that causes inaccuracies in the prices of X and Y shares, as well as the share prices themselves, will affect the prices of any new issue of bonds or preferred stock and the terms on which a financial intermediary will be willing to make a loan. The fact that all outside sources of funds may be affected in a like manner is important because the amount of funds available to a firm from internal sources is limited, at most, to its net revenues

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37 One might argue that because management would be glad to provide voluntarily any information that would improve its share price, the shares of a firm engaging in a public offering would never be priced inaccurately low for a reason that due diligence could correct. One reason this argument is wrong is that management might wish to withhold information even if it would improve share price. For example, the information might be of value to a competitor. See Easterbrook & Fischel, 70 Va. L. Rev. 669, 685-86 (1984). If all firms act under a regime inducing greater disclosure of information that may be useful to competitors, any particular firm will sometimes gain and sometimes lose. In the long run the effects will balance out. Yet the regime inducing greater disclosure would produce a social gain because securities would be more accurately priced. Management might also wish to withhold information that, despite its favorable impact on price, would increase the chance of takeover by enabling a potential predator to assess more accurately the value of the firm in its hands. See infra text accompanying note 46; cf. Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 741-42 (1984) (management might wish to withhold information and then buy the stock at artificially low prices).

A second reason why the argument is wrong is that a firm that truthfully discloses no bad news might be priced lower in a market without due diligence than in one with it: the market would assign a higher probability to the possibility that the absence of bad news was a lie.

38 Modigliani and Miller, as part of their argument that financial structure is irrelevant, suggest that the market evaluates the expected level and riskiness of a firm's whole income stream before deduction for interest. The capital structure of a firm is the way the firm parcels out rights to portions of that stream. Thus the price of debt and equity are each functions of the same evaluation based on the same information. Modigliani & Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 Am. Econ. Rev. 261 (1958).

39 Kripke argues that the market price of a firm's shares can directly affect its borrowing power and the interest it pays on debt. H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose 123 (1979).
from operations, and if management feels a certain dividend payout is necessary, to an amount less than that.

Finally, many finance theorists argue that there is an optimal debt/equity ratio for the firm.\textsuperscript{40} If a firm possessing an optimal ratio chooses to finance a particular project entirely by debt, it must keep in mind the cost of equity, because it will need to engage in additional equity financing at some point in the future to restore the optimal ratio. Similarly, a firm with such a ratio financing a project entirely with retained earnings will need to engage in additional debt financing in the future. For a firm following the advice of such theorists, the appropriate measure of its cost of capital is a mix of its cost of debt and its costs of internally and externally raised equity.\textsuperscript{41}

2. The Market for Corporate Control

Managers and their motivations also influence the allocation of resources. Management determines whether the corporation should incur the cost of capital necessary to implement each investment project it is considering. Management also decides how to use the corporation's existing productive capacity—the level of production of each good and service capable of being produced by such capacity and the combination of inputs used to achieve that level. Conventional economic theory holds that in a competitive economy where antisocial behavior, such as pollution, is properly regulated, management decisions that are best for existing shareholders are also the ones that allocate the economy's scarce resources most efficiently.\textsuperscript{42}

Most large corporations in the United States are "management controlled." Share ownership is so dispersed that management can

\textsuperscript{40} Notwithstanding Modigliani and Miller's argument concerning the irrelevance of financial structure, see supra note 38, there are factors weighing against both too little debt and too much. A small amount of debt deprives the firm of the tax deductions arising from interest payments. A large amount of debt creates significant conflicts of interest between debtholders and shareholders that require expensive supervision by debtholders to prevent management from making decisions contrary to debtholder interests. It also increases the chances of bankruptcies, which involve significant costs. E. Brigham, supra note 34, at 641-66.

\textsuperscript{41} See sources cited supra note 34.

perpetuate itself indefinitely by controlling the firm’s proxy machinery and nominating as directors its own members and persons friendly to current management.\textsuperscript{43} There is no assurance that the decisions made by such a management group will be the ones that are in the best interests of shareholders. Management may not be competent, and even if it is, its best interests are sometimes different from those of the shareholders. A corporate manager, like anyone, can be expected to value compensation, perquisites, respect, power, affection, a sense of rectitude, and job security. The decisions the manager makes for the firm may affect the level of these rewards. The extent to which a manager makes decisions that are in the best interests of shareholders depends on the structure of incentives in which he operates.

One obvious way that shareholders might prevent management decisions that are not in the best interests of shareholders is for them to replace an unsatisfactory management by electing one more to their liking. But as noted, ownership of management controlled corporations is so dispersed that concerted action of this sort is nearly impossible. On the other hand, if an existing shareholder or an outsider can purchase enough shares of the corporation to obtain a controlling interest, he can replace incumbent management on his own.\textsuperscript{44} The existence of such a market for corporate control results in incompetent or self-interested management being terminated by takeover. Equally important, the fear of a takeover will motivate incumbent management to make decisions more in accord with the best interests of shareholders than it might otherwise make.

\textsuperscript{43} W. Cary & M. Eisenberg, Corporations: Cases and Materials 208-09 (5th ed. 1980); E. Herman, Corporate Control, Corporate Power 54 (1981). Herman estimates that 78 of the largest 100 industrial corporations and 165 of the largest 200 nonfinancial corporations are management controlled. Id. at 58-61. See also Palmer, The Separation of Ownership from Control in Large US Industrial Corporations, Q. Rev. Econ. & Bus., Autumn 1972, at 55. A sense of the share of the economy's allocation decisions that are made by the managements of management controlled firms comes from the congressional testimony of Michael Pertschuk, former FTC Chairman. He estimated that in 1977 the largest 200 manufacturing corporations had a 60% share of all manufacturing assets and that in 1976, 451 firms controlled 70% of all manufacturing assets. Mergers and Industrial Concentration: Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 95th Cong., 2d Sess. 155 (1978) (statement of Michael Pertschuk).

The effectiveness of the market for corporate control in restricting management discretion depends on the accuracy of the price of a firm's shares and the quality of information available to the market concerning the firm's operations. To see the relevance of the accuracy of a firm's share price, consider the following example. Suppose that the incumbent management of a firm (the target) is making decisions that are not in the best interests of its shareholders, and that an outsider is aware of this mismanagement and thinks that it could do a better job. Assume for a moment that the outsider is certain of how much the target will be worth in its hands. If the target's share price accurately states the value of the firm assuming the continuation of incumbent management, the outsider will find a takeover worthwhile. The price it must pay to acquire the shares necessary to effect the takeover will be less than what the shares will be worth once it is in control. But if the price is inaccurate, and the inaccuracy sufficiently overstates actual value, the takeover will not be worthwhile, notwithstanding the poor quality of incumbent management's decisions and the outsider's certainty as to the greater worth of the target in its hands. The more inaccurate share prices are generally, the more cases there will be where the takeover mechanism will fail because the target's share price is too high.

To see the relevance of the quality of information available to the market, consider a variation on the example above. Assume, more realistically, that the outsider's assessment of the value of the target in its hands, though unbiased, is uncertain because the outsider is not perfectly informed about the future. Thus, the outsider knows that in any particular case his assessment is equally likely to be too high or too low, and is unlikely to be exactly right. In this situation, even if both the price of the shares and the assessment are correct, the outsider cannot be confident of these facts and, if risk averse, may not undertake the takeover despite the expected gain from doing so.

The outsider's fear results from the all or nothing aspect of a takeover. The outsider must acquire a certain number of shares or

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45 This assumption of certainty is unrealistic, but its unrealism makes the market for corporate control appear more effective on average than it really is in restricting management discretion.

46 See supra notes 20, 26 and accompanying text.
it will be unable to effect the transfer of control on which its expectation of gain is based. For a target corporation of any significance, this minimum number of shares would constitute a large investment relative to the size of the typical outsider's portfolio. Altering the portfolio to include these shares would add to its riskiness because the unsystematic component of the risk could not be fully diversified away. The outsider's expected gain from the transfer of control may not be sufficient to compensate for the added risk. When more information about a potential target is available to the market, less unsystematic risk will be involved in an outsider's assessment of what the firm would be worth in its hands, and less expected gain will be necessary to motivate the outsider to undertake the takeover.

3. Stock Price Based Management Compensation Schemes

The role of share price in motivating management is not confined to its place in the operation of the market for corporate control. A number of management compensation schemes—stock options, stock appreciation rights, warrants, and employee stock ownership plans—depend on share price to determine the magnitude of the reward given the recipient.47

The importance of such schemes is clear given the shortcomings of the other incentives for aligning management interests with those of the shareholders. The takeover threat is a relatively blunt instrument for limiting management discretion. Those parts of a manager's compensation package not tied to share price also have problems as effective alignment mechanisms. Straight contractual salary will have no effect on management decisions, because it is set in advance and does not vary with performance. The promise of year-end bonuses and future salary increases based on merit are devices by which top management as a group can reward those members who have made decisions contributing to the group's goals. Incentives awarded by a management group, however, will protect shareholders only if there is in turn a way to align the interests of the group with those of the shareholders. A profit-sharing arrangement may work to align management and shareholder interests to some extent, but a defect in those plans is that "profit"

47 F. Scherer, supra note 44, at 36.
is an accounting figure that at best captures only imprecisely many of the gains and losses experienced by a firm.\textsuperscript{48} Profit-sharing arrangements often create incentives to make decisions that emphasize a firm's short-run performance over its long-run performance.\textsuperscript{49} In contrast, when a manager, in choosing among alternative courses of action, chooses the one that most benefits the firm, that choice will on average have the most positive immediate effect on share price, even if the benefit will not be realized until some point in the future.\textsuperscript{50}

These virtues might suggest that it would be desirable to have each top manager's compensation entirely stock price based. Shareholders and management would both gain. At the beginning of the year, management would receive a compensation package with a higher expected yield than if the package were not stock price based, but not so much higher that shareholders would receive none of the benefits from the resulting improvement in management decisions.\textsuperscript{51} The problem again is risk. Compensation based on share price might end up well above or well below what is expected. For the typical manager, his job compensation is a large part of his annual income, so this risk cannot be diversified away.

The accuracy of share price again turns out to be important in the efficient allocation of resources. The higher the expected accuracy of a firm's share price, the more willing a manager will be for a large portion of his compensation package to be share price based. With more of his compensation based on share price, a manager will be more motivated to make decisions that are in the shareholders' best interests.

\textsuperscript{48} For example, research and development expenditures are generally not capitalizable and must be treated as a current expense even though they may enhance the future revenues of the firm as much as capital expenditures for bricks and mortar. Financial Accounting Standards Board, Statement No. 2 (1974).

\textsuperscript{49} It is true that long term investments will eventually start producing recognizable "profits," but if the manager expects to retire or leave the firm, he will have a shorter time horizon than shareholders, and will not take such profits into account.

\textsuperscript{50} There is evidence that a compensation package that emphasizes stock returns results in management decisions more in the interests of shareholders. Masson, Executive Motivations, Earnings, and Consequent Equity Performance, 79 J. Pol. Econ. 1278, 1289 (1971).

\textsuperscript{51} The concept that it can be in the interests of both shareholders and management to develop an incentive structure that limits management discretion derives from agency theory. See Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).
D. Choosing the Appropriate View for the Making of Policy

Which of these three views of the securities market is the most appropriate for the making of regulatory policy? The first view, the market as Las Vegas, is clearly too narrow. The proportion of publicly traded securities held by institutional investors, such as insurance companies, pension trusts, and conservative, income-oriented mutual funds, is sufficient evidence that the market serves a function beyond speculation.

The second view, which takes account of the function of the market as a place to store savings, would, as we have seen, be sufficiently broad if all that occurred in the market for securities were secondary trades of previously issued securities, no one ever made a purchase of a security with a desire to acquire control of its issuer, and no executive received stock price based compensation. But none of these assumptions are valid.

It is clear that the third, broadest view should be the one on which policy is based. Only this view adequately accounts for the socially desirable mechanisms of cost of capital, the market for corporate control, and stock price based compensation schemes. The only way to avoid this conclusion is to argue that, as a practical matter, the securities market has through these mechanisms only a de minimis effect on choices concerning the implementation of investment projects and the utilization of existing productive capacity.

The claim that the price of an issuer's securities has little effect on whether it will engage in any particular investment project reflects a respectable intellectual tradition. The late A.A. Berle, for example, argued twenty years ago that because large corporations generate most of their capital expenditure funds from internal sources, and because most trades in the stock market are secondary, the market is more appropriately considered as an allocator of wealth among its participants than as an allocator of capital among business enterprises. More recently, Professor Homer Kripke, picking up on the same theme, has argued that SEC-mandated dis-

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closure does not affect allocational efficiency in the economy. These commentators made too hasty a judgment.

To start, the absolute amount of investment funds raised by corporations through public offerings of new securities, over seventy-two billion dollars in 1982, is very large, even if most corporate investment funds are internally generated. Moreover, a significant portion of all large corporations do, in fact, raise some investment funds through public offerings of new securities. It is ironic that Professor Banoff chose to apply her argument using portfolio theory to the value of Securities Act disclosure, rather than to the value of Exchange Act disclosure. Whatever the effect of securities prices on the investment behavior of firms that do not engage in any public offerings, it is much harder to argue that prices have no such effect on those that do—the target group of the Securities Act registration process.

Even in the case of firms that do not engage in any external financing, the prices of their securities would still influence their investment behavior. Assuming that management of such a firm is interested in maximizing shareholder welfare, management would take the firm’s securities prices into account when calculating the firm’s cost of capital. Of course there is the question of how interested the management is in maximizing shareholder welfare, but that question simply shifts our attention to the other two mechanisms whose effectiveness depends on individual share price accuracy: the market for corporate control and stock price based management compensation. As was shown, these mechanisms limit management discretion not only in making investment choices, but also in deciding how to use existing productive capacity. Despite the limitations of these mechanisms for aligning management and shareholder interests, it is hard to deny their importance in the economy. A casual reading of the newspapers will reveal that even

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84 H. Kripke, supra note 39, at 134-39. Berle must have been chagrined that his argument was turned around against the government regulatory efforts he helped to create and later continued to support. See Berle, supra note 53, at 433-35.
86 A computer search of SEC filings, conducted at the request of the author by Disclosure, Inc., revealed that 190 of the “Fortune 500” largest companies in the United States filed at least one S-1, S-2, or S-3 registration statement during the 18 month period from May 1982 through November 1983.
87 See supra note 34 and accompanying text.
the managements of the largest U.S. corporations are not insulated from the fear of a hostile takeover. There is evidence that in large corporations a significant share of top managers' compensation is stock price based.\textsuperscript{88}

What happens in the securities market is important to real economic events, and not just to those who trade.\textsuperscript{99} Improved information about individual issuers increases the expected accuracy of the prices of their securities. Increased price accuracy improves the functioning of the mechanisms that link the market with these real events and enhances the efficient allocation of resources. Policymakers should keep these effects in mind when considering rules that might affect price accuracy. In particular, integrated disclosure should be scrutinized to see whether it will reduce the amount and quality of information available to the market by reducing underwriter due diligence.

II. THE EFFECT OF THE INTEGRATED DISCLOSURE PROGRAM ON UNDERWRITER DUE DILIGENCE

A. Changes in the Environment in Which Due Diligence Occurs

The integrated disclosure program will substantially affect the environment in which an underwriter conducts due diligence. Because most of the short form S-3 consists of material incorporated by reference from an issuer's Exchange Act filings that in long form registrations was set out in full,\textsuperscript{60} the underwriter no longer plays a role in drafting these parts of the S-3 at the time of registration.\textsuperscript{61} In theory, the underwriter can ask that incorporated lan-

\textsuperscript{88} Information gathered by Lewellen on the compensation of the five top managers of each of 50 large U.S. corporations showed that during the period 1940-1963, the average yearly ratio of the total dividends, capital gains and changes in the value of stock options accruing to these executives compared to their total salary, bonuses, and noncontributory pension benefits was, on an after tax basis, 1.36. W. Lewellen, The Ownership Income of Management 103 (1971).

\textsuperscript{89} One should not only that to the extent that the overall economy improves, investors as a group are better off.

\textsuperscript{60} See supra note 8.

\textsuperscript{61} The drafting of the long form registration statement was a group exercise involving the issuer, the underwriter, and their respective counsel. The first draft, which was usually prepared by the issuer, might in many places track the language of the issuer's annual Exchange Act filing (the 10-K), but there was a general understanding that none of the language was sacred, and the underwriters and their counsel participated in redrafting the
guage be explicitly corrected, either by an 8-K filing or in the registration statement itself, but an issuer is likely to resist strenuously. A correction implies that one of its prior filings was somehow defective.62 The short form increases the speed with which securities may be offered to the public. It takes very little time to prepare an S-3 registration statement and, once filed, it can become effective in as little as forty-eight hours.63 A process that once inevitably took a few weeks to a few months now can be undertaken in a few days, a period far shorter than underwriters traditionally devoted to due diligence. In the past, the active participation of the underwriter in the drafting of the registration statement, combined with the extensive examination of the company permitted by the time schedule, interacted to create a process that often by the final draft revealed a great deal about the issuer not revealed in its Exchange Act filings.64 The universal view of those who have commented on this process is that it frequently resulted in significant additional disclosure.65

Shelf registration accentuates the effects of these changes in environment. There is unlikely to be even minimal underwriter involvement in preparation of the registration statement that occurs with a non-shelf-registered S-3. The issuer can name several potential managing underwriters in its registration statement (without their permission), and then select one to underwrite any particular block of shares when the issuer decides to offer it.66 Securities can be offered to the public within hours of being taken off the shelf,

registration statement on a line-by-line basis. There was a concern in the sequence of presentation both with providing appropriate emphasis for particularly material facts and avoiding the presentation of facts out of context. For a good description of the traditional registration process of a public offering of securities, see Pryor & Smith, Significant Changes in Primary Stock Distributions over the Last 25 Years, Nat'l L.J., Aug. 9, 1982, at 21, 39-41. See also Fortenbaugh, Underwriters' Due Diligence, 14 Rev. Sec. Reg. 799, 805 (1981); Hovdesven & Wolfram, Underwriter Liability in the Integrated Disclosure System, Nat'l L.J., July 5, 1982, at 13, col. 1.


63 Nicholas, supra note 13, at 21.

64 Nicholas, supra note 13, at 15; Hovdesven & Wolfram, supra note 61, at 13, col. 4.

65 Nicholas, supra note 13, at 15; Hovdesven & Wolfram, supra note 61, at 13, col. 4.


66 The underwriter may, of course, decline to participate in the offering.
with the chosen underwriter being deprived of even the few days in which to conduct a due diligence investigation that would be available with a non-shelf-registered short form offering.

In response to criticisms that this change in environment would impede due diligence, the SEC has suggested that interaction between the issuer and the underwriters will occur when the 10-Ks, 10-Qs, and 8-Ks are drafted. The disciplining effect of due diligence on disclosure traditionally associated with the drafting of Securities Act registration statements will instead become associated with the drafting of an issuer's Exchange Act filings. The speed with which public offerings can be consummated need not impede due diligence, because the underwriter will already be examining the issuer on a regular basis.

There are, however, reasons to believe that underwriters will not often participate in the drafting of Exchange Act filings, and that when they do, the nature of their participation will differ from what it has been in the drafting of traditional registration statements. In most cases, neither the issuer nor any particular investment bank can be confident, when an Exchange Act filing is drafted, that the issuer will engage in a public offering with the investment bank in question as managing underwriter. The more distant relationship between the issuer and the banker may deter the issuer from providing "soft" confidential information, as well as increase its resistance to underwriter intrusion in the drafting of what the issuer considers to be "its" document. Because the investment bank is far from certain to receive any return for its efforts, it, in turn, will invest fewer resources in drafting documents and in examining the firm than it would with a traditional registration.

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68 Nicholas, supra note 13, at 34; Hovdesven & Wolfram, supra note 61, at 15, col. 1.

69 Professor Banoff suggests that for shelf registrations "the most convenient method of conducting continuing due diligence" is for the issuer to hire special counsel for the underwriters at the time of registration. Banoff, supra note 1, at 177 n.199. This hardly seems an adequate substitute for the traditional process. To start, because they lack financial expertise, lawyers acting alone do not constitute as effective an investigatory team as lawyers and investment bankers acting together. Moreover, despite a law firm's concern with its professional reputation and ethics, it is hard to conceive that the firm is as eager, when it represents a phantom client, to investigate the very issuer that selected it as the firm is when it represents a real client and is selected by that client.
Nor is the bank as likely to ask pointed, potentially antagonizing, questions of a potential issuer that has little at stake in this relationship and that remains free to consummate its offering with a more deferential underwriter.

Evidence confirms the limited extent of underwriter participation in the preparation of Exchange Act filings. A survey of issuers conducted by the Securities Industries Association (SIA) in 1982 revealed that only thirteen percent involved underwriters, and only twenty-four percent involved underwriter’s counsel, in preparation of their 10-Ks. The respective percentages were much lower for 10-Qs and 8-Ks. Of those issuers that did not involve underwriters in the preparation of their Exchange Act filings, only twenty-two percent expressed a willingness to do so in the future. These rather dramatic findings may, however, need to be discounted to some extent because the SIA actively opposed Rule 415 and conducted this survey in preparation for its testimony concerning the rule.

B. Information Availability and the Current Standard of Underwriter Liability

The changed environment in which due diligence will occur, and the probable lack of underwriter participation in issuers’ Exchange Act filings, do not by themselves prove that the quality of issuer disclosure will suffer under an integrated disclosure program. As the SEC argues, “nothing compels an underwriter to proceed prematurely with an offering,” and an underwriter can delay a public offering until it has conducted a thorough investigation of the issuer and obtained whatever additional disclosure that investigation suggests is necessary. So long as the standard of underwriter liability under Section 11 remains unchanged, the legal consequences of an inadequate investigation remain the same.

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70 Nicholas, supra note 13, at 33-34 n.92.
71 Id.
72 Id.
73 Banoff, supra note 1, at 155; Nicholas, supra note 13, at 33-34 n.92.
Potential liability, however, is only one item that an underwriter will consider when deciding how much due diligence to exercise. Integrated disclosure involves other changes to which a rational underwriter will react. The language now incorporated by reference in an S-3 would, in a traditional registration, have been included as part of the prospectus, the part of the registration statement distributed to thousands of investors and market professionals. The prospectus has on its cover the name of the managing underwriter in letters almost as bold as those used for the name of the issuer. Thus, the underwriter's reputation was more closely associated with this language when it was included in the prospectus than it is now. Another consideration is that performing the traditional amount of due diligence would now cause a significant delay of the offering. Under the previous regime, due diligence did not act as a brake, because the registration procedures required considerable time in any event. An issuer operating under integrated disclosure, however, will see due diligence as an impediment, in an increasingly volatile market, to exploiting perceived short-lived windows of financing opportunity. Given the cost of the delay in the eyes of the issuer, it may be rational for the underwriter to proceed to market with less due diligence to avoid losing the deal.

The forgoing discussion assumes that underwriters will react in a rational fashion to changes in the environment, but such an assumption is questionable. Assuming participation by an underwriter in the drafting of Exchange Act filings is limited or nonexistent, the level of disclosure resulting from these filings will be less than was the case with a traditional registration statement. An issuer, as this article has shown, will be reluctant to grant an underwriter involved in an S-3 registration the time to conduct a thorough inves-

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7 In connection with a comment letter on a component of the integrated disclosure program, Morgan Stanley & Co. collected data on 20 year treasury note weekly yields during each year from 1971 to 1980. The average of the standard deviations for the last three years of the period was almost three times that of the average for the first three years of the period. Greene, supra note 5, at 789. To the extent that firms are risk neutral, the increased volatility of the market should make no difference, because at any given time interest rates are as likely to decrease as increase. Fama, supra note 17, at 400-01 (reporting on a study by Roll showing that the market for treasury bills is efficient). Casual empiricism suggests, however, that firm managers do feel that certain market conditions create temporary financing opportunities, and they prefer to be able to act quickly to take advantage of such conditions.

76 See supra note 8.
tigation or to agree to make additional disclosure through language in the registration statement superseding what otherwise would be incorporated by reference or through the filing of an 8-K. To the extent that an underwriter insists on obtaining this additional time and disclosure, it will be only out of fear of liability. Christopher Stone, in his work on enterprise liability, argues persuasively that large organizations tend not to act rationally when calculating the tradeoff between short-run gain (in this case, getting the issuer's business) and an increased risk of future liability for damages (in this case, having to accept the issuer's terms concerning due diligence in order to get the business). Furthermore, at least for the next few years, the possibility of liability will seem to underwriters more remote than it actually is. In the past there have been relatively few cases where an underwriter has had to pay out large damages for a Section 11 claim. The present historical record is the product of a period when underwriters played a traditional due diligence role.

C. Effect on the Standards of Underwriter Liability

The assumption made above that integrated disclosure will have no effect on the standards of underwriter liability is, in any case, probably incorrect. Section 11(c) of the Securities Act provides that the standard for judging the reasonableness of an underwriter's investigation and belief in the truth of the registration statement is that of a "prudent man in the management of his own property." Legislative history suggests that the conduct necessary for an underwriter to be entitled to the due diligence defense de-

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78 Of the 30,000 registration statements filed during the first 35 years after the enactment of the Securities Act, there were only 23 cases giving rise to a Section 11 claim; of these, only two resulted in recoveries for plaintiffs, and six in approved settlements of class actions. See L. Loss, supra note 8, at 1040; Greene, supra note 5, at 770. For a discussion of the more recent cases, see id. at 770-81.
79 There is some evidence, again from the Securities Industry Association, that the integrated disclosure program has in fact reduced the amount of underwriter due diligence. SIA surveyed underwriters in July 1982 and found that only nine percent of underwriters believed they were performing as much due diligence as two years before. Nicholas, supra note 13, at 33-34 n.92. See also supra note 73 and accompanying text.
pends on the surrounding circumstances. One circumstance that might be relevant is whether an underwriter is the one managing the issue or a minor participant in a syndicate selling the issue. Similarly, Rule 176 provides in part that in determining the reasonableness of a person's conduct for purposes of Section 11(c), relevant circumstances include "[w]hether, 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." Obviously, an underwriter would generally not have any such responsibility.

The likelihood that integrated disclosure will lower standards of liability is reinforced by the tendency of most courts to be influenced by prevailing behavior when deciding whether a particular act is reasonable. If, for any of the reasons discussed above, inte-

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81 This language was added to the Act one year after its passage. The amendment substituted the accepted common law definition of fiduciary duty for the term "fiduciary relationship," because the latter term had been "terrifyingly portrayed." 78 Cong. Rec. 8669 (1934). See Greene, supra note 5, at 767-70, 794.

82 There is some authority to support the argument that the managing underwriter must engage in a more thorough investigation because of its close contact with the issuer. Greene, supra note 5, at 775-78, 794-800.


84 17 C.F.R. § 230.176(h) (1984). An SEC rule of this sort, which in essence interprets a provision of a statute, is not binding on courts, but courts, out of deference to expertise, do give considerable weight to the interpretations of the agency charged with administering a statute. In International Bhd. of Teamsters v. Daniel, the Supreme Court stated:

It is a commonplace in our jurisprudence that an administrative agency's consistent, longstanding interpretation of the statute under which it operates is entitled to considerable weight. This deference is a product both of an awareness of the practical expertise which an agency normally develops, and of a willingness to accord some measure of flexibility to such an agency as it encounters new and unforeseen problems over time.

439 U.S. 551, 566 n.20 (1978) (citations omitted). In that case, the Court went on to reject the SEC's interpretation, noting the Court's "obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history." Id. But the Court has cited SEC interpretations as authority in support of the Court's positions in other cases. See, e.g., United States v. National Ass'n of Sec. Dealers, 422 U.S. 694, 717-19 (1974).

85 The concepts of a "reasonable investigation" and a "reasonable ground to believe" under Section 11(b) have as their common law origins the concept of nonnegligence in tort, conduct which does not involve an unreasonably great risk of causing damage. L. Loss, Securities Regulation 1729-30 (2d ed. 1961). Prosser states:

[E]vidence of the usual and customary conduct of others under similar circumstances is normally relevant and admissible [evidence with respect to the issue of negligence], as an indication of what the community regards as proper, and a composite judgment
grated disclosure results in less due diligence activity, over time courts will require less of underwriters seeking to avoid liability.

III. CONCLUSION

The preceding discussion leads to two conclusions. The improvement in the quality of information about an issuer that results from underwriter due diligence enhances efficient allocation of resources in the economy. Short form and shelf registration—the heart of the integrated disclosure program—can be expected to reduce the amount of due diligence underwriters perform, and therefore reduce the benefits to the economy that flow from that activity.

The real issue concerning due diligence these reforms raise is whether the benefits of the traditional level of underwriter due diligence are worth their accompanying costs. Professor Banoff and the SEC both avoid confronting this issue. Professor Banoff accepts that the reforms may reduce the level of due diligence, but by implicitly taking an erroneously narrow view of the functions of the securities market, denies that due diligence produces any benefits. The SEC acknowledges the value of the improvement in the quality of information resulting from due diligence, but denies that its reforms would reduce the level of underwriter due diligence. It suggests that an underwriter can continue to perform its traditional level of due diligence by substituting participation in the drafting of an issuer's Exchange Act filings for its participation in the drafting of the registration statement. It points out that no underwriter is forced to bring an offering to market before it feels it has completed as thorough an investigation of the issuer as it traditionally conducted. Both these arguments are unpersuasive.

A great deal is at stake with these reforms. In 1982, business expenditures in the United States for plant and equipment exceeded $328 billion, and the privately generated portion of the gross national product exceeded $2.7 trillion. Firms that qualify

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as to the risks of the situation and the precautions required to meet them.


86 U.S. Bureau of the Census, supra note 55 at 540, Table 907 (103d ed. 1982) (estimate).

87 Economic Report of the President, at 232, Table B-10 (Feb. 1984). This figure comes from deducting the amount for government and government enterprises from the total gross national product.
as S-3 issuers make decisions concerning significant portions of these vast amounts of investment and production. A very small relative decline in the efficiency of choices concerning new investment projects and the uses of existing capacity will have a very large negative effect, measured in absolute terms, on economic welfare. Changes that might have an adverse effect on allocational efficiency should be undertaken only with great caution, particularly given how well the traditional system of registering new issues of securities has served the economy for the past fifty years.

The SEC should reconsider the integrated disclosure program by facing squarely the real issue raised here. If, as seems likely, the Commission cannot after study confidently predict that cost savings from reduced due diligence will exceed the inevitable reduction in the economy's allocational efficiency, the Commission need not necessarily conclude that it should move backwards and scrap a program with a number of positive features. Rather, it should conclude that the reforms are incomplete. The disclosure systems of the Securities Act and the Exchange Act have not been fully merged. Exchange Act filings have become the central disclosure

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88 See supra note 43.
89 See supra note 43.
There is a considerable body of theoretical literature concerning whether a corporation will voluntarily provide the market with as much information as is cost justified in terms of the resources required to collect, package and disseminate it. One article suggesting it will is Jensen & Meckling, supra note 51. Cf. Easterbrook & Fischel, supra note 37, at 680-87 (discussing incentives to disclose and the limitations on any self-interest model of disclosure). But see Coffee, supra note 37 (concluding that efficiency based arguments may support a mandatory disclosure system). If that position is correct, obviously the benefits from the additional disclosure resulting from the traditional level of underwriter due diligence are not worth the extra costs. There is also a body of empirical literature concerning whether the Securities Act and the Exchange Act have had a meaningful effect on the level of corporate disclosure. Compare Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Econ. Rev. 132 (1973); Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 117 (1964) (suggesting they have not), with Friend & Herman, The SEC Through a Glass Darkly, 37 J. Bus. 382 (1964) (suggesting they have). A survey of both bodies of literature is found in Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1 (1983). It is fair to say that opinion on the question is divided. Certainly, there are some good reasons why the management of an established corporation might sometimes choose not to disclose material information even though to do so would not require a significant expenditure of resources. Arguments made concerning why a firm might not voluntarily release favorable information—fear that information would be of value to a competitor or to someone considering a takeover attempt—apply as well to why they would not supply both favorable and unfavorable information even where a policy of doing so would on average enhance share price. See supra note 37.
documents of the reformed system. But the issuer preparing these filings is not subjected to the unique pressures for disclosure that result from the participation of an underwriter subject to Section 11 liability. To complete the reform, the SEC should develop a plan requiring issuers to hire an investment bank to participate in the preparation of the issuer's Exchange Act filings. If the filing turned out to contain materially false or misleading statements or omissions, the bank would face liability for a substantial amount of damages that could be avoided only by a Section 11-type due diligence defense.90 Integrated disclosure would then become a reform that raises the quality of disclosure in issuers' periodic reports to the level traditionally associated with the registration of public offerings, instead of one that lowers the quality of disclosure at the time of a public offering to the level traditionally associated with periodic reports.

90 The conclusions of this article also support statutory changes in accordance with section 1704 of the American Law Institute's proposed Federal Securities Code, which would impose liability for damages, subject to a due diligence defense, on an issuer's principal executive officers and directors if the issuer's annual report filed with the SEC contained a misrepresentation or an omission of a material fact. This article also suggests that repeal of Rule 176 would be desirable. See supra note 83 and accompanying text.