THE MARKET FOR SECURITIES AND ITS REGULATION THROUGH GATEKEEPERS

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ABSTRACT

The financial scandals of the last decade have called into question the effectiveness of the system of securities regulation in many countries. Articles that have examined the origins of the regulatory crisis have concluded that the classical tools of corporate governance used for the supervision of management have lost their force in light of new incentive structures in the financial markets. They see as the solution to the regulatory lacunae the use of financial intermediaries and other market participants as gatekeepers or agents that ensure compliance of the primary market actor (the issuer) with applicable rules by reviewing its disclosures and withholding their participation in transactions if violations occur. However, commonly acknowledged contours of gatekeeper liability have not yet emerged. Furthermore, the discussion is largely confined to an abstract analysis of the advantages and disadvantages of the gatekeeper theory without asking whether the legislative measures that are in force may be construed in a way that facilitates considerations of the theory. This comment undertakes to remedy the omission. It conducts a comprehensive analysis of the U.S. and European regulation of the market for securities, identifies deficiencies and suggests a new approach to solve one of the major conundrums of the current discussion—the standard of care that the gatekeeper should be held accountable for when reviewing the acts of the primary market participant. The comment concludes by advancing a tentative explanation of certain trends of convergence between U.S. and European regulatory mechanisms that can be observed.

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I. INTRODUCTION

Securities regulation has come under increased criticism in recent years. Beginning with the major accounting scandals in the United States and Europe in the late 1990s and the first years of the new millennium,[1] a significant increase in the number of financial restatements announced by publicly listed companies over the last decade,[2] the dotcom bubble, the disappearance of a whole market segment of the Frankfurt Stock Exchange in 2003,[3] and finally the stock market crash and

1. Names such as Enron, WorldCom, Global Crossing, Cendant, or Tyco in the United States and Parmalat in Europe have come to epitomize the failure of the regulatory system.

2. U.S. Gov't Accountability Office, GAO Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate: Financial Statement Restatements – Trends, Market Impacts, Regulatory Responses, and Remaining Challenges (2002), GAO-03-138, at 14-22 *passim*, *available at* http://www.gao.gov/new.items/d03138.pdf; Gov't Accountability Office, GAO Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate: Financial Restatements – Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities 11-19 (2006, reissued March 2007), *available at* http://www.gao.gov/new.items/d06678.pdf. The GAO identified ninety-two restatement announcements for 1997. Through September of 2005, the number had grown to 523. Similarly, the GAO identified eighty-four listed companies on NYSE, Amex and Nasdaq that restated at least once in 1997. In 2005 (through March for NYSE and Amex-listed companies, and through June for Nasdaq-listed companies), that number had grown to 439 companies.

3. Mark Landler, *German Technology Stock Market to Be Dissolved*, N.Y. TIMES, Sept. 27, 2002, at W1. The Frankfurt Stock Exchange opened an entrance standard for new economy companies in March 1997 that was named the New Market. In the first years of its existence, the New Market enjoyed unprecedented growth; in the time from 1997 to March 2000 the market share index rose from 1,000 points to almost 10,000 points. A few months later the dotcom bubble burst and the first issuers filed for bankruptcy. By October 2002, the share index had fallen to 318 points, annihilating €200 billion of shareholder value. The Frankfurt Stock

the demise of the investment bank in 2008, investors have lost their faith in the integrity of the financial markets. The regulatory response to such excesses can operate from two angles. It can stress the role and the competences of the public regulator or fashion a system of private obligations that requires market actors to supervise each other. This comment explores the latter approach: the enhancement of investor protection through private parties.

Many articles and treatises that have examined the origins of the regulatory crisis have concluded that the classic tools of corporate governance for the supervision of management—notably the outside director or, in companies with a two-tier board structure, the supervisory board—have lost their effectiveness in light of new incentive structures in the financial markets and an increased fixation of management on short-term share price maximization.[4] These authors conclude that the solution to the regulatory lacunae is to utilize financial intermediaries and other market participants as gatekeepers and agents that ensure compliance of the primary market actor ("the issuer") with applicable rules by reviewing its disclosures and withholding their participation in transactions if violations occur. This concept was developed by Rainier Kraakman in the 1980s.[5] Its general usefulness is now widely accepted in the United States.[6]

Exchange discontinued the operation of the New Market shortly thereafter (in June 2003). The ensuing investigations uncovered widespread instances of falsification of financial statements and disclosure of incorrect, often entirely imaginary issuer-related information. The fraudulent behavior triggered lawsuits associated with names such as EM.TV, Comroad, and Infomatec that have begun to transform German securities regulation.

4. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 327-28 (2004) (explaining this transition, *inter alia*, with the rise of stock-option based remuneration).

5. Rainier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 868, 888-97 (1984) [hereinafter Corporate Liability Strategies]; Rainier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 54 (1986) [hereinafter Kraakman, Gatekeepers].

6. *See e.g.*, JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE *passim* (Oxford 2006) [hereinafter Coffee, Gatekeepers]; James D. Cox, *The Oligopolistic Gatekeeper: The US Accounting Profession, in* AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE U.S. 269-316 (John Armour and Joseph A. McCahery eds., 2006); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, 793-96 (2001); Rutherford B. Campbell & Eugene R. Gaetke, The *Ethical Obligation of Transactional Lawyers to Act as Gatekeepers*, 56 RUTGERS L. REV. 9, 63 (2003); Stephen Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 584-87 (1997); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 917 (1998); John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXF. REV. ECON. POL'Y 198, 198-200 (2005); John C. Coffee, Jr., *supra* note 4, at 309 ; John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269, 280 (2004); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid"*, 57 BUS. LAW. 1403.1413-16 (2002); John C. Coffee, Jr., *Brave New World? The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1212-13 (1997); Jill E. Fisch & Kenneth M. Rosen, *Is there a Role for Lawyers in Preventing Future Enrons*?, 48 VILL. L. REV. 1097, 1099 (2003); Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate*

In Europe, on the other hand, the legal community largely ignores the insights developed by the gatekeeper theory when drafting and construing financial market regulations.[7] In addition, and despite voluminous U.S. literature, commonly acknowledged contours of gatekeeper liability have not yet emerged. Controversies exist, particularly, in identifying the class of suitable gatekeepers and the standard of care for the gatekeepers when reviewing the acts of the primary market participant.[8] Furthermore, commentators often confine themselves to abstract discussions of the advantages and disadvantages of the gatekeeper theory without asking whether the legislative measures that are in force may be construed in a way that facilitates considerations of the theory.

This article undertakes to remedy the lack of commentary regarding the ways in which current legislative measures may be construed to improve the effectiveness of securities regulation by means of gatekeeper liability. It conducts a comprehensive analysis of the regulation of the securities' markets in both the United States and Europe and tries to ascertain whether provisions for the protection of investors are based on, or can be interpreted in light of, the gatekeeper theory. The inquiry first addresses allegations that the potential liability of financial intermediaries is, on the one hand, unnecessary as market forces are capable of ensuring an optimal supervision of the primary market participant by the gatekeeper; and on the other hand, harmful since the risk of liability increases the cost of capital (II). It then analyzes the current regime of securities regulation in the United States and in Europe (III). As far as the legal situation in Europe is concerned, the article focuses on English and German national law with references to the applicable European Community ("EC") directives and regulations. The comparative analysis (IV) helps to identify provisions that are conducive to investor protection and the gatekeeper theory, or that create inefficiencies.

In its discussion of ways in which to construe current legislative measures to facilitate considerations of the gatekeeper theory, this article presents an opportunity to address the controversial issue of the adequate standard of care to be applied to gatekeepers, which is defined differently in each of the countries under investigation. In addition, the European regulatory regime may profit from a comparative analysis in view of the high level of detail and enforcement that

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Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. PA. L. REV. 1147, 1149-51 (2006); Assaf Hamdani, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS. 45, 58 (2000); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 496-500 (2001); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 366-68 (2004); Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 139-41 (2004); Noam Sher, *Negligence versus Strict Liability: The Case of Underwriter Liability in IPO's*, 4 DEPAUL BUS. & COM. L.J. 451, 453-54 (2006); John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* (Columbia Law and Economics Working Paper No. 191, 2001), *available at* http://papers.ssrn.com/id=270944;

7. An exception is KLAUS J. HOPT, DIE VERANTWORTLICHKEIT DER BANKEN BEI EMISSIONEN [The Responsibility of Banks in Public Offerings] 33-37 (1991).

8. *See infra* IV(B)-(D).

characterizes the U.S. system.[9] In the United States, Congress and the Securities and Exchange Commission ("SEC"), the supervisory authority that has rule-making powers under the Securities Acts,[10] regulate all aspects of disclosure and governance. The plethora of rules these two bodies have created have been vigorously enforced for many decades and therefore have had the opportunity to stand the test of time—as opposed to certain measures of European provenance that, while dating back as far as the 19th century, have rarely been invoked by investors or applied by the courts.[11] The U.S. practitioners and legal scholars are able to take recourse to an extensive body of case law that interprets and develops the codified rules, whereas in Europe litigation has been scarce until recently. Finally, the conclusion (V) will provide a summary of the findings and advance a tentative explanation of certain trends of convergence between U.S. and European regulatory mechanisms that can be observed.

II. THE MARKET FOR SECURITIES

A. Market Competitiveness and Transparency

Some scholars have alleged that the regulation of financial intermediaries and, for that matter, the whole financial sector, impedes the efficient allocation of risks and thus increases the cost of capital.[12] It is argued that market forces constitute a sufficient incentive for market participants to act with due diligence.[13] Intermediaries, for example, rely on their reputation in attracting business.[14] Investment banks that market securities of a low-quality issuer as a high-quality investment will damage their reputation as investors, in relying on the underwriter's assessment of the issuer's financial position, suffer a loss.[15] In future

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9. *See infra* III(A).

10. *E.g.,* Securities Act of 1933 §§ 3(b), 7, 10, 19(a), 28, 15 U.S.C. §§ 77c(b), 77g, 77j, 77s(a), 77z-3 (2007); Securities Exchange Act of 1934 §§ 9(a)(6), 9(b), 10(b), 15 U.S.C. §§ 78i(a)(6), (b), 78j(b) (2007).

11. A good example is the German Stock Exchange Act (Börsengesetz) of 22 June 1896, RGBl. [Imperial Law Gazette] at 157, with its rules on prospectus liability (sections 44, 45 of the Act). After the Imperial Court (Reichsgericht) had relied on the provisions in a few cases to accord defrauded investors damages (RG BankArch 1910/11, 123; RGZ 80, 196), the last one dating from 1912, it was to take seventy years for the first major recovery to occur (BGH WM 1982, 862 – Beton- & Monierbau).

12. George J. Benston, CORPORATE FINANCIAL DISCLOSURE IN THE UK AND THE USA 133-34 (Saxon House 1976); Henry G. Manne, INSIDER TRADING AND THE STOCK MARKET 163-170 (The Free Press 1966); Henry G. Manne et al., WALL STREET IN TRANSITION (New York University Press 1974); George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 133-34 (1973); George J. Benston, *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code*, 33 U. MIAMI L. REV. 1471, 1471 (1979); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 120, 129 (1964).

13. Kraakman, Gatekeepers, *supra* note 5, at 94.

14. *Id*.

15. *Id.* at 97.

offerings, the investment banks will not be able to sell the securities they have underwritten—even those of a high-quality issuer—without a discount. This, in turn, will require the banks to charge the issuers lower fees. Thus, the quality of the underwriters' due diligence procedures (and, in analogy, the due diligence of other financial intermediaries) has a bearing on their market position and revenue.[16]

This analysis, however, holds only if two conditions are satisfied: The market has to be competitive; and be sufficiently transparent to enable the recipients of financial services (investors that buy securities, and the issuers that employ the intermediary) to distinguish between high-quality and low-quality providers of services. These two constraints will be dealt with in turn.

The degree of competitiveness of a market depends on three factors:[17] (1) the number of firms competing in the market,[18] (2) product homogeneity[19]and (3) the costs of entry to and exit from the market. For the two most important intermediaries in the securities market, the underwriter and the auditor, these factors indicate a low level of competitiveness.

The market for auditing services is highly concentrated. After the dissolution of Arthur Andersen in 2002, four major auditing firms remain in the market and are responsible for the auditing services of approximately eighty percent of all public companies in the United States and in Europe.[20] While the market for

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16. *Id*.

17. *See generally* Robert S. Pindyck & Daniel L. Rubinfeld, MICROECONOMICS 262-63 (6th ed. 2005).

18. *See generally id*. (a highly competitive market requires firms and consumers to be price-takers, i.e. to command such a small market share that they cannot influence the price by reducing or increasing output or consumption).

19. *Id*. (the products must be substitutable with one another, such that no firm can raise the price of its products above market average without losing much of its business).

20. *See* GOV'T ACCOUNTABILITY OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION 16 (2003) *available at* http://www.gao.gov/new.items/d03864.pdf. [hereinafter U.S. GOV'T ACCOUNTABILITY OFFICE] (indicating that in the United States, the top four firms (Ernst & Young, Deloitte & Touche, KPMG, and PricewaterhouseCoopers) have audited seventy-eight percent of all public companies, ninety-seven percent of all public companies with sales over $250 million, and ninety-nine percent of all public company sales in 2002); *Id.* at 19 (using the Hirschman-Herfindahl Index (HHI) as a benchmark for market concentration, an HHI of or above 1,800 indicating a highly concentrated market. The HHI has increased to 2,566 following the dissolution of Arthur Andersen); *Id.* at 110-33 (explaining that, in addition, audit firms tend to specialize on industry sectors. Therefore, the concentration in some sectors is even higher, with only two firms auditing more than eighty percent, and often up to ninety or ninety-five percent of the assets in the industry)*; see also* Robert Bloom & David C. Schirm, *Consolidation and Public Accounting: An Analysis of the GAO Report,* CPA JOURNAL, June 2005, *available at* http://www.nysscpa.org/cpajournal/2005/605/infocus/p22.htm; *and see* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra*, at 6 (concluding that due to the high costs associated with the staff, technical expertise, and global reach necessary to audit large and complex national and multinational public companies, barriers to entry into the market for such companies are significant).

For Europe *see* LONDON ECONOMICS, STUDY ON THE ECONOMIC IMPACT OF AUDITORS' LIABILITY REGIMES (2006). London Economics, commissioned by the DG Internal Market and Services of the European Commission, has analyzed the concentration of the audit market in the services provided by underwriters is less concentrated than the audit market, it also exhibits oligopolistic tendencies. The number of firms underwriting large offerings is low; the costs of entry are high.[21] Therefore, it is questionable whether the

EU and concluded that the market is highly concentrated in most Member States. In the majority of EU states, the top four firms audit ninety percent or more of the companies listed in the main index of the national stock exchanges. For the four biggest economies, the rate of concentration was determined as follows (percent of total number of mandates): In Germany, ninety-seven percent; in the United Kingdom, ninety-nine percent; in France, seventy-three percent; in Italy, one hundred percent. The HHI for the countries was 4022, 2912, 1818, 2662, respectively, far above competitive levels. *Id.* at 20. If all companies listed on regulated national stock exchanges are considered, the concentration index by number of mandates falls to sixty or below in some cases (e.g., Germany fifty-five, France forty-two), but remains at seventy or higher on average. *Id.* at 22-23. The degree of concentration is even more pronounced if the index is based on the revenues audited: The top four firms audit more than ninety percent of the revenues of listed companies in most Member States; the HHI is above the concentration threshold in all but three States. *Id.* Barriers to entry into the audit market in Europe are as significant as in the United States. *Id.* at 40-47.

21. *See* Nicola Cetorelli et al., *Trends in Financial Market Concentration and Their Implications for Market Stability*, 13 FRBNY ECON. POLICY REV. 33, 38 (March 2007), *available at* http://www.newyorkfed.org/research/epr/07v13n1/0703hirt.pdf (showing that in the United States, the five largest investment banks underwrote more than sixty percent of all IPOs and fifty percent of debt offerings in the years 1990 to 2004); s*ee also* HAROLD S. BLOOMENTHAL, GOING PUBLIC HANDBOOK § 3:01 [1][4](c)(v) (2008-2009) (pointing out that while investment banks actively compete for underwritings, the composition of underwriting syndicates is largely static: "[L]ong-standing relationships tend to develop between [the issuers] and their 'investment bankers' who invariably acted as their managing underwriter." One sentence later, he speaks of "almost historic, relationships."); JAMES D. COX, ET AL, SECURITIES REGULATION 125 (5th ed. 2006) (indicating that the investment industry's capital is equally concentrated. In 2004, the six largest firms accounted for seventy-seven and one half percent of the capital).

The situation in Europe is comparable. The market for underwritings in Germany may serve as an example. In 2006, only three investment houses participated as lead underwriters in five or more offerings of a total of thirty-five IPOs on the regulated market of the Frankfurt Stock Exchange (namely, Deutsche Bank, Sal. Oppenheim jr. & Cie., and UBS). Based on the total number of lead underwriter positions in these offerings, the three banks had a market share of thirty-one percent. The concentration index rises to forty-three percent if the five largest institutions are taken into consideration, thus crossing the threshold of forty percent that commonly indicates an oligopolistic market, and to forty-nine percent for the six largest banks . FRANKFURT STOCK EXCHANGE, PRIMARY MARKET STATISTICS 2006, http://deutsche-boerse.com (follow "Listing" hyperlink, then "Statistics" hyperlink). As far as IPO volume is concerned, in 2006, the three largest banks underwrote as lead managers (including joint lead and co-lead managers) out of a total volume of €10,315.22 million (regulated and open market of the Frankfurt Stock Exchange) €5,147.48, equaling a market share of 49.9 percent. The five largest banks commanded of a market share of more than sixty-six percent. FRANKFURT STOCK EXCHANGE, CORPORATE FINANCE RANKING 2006, http://deutsche-boerse.com (follow "Listing" hyperlink, then "Statistics" hyperlink). In 2007, in a total of twenty-three new issues on the regulated market of the Frankfurt Stock Exchange, the three largest banks had a market share of thirty percent, calculated as the ratio of participation in the offerings as lead underwriter and total number of lead underwriter positions. Again, the concentration index crosses the threshold of forty percent if the five largest banks are considered (market share of forty-four percent). The top six banks, finally, comprise fifty percent of the market. FRANKFURT STOCK EXCHANGE, PRIMARY MARKET STATISTICS 2007, http://deutsche-boerse.com. The figures from 2008 and 2009 are less meaningful due to the very low activity on the primary market (two new issues on degree of competition on the market for underwriting and auditing services allows the market participants to switch between different service providers, which would force low-quality providers to reduce their fees or increase the quality of their services.

The second condition—the transparency of the market—is similarly problematic. The issuer will only be able to tailor the fees according to the quality of the services provided if it is able to distinguish between low-quality and high-quality providers. This will often not be possible, at least not ex ante. An issuer can only judge the quality of the services on the basis of the information provided by the intermediary. The provider has more knowledge about the services than the recipient, who is not able to confirm the intrinsic value of the services. In this sense, the market for securities is a "market for lemons."[22] In the absence of institutions that counteract the informational asymmetries market quality is prone to decline.[23] Of course, there already exist institutions that are designed to counterbalance the effects of quality uncertainty in the financial markets.[24] Most financial intermediaries have to be licensed and are under the supervision of a regulator.[25] Investment banks, auditors and other intermediaries that have provided services of a good quality for a longer time, signal that future performance will be of an equally high standard.[26]

However, regulatory supervision is not effective where regulators are ill-equipped to supervise a whole industry, in particular due to understaffing. Past experience has shown that this is a problem even in the United States, where levels of investment in the regulation of the financial markets and enforcement have traditionally been high.[27] In Europe, enforcement is rare and anecdotal evidence

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the regulated market in 2008 and one in 2009). FRANKFURT STOCK EXCHANGE, PRIMARY MARKET STATISTICS 2008, 2009, http://deutsche-boerse.com.

22. *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

23. *Id.* at 495-96 (analyzing the market for automobiles, wherein unchecked information asymmetries between buyer and seller as to quality would create an incentive for low-quality sellers to overstate the quality of their cars, which, in turn, would drive the prices down that buyers were willing to pay until no high-quality sellers were left on the market).

24. *See id.* at 499-500 (for example, guarantees, brand names, and licensing practices).

25. Kraakman, Gatekeepers, *supra* note 5, at 70.

26. *See* Kraakman, Corporate Liability Strategies, *supra* note 5, at 898 n.124 (discussing other signaling techniques and giving further references). In the investment industry, the composition of the tombstone that announces an upcoming or completed public offering provides a good example of signaling by means of reputation. The participating underwriters are listed by brackets with the most reputable underwriters—the underwriters that have, accordingly, received the largest allotments—being prominently displayed in the bulge bracket, and less well established banks mentioned in the major bracket and further sub-brackets.

27. *See* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253, 255, 290 (2007), comparing regulatory costs and staff levels in several common law and civil law jurisdictions adjusted for market size (but not for economies of scale, which would have emphasized the lead of the United States even more due to its large financial markets) and coming to the conclusion that the United States outstrips all other jurisdictions both as far as total regulatory costs as a percentage of GDP and total regulatory staff as a percentage of population are concerned. Investment in the

suggests that questionable behavior of market participants has repeatedly gone unchecked.[28] The quality of past services is an equally imperfect mechanism to compensate for the informational disadvantages of the issuer. The actual level of quality depends to a great extent on the lead partner who has responsibility for the provision of the services.[29] The integrity and independence of the partner may be compromised, as can be seen in recent, admittedly exceptional, cases of securities fraud.[30] Short of securities fraud, the quality may differ depending on the expertise and experience of the lead partner and the other employees of the intermediary

regulation of the banking sector by far surpasses all other countries. In 2004, U.S. banking regulatory costs were $247,405 per billion dollars of banking assets, almost four times as much as the next most costly jurisdiction, Germany, with $67,815 of costs per billion dollars of banking assets. In the insurance and securities sectors, U.S. costs are comparable to those of other common law jurisdictions but far above the levels reported for civil law countries. Securities regulation costs, for example, amount to $83,943 per billion dollars of stock market capitalization in the United States ($138,159 in the UK), but only $19,041 in France and $8,896 in Germany (all figures from 2004). *Id.* at 267-68. The number of enforcement actions markedly differs as well. In the years 2002-2006, the SEC (which is responsible for the supervision of the securities sector only) instigated, on average, 624 enforcement actions per year (civil actions, administrative proceedings and 21A reports; not counted are investigations of possible violations). S.E.C., ANNUAL REPORTS AND MARKET DATA STATISTICS, http://www.sec.gov/about.shtml (follow "Annual Reports and Statistics" hyperlink) (last visited Oct. 23, 2009). In comparison, during the same time, the FSA, the English regulator, opened, on average, 206.4 enforcement cases per year. FINANCIAL SERVICES AUTHORITY, ANNUAL REPORTS, http://www.fsa.gov.uk/pages/Library/Corporate/Annual/index.shtml (last visited Oct. 23, 2009). *See also* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement* (Columbia Law and Economics Working Paper No. 304, 2007), at 33-39, *available at* http://ssrn.com/abstract=967482 (pointing out that the U.S. numbers do not take account of private enforcement activities by the NASD and enforcement cases brought by state regulators; therefore, they understate the true level of enforcement in the United States). For further analyses of differences in the level of enforcement with similar results, see Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (Harvard University Law School: Public Law & Legal Theory Research Paper Series Paper No. 0-28 & John M. Olin Center for Law and Business Law & Economics Research Paper Series Paper No. 638, 2009), *available at* http://ssrn.com/abstract=1000086.

28. *See e.g.* the events in the aftermath of the implosion of the New Market of the Frankfurt Stock Exchange. Several surveys conclude that a large number of the issuers listing on the New Market published consolidated statements that violated IAS or GAAP. However, virtually all of the statements received an unqualified audit opinion. *See* Wolfgang Ballwieser, *Rechnungslegung und Prüfung am Neuen Markt*, ZFBF 2001, 840; Martin Glaum & Donna Street, *Rechnungslegung der Unternehmen am Neuen Markt*, 17 STUDIEN DES DAI (2002), *available at* http://www.dai.de/internet/dai/dai-2-0.nsf/dai_publikationen.htm (follow "Studien" hyperlink, then "2002" hyperlink).

29. WILLIAM M. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS app. C, pt. II(C)(2) (2009), *available at* SECPUBPRIV APP C4 (Westlaw) (noting that "[i]t is the lead partner . . . who has the primary responsibility for the audit.").

30. *See e.g.*, *In re* Enron Corp. Sec, Derivative & ERISA Litig, 235 F. Supp. 2d 549, 617 (S.D. Tex. 2002) [hereinafter Newby v. Enron Corp.] (alleging that "Enron's banks and high-level bankers were offered [a highly lucrative] investment opportunity as a reward for their ongoing participation in the Ponzi scheme.").

who are entrusted with the mandate, and these employees may change from time to time.[31]

The problem is even more pronounced in respect to investors. In order to evaluate the intrinsic value of the securities, the investor needs to be informed about the particulars of the investment, evaluate the financial condition of the issuer and its likely future performance, and assess the possible impact of macro-economic variables. Some of the information necessary to perform such an examination has to be provided pursuant to the disclosure rules of U.S. and European financial market regulation. For example, a public issue of debt or equity securities requires the comprehensive disclosure of information about the issuer,[32] the rights attached to the securities, conditions of the offer,[33] and risk factors associated with the investment.[34] The admission to trading in a regulated market triggers periodic and ongoing obligations that again require the disclosure of financial data and of current events that materially affect the issuer's financial position.[35] On the secondary market, the investment firm that offers investment services has to provide its client with appropriate information about the specific type of financial instrument concerned and the risks associated with that type.[36]

In spite of this wide range of information available to the investing public, investors are at a significant informational disadvantage. Investment firms are not required to advise their clients on the value and the risks of a particular financial

31. In some circumstances, a rotation of the lead partner is mandatory. *See* Sarbanes-Oxley Act, Pub. L. 107-204, § 203, 116 Stat. 745 (2004) (codified in 15 U.S.C. § 78j-1(j) (2007)) (requiring the lead audit partner to be changed every five years).

32. *Inter alia*, a description of its business, investments, organizational and management structure, remuneration policy, capital resources, past financial data and profit forecasts). *See* Securities Act of 1933 § 7, 15 U.S.C. § 77g (2007), Schedule A to the Securities Act of 1933, 15 U.S.C. § 77aa (2007); Securities Act Regulation S-K, 17 C.F.R. §§ 229.10-229.802 (2008) (for the United States.). Articles 5, 7 and Annex I-IV of Directive 2003/71/EC, OJ L 345, December 31, 2003, at 64 [hereinafter Prospectus Directive], Regulation (EC) No 809/2004, OJ L 149, April 30, 2004, at 1 [hereinafter Prospectus Regulation] (for the EU).

33. Plan of allotment and pricing method, arrangements for admission to trading and stabilization, etc. *See id*.

34. *See id*.

35. In the United States, Securities Exchange Act of 1934, §§ 12(a), 12(g), 13, 15(d), 15 U.S.C. §§ 78*l*(a), 78*l*(g), 78m, 78o(d) (2007), Regulation 13A, 17 C.F.R. §§ 240.13a-1 to 240.13a-20 (2008), Forms 8-K, 10-Q, and 10-K, 17 C.F.R. §§ 249.308, 249.308a, 249.310 (2008) (requiring exchange-traded companies, issuers with 500 or more shareholders and total assets exceeding $10 million, and issuers that have filed a registration statement under the Securities Act of 1933 to publish annual and quarterly reports and current reports in case of certain significant events (e.g. the acquisition or disposition of a significant amount of assets or a change in control)); in the European Union, Council Directive 2004/109/EC, arts. 4-6, 2004 O.J. (L 390) 38, 44-46 [hereinafter EU Transparency Directive] (requiring issuers whose securities are admitted to trading on a regulated market within the EU to publish annual and half-yearly financial reports and interim management statements); and Council Directive 2003/6/EC, art. 6, 2003 O.J. (L 96) 16, 21 [hereinafter Market Abuse Directive] (requiring issuers to inform the public as soon as possible of inside information that directly concerns the issuers).

36. Council Directive 2004/39/EC, art. 19(3), 2004 O.J. (L 145) 1, 17 [hereinafter Market in Financial Instruments Directive]; Commission Directive 2006/73/EC implementing Directive 2004/39/EC, art. 31, 2006 O.J. (L 241) 26, 49.

instrument, such as the securities of an individual issuer that the investor wishes to trade in.[37] They satisfy their obligations by giving general and abstract information on the nature of the respective *type* of instrument (debentures, shares, options, futures, money-market instruments, etc.).[38] While the Transparency Directive has increased the transparency for investors operating on the secondary market, the periodic disclosure requirements do not guarantee a supply of information that is always current and complete.[39] Comprehensive information has to be published on an annual basis, comprising the audited financial statements and a management report that discusses the past and the likely future development of the company's business.[40] In addition, issuers have to make public a half-yearly financial report that contains a condensed balance sheet and profit and loss account, together with explanatory notes and an interim management report.[41] The condensed financial statements do not have to be audited.[42] During the time between publication of the annual and the half-yearly reports, publicity requirements are reduced: Once in each six-month period of the financial year, the issuer has to publish a statement with an explanation of recent material events and transactions that have an impact on the issuer's financial position (interim management statement).[43]

Aside from this requirement, events that occur after the publication of the annual or the half-yearly report generally do not need to be disclosed. However, if the events result in a change in major holdings that crosses certain thresholds[44] or if they fall within the definition of "inside information,"[45] i.e. information of a precise nature that has not been made public, relates to the issuer, and is likely to have a significant effect on the price of the issuer's securities,[46] then they must be disclosed even after the publication of the annual or half-yearly report.

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37. *Cf.* Directive 2006/73/EC, *supra* note 36, at 49 (art. 31, providing what advice investment firms are required to give investors).

38. *See id.* at 49 (arts. 31(1) and 31(2)(a), noting that the exact level of detail that has to be provided depends on the circumstances of the case, in particular the experience of the client and the risk profile of the financial instruments); *see also id.* at 30 (recital 45: "It is possible that for some financial instruments only the information referring to the type of an instrument will be sufficient whereas for some others the information will need to be product-specific.").

39. *See* EU Transparency Directive, *supra* note 35.

40. EU Transparency Directive, *supra* note 35, at 44 (art. 4(2)); Council Directive 78/660/EEC, art. 46, 1978 OJ (L 222) 11 [hereinafter Fourth Company Law Directive]; Council Directive 83/349/EEC, art. 36, 1983 O.J. (L 193) 1 [hereinafter Seventh Company Law Directive].

41. EU Transparency Directive, *supra* note 35, at 45 (arts. 5(2)(a), 5(3), 5(4)). *Cf.* INT'L ACCOUNTING STANDARD COMM. INT'L ACCOUNTING STANDARD 34 (2009) [hereinafter IAS 34] for the content of the condensed financial statements. However, use of IAS is only mandatory for issuers that are required to prepare consolidated accounts. EU Transparency Directive, *supra* note 35, at 45 (art. 5(3)).

42. EU Transparency Directive, *supra* note 35, at 46 (art. 5(5)).

43. *Id.* at 46 (art. 6).

44. *Id.* at 47 (art. 9).

45. Market Abuse Directive, *supra* note 35, at 17 (recital 16).

46. *Id.* at 21-22 (art. 6).

Furthermore, investors often lack the expertise to utilize appropriately the information that is provided to them. In order to fully appreciate the financial situation of the issuer, they have to be able to interpret the balance sheet, infer the profitability (return on investment and equity), liquidity, debt-equity ratio etc., and compare the issuer on the basis of these figures with competitor firms from the same industry. If the figures and ratios are contained in the company's publications, the investor needs to be aware of the way in which they are calculated and defined, as firms may use different methods. Firms that are listed abroad may employ accounting practices that vary from those prevalent in the home country of the investor. Finally, the investor is usually not in a position to verify whether the information presented in the financial statements or other company publications is accurate as the officers may have misstated data, omitted certain details or used aggressive accounting techniques that disguise the true condition of the enterprise.

Consequently, due to the lack of market competitiveness and transparency, market forces alone will not ensure that intermediaries will act in all instances with the appropriate level of care and diligence.

B. Mechanisms to Counteract Informational Asymmetries

As pointed out, several mechanisms have been developed in order to alleviate informational asymmetries. The producer of goods or provider of services may grant a guarantee[47] or strive to develop a reputation for high quality products or services.[48] The first method is not feasible in the securities market: Shares, bonds, and other investment instruments entitle the holder to receive certain payments (dividends, interest payments, premiums, or bonuses). If the issuer/provider defaults on the payments, the guarantees will most likely also not be enforceable.

The second method might be suitable for seasoned issuers but, in general, not for firms that wish to conduct an initial public offering. The employment of financial intermediaries therefore serves an important signaling function. By preparing or certifying the public disclosures, the intermediary lends the primary market participant the weight of its expertise and qualifications and confirms that the statements have been drawn up in accordance with applicable laws and regulations.[49] By participating in the distribution of securities or the provision of services the intermediary shows that the product is of a sufficiently high quality to tie its own reputation to the success of the operations of the primary market participant.

The employment of financial intermediaries leads to a second informational asymmetry: that between the investor and the intermediary. The investor is, even more than the primary market participant, unable to discern whether the intermediary has performed its verification and certification functions with due care. In the case of certain transactions, the published documents have to contain

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47. Akerlof, *supra* note 22, at 499-500.
48. *Id.* (brand-naming is the prototypical example of this reputation development).
49. *See e.g. In re Enron Corp. Sec.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

information on the intermediary.[50] The public offering prospectus or registration statement, for example, has to disclose the name and address of the underwriters, the type of underwriting (firm commitment or best efforts), and the material features of the underwriting agreement, in particular the quotas and the underwriting commission.[51]

While the type of underwriting constitutes an indication of the underwriter's valuation of the securities (with a best efforts underwriting generally implying a higher risk),[52] the factors that are of greatest interest to the investor are not disclosed: the methods and standards applied by the intermediary in examining the financial situation of the issuer and the viability of the offer.[53] The investor does not know whether the underwriter performs a full (commercial, financial, technical, legal and tax) due diligence or follows a lower standard; whether it is subject to conflicts of interest that might compromise the objectivity of its analysis or operates at arm's length. Even if the standards that the intermediary is required to employ are laid down in an accessible and binding body of rules (e.g. in the GAAS), the investor does not, in general, have the opportunity to verify compliance with these rules.

The reputation of the intermediary might constitute a signal that is able to counteract the informational disadvantage of the investor.[54] However, reputation is an imprecise signal.[55] Two problems frustrate a clear determination of the level of quality of the intermediary's services: the multiplicity of causes for market movements, and a high interdependence between intermediaries in the financial markets.[56]

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50. *See* Securities Act of 1933, Sched. A, 15 U.S.C. § 77aa (2007); Prospectus Regulation, *supra* note 32, annex III, 5.4.

51. Prospectus Regulation, *supra* note 32. United States regulations require filing of a copy of the underwriting agreement as part of the registration statement. Securities Act of 1933, 15 U.S.C. § 77aa(28) (2006 & Supp. 2007); Securities Act Regulation S-K, 17 C.F.R. § 229.601(b)(1) (2008).

52. *See* Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPREN. BUS. L.J. 369, 375 (2007) ("Investors discount the price of the shares to reflect the higher valuation risk, reflecting the investment bank's lack of confidence in the securities.").

53. *See* Prospectus Regulation, *supra* note 32, at annex III (no provision requiring disclosure of the methods and standards applied by the intermediary in examining the financial situation of the issuer and the viability of the offer).

54. *See* Peter B. Oh, *A View of the Dutch IPO Cathedral*, 2 ENTREPREN. BUS. L.J. 615, 626 (2008) ("An issuer can signal the relative quality of its offering merely by retaining an underwriter and disclosing whether their arrangement is of the firm-commitment or best-efforts variety."); Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) ("In essence, the investment banker rents the issuer its reputation. The investment banker represents to the market (to whom *it*, and not the issuer, sells the security) that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation on the value of the innovation.").

55. Kraakman, Gatekeepers, *supra* note 5, at 97-99.

56. *Id*.

A drop in the share price after the initial public offering can be caused by various factors: the unsound financial condition of the issuer as well as a general economic downturn or a change in the particular economic variables that influence the issuer's industry.[57] The intermediary may claim that the misstatements in the company's disclosures were disguised by the issuer's management and could not have been discovered by the due diligence examination.[58] Alternatively, if more than one intermediary has participated in the transaction, the intermediaries may seek to exculpate themselves by alleging deficiencies in the actions of the other parties.[59] The investor does not have the possibility to evaluate such claims and determine the true allocation of responsibilities.[60]

An analysis of the second issue—a high interdependence between intermediaries in the financial markets—can draw from several studies that have examined the interrelations between individual and group reputation, focusing on different markets such as the drug, car, wine or airline travel markets.[61] The main conclusion of the studies is that the behavior of individual agents may contribute to a collective reputation—the reputation of a group of agents with like characteristics.[62] In the same way that the whole group will profit from members that perform above average, the reputation of all members of the group will be affected by individual firms that produce low quality goods or provide low quality services. The less the behavior of the individual agent can be observed, the more pronounced is this interdependence.[63] In the financial markets, the investor can observe the quality of the intermediary's performance only with great difficulty.[64] As a consequence, the investor is likely to extrapolate from his experience with a particular intermediary (such as an intermediary who has audited the financial accounts that have been "cooked;" or the investment bank that has underwritten and distributed a public offering that proves to be highly overvalued) to the whole industry.

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57. *Id.* at 97 (referring to reputation as "a noisy signal").

58. *Id.* at 97-99.

59. *Id.*

60. *Id.*

61. Severin Borenstein & Martin B. Zimmerman, *Market Incentives for Safe Commercial Airline Operation*, 78 AM. ECON. REV. 913 (1988); Olivier Gergaud & Florine Livat, *Team versus Individual Reputations: a Model of Interaction and some Empirical Evidence*, CAHIERS DE LA MAISON DES SCIENCES ECONOMIQUES no. bla04015 (2004) [hereinafter Gergaud & Livat]; Gregg A. Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. OF POLITICAL ECONOMY 512 (1985); Michael Lynch et al., *Product Quality, Informational Efficiency, and Regulations in Experimental Markets*, 4 RES. IN EXPERIMENTAL ECON. 269 (1991).

62. *See e.g.*, Gergaud & Livat, *supra* note 61(offering, by way of example, that the producers of Bordeaux wines create a collective reputation that is determinative for all sub-appellations); Borenstein & Zimmerman, *supra* note 61, at 913 (offering, by way of example, that an airplane crash does not only affect the reputation of the involved airline but also that of competitors).

63. Jean Tirole, *A Theory of Collective Reputations (with Applications to the Persistence of Corruption and to Firm Quality*, 63 REV. OF ECON. STUDIES 1, 2 (1996).

64. *See supra* at II(A).

This intuitive result is corroborated by anecdotal evidence. After the Great Crash of October 1929, U.S. President Hoover appointed a commission to investigate the causes of the crisis, known as the *Gray-Pecora Commission*.[65] The investigations revealed widespread fraud and speculative transactions. Insiders traded on undisclosed information and realized profits in the millions even as the market was in decline and left outside investors ruined.[66] Issuers and intermediaries engaged in market manipulation in order to create advantageous conditions for the placement of their securities.[67] They falsified financial statements, bribed reporters and analysts, and disseminated misleading promotional material describing the business prospects of the venture in glowing terms while omitting facts that were essential for the appreciation of the risks associated with the investment.[68]

The investigations also showed that the wrongdoing was largely confined to the incorporated banks of deposit that were, at that time, permitted to offer both commercial and investment banking services.[69] The venerable private banks that had dominated the investment industry for many decades and played a crucial role in the rapid growth of the U.S. economy towards the end of the 19th and the beginning of the 20th century[70] had, in general, acted in conformity with established practices of fair dealing, subjected the issuers to meticulous scrutiny

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65. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA, A HISTORY 322-51 (Harvard University Press 1970); FERDINAND PECORA, WALL STREET UNDER OATH (Simon and Schuster 1939) (providing a detailed account of the *Gray-Pecora* investigations).

66. PECORA, *supra* note 65, at 154 (insiders were able to realize the profits by short selling).

67. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 1-A (3d ed. 1993 & supp. 11/2008) (quoting the report of the House of Representatives on the draft of the Securities Act of 1933 that complains of "the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise").

68. *Cf. e.g.* PECORA, *supra* note 65, at 100 (describing that the National City Co., one of the largest and most respected investment houses of those days conducted three offerings of Peruvian government bonds in 1927 and 1928 although internal analysts had described the securities as "an adverse moral and political risk").

69. *See* the Banking (Glass-Steagall) Act of 1933, 48 Stat. 162 (enacted by Congress as a reaction to the findings of the investigations; the Banking Act included provisions requiring the separation of commercial and investment banking); Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 WASH. & LEE L. REV. 1503, 1538 (2006) ("In 1933, the Pecora investigation of banking and securities led to the passage of the Glass-Steagall Act, which 'prohibited bank affiliates from owning and dealing in securities, thereby severing commercial banks from investment banks.'" (internal citations omitted)). *But see* the Gramm-Leach-Bliley Act of 1999 (official title: Financial Services Modernization Act of 1999), Pub. L. 106-102, 113 Stat. 1338 (repealing the prohibition); John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury have a Better Idea?*, 95 VA. L. REV. 707, 718 (2009) ([T]he Gramm-Leach-Bliley Act of 1999 . . . essentially repealed the Glass-Steagall Act . . .").

70. *See* U.S. v. Morgan, 118 F. Supp. 621, 655-80 (S.D.N.Y. 1953) (recounting the history of private banking firms such as Kidder, Peabody & Co., founded in 1865; Kuhn, Loeb & Co., founded in 1867; Drexel, Morgan & Co., founded in 1871 (later renamed J. P. Morgan & Co.); Chas. D. Barney & Co., founded in 1873 (later renamed Smith Barney & Co.)).

and avoided the underwriting of speculative offerings.[71] Nevertheless, when the *Gray-Pecora Investigation* uncovered the extent of negligent and fraudulent behavior, the wrath of the investing public was leveled at incorporated banks of deposits and private bankers alike.[72]

A second example is the collapse of the New Market of the Frankfurt Stock Exchange in 2000.[73] Although the fraudulent activities were confined to some of the new technology issuers listed on that market, the uncovering of balance sheet manipulations and dissemination of incorrect ad-hoc announcements negatively affected the reputation (and, hence, the share price) of all issuers in the technology sector as well as issuers from other industries listed on the regulated market.[74]

The fact that reputation is not an adequate device to counteract the informational asymmetries makes the case for legislative intervention. Liability rules that hold the intermediary accountable provide the investor with an additional defendant who will, in many cases, be more solvent than the issuer. Further, such rules address the problems related to the use of the reputation of the issuer as a signaling device. In the course of the investor's litigation, the court will discuss questions of causality[75] and the standard of care displayed by the defendants. In addition, it will allocate responsibility among the defendants.

Therefore, the investor will be in a position to accurately adjust his assessment of the quality of the intermediaries' services. The intermediaries will not be able to shift responsibility amongst each other and to the issuer through unsubstantiated claims. The problem of group reputation is alleviated, although the psychological effects that are the consequence of a major crisis in the financial

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71. CAROSSO, *supra* note 65, at 339. The higher standards applied by the private banks may be explained by the fact that they were not incorporated but organized as partnerships, thus allowing less shielding against personal liability than the banks of deposit. In addition, during the first decades of their operation, while the U.S. financial markets were in their infancy, the private banking houses seem to have developed a stringent code of business ethics in order to gain the trust of clients and investors. In spite of the lack of regulatory supervision or a mandatory disclosure regime, this ethical code was, for a long time, instrumental in shaping the conduct of the private bankers. The early days of investment banking in the United States were, accordingly, known as an "era of dignity and mystery." *Morgan*, 118 F. Supp. at 645.

72. CAROSSO, *supra* note 65, at 336-51, 353.

73. Martin Glaum & Donna L Street, *Compliance with the Disclosure Requirements of Germany's New Market: IAS Versus US GAAP*, 14 J. OF INT'L FIN. MGMT. & ACCT. 64, 92 (2003) ("Since spring 2000 however … the worldwide technology bubble has collapsed and with it the New Market.").

74. For instance, Lycos and Telegate, two relatively successful issuers of the software and telecommunication sectors that listed on the New Market in 1999 and 2000 and that were not confronted with allegations of misconduct, suffered a decline in their share price not significantly different from that of companies that were under investigation: From a high of €160 in March 2000, the price of Telegate stock sank to €1.35 in August 2001. Lycos stock was offered at €24 in March 2000 and traded at €0.74 in December 2001. The whole New Market declined by ca. 96 percent between March 2000 and the end of 2002. *See* http://www.boerse-frankfurt.de (click "English Version" and use "Price search" to find market data for Lycos and Telegate).

75. Causality is determined based on whether the security price has decreased as a result of a breach of securities law.

markets will still, at least to some extent, affect uninvolved market participants.[76] These conclusions are also valid if the proceedings do not end with a final judgment but with a settlement, which is not uncommon in securities litigation. Settlements are preceded by various court orders that grant or dismiss motions. In their orders, particularly in motions to dismiss, judges usually discuss the legal situation in great detail and give a clear indication of the responsibility of the different defendants.[77]

III. ELEMENTS OF GATEKEEPER LIABILITY IN SECURITIES REGULATION

A. U.S. Law

The four most important liability provisions of U.S. securities law for the regulation of the primary and secondary market are sections 11, 12(a)(1), and 12(a)(2) of the Securities Act of 1933[78] and section 10(b) of the Securities Exchange Act of 1934,[79] which is to be read in conjunction with Exchange Act Rule 10b-5.[80] These provisions will be dealt with in turn. In doing so, this article does not seek to provide a comprehensive analysis of all elements of the causes of action. Instead, it addresses the issues relevant for gatekeeper liability: the class of defendants (the potential gatekeepers) and the standard of care.

Sections 11 and 12 of the Securities Act are restricted to the primary market, they penalize false or misleading statements in the registration statement or prospectus, or a violation of the requirement to register a security with the SEC before it is offered or sold.[81] Section 10(b) of the Securities Exchange Act, on the other hand, is a broad "catch all" provision that is triggered by any type of fraudulent behavior in connection with the purchase or sale of a security on the primary or secondary market.

1. Section 11 of the Securities Act of 1933

Section 11 of the Securities Act is addressed to the signatories of the registration statement, being the issuer and, *inter alia*, its CEO, CFO, and CAO,[82] its directors,[83] experts (accountants, engineers, appraisers etc.),[84] and the

76. For example, in the aftermath of the crash of 1929, all market participants were similarly affected, not only those involved in fraudulent activities. *Cf. supra*, text accompanying note 72.

77. *See, e.g.,* In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004); Newby v. Enron Corp., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

78. 15 U.S.C. §§ 77k, 77l(a) (2006 & Supp. 2007).

79. *Id.* § 78j(b).

80. 17 C.F.R. § 240.10b-5 (2008).

81. 15 U.S.C. § 77e (2006 & Supp. 2007).

82. *Id.* §§ 77f(a), 77k(a)(1).

83. *Id.* § 77k(a)(2)-(3).

84. *Id.* § 77k(a)(4).

underwriters.[85] Thus, even though the gatekeeper theory was developed much later than section 11, the provision uses secondary market actors[86] to monitor the issuer and ensure its compliance with securities regulation. The section divides the defendants into three groups. First, liability for the issuer is strict, i.e. the issuer cannot raise a section 77(b) defense to liability.[87] Second, the other defendants must show that they have conducted a reasonable investigation of the registration statement and, after such investigation, had reasonable grounds to believe that the documents were correct and complete.[88] Third, defendants other than experts who relied on expert-reviewed portions of the registration statement (e.g. the audited accounts of the issuer), must only prove that they had "no reasonable ground to believe and did not believe" that anything contained in the expert opinion was untrue. An independent investigation is not required.[89]

Thus, section 11 establishes a "sliding scale of responsibility."[90] As the primary originator of the registration documents, the issuer is held to the highest standards. Experts have to apply their expertise when reviewing the registration statement. Other defendants may assume, at least in respect to expertised portions, that the information stemming from third parties is accurate.[91] The courts have further refined this sliding scale. The first important opinion concerning the due diligence defense emphasized that "[i]t is all a matter of degree."[92] If a defendant is "directly concerned with writing the registration statement and assuring its accuracy, more [is] required of him in the way of reasonable investigation than [can] fairly be expected of [someone] who [has] no connection with this work."[93] Furthermore, the requisite level of care depends on the cost involved in verifying the issuer's disclosures: "To require an audit might be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable."[94] This

85. *Id.* § 77k(a)(5).

86. *Id*. § 77k(a)(2)-(5).

87. 15 U.S.C § 77(b).

88. *Id.* § 77k(b)(3)(A)-(B).

89. *See id.* § 77k(b)(3)(C).

90. COX ET AL., *supra* note 21, at 503.

91. Reliance on the information of third parties is not reasonable if so-called *red flags* exist, i.e. if the defendant is aware of events or facts that cast doubt on the accuracy of the information, e.g. if the issuer's E/R ratio is substantially different than that of competitors, or if it employs aggressive accounting techniques. *See In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 673 (S.D.N.Y. 2004) (defining red flags as: "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements. . . whether or not it relates to accounting fraud or an audit failure"); *Id.* at 679 ("If a 'prudent man in the management of his own property,' . . . would have questioned the accuracy of the figures [in the registration statement], then those figures constituted a red flag . . ."). *See also* In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 623-24 (9th Cir. 1994).

92. Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

93. *Id.*

94. *Id.* The remarks of the court in *BarChris* are as relevant today as they were in 1968. Recently, the suitability of underwriter liability pursuant to the principles of *BarChris* has been questioned in light of modern practices such as shelf registration and competitive bidding. It is beyond the scope of this comment to reproduce these controversies. *See* WorldCom, 346 F. Supp. at 670-71; Coffee, *Brave New World*, *supra* note 6, 52 Bus. Law. 1195.

approach has led courts to draw a distinction between corporate insiders (executive directors) and outsiders (non-executive directors and third parties, such as the underwriters), imposing stringent requirements on the former, while being more lenient in case of the latter.[95]

This dichotomy does not change the fact that the "sliding scale" is gradual and that within the two groups of insiders and outsiders the standard of care continues to depend on the specific position of the defendant and his access to the issuer. Essentially, the courts have adopted a cost-benefit analysis that seeks to determine the efficient measure of precautionary or supervisory activity.

2. Rule 10b-5

The second prominent liability provision of U.S. securities regulation is section 10(b) of the Securities Exchange Act of 1934, taken in conjunction with Exchange Act Rule 10b-5. Unlike section 11 of the Securities Act, section 10(b) of the Securities Exchange Act and Rule 10b-5 do not define the class of defendants, nor do they specify the elements of the cause of action, in particular the standard of care that the defendant is expected to employ. This is not surprising, as section 10(b) and Rule 10b-5 were not designed to create a private cause of action. Rather, they were intended to broaden the powers of the SEC and facilitate *public enforcement* of the securities laws.[96] The courts, through ingenious interpretation, granted defrauded investors an implied remedy based on Rule 10b-5,[97] a development that was vividly described by then Justice Rehnquist: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."[98] However, the development of the private cause of action under the auspices of the judiciary has proven to be a mixed blessing for investors.[99] In order to limit the risk of liability, the Supreme Court has overruled decisions of the lower federal courts that allowed negligence claims to be brought but required the plaintiff to prove that the defendant acted

95. *See, e.g.,* Feit v. Leasco, 332 F. Supp. 544, 578 (E.D.N.Y. 1971) (explaining that the liability of inside directors "approaches that of the issuer as guarantor of the accuracy of the prospectus").

96. *See* Milton v. Freeman et al., *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW 793, 922 (1967) ("I never thought that twenty odd years later [Rule 10b-5] would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with [fraudulent behavior]. It had no relation in the Commission's contemplation to private proceedings.").

97. *See* Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("Although Sec. 10 does not expressly permit civil suits for violation of this section, violation of a statute is still a wrongful act and tort under the law. The right to sue for a statutory violation is so fundamental and deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly.").

98. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

99. *See, e.g.,* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that negligent nonfeasance alone is not sufficient for the imposition of civil liability for a violation of Rule 10b-5).

with scienter.[100] Who can be sued under Rule 10b-5 is one of the most controversial questions in U.S. securities regulation. The relevant criteria have always been vague and ambiguous; they have changed over time, and courts in different federal circuits have followed different approaches.[101]

The leading case is the Supreme Court decision of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A*.[102] The Court overturned a line of circuit court decisions that held both *primary violators*, persons that committed the fraudulent act themselves, and *secondary violators*, persons that aided and abetted the primary violator (possible gatekeepers), responsible for a Rule 10b-5 violation.[103] *Central Bank* limited liability to primary violators, thus consolidating a trend to restrict the scope of Rule 10b-5.[104] The main reason for the Court's turnaround was its fear of vexatious litigation. The unclear principles of aiding and abetting liability made the outcome of lawsuits unpredictable. In addition, the inquiries were highly fact-oriented; a motion for summary judgment was therefore unlikely to be successful.[105] As a result, parties might have found it prudent, "as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial."[106] However, in one of the last paragraphs of the judgment the Court opened the door again to the potential liability of gatekeepers:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of

100. *Id.* at 193 (defining scienter as "a mental state embracing intent to deceive, manipulate, or defraud"). Lower courts have somewhat relaxed the standard of the Supreme Court and held that recklessness is sufficient. *See e.g.* Broad v. Rockwell Intern. Corp., 642 F.2d 929, 961-962 (5th Cir. 1981) (defining recklessness as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it"); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).

101. *See infra* discussion accompanying notes 119-41.

102. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

103. *Id.* at 194. *See also* Roberts v. Peat, Marwick, Mitchell & Co., 857 F.2d 646 (9th Cir. 1988) (holding that the elements for a cause of action for aiding and abetting are: "(1) the existence of an independent wrong, (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it, and (3) substantial assistance in the wrong." *Accord* Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985); Moore v. Fenex, Inc., 809 F.2d 297 (6th Cir. 1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir. 1986). For further references *cf.* THOMAS L. HAZEN, SECURITIES REGULATION § 12.25[4] n.148 (6th ed. 2009). The precise reach of the elements was unclear, *cf. id.* at § 12.25[4][A], [B] (knowledge of the wrong), § 12.25[4][C] (substantial assistance).

104. *Cent. Bank,* 511 U.S. at 191.

105. *Id.* at 188-91.

106. *Id.* at 189.

securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.[107]

Courts were unsure how to implement the standards established by the Supreme Court. Some purported to apply *Central Bank* literally and required that the defendant actually make the false or misleading statement that gave rise to the claim under Rule 10b-5 (so-called *bright line test*).[108] However, even these courts departed somewhat from this clear rule by allowing the claim to be brought against a person other than the one who communicated the misleading statement to plaintiffs, provided that the secondary actor "controlled the content of the statement"[109] or "knew or should have known that his representation would be communicated to [and relied upon by] investors. . . ."[110] Other courts approached the legal situation before *Central Bank* in a more undisguised manner. They held responsible as primary violator anyone who had "played a significant role,"[111] "a central role,"[112] who was "intricately involved,"[113] who "actively participated"[114] in the making of, or who could be seen as "the 'author' or 'co-author' of the statement."[115] Issuers might be liable for misleading statements by analysts if they

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107. *Id.* at 191.

108. Shapiro v. Cantor, 123 F.3d 717, 720 (2d Cir. 1997) ("[I]f Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)") (quoting *In re* MTC Elec. Techs. S'holders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995); *Id.* ("[W]e conclude that in order for [secondary participants] to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.") (quoting Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996)); *see also* Seippel v. Sidley, Austin, Brown & Wood, LLP, 399 F. Supp. 2d 283, 292-95 (S.D.N.Y. 2005); *In re* Rent-Way Sec. Litig., 209 F. Supp. 2d 493, 502-05 (W.D. Pa. 2002).

109. Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1120 (W.D. Mich. 1996) (citing Greenberg v. Compuware Corp., 889 F. Supp. 1012, 1020-21 (E.D. Mich. 1995)).

110. *Anixter*, 77 F.3d at 1226-27 (discussing the liability of accountant who issued certifications and opinion letters regarding the issuer's financial data that were reproduced in prospectuses, annual reports, registration statements, and other promotional material; the court acknowledges itself that, under this interpretation, the Supreme Court's rule is "far from a bright line . . .").

111. *In re* Software Toolworks, Inc. v. Painewebber Inc., 50 F.3d 615, 628 n. 3 (9th Cir.1994).

112. Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432 (N.D. Ill. 1995).

113. *In re* ZZZZ Best Securities Litigation, 864 F. Supp. 960, 970 (C.D. Cal. 1994).

114. Phillips v. Kidder, Peabody & Co., 933 F. Supp. 303, 316 (S.D.N.Y. 1996).

115. Klein v. Boyd, 949 F. Supp. 280 (E.D. Pa. 1996), *aff'd*, Nos. 97-1143, 97-1261, 1998 WL 55245, Fed. Sec. L. Rep. (CCH) ¶90,136, at 90,325 (3d Cir. 1998); *see also* Newby v. Enron Corp., 235 F. Supp. 2d 549, 588 (S.D. Tex. 2002) ("[W]hen a person, acting alone or with others, creates a misrepresentation . . ., the person can be liable as a primary violator. . . . [I]t would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove scienter, a person can be a primary violator

"entangled" themselves in the fraudulent acts of the analysts.[116] As opposed to the *bright line test*, these courts did not hold that the misrepresentation must be attributable to the defendant. Finally, it was sufficient for liability that the defendant "directly or indirectly engage[d] in a manipulative or deceptive act as part of a scheme to defraud"[117] even if the material statement by another person implemented the scheme and created the nexus with the securities market.[118]

In its recent decision in *Stoneridge*,[119] the Supreme Court partly agreed with the wider approach, pointing out that in order for a defendant to be liable he did not need to make a specific oral or written statement that was communicated to the plaintiff, as "[c]onduct itself [could] be deceptive."[120] However, the court then employed a narrow construction of the requirement to show reliance and by this means effectively approached the *bright line test*.

Reliance could only be established, the Court argued, if the defendant's deceptive acts were disclosed to the investing public or if they made it "necessary or inevitable" for the issuer to publish the misleading information, for example the falsified financial statements.[121] While this holding appears to favor the restrictive view outlined above, it is unlikely that the Supreme Court has dispelled all

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if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else.").

116. *See In re* Boston Tech., Inc. Sec. Litig., 8 F. Supp. 2d 43, 55 (D. Mass. 1998) ("[A]n issuer may be liable under the statute for failure to correct an analyst statement [if] . . . (1) the issuer 'entangled' itself in the making of a statement by the analyst; (2) the issuer knew that the statement (commonly a prediction) was false or lacked a reasonable factual basis when made; and (3) the issuer failed to disclose the falsity or the unreasonableness to investors . . . The element of entanglement may be satisfied by the issuer having either 'fostered,' 'induced,' or otherwise caused the statement to be made in the first place, or having adopted, ratified, or otherwise 'endorsed' the statement after it was made."); Pilarczyk v. Morrison Knudsen Corp., 965 F. Supp. 311, 320 (N.D.N.Y. 1997); Shuster v. Symmetricon, Inc., No. 94-20024 RMW, 1997 WL 269490, at 7 (N.D. Cal. Feb. 25, 1997); Weisburgh v. St. Jude Med., Inc., 158 F.R.D. 638, 644 (D. Minn. 1994).

117. *In re* Enron Corp. Sec., Derivative, & "ERISA" Litig., 439 F. Supp. 2d 692, 714 n.27 (S.D. Tex. 2006).

118. *Id.* at 714-15 ("Scheme liability" is discussed in Rule 10b-5(a) and (c)). The *Enron* court determined that "prior fraudulent activity, from which the making of [a] false statement flowed as a natural consequence" gave rise to liability. *Id.* at 717 n. 30; *see also* Simpson v. AOL Time Warner Inc., 452 F.3d 1040, 1048 (9th Cir. 2006) ("[T]o be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme."), *vacated sub nom.* Avis Budget Group, Inc. v. Cal. St. Teachers' Ret. Sys., 128 S.Ct. 1119 (2008); *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 502 (S.D.N.Y. 2005). For examples of a more restrictive approach *see* Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 386-92 (5th Cir. 2007); *In re* Charter Commc'ns, Inc. Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006), *aff'd sub nom.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (determining that the defendant must make or affirmatively cause to be made a fraudulent statement or omission or directly engage in manipulative securities trading practices).

119. *Stoneridge*., 552 U.S. 148.

120. *Id*. at 158.

121. *Id.* at 161 (according to the Court, the presumption of the fraud-on-the-market theory did not apply unless these conditions were satisfied).

ambiguities. First, the decision only dealt with scheme liability pursuant to Rule 10b-5(a) and (c), not with misleading statements within the meaning of Rule 10b-5(b). Thus, questions such as who is the "author or co-author" of the statement, who has played "a central role" in drafting it or "controlled its content," and whether it needs to be attributable to the author, still await conclusive answers. Second, the Court held that the employment of a deceptive device or scheme that necessitated the issuer's incorrect statements gave rise to liability even if the device itself was not disclosed.[122] The indefinite concepts developed by the Supreme Court have already produced inconsistent decisions of the lower courts.[123] The border between primary and secondary violators remains blurred, and legal uncertainty has reached, if not surpassed, pre-*Central Bank* levels.

In light of the ambiguous legal situation it is not surprising that the considerations of the gatekeeper theory are not reflected clearly in the structure of section 10(b). According to the Supreme Court, gatekeepers can only be liable as primary violators.[124] This is not satisfactory, as gatekeepers are precisely in the position of secondary market participants that verify the acts of the primary participant. The lower courts have realized that adequate results cannot be reached by way of a literal application of *Central Bank*. All of the opinions allow for certain exceptions that are intended to bring secondary actors within the reach of section 10(b). However, the courts are hindered in discussing and implementing the principles of gatekeeper liability because they must adhere to Supreme Court precedent. Thus, the decisions focus on the question of delineating the boundaries of primary liability rather than trying to identify the intermediaries that are able to monitor the primary actor in the most efficient way. In other words, the criteria that should govern the construction of the liability provision are obscured by the failure of the legislature and the judiciary to acknowledge that the issue at hand is one of gatekeeper liability.

3. Section 12(a) of the Securities Act of 1933

Section 12(a)(1) of the Securities Act[125] differs from the two provisions discussed above in that it does not constitute an antifraud provision. Rather than

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122. *See also id.* at 167-75 (Stevens, J., dissenting) (asserting that the majority decision was based on an incorrect reading of *Central Bank* and an understanding of causation that was not in accordance with longstanding precedent).

123. *Compare In re* DVI Inc. Sec.Litig., 249 F.R.D. 196, 216-18 (E.D. Pa. 2008) (rejecting liability of issuer's counsel that had initiated and masterminded the deceptive scheme), *with* Burket v. Hyman Lippitt, P.C., 560 F. Supp. 2d 571 (E.D. Mich. 2008) (denying motion for summary judgment of legal counsel who had incorporated an investment vehicle and prepared or reviewed the stock subscription agreement), *and In re* Bristol Myers Squibb Co. Securities Litigation, 586 F. Supp. 2d 148 (S.D.N.Y. 2008) (acknowledging responsibility of the issuer's officer who negotiated a settlement agreement that was subject of a misleading announcement without making public statements himself).

124. *Stoneridge*, 552 U.S. at 165-66 (holding that liability only extends to secondary violators who commit primary actions).

125. 15 U.S.C. § 77*l*(a)(1) (2007).

serving the goal of restitution for the benefit of defrauded investors, it seeks to provide deterrence.[126] The structure of the provision is simple: All offerors and sellers of securities are liable for damages if they do not comply with the registration and/or prospectus delivery requirements of the Securities Act.[127] Accordingly, section 12(a)(1) is not concerned with gatekeeper liability; it intends to punish a violation of the registration and prospectus requirements by holding responsible the addressees of these requirements, the primary actors.

Again, case law has obfuscated this seemingly clear rule. Initially, the courts were split on the construction of the terms "offeror" and "seller." The narrow view required strict contractual privity between seller and buyer, thus shielding most financial intermediaries from liability.[128] The opposing view considered as seller/offeror not only the owner but also a third party who acted as agent for the owner and actively participated in the solicitation or implementation of the agreement[129] or, more restrictively, who set a direct and proximate cause for the injury to the plaintiff,[130] or was sufficiently close to the transaction to be able to obtain information relevant to the buyer.[131] The Supreme Court overruled the

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126. LOSS & SELIGMAN, *supra* note 67, § 11-C-2 a (i), at 4179.

127. *See* Securities Act of 1933, ch. 38, 48 Stat. 77, § 5 (1933) (codified as amended at 15 U.S.C. § 77e(a) (2006)) (mandating that offers to sell a security may only be made after the registration statement has been filed and that they may not be transmitted unless in the form of a prospectus within the meaning of § 5(b)(1); in addition, the sale may not be executed before the registration statement has become effective).

128. *See* Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1226 (7th Cir. 1980); Collins v. Signetics Corp., 605 F.2d 110, 114 (3d Cir. 1979). According to the narrow view, the only financial intermediary that might be liable in an initial public offering is the investment bank that underwrites the securities on a firm commitment basis. In a best efforts underwriting, title does not pass from the issuer to the underwriter; therefore, the relationship between investor and investment bank is not one of contractual privity. *See, e.g.,* Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 222-223 (S.D.N.Y. 1973); Bailey v. Huntington Sec. Co., 35 F.R.D. 169, 175 (S.D.N.Y. 1963). Likewise, the employees of the issuer who represent the owner in the transaction are not proper defendants under § 12(a)(1); the principal is the only proper defendant.

129. *E.g.,* Katz v. Amos Treat & Co., 411 F.2d 1046, 1052-53 (2d Cir. 1969).

130. Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964 (asking: "But for the presence of the defendant . . . in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have materialized without the efforts of that defendant, we must find him guilty."); *accord* Hill York Corp. v. American Int. Franchises, Inc., 448 F.2d 680, 692-693 (5th Cir. 1971) (also stating that the Lennerth test (also sometimes referred to as "proximate cause test") takes the middle ground between the restrictive view and the participation test). *Cf. also* Lewis v. Walston & Co. Inc., 487 F.2d 617, 622 (5th Cir. 1973) (indicating that the test leads to problems when courts, in applying the precedents, define all actions as "proximate" that were a "substantial factor" in bringing about the securities transaction) *and* Pharo v. Smith, 621 F.2d 656, 667 (5th Cir. 1980) (showing that courts faced the issue of how to give the term "substantial" clear contours: "Mere participation in the events leading up to the transaction is not enough. But beyond the words 'substantial factor,' we have no guideposts other than the factual situations presented in [the case law] . . ."). The test of the Ninth Circuit is similar. *See* Anderson v. Aurotek, 774 F.2d 927, 930 (9th Cir. 1985); S.E.C. v. Murphy, 626 F.2d 633, 649-50 (9th Cir. 1980).

131. By focusing on the position of the defendant in respect to the transaction and, hence, the primary violator (the seller), this approach is in accordance with the considerations of the gatekeeper theory. *See* Wasson v. S.E.C., 558 F.2d 879, 886 (8th Cir. 1977) ("The Securities Act

decisions of the lower federal courts and held in the leading case *Pinter v. Dahl*[132] that 'seller' within the meaning of section 12(a)(1) "is not limited to an owner who passes title, . . . but extends to a broker or other person who successfully solicits a purchase of securities, so long as he is motivated at least in part by a desire to serve his own financial interests or those of the securities owner."[133] The test for third party liability, therefore, consists of two parts. First, the third party must have solicited the securities transaction, e.g. *urged* the investor to make a purchase;[134] and second, the third party must have done so with the expectation of receiving a financial benefit.[135]

On this basis, some of the potential gatekeepers fall within the scope of section 12(a)(1). The underwriters[136] can be liable if they are in contact with the investors and promote the offering, either by direct or telephone contact or by participating in road shows and placing their name on the securities prospectus or other advertising material.[137] The same considerations apply to brokers and dealers.[138] However, other parties that might function as gatekeepers are generally

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of 1933 was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce. To accomplish this end, registration and disclosure requirements were imposed on those with access to relevant information . . . [O]ne factor which ought to be considered in determining the 'sale' or 'offer to sell' issue is whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings." (citation omitted)).

132. Pinter v. Dahl, 486 U.S. 622 (1988).

133. *Id.* at 647.

134. *Id. See also* Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1124, 1126 (2d Cir. 1989) (legal counsel for the issuer whose participation in the sale consists solely of "mailing a copy of the private placement memorandum" or who has "performed only [its] usual professional functions in preparing documents for an offering" cannot be held liable as a seller); *In re* Gas Reclamation, Inc. Sec. Litig., 733 F. Supp. 713, 723 (S.D.N.Y. 1990) (participation in a sales presentation in a subordinate capacity without directly speaking to the investors is not sufficient to establish a claim). *But cf.* Flournoy v. Peyson, 701 F. Supp. 1370, 1373, 1379 (N.D .Ill. 1988) (a more active role during an investment seminar, for example recommending investment opportunities, will give rise to liability).

135. *Pinter*, 486 U.S. at 654 (explaining that the financial benefit may stem from the proceeds of the transaction, e.g. consist of a share of the profits or a commission); Cook v. Goldman, Sachs & Co., 726 F. Supp. 151, 155 (S.D. Tex. 1989) (alternatively, the financial benefit may be of a more indirect nature, such as the benefits that shareholders or managers receive from a sale of the corporation's shares); *In re* Keegan Management Co. Sec. Litig., 1991 WL 253003, at 8 (N.D. Cal. 1991) (stating that the protection of the manager's executive position or an enhancement of the value of the defendant's holding may constitute a benefit within the parameters set by *Pinter*). *See also Pinter*, 486 U.S. at 655 (the rendering of gratuitous investment advice may support a claim under section 12(a)(1) if the defendant intends to serve the financial interests of the *securities owner* (not the buyer)). The reach of the latter qualification is unclear. Any assistance in the sales efforts of the owner furthers the owner's financial interests; in order for the liability threat not to be limitless, the assistance must reach some level of intensity. The Supreme Court has not yet ruled as to what that level should be.

136. This refers to both a firm commitment and a best efforts underwriting.

137. *In re* ZZZZ Best Sec. Litig., Fed. Sec. L. Rep. (CCH) 94, 485, 1989 WL 90284 (C.D. Cal. 1989).

138. *See* Moore v. Kayport Package Exp., Inc., 885 F.2d 531, 538-39 (9th Cir. 1989).

not encompassed by the *Pinter* definition of "seller," at least not by virtue of their position as directors, officers, lawyers, auditors or experts.[139] Consequently, as in the case of section 10(b) of the Securities Exchange Act, liability under section 12(a) does not depend on the gatekeeper's capability to ensure compliance with the applicable regulatory requirements by the securities owner (such as section 5 of the Securities Act of 1933).[140] Rather, the restrictive construction of the provision is intended to compensate for the overly broad elements of the cause of action.[141]

Section 12(a)(2) of the Securities Act provides for liability in cases of untrue statements in the securities prospectus. The class of defendants is identical to that of section 12(a)(1).[142] The gatekeeper problem, however, presents itself in a different fashion. As pointed out, section 12(a)(1) holds liable both the owner and some of the financial intermediaries as offerors or sellers. Since all offerors/sellers are addressees of section 5, all of the defendants can, at least in some formal sense of the term, be described as primary market participants, notwithstanding their role as intermediaries that facilitate the sales efforts of the owner.[143] In section 12(a)(2), on the other hand, the offeror/seller is in the position of a genuine gatekeeper. Liability attaches to the offer or sale by means of a prospectus that contains an untrue statement or a material omission. The defendant will often be an underwriter, dealer or broker. Accordingly, the statute uses a third party to review

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139. Depending on the facts of the case, they may, of course, fall under the *Pinter* definition if they display solicitation efforts and pursue their (or the securities owner's) financial interests. But the exercise of their professional duties without more does not, according to most courts, constitute a claim under section 12(a)(1). For example, directors and officers who prepare the public offering documents, sign them and cause them to become effective are not statutory "sellers." *In re* Infonet Services Corp. Sec. Litig., 310 F. Supp.2d 1080, 1101 (C.D. Cal. 2003); *In re* Worlds of Wonder Securities Litigation, 694 F. Supp. 1427, 1435 (N.D. Cal. 1988); Jackson v. First Fed. Sav. of Ark., F.A., 709 F. Supp. 863, 884 (E.D. Ark. 1988). Neither are lawyers or accountants who give legal advice, draft the registration statement, or prepare an audit opinion. *Moore*, 885 F.2d at 538; Abell v. Potomac Ins. Co., 858 F.2d 1104, 1114-15 (5th Cir. 1988); *Worlds of Wonder*, 694 F. Supp. at 1435. *See generally* J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT § 6:101-105 (supp. 11/2008) (discussing liability for directors, officers, attorneys, accountants, banks and other finance companies).

140. 15 U.S.C. § 77e (2006 & Supp. 2007).

141. Section 12(a)(1) does not require the plaintiff to show more than that the defendant was a seller and that he violated section 5. *Id.* § 77*l*(a)(1). The defenses of section 12(b) or section 11(b) are not at the defendant's disposal (in exceptional circumstances the courts permit the defendant to invoke *in pari delicto*, *Pinter*, 486 U.S. at 632-41). Thus, commentators have observed that liability pursuant to section 12(a)(1) is "close to absolute," SELIGMAN, *supra* note 67, § 11-C-2.

142. The majority of lower courts apply the *Pinter* principles in an identical way to both subsections. *See, e.g.,* Smith v. Am. Nat'l. Bank and Trust Co., 982 F.2d 936, 941-42 (6th Cir. 1992); Ryder Int'l. Corp. v. First Am. Nat'l. Bank, 943 F.2d 1521, 1527 (11th Cir. 1991); Ackerman v. Schwartz, 947 F.2d 841, 844 (7th Cir. 1991); Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 635 (3d Cir. 1989); Moore v. Kayport Package Exp., Inc., 885 F.2d 531, 536 (9th Cir. 1989); Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988).

143. The intermediaries could be characterized as secondary market actors, i.e. gatekeepers, in a material sense.

the accuracy of the prospectus, protecting investors by refraining from effectuating the transaction if the documents do not conform to legal requirements.

However, the principles that ensure the efficiency of gatekeeper liability as a regulatory instrument are imperfectly embodied in section 12(a)(2). The provision does not distinguish between different types of defendants and does not establish a sliding scale of responsibility comparable to that of section 11, allowing for differences concerning access to the source of the information. Some modicum of case-by-case adjustment in light of the position of the defendant is achieved by means of the so-called *defense of due care* in section 12(a)(2). The defendant shall not be liable if he can prove that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.[144] The courts draw a parallel to the due diligence defense of section 11(b)(3). According to the leading decisions, the required standard of care depends on the type of defendant; its relationship to the source of the information (in particular the issuer) and to the investor; the degree of involvement in the transaction; and the reliance on officers, experts, and others that have drawn up parts of the prospectus.[145] But considerable uncertainty remains. Where section 11(b)(3) specifies that the duty to conduct an independent investigation does not apply in respect to expertised portions of the registration statement, section 12(a)(2) is silent. By allowing exceptions from the requirement to register a security,[146] the Securities Act implies that the level of investor protection should be higher in some transactions than in others. Since section 12(a)(2) comprises registered as well as unregistered securities, the standard of care in that provision is arguably lower than that under section 11.[147] However, the precise differences in the contours of gatekeeper liability remain undetermined.

144. 15 U.S.C. § 77*l*(a)(2) (2006 & Supp. 2007).

145. *See* Dennis v. Gen. Imaging, Inc., 918 F.2d 496, 505 (5th Cir. 1990) (appending lower court opinion); Davis v. Avco Fin. Serv., Inc., 739 F.2d 1057, 1068 (6th Cir. 1984); Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1227-28 (7th Cir. 1980) (asserting that defendant need to discover and review all information that is "reasonably ascertainable" and that "a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker"); *see also* Securities Offering Reform, Securities Act Release No. 8591, 2005 WL 1692642, at 79 (Aug. 3, 2005) (acknowledging that Securities Act Rule 176, 17 C.F.R. § 230.176 (2008), pertaining to section 11, may be referred to in construing "reasonable care" under section 12(a)(2)).

146. Pursuant to section 3 of the Securities Act, 15 U.S.C. § 77c (2006).

147. *See* John Nuveen & Co., Inc., v. Sanders, 450 U.S. 1005, 1009 (1980); *see also* Securities Offering Reform, Securities Act Release No. 8591, 2005 WL 1692642, at 79 (Aug. 3, 2005) (stating that "the standard of care under Section 12(a)(2) is less demanding than that prescribed by Section 11 or, put another way, that Section 11 requires a more diligent investigation than Section 12(a)(2)"); *but cf.* HICKS, *supra* note 139, at § 6:166 (pointing out that it could be argued reversely that stringent due care requirements are more important where the investor is not the beneficiary of the protection offered by registration and the liability provisions of sections 11, 12(a)(1)).

4. Summary

Section 11 of the Securities Act is a paradigmatic provision embodying the principles of gatekeeper liability. While case law has put a considerable gloss on statutory terms such as "reasonable investigation" and "reasonable ground to believe," the provision's text reaches a high degree of legal certainty by outlining the main parameters of the gradual scale of responsibility in the statute. Section 12(a)(2) goes in the same direction but falls short of giving precise criteria that could guide market participants and legal practitioners. The effectiveness of section 12(a)(1) as an instrument of gatekeeper regulation is hampered by the desire to restrict the broad elements of the cause of action, which obscures the criteria that are of importance for gatekeeper liability. Finally, section 10(b) of the Securities Exchange Act is symptomatic of a provision that was not intended to grant a private cause of action but that has undergone a major transformation through case law. The requirements to bring a claim are not clearly defined, several issues, in particular the class of defendants, are highly controversial and the outcome of lawsuits involving section 10(b) is correspondingly uncertain. Furthermore, the relationship between the different liability provisions under the Securities Act and the Securities Exchange Act is not conclusively resolved.[148]

B. English Law

1. Prospectus Liability

An important feature of the British regulatory system is the employment of sponsors or, when listing on the Alternative Investment Market ("AIM"), nominated advisers ("nomads"). Both are in general investment banks, and both monitor compliance of the issuer with the regulations promulgated by the Financial Services Authority ("FSA").[149] On the primary market, the issuer has to appoint a sponsor if it applies for a listing of its equity securities on a regulated market.[150] The sponsor's role is to provide assurance to the FSA that the issuer's responsibilities under the listing rules have been met and to guide the issuer in understanding and meeting its responsibilities.[151] If a prospectus has to be published, the sponsor is expected to make due and careful enquiry that the prospectus conforms to regulatory requirements.[152] In order to ensure the effectiveness of the sponsor (or nomad) as a tool of securities regulation, the FSA

148. *See, e.g.,* Herman & MacLean v. Huddleston, 459 U.S. 375, 380-87 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-11 (1976).

149. FSA Handbook, http://fsahandbook.info/FSA/html/handbook (2009).

150. FSA Listing Rules 8.2.1 [hereinafter LR]. An issuer listed on AIM has to retain a nominated adviser at all times, *see* Rule 1 of the AIM Rules for Companies, London Stock Exchange, *available at* http://www.londonstockexchange.com/companies-and-advisors/aim/documents/aim-rules-for-companies.pdf.

151. LR, *supra* note 150, at R. 8.3.1.

152. LR, *supra* note 150, at RR. 8.4.2, 8.4.8.

has set up rules on the independence and qualifications of the intermediary.[153] Furthermore, it supervises the sponsor and may impose sanctions if the sponsor breaches the applicable regulations.[154]

However, supervision of sponsors by the regulator might not be effective, and secondary market participants other than sponsors may, in certain situations, be in an equally good or better position than investment banks to function as gatekeepers. Consequently, the main avenue for third party enforcement of securities regulation in the U.K., as in the United States, is through the adoption of liability provisions.[155] Liability for misstatements and omissions on the primary market is dealt with by section 90 of the Financial Services and Markets Act ("FSMA")[156] and the implementing legislation.[157]

Section 90 applies to misstatements in the prospectus or the listing particulars,[158] not to advertisements or the admission document required for an AIM listing.[159] In the case of an equity issue, the responsible persons include the issuer, the issuer's directors, each person who accepts responsibility for the prospectus or authorizes its contents, and the offeror if not identical with the issuer.[160] This enumeration evidently aims at both primary and secondary market participants; however, it does so in a rather obscure manner. Persons who accept responsibility for the prospectus[161] are often the experts (e.g. reporting accountants). On the other hand, the prospectus rules stipulate that a person shall not be responsible solely for giving advice in a professional capacity.[162] This is commonly interpreted to exclude lawyers, although the precise reach of the

153. *See* LR, *supra* note 150, at RR. 8.3.7A-8.3.12 (addressing "identifying and managing conflicts"); *id.* at R. 8.6 (addressing "[c]riteria for approval as a sponsor").

154. LR, *supra* note 150, at R 8.7.

155. The Financial Services Authority has powers to take regulatory action against secondary participants that have been "knowingly concerned" in a contravention of the requirements of the Financial Services and Markets Act by a primary addressee of the Act. *See* Financial Services and Markets Act 2000 (c. 8) §§ 66(2)(b), 91(2), 97(1)(b), (c), 380(2), (3)(b), 382(1), 384(1) (Eng.) [hereinafter FSMA]. *See generally* Eva Z. Lomnicka, *Placing Bankers in the Front Line: The Secondary Liability of Bankers for Their Customers' Regulatory Contraventions*,12 J. FIN. CRIME 200, 200 (2005) (providing an in depth discussion of the concept of "knowingly concerned" and liability that attaches therewith).

156. Financial Services and Markets Act 2000 (c. 8), *supra* note 155.

157. *Id.* § 90(2), (5), Sched. 10, (Eng.); Financial Services Authority, Prospectus Rules, 5.5 (Eng.) [hereinafter PR] (for prospectuses); FSMA (Official Listing of Securities) Regulations 2001, S.I. 2001/2956, reg. 6 (Eng.) (for listing particulars).

158. Listing particulars have to be published for certain types of securities for which a prospectus is not required under the Prospectus Directive. *See* FSMA, *supra* note 155, § 79; LR, *supra* note 150, at R. 4.

159. PAUL L. DAVIES, GOWER & DAVIES' PRINCIPLES OF MODERN COMPANY LAW, para. 25-32 (8th ed. 2008) ("the statutory provisions apply only to misstatements in prospectuses . . . [and not] to advertisements issued in connection with a public offer but separately from the prospectus").

160. PR, *supra* note 157, at R. 5.5.3.

161. *Id.* at R. 5.5.3(2)(c).

162. *Id.* at R. 5.5.9.

provision is unclear. The work of the solicitors could be regarded as consisting not only of rendering advice but also arranging the offering;[163] conversely, the exception might be extended to other intermediaries, such as investment banks that do not underwrite securities but advise on the transaction.

Underwriters, who are one of the most important types of gatekeeper,[164] are not expressly mentioned as defendants. In theory, the rules are drafted broadly enough that three of the above groups of people may comprise underwriters: those who accept responsibility for the prospectus,[165] those who authorize its content,[166] and those who offer the securities.[167] Evidence of accepting responsibility may be in the form of a declaration to that effect in the prospectus; in practice, however, generally only the issuer and its directors accept responsibility.

As far as the second alternative (authorization) is concerned, the prospectus rules state that the defendant must have authorized *the contents* of the prospectus. This is a change from the legal situation under the Companies Act 1985, which referred to *the issue* of the prospectus.[168] Under the old law, signing the prospectus could be qualified as the act of authorization. Now some relation to the information contained in the prospectus is required. But the extent of the involvement is not defined. According to some commentators, mere participation in the preparation is not sufficient.[169] This must rule out liability of ordinary members of the underwriting syndicate that do not, in general, exercise much control over the content of the prospectus. Even liability of the lead underwriter or the investment bank that is appointed as a sponsor (usually a member of the underwriting syndicate) is questionable.[170] The last group of possible defendants poses equally intricate problems. Whether the underwriters fall under the term "offeror" is an "unanswered and generally unasked question."[171] The offeror is the person who makes the offer to the public.[172] This will commonly be the underwriters,[173] unless they do not communicate with investors but use a group of selling agents.

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163. DAVIES, *supra* note 159, at para. 25-34.

164. *See* discussion *infra* Part IV(B).

165. PR, *supra* note 157, at R. 5.5.3(2)(c).

166. *Id*. at R. 5.5.3(2)(f).

167. *Id.* at R. 5.5.3(2)(d)(i).

168. Companies Act 1985 (c. 6) § 67(2)(d) (Eng.).

169. *See generally* ANDREW WHITTAKER & GEOFFREY MORSE, THE FINANCIAL SERVICES ACT 1986: A GUIDE TO THE NEW LAW 164-65 (Butterworths 1987) (describing the extent of involvement necessary).

170. ALISTAIR ALCOCK, THE FINANCIAL SERVICES AND MARKETS ACT 2000: A GUIDE TO THE NEW LAW 211 (Jordans 2000). *But cf.* Patrick C. Leyens & Ulrich Magnus, *England*, *in* PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG [PROSPECTUS LIABILITY AND LIABILITY FOR CAPITAL MARKET DISCLOSURES] 417, 471 (Klaus J. Hopt & Hans-Christoph Voigt eds., 2005) (affirming, tentatively, liability of the sponsor).

171. Simon Gleeson & Harold S. Bloomenthal, *The Public Offer of Securities in the United Kingdom*, *in* INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 36:48 (Harold S. Bloomenthal & Samuel Wolff eds., Supp. 2008).

172. FSA Handbook, *supra* note 149, glossary.

173. It is not clear whether the underwriters would need to purchase the securities in order to be qualified as offerors (as can happen—but does not necessarily need to happen—in a firm

The scope of the provision has been restricted through a subsequent amendment,[174] which stipulates that the offeror is not liable if "the issuer is responsible for the prospectus . . .; the prospectus was drawn up primarily by the issuer, or by one or more persons acting on behalf of the issuer; and the offeror is making the offer in association with the issuer."[175] The amendment fits the underwriters who conduct the offering in collaboration with the issuer. However, the question remains: when is the prospectus "drawn up primarily by the issuer" so as to exclude underwriter liability? This is particularly pertinent in respect to the lead underwriter, who may be extensively involved in the drafting of the offering documents.[176] Guidance on this issue is not available.[177]

The defenses available under section 90(2) of the FSMA and Schedule 10 to the FSMA exhibit further similarities of the English provision and its U.S. counterpart. The defendant does not incur liability if he "reasonably believed"[178] that the incorrect statement was true and not misleading and if he "made such enquiries, if any, as were reasonable" to verify the correctness of the prospectus.[179] The standard of care is reduced if the incorrect statement is contained in an expert's opinion.[180] The defendant is not liable if he "reasonably believed that the other person [the author] was competent to make or authorise the statement, and had consented to its inclusion in the form and context in which it was included."[181] Interestingly, this provision does not require that the defendant had reasonable ground to believe that the prospectus was accurate, as is the law under section 11 of the Securities Act of 1933.[182] Arguably, belief in the competence of the expert is a less exacting standard than the requirement to reflect on the accuracy of the information itself. The person responsible for the prospectus might have been able to discover the mistake without further enquiries simply by studying the information provided by the expert. Exculpation in such cases is hardly justified. Neither the regulator nor the courts have addressed this inconsistency, nor have they endeavored to define the terms "reasonably believe" and "reasonable enquiries."

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commitment underwriting), or whether acting as an agent, as in a best efforts underwriting, is sufficient. *Cf.* BARRY A. K. RIDER, CHARLES ABRAMS & MICHAEL ASHE, GUIDE TO FINANCIAL SERVICES REGULATION ¶823 (3d ed. 1997).

174. The original provision stems from the Financial Services Act 1986 (U.K.) and the Public Offers of Securities Regulations, 1995, S.I. 1995/1537, reg. 13, which were amended in 1999 in a way that corresponds to the prospectus rules in force today.

175. PR, *supra* note 157, at R. 5.5.7.

176. CARSTEN GERNER-BEUERLE, DIE HAFTUNG VON EMISSIONSKONSORTIEN 55 (2009).

177. *See* Gleeson & Bloomenthal, *supra* note 171, § 36:48 ("whether a prospectus has been prepared 'primarily' by the issuer could raise some interesting questions.").

178. FSMA 2000, *supra* note 155, at sched. 10, § 1(2).

179. *Id.*

180. *Id.* at sched. 10, § 2; *see generally id.* at sched. 10, § 8 ("An 'expert' includes any engineer, valuer, accountant or other person whose profession, qualifications or experience give authority to a statement made by him.").

181. FSMA, *supra* note 155, at sched. 10, § 2(2).

182. ALCOCK, *supra* note 170, para. 12.4.2.

2. Deceit and Negligent Misrepresentation

Section 90 of the FSMA does not exclude remedies that exist under common law.[183] For misstatements in publications that fall outside the scope of section 90, particularly the admission document for AIM and communications with the investing public that are not made in the form of a prospectus or listing particulars, such as promotional material or communications on the secondary market, common law might provide the only remedies. Historically, the tort of deceit and fraudulent misrepresentation was the exclusive remedy available to investors that sought relief against a defendant that was not a party to the contract with the claimant.[184] While such a claim may be brought against the issuer as well as its directors, underwriters, and experts whose reports are included in the prospectus,[185] investors face high hurdles to recovery. In *Derry v. Peek*, the House of Lords held that plaintiffs must show that the defendant knowingly made a false representation or was reckless.[186] Belief in the truth of the statement will exculpate the defendant even if the belief is not based on reasonable grounds. Furthermore, where the incorrect statement has been made to a person other than the plaintiff, the claim will only be successful if the defendant intended the claimant to act on the statement.[187] Finally, the plaintiff must show that he relied on the misrepresentation.

The restrictive legal situation under the traditional common law led the House of Lords to refine *Derry v. Peek* in 1964 and hold that liability for misstatements does not only exist in cases of fraud or deceit, but also in cases of negligence.[188] In accordance with general principles of negligence, the claimant needs to establish that the defendant owed him a duty of care[189] and that he breached that duty. It is problematic whether and to what extent such a duty exists in the financial markets. As a general rule, the author of the misleading statement must know that it will be

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183. FSMA, *supra* note 155, § 90(6).

184. For the limits of contractual remedies, *see* Collins v. Assoc. Greyhound Racecourses Ltd., [1930] 1 Ch. 1, 19 (holding that a claim of rescission of contract was unavailable when the contract was formed by an agent of the principle).

185. PALMER'S COMPANY LAW para. 5.773 (Geoffrey Morse et al., eds., 25th ed. 1992 & supp. 2008) [hereinafter Morse].

186. (1889) 14 App. Cas. 337, 374 (H.L.) (defining "reckless" as "careless whether [the representation] be true or false").

187. *See* Peek v. Gurney, (1873) L.R.E. 377 (H.L.) (purchaser in the aftermarket denied recovery for false statement not made "with the direct intent that it should be acted upon by such third person"); Andrews v. Mockford, [1896] 1 Q.B.D. 372 (holding that a person who knowingly makes false representation with direct intent to induce persons to purchase shares in the company is liable to a purchaser who relies on the false representation when purchasing shares and sustains a loss).

188. Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd., [1964] A.C. 465 (H.L).

189. The duty of care comprises three elements: (1) foreseeability of damage, (2) relationship of proximity between the party owing the duty and the party to whom the duty is owed, and (3) fairness, justice and reasonableness of the imposition of the duty. CLERK & LINDSELL ON TORTS 390 (Anthony M. Dugdale et al., eds., 19th ed., Sweet & Maxwell 2006); *see e.g.,* Caparo Indust. Plc v. Dickman, [1990] 2 A.C. 605 (H.L.) (no duty of care owed to purchaser of defendant company's shares).

communicated to the recipient to be used for a specific purpose, and that it is likely to be acted upon by the recipient for that purpose.[190]

Two decisions of the Chancery Division of the High Court have applied this rule to offerings of securities in a seemingly contradictory way. The first, *Al Nakib Investments (Jersey) Ltd. v Longcroft,*[191] rejected the notion of a proximate relationship between the issuer and purchasers on the open market because, as the court reasoned, the prospectus was addressed to the shareholders solely for the purpose of enabling them to consider the rights issue.[192] A few years later, the court in *Possfund Custodian Trustee Ltd. v. Diamond*[193] took a broader view. It held that the purpose of a prospectus might traditionally have been the information and encouragement of the original allottees; however, in light of changed market practices the information was now generally also directed at aftermarket purchasers.[194] Thus, the duty of care recognized by common law assumed contours that are substantially equivalent to those of that same duty under section 90 of the FSMA.[195]

The court suggested that the rule in *Al Nakib Investments* should be reviewed,[196] and some academic authors agree that the law as expressed in *Possfund* is more in line with current regulatory demands and philosophies.[197] If this view is correct, the tort of negligent misrepresentation provides a comprehensive liability provision for communications on the primary market. On the secondary market, it might be possible to establish liability under this notion as well, albeit the requirement that the defendant expected the plaintiff to rely on the communication will provide a greater obstacle, as statements will typically not be as all-inclusive as primary market disclosures and often will not have been made with the intention to induce investment decisions.[198] Notwithstanding this

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190. *Caparo*, [1990] 2 A.C. at 638.

191. Al Nakib Inv. (Jersey) Ltd. v Longcroft, [1990] 1 W.L.R. 1390 (Ch.) (plaintiffs suffered losses after directors announced a rights issue which entitled them, as shareholders in the existing parent company, to subscribe to one share in the newly-formed subsidiary company for every five they held in the parent company).

192. *Id.* at 1399 (no duty of care owed to plaintiffs where prospectus was not given to them for the purpose of buying shares but rather for considering the rights issues, which allows existing shareholders to have the privilege of buying a specified number of new shares from the firm at a specified price within a specified time).

193. [1996] 1 W.L.R. 1351.

194. *Id.* at 1365-66.

195. *Id.* at 1365.

196. *Id*. at 1366.

197. DAVIES, *supra* note 159, para. 25-37; MORSE, *supra* note 185, para. 5.797.

198. Pursuant to FSMA § 90A, claims based on the tort of negligent misrepresentation against the issuer and other persons are excluded within the scope of § 90A (i.e. if the issuer's securities are traded on a regulated market and if the misrepresentation is contained in one of the periodic disclosures required under articles 4, 5 or 6 of the Transparency Directive: in the annual or half-yearly financial report or an interim management statement). Liability under FSMA § 90A is restricted to fraudulent acts (the defendant must have known that the statement was untrue or he must have been reckless to that effect, § 90A(4)) and to claims against the issuer. According to

ambiguity, the relevance of the tort of negligent misrepresentation will remain limited for another reason. As opposed to an action under section 90 of the FSMA, the plaintiff in a claim under common law must show that he relied on the material representation and believed that the defendant intended him to act upon it.[199] This creates a high burden of proof and may serve to bar many potential cases from being heard.

3. Summary

Section 90 of the FSMA incorporates some considerations of the gatekeeper theory by including secondary market participants—most notably underwriters and experts—as potential defendants. However, the provision is characterized by a great degree of legal uncertainty. It is vague in respect to the parameters of gatekeeper liability, and almost every aspect of the prospectus rules defining the class of responsible persons is highly ambiguous.[200] As has been shown, the torts of deceit and negligent misrepresentation do not constitute genuine gatekeeper provisions. They are addressed to the tortfeasor only, i.e. to the primary actor. A general rule of secondary liability is alien to English tort law.[201] Accordingly, the situation is comparable to that under section 10(b) of the Securities Exchange Act 1934[202] after the *Central Bank*[203] decision, albeit without the courts' attempts to extend the class of defendants to secondary participants. As a result, there is little authority on the question of when an intermediary can be considered the author or originator of the incorrect statement, an issue that has created considerable confusion in U.S. case law.

C. German Law

Two provisions shall be discussed that potentially impose liability on primary and secondary participants in the financial markets and that might, accordingly, be used to establish incentive structures conducive to gatekeeper liability: (1) The statutory prospectus liability provision, found in sections 44 and 45 of the Stock

FSMA § 90A(5), the issuer need not expect the plaintiff to rely on the disclosure, but the plaintiff must have nevertheless relied on it and his reliance must have been reasonable. For other communications, such as the episodic (ad-hoc) disclosures required pursuant to article 6 Market Abuse Directive, the torts of misrepresentation and deceit can be invoked against all tortfeasors. *See generally* DAVIES, *supra* note 159, para. 26-11.

199. *Possfund*, [1996] 1 W.L.R. at 1364 (Ch.).

200. PR, *supra* note 157, at 5.5.3.

201. *See* Credit Lyonnais Bank Nederland N.V v. Export Credits Guarantee Dep't, [2000] 1 A.C. 486, 497-500 (H.L.). *But see* Lomnicka, *supra* note 155, at 202 (indicating that limited exceptions exist for the economic torts (e.g. breach of contract, fiduciary duty, and statutory duty) and for assistance in the breach of trust).

202. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2007).

203. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

Exchange Act (BörsG);[204] (2) and liability for intentional damage contrary to public policy pursuant to section 826 of the Civil Code (BGB).[205]

1. Statutory Prospectus Liability

Section 44 of the Stock Exchange Act grants a claim for compensation if securities have been admitted to stock exchange trading on the basis of a prospectus that contained a material misstatement.[206] Defendants are "those having assumed responsibility for the prospectus,"[207] and "those initiating the issue of the prospectus."[208] The interpretation of these indefinite concepts contains the key to gatekeeper liability pursuant to sections 44 and 45. The reach of both alternatives is controversial. The first—assuming responsibility for the prospectus—is commonly construed as encompassing the signatories of the prospectus, and those making a declaration that to the best of their knowledge the information contained in the prospectus is accurate.[209] The second part of this definition refers to the declaration required by the EC Prospectus Regulation.[210] If admission of the securities is intended for trading on a regulated market, the prospectus needs to be signed by the individuals and institutions who file the application for admission, usually the issuer and at least one financial institution.[211] In general, the lead underwriter files the application.[212] Often—but not always[213]—the other underwriters also sign the prospectus in order to benefit from the ensuing publicity.

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204. Börsengesetz [BörsG] [Stock Exchange Act], July 16, 2007, BGB1. I at 1330, §§ 44, 45 (F.R.G.).

205. Law of August 18, 1896, RGBl at 195, *as amended and promulgated by* Law of January 2, 2002, BGBl. I at 42 (F.R.G.). The general provision of German tort law does not give rise to claims for pure economic loss and, therefore, cannot be utilized in this context. *See* Bürgerliches Gesetzbuch [BGB] [Civil Code] § 823(1) (F.R.G.). Other liability provisions exist that apply when statements directed at the investing public are incorrect. *E.g.*, Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], July 26, 1994, BGBl. I at 1794, *as amended and promulgated by* Law of September 9, 1998, BGBl. I at 2708 (F.R.G.) §§ 37b, c (concerning violations of the ad-hoc disclosure obligations). However, these provisions are, in general, addressed to the primary violator only and are too narrowly drafted to be of use for the gatekeeper theory.

206. Börsengesetz [BörsG] [Stock Exchange Act] § 44.

207. *Id.* § 44(1) sentence 1, No. 1.

208. *Id.* § 44(1) sentence 1, No. 2.

209. *Cf.* EXPLANATORY MEMORANDUM TO THE THIRD MARKET DEVELOPMENT ACT, BTDrucks. 13/8933, at 78; HEINZ-DIETER ASSMANN *in* HANDBUCH DES KAPITALANLAGERECHTS, § 6/222 (Heinz-Dieter Assmann & Rolf A. Schütze eds., 3d ed. 2007); EBERHARD SCHWARK *in* KAPITALMARKTRECHTSKOMMENTAR §§ 44, 45 BörsG, para. 8 (Eberhard Schwark ed., 3d ed. 2004).

210. Prospectus Regulation, *supra* note 32, at annex I, III, IV, V, no. 1

211. *See* Wertpapierprospektgesetz [WpPG] [Securities Prospectus Act], June 22, 2005, BGBl. I, at 1698, § 5(3), sentence 2; Börsengesetz [BörsG] [Stock Exchange Act] § 32(2).

212. This assertion is based on personal experience in private practice.

213. *See* Oberlandesgericht Frankfurt, Wertpapiermitteilungen [WM] 1994, 291 (293) (F.R.G) (Bond I) (holding that only the lead manager was a signatory to the prospectus).

Some scholars interpret the first alternative of section 44(1) of the Stock Exchange Act broadly in order to capture anyone who is mentioned in the prospectus and whose inclusion causes investors to rely on the review of the accurateness of the prospectus by that participant.[214] There are two problems with this suggestion. First, it does not sit easily with the wording of the statute. The mere mention of a person in the documents does not imply that this person wishes to "assume responsibility for the prospectus." Rather, as the EC Prospectus Regulation shows, the law expects the responsible persons to draft a formal declaration to be included in the prospectus.[215] Second, it is unclear when the participation of a person or institution in the securities offering creates the effect of heightened reliability of the disclosures. This is presumably not the case if the person has not been extensively involved in the drafting of the prospectus. Accordingly, should outside directors be held responsible? Should all members of the underwriting syndicate be liable or only those that have been actively involved in the drafting of the disclosure materials? Does the investor have to be aware of the degree of involvement of the potential defendant? Courts have yet to develop case law answering these questions.

The second alternative of section 44(1) of the Stock Exchange Act is equally obscure. It targets those that have not undersigned the prospectus but control its content and publication. The explanatory memorandum to the Third Financial Market Development Act that modernized the prospectus liability provisions states that the market participant, in order to be liable, needs to pursue his own financial interests with the securities offering.[216] For example, the parent company that instructs the subsidiary to conduct an offering, or the majority shareholder who orchestrates the transaction to sell his holdings would fall within the definition.[217]

Some scholars seek to go beyond the literal meaning of the statute and the legislative history.[218] They propose to hold responsible all parties who receive *some* financial advantage due to their participation in the offering, for example in the form of a fee or commission.[219] Thus, all underwriters would qualify as defendants pursuant to section 44(1) Sentence 1 no. 2 of the Stock Exchange Act.[220] Experts such as lawyers or auditors who receive remuneration for their services would effectively also be encompassed by this wide interpretation.

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214. JENS EKKENGA & HEYO MAAS, DAS RECHT DER WERTPAPIEREMISSIONEN [The Law of Securities Offerings] 341 (2006); KAY-MICHAEL SCHANZ, BÖRSENEINFÜHRUNG. RECHT UND PRAXIS DES BÖRSENGANGS [Listing on the Stock Exchange. Law and Practice of Going Public] § 13/106 (3d ed. 2007); Ulrich Bosch, *Emissionsgeschäft* [Underwriting Transactions], *in* BANKRECHT UND BANKPRAXIS [Banking Law and Banking Practice] ¶10/126 (Thorwald Hellner & Stephan Steuer eds., supp. 10/2008).

215. *See* Prospectus Regulation, *supra* note 32, at annex I, III, IV, V, no. 1.

216. BTDrucks. 13/8933 at 78 (F.R.G.).

217. *Id.*

218. *See infra* note 222.

219. *See* EKKENGA & MAAS, *supra* note 214, at 342; JÜRGEN ELLENBERGER, PROSPEKTHAFTUNG IM WERTPAPIERHANDEL [Prospectus Liability in Securities Transactions] 26 (2001).

220. *Id.*

However, while some authors do tentatively support the responsibility of these experts,[221] the majority rejects it, arguing that sections 44 and 45 of the Stock Exchange Act did not support the notion of liability for a part of the prospectus.[222]

A construction of the provision that is faithful to its wording and its legislative history argues against the wide interpretation. The requirement that the defendant must have "initiated the issue of the prospectus" suggests that he has to play a prominent role in the realization of the offering.[223] Auditors and other experts provide assistance, but they are not the driving force behind the transaction. The lead underwriter assumes a more central position, although the initiative for the offering does not originate from him either. The other underwriting banks are often not involved in the structuring of the offering and the drafting of the prospectus.[224] Furthermore, the examples in the explanatory memorandum make clear that an indirect financial interest in the offering, such as a selling commission, does not suffice. The offering *itself* (and not a subsequent obligation of the issuer) has to generate the financial advantage for the defendant. Both elements—the assumption of a central role and a direct financial interest in the offering—are indispensable for section 44(1) sentence 1, no. 2.[225] They might be satisfied if a member of the issuer's management organizes the offering to further his own interests.[226] Other potential gatekeepers, however, will virtually never fall within the scope of the provision.

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221. *See* Ulrich Bosch, *Expertenhaftung gegenüber Dritten. Überlegungen aus der Sicht der Bankpraxis* [Liability of Experts to Third Parties. Considerations from the Perspective of the Banking Practice] *in* ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT [ZHR] 163, 274, 279 (1999); WOLFGANG GROß, KAPITALMARKTRECHT [Capital Markets Law] §§ 44, 45 BörsG, para. 37 (3d ed. 2006).

222. ASSMANN, *supra* note 209, § 6/224; Ulrich Ehricke, *Deutschland* [Germany], *in* PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG 187, 228 (Klaus J. Hopt & Hans-Christoph Voigt, eds., 2005); EKKENGA & MAAS, *supra* note 214, at 304; ELLENBERGER, *supra* note 219, at 28; Markus R. Hauptmann, *Die spezialgesetzliche Prospekthaftung gemäß Börsengesetz und Verkaufsprospektgesetz* [Prospectus Liability Pursuant to the Stock Exchange Act and the Law on the Prospectus for Securities Offered for Sale], *in* PROSPEKTHAFTUNG UND ANLAGEBERATUNG [Prospectus Liability and Investment Advice] § 3/54, 55 (Jürgen Vortmann ed., 2000); SIEGFRIED KÜMPEL, BANK- UND KAPITALMARKTRECHT [Banking and Capital Markets Law] para. 9.367 (3d ed. 2004). The view that persons such as auditors who supplied individual sections for the prospectus were not defendants is hardly convincing. If it is accepted that an indirect financial interest in the offering is sufficient to bring the party within the scope of section 44(1) Sentence 1 no. 2 Stock Exchange Act, it follows that experts are in the same position as, for example, underwriters. In addition, the Prospectus Regulation makes it unequivocally clear that responsibility can be assumed for parts of the offering documentation. *Cf.*, *inter alia*, Prospectus Regulation, *supra* note 32, at annex I, 1.

223. BTDrucks. 13/8933, at 78.

224. It is common that the lead underwriter does not contact the other members of the underwriting syndicate earlier than a few days before the offering commences.

225. *See* BTDrucks. 13/8933, *supra* note 209, at 78.

226. GROß, *supra* note 221, §§ 44, 45 BörsG, para. 35.

2. Fraud

Because of the inapplicability of sections 44 and 45 of the Stock Exchange Act to communications on the secondary market and the difficulties associated with other liability provisions,[227] the courts have, in the wake of the numerous accounting frauds committed by companies listed on the New Market of the Frankfurt Stock Exchange,[228] begun to make use of a provision of the German Civil Code that is, at first view, not well suited to remedy excesses in the financial markets.[229] Section 826 stipulates that a person "who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage."[230] The main advantage of the provision, and the reason why the courts have taken recourse to it, is that it is not excluded within the scope of sections 44 or 45 of the Stock Exchange Act, i.e. when the misleading statements relate to a security listed on a regulated market or offered to the public.[231]

Liability under section 826 of the Civil Code is not restricted to certain types of defendants. Under it the courts have held auditors,[232] lawyers,[233] and tax consultants[234] responsible. However, recovery is impeded by the fact that the plaintiff must show a violation of public policy, scienter, and reliance. Thus, a claim based on section 826 is generally only feasible in cases of clear, profound mistakes in the disclosures of the defendant. An example of such a mistake is an expert submitting an entirely unsubstantiated opinion, without verifying the factual basis of the information and ignoring concerns that have arisen during the investigation in an unscrupulous manner, in order to further his own financial interest and without taking regard of the interests of the recipient.[235]

Furthermore, investors need to demonstrate that they were aware of the incorrect information and relied on it when making their investment decision, a requirement that does not reflect common practice in the financial markets where,

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227. In particular general civil law prospectus liability, a concept that has been developed by the courts. *E.g.*, BGHZ 79, 337 (342); BGHZ 111, 314 (320); BGHZ 123, 106.

228. Landler, *supra* note 3, at W1.

229. Three of the most infamous economic scandals of the recent past in Germany – Infomatec, Comroad, and EM.TV – have given the courts ample opportunity to develop their doctrines. *See* Infomatec cases: BGHZ 160, (Infomatec I); BGHZ 160, 149 (Infomatec II); BGH NJW 2004, 2668 (Infomatec III); EM.TV cases: BGH ZIP 2007, 1407 (reliance); BGH NJW 2005, 2450 = ZIP 2005, 1270. Comroad cases: BGH WM 2007, 683 = ZIP 2007, 681 (Comroad I); WM 2007, 684 = ZIP 2007, 679 (Comroad II); WM 2007, 486 = ZIP 2007, 326 (Comroad III); WM 2007, 1557 = ZIP 2007, 1560 (Comroad IV); WM 2007, 1560 = ZIP 2007, 1564 (Comroad V); WM 2008, 395 = ZIP 2008, 407 (Comroad VI); WM 2008, 398 = ZIP 2008, 410 (Comroad VII).

230. Bürgerliches Gesetzbuch [BGB] [Civil Code], *supra* note 205, § 826, *translated by* Langenscheidt Translation Service, *available at* http://bundesrecht.juris.de/englisch_bgb/.

231. Börsengesetz [BörsG] [Stock Exchange Act], *supra* note 204, § 47(2).

232. BGH NJW 1956, 1595.

233. BGH NJW 1972, 678 (680).

234. NJW 1986, 180 (181); NJW 1987, 1758. In this context, *see also* BGH NJW 1992, 3167 (3174) (IBH/Scheich Kamel); NJW 1980, 2460 (2461); NJW 1979, 1599 (1600).

235. BGH NJW 1991, 3282 (3283).

generally, only professional participants study all disclosures.[236] Several lower courts acknowledged this and granted relief if the plaintiff was able to show that the misrepresentation had substantially negatively affected the market price of the securities.[237] In such a case, they argued, it was apparent that the plaintiff's investment decision would have been different had the correct information been revealed: the plaintiff would not have bought at the unjustified higher price.[238] Even though the courts did not explicitly refer to the American fraud-on-the-market theory, their reasoning makes clear that they adopted its rationale.[239] However, on appeal, the Federal Court of Justice quashed the decisions.[240] It stipulated that even in cases of blatant fraud the investor was not entitled to rely on the artificially inflated market price but had to prove actual reliance.[241] The court's more restrictive interpretation was guided by the desire to prevent section 826 of

236. *See infra* note 239.

237. LG München I, ZIP 2006, 1586 (Comroad); OLG München, ZIP 2005, 1141 (1142-43) (Comroad).

238. ***Id.***

239. Major works that have shaped the fraud-on-the-market theory are Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Eugene F. Fama, *Efficient Capital Markets II*, 46 J. FIN. 1575 (1991); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549-50 (1984). It should be noted that the fraud-on-the-market theory often fails in cases of primary market disclosures. The theory requires that the securities are traded in a (semi-) efficient market. Public offerings intend to create the market; the issue price does not reflect information already available in the market but generally rests on the assumptions of the bookrunner that evaluates the order book. Thus, the investor cannot argue that he has been disappointed in his expectation that the security's market price is a reflection of its true value. This problem has been discussed in Freeman v. Laventhol & Horwath, 915 F.2d 193, 198-99 (6th Cir. 1990). For a different approach, the so-called fraud-created-the-market theory, *see* Ockerman v. May Zima & Co., 27 F.3d 1151, 1159-60 (6th Cir. 1994):

> [I]nvestors should be able to rely on the fact that local governments would not authorize, underwriters would not finance and brokers would not offer to sell bonds they knew were unmarketable. … There are at least two possibilities. One view, economic unmarketability, holds that a security is unmarketable if no investor would buy it because, assuming full disclosure, the security is patently worthless. Second, a security is legally unmarketable if, absent fraud, a regulatory agency or the issuing municipality would have been required by law to prevent or forbid the issuance of the security. Under both theories of unmarketability, it is argued that the investment decision is caused by fraud because but for the fraud, the security could not have been proposed, issued, or sold.

In Germany, the Court of Appeal [OLG] Frankfurt, AG 2006, 584, followed a similar path: Reliance of the investor on the issuer's financial statements was irrelevant if the securities would not have been admitted to trading had the issuer disclosed its true financial condition. The Federal Court of Justice repealed the decision of the OLG Frankfurt, arguing that causality under section 826 Civil Code required more than a mere application of the but-for test (the conditio-sine-qua-non formula). BGH ZIP 2008, 410 (411-12) (Comroad VII); ZIP 2008, 407 (408-09) (Comroad VI).

240. BGH ZIP 2008, 410 (411) (Comroad VII); ZIP 2008, 407 (409) (Comroad VI); ZIP 2007, 326 (Comroad III); ZIP 2007, 679 (680) (Comroad II); ZIP 2007, 681 (682) (Comroad I).

241. BGH ZIP 2007, 326.

the German Civil Code from becoming an indiscriminate catch-all provision that would significantly increase the risk of liability for professional market participants. The court argued that since section 826 could be invoked by anyone against an undefined class of defendants, the necessary limitations had to be achieved by means of a narrow construction of the causality requirement.[242]

3. Summary

German law is, *de lege lata*, ill-equipped to implement gatekeeper liability. Sections 44 and 45 of the Stock Exchange Act do not encompass most of the parties that are suitable gatekeepers, and section 826 of the Civil Code is not an adequate instrument to address the particularities of transactions in the financial markets, at least not if the narrow interpretation advocated by the Federal Court of Justice is accepted.

IV. COMPARATIVE ANALYSIS

A. The Regulatory Structure

Any system of financial market regulation has to balance two antagonistic objectives: comprehensive investor protection on the one hand, and the provision of a regulatory environment that is conducive to economic activity on the other hand. Comprehensive investor protection requires that investors have remedies at their disposal if professional market participants sell deficient products or otherwise harm the interests of the investing public. The most important case of such harmful activity is the dissemination of incorrect information that affects the investment decisions of the public in a way that causes financial loss.[243] The publication of misleading or inaccurate information can occur in the primary and the secondary market. Accordingly, remedies should be available in both markets.

Investor protection is not effective if the hurdles to recovery are too high, in particular if the investor bears the burden of proof for factors that he can only verify with great difficulty. For instance, it may be overly burdensome if the investor has to show that he relied on an incorrect piece of information where that information was phrased in highly technical terms, was circulated by a party that stands in no legal relationship with the investor, and has influenced the value of the investor's interest through market operations. Likewise, the hurdle to recovery would be too high if the investor had to determine negligence or scienter on the part of a market participant with whose operations he is not familiar. Finally, the investor needs to be protected against a judgment-proof defendant. Major financial scandals often leave a bankrupt issuer behind; if the issuer is the only addressee of liability provisions, investors will frequently not be able to recover their losses.

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242. *Id*.

243. Other important instances of harmful behavior are insider trading and market manipulation. Both types of behavior are regulated (in the United States: *inter alia* section 10(b) Securities Exchange Act, Rule 10b-5; in the EU: Market Abuse Directive, *supra* note 35), and have been widely discussed in the literature. They shall not be pursued here.

The problem of high capital costs occurs if the defendant cannot calculate or control the risk of liability. He cannot calculate the risk of liability if the respective provisions are drafted in an ambiguous way. The market participant will then have to allocate higher expenses for legal advice and the defense against lawsuits. Additionally, he might be forced to enter into settlements to save litigation expenses because the outcome of an action is uncertain despite its frivolous nature. He is not able to control the risk of liability if the law establishes a regime of strict liability, and he cannot review compliance of the actions that give rise to the claim, such as the publication of incorrect information, with absolute certainty. This problem is particularly pronounced if the defendant is responsible for the actions of another party, i.e. in the gatekeeper context. A regime of negligence alleviates the issue to some extent, but the defendant faces the additional difficulty of determining the appropriate standard of care he must employ in order to be absolved from liability.

The provisions of U.S., U.K., and German law introduced above shall be examined in light of these considerations. All three jurisdictions provide for liability for misrepresentations both in the primary and secondary market.[244] While primary market liability is contained in provisions that have been drafted precisely for this purpose,[245] liability in the secondary market is fragmented. Some express causes of action exist, but they only encompass specific disclosures.[246] In order to ensure a more comprehensive protection of investors, the courts in all three countries have taken recourse to general antifraud and tort law principles.[247] This approach has produced two problems: First, concepts that were not developed with a view to the regulation of the financial markets[248] or intended to grant a private cause of action[249] needed to be modified or newly construed in order to conform to the particular features of capital market transactions. Second, this modification was

244. *See infra* notes 245-46.

245. United States: Securities Act of 1933 § 11, 15 U.S.C. § 77k (2007); United Kingdom: FSMA 2000 (c. 8) § 90; Germany: Börsengesetz [BörsG] [Stock Exchange Act], July 16, 2007, BGB1. I at 1330, §§ 44, 45.

246. U.K.: FSMA 2000, § 90A; Germany: WpHG [Securities Trading Act], Sept. 9, 1998, BGB1. I at 2708 §§ 37b, c. The reach of these provisions is explained *supra,* notes 198 and 205. Securities Exchange Act of 1934 §18, 15 U.S.C. § 78(r) (2007), applies to most documents that have to be filed with the SEC under the Exchange Act; however, in practice it is of little use since it requires actual reliance. *Cf.* Ross v. A.H. Robins Co., 607 F.2d 545, 552 (2d Cir.1979); Heit v. Weitzen, 402 F.2d 909, 916 (2d Cir.1968), *cert. denied*, 395 U.S. 903 (1969).

247. United States: Securities Exchange Act § 10(b); Germany: Bürgerliches Gesetzbuch [BGB] [Civil Code], August 18, 1896, RGBl. at 195, *as amended and promulgated by* Law of January 2, 2002, BGBl. I at 42, § 826 (F.R.G.); U.K: Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd., [1964] AC 465 (H.L.) (establishing the tort of negligent misrepresentation and holding that if a party disseminates information likely to be relied on, a "special relationship exists" in which the defendant has to take sufficient care in giving advice to avoid negligence liability).

248. Germany: Bürgerliches Gesetzbuch [BGB] [Civil Code], *supra* note 247, § 826; United Kingdom: *Hedley*, [1964] A.C. 465.

249. United States: Securities Exchange Act § 10(b).

brought about by the judiciary rather than the legislator. Necessarily, courts cannot fashion an overarching and coherent regulatory system; they are confined to operating within a given legislative framework and to reacting to specific, separate issues. Their decisions rest on the facts of the individual case and may not provide generally applicable solutions.

The movement towards tort law in Europe is relatively novel.[250] In the United States, on the other hand, the first decisions discussing the nature of Exchange Act Rule 10b-5 as a private cause of action go back more than sixty years.[251] Therefore, a review of the development of Rule 10b-5 might prove insightful when assessing the case law in Europe. The first decades after the "discovery" of Rule 10b-5 as a private cause of action were characterized by an increasingly expansive interpretation of the elements of the provision. The section was held to apply to securities registered on a national securities exchange as well as securities not traded in a regulated market[252] and face-to-face transactions.[253] It could be invoked in cases falling within the scope of section 11 Securities Act and any other liability provision of the Securities Act of 1933 and the Securities Exchange Act of 1934 free of the procedural and other restrictions imposed on the express causes of action.[254] The defendant need not have acted with scienter; negligence was sufficient.[255] If he failed to disclose facts that were material "in the sense that a reasonable investor might have considered them important in the making of [his investment] decision,"[256] plaintiffs were not required to establish reliance.[257] Claims could be brought against the perpetrator of the fraud and those aiding and abetting the violation.[258]

In 1975, the Supreme Court began to retreat from this liberal position. This turnaround was prompted by its realization that a broad construction of Rule 10b-5 opened the door to strike suits,[259]distorted the balance between Rule 10b-5 and the

250. In the U.K., it started in the 1990s with Caparo Indus. Plc v. Dickman, [1990] 2 A.C. 605 (H.L.) (Appeal taken from Q.B.). In Germany, it started even more recently with the Infomatec decisions of the Federal Court of Justice in 2004. BGHZ 160, 134 (Infomatec I); 160, 149 (Infomatec II); BGH NJW 2004, 2668 (Infomatec III).

251. Kardon v. Nat'l Gpysum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

252. Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).

253. Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

254. Herman & MacLean v. Huddleston, 459 U.S. 375 (1983); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-787 (2d Cir. 1951); Ellis v. Carter, 291 F.2d 270, 273-74 (9th Cir. 1961).

255. *E.g.,* Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963). The circuits were split regarding the applicable standard. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193at n.12 (1976).

256. Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 153-54 (1972).

257. *Id.*

258. The leading case until 1993 was Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

259. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742 (1975) (providing examples of the danger of "strike suits," i.e. lawsuits that are brought with the intention to obtain a private settlement rather than addressing a perceived wrong by the company or its officers).

express liability provisions of the Securities Acts, and led to increased litigation expenses and capital costs.[260] Thus, the Supreme Court limited the class of plaintiffs to actual purchasers and sellers,[261] rejected the notion that Rule 10b-5 applied to negligent actions[262] or to breaches of fiduciary duties that did not display any element of manipulation or deception,[263] overruled decisions that had allowed claims against secondary violators,[264] and reinstated the traditional elements of causation and loss.[265] However, most of these clarifications have generated a wealth of new problems,[266] and after sixty years of oscillating case law, clearly defined parameters of responsibility under Rule 10b-5 have still not emerged.

The similarities between Rule 10b-5, the English tort of negligent misrepresentation and section 826 of the German Civil Code are striking. Rule 10b-5 has evolved from the tort of deceit and misrepresentation;[267] it therefore

260. *Id.* (quoting Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136, 147 n.9 (9th Cir. 1973): "The great ease with which plaintiffs can allege the requirements for [standing under a suggested broad interpretation of Rule 10b-5] and the greater difficulty that plaintiffs are going to have proving the allegations [because standing could be based on hypothetical facts: the plaintiff could allege that he would have purchased the securities but for the misrepresentation] will allow a relatively high proportion of 'bad' cases into court. The risk of strike suits is particularly high in such cases; although they are difficult to prove at trial, they are even more difficult to dispose of before trial."); *see also* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 552 U.S. 148, 163-65 (2008); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-10 (1976) (concerning the question whether Rule 10b-5 covered negligent acts, the court stated: "We . . . consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct … is subject to significant procedural restrictions not applicable under s 10(b) . . . We think these procedural limitations indicate that the judicially created private damages remedy under § 10(b) . . . cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by §§ 11, 12(2), and 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.").

261. *Blue Chip*, 421 U.S. at 742.

262. *Ernst*, 425 U.S. at 185. *See supra* note 100 (definition of scienter).

263. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (involving a breach of fiduciary duties of the majority shareholder towards the minority with the majority fully disclosing the effects of the transaction).

264. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

265. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). Accordingly, plaintiffs must prove that the misrepresentation has proximately caused their economic loss. They cannot recover for a loss brought about by other factors influencing market movements.

266. *See supra* Part III(A)(2) (discussion concerning the different approaches to an application of *Central Bank*). *See also* the exceptions to the *Birnbaum* rule applied in *Blue Chip* (*e.g.,* Alley v. Miramon, 614 F.2d 1372 (5th Cir. 1980), affirming the pre-*Blue Chip* forced seller exception; Gurley v. Documation Inc., 674 F.2d 253 (4th Cir. 1982), holding that the delayed sale exception did not survive *Blue Chip*), and the allegation that the *Birnbaum* rule draws an arbitrary line between actual sellers and purchasers (who have standing) and other parties who might have been affected by the misrepresentation in the same way but, as a result of the fraud, abstained from entering into a transaction**,** Lewis D. Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968).

267. *Blue Chip*, 421 U.S. at 744.

shares common ancestors with its European counterparts.[268] All three provisions started out by imposing high hurdles to a claim for damages: plaintiffs had to show scienter,[269] reliance, loss causation, and an element of fraud, deceit or violation of public policy. All provisions have later been interpreted expansively by the courts in order to make allowance for the specific characteristics of transactions in the capital markets.[270] In all three countries, the case law is contradictory and inconsistent. In the United Kingdom and Germany the development is still in its infancy, but if Rule 10b-5 can serve as an example, the road to legal certainty and a balanced regime of investor protection will be long, and a satisfactory solution may never be achieved without intervention of the legislator.

Despite the "retrenchment" decisions of the U.S. Supreme Court, investor protection under Rule 10b-5 is more extensive than under the torts of deceit and negligent misrepresentation in the United Kingdom or section 826 of the German Civil Code. Rule 10b-5 is no longer governed by traditional principles of tort law. While the concept of "recklessness" applied by the U.S. courts is nearly identical to that of *Derry v. Peek*,[271] investors do not have to show that the defendant intended them to act on the misrepresentation.[272] Thus Rule 10b-5, as opposed to

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268. *See supra* Parts III(B)(2), III(C)(2).

269. This is true for the English tort of deceit that was the antecedent to the tort of negligent misrepresentation.

270. In Germany, the expansive interpretation has been advocated by lower courts, but then to some extent been curtailed by the Federal Court of Justice. *See supra* Part III(C)(2).

271. *Compare* the definitions in Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990), and Broad v. Rockwell Int'l. Corp., 642 F.2d 929, 961-62 (5th Cir. 1981), and Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) on the one hand, *with* Derry v. Peek (1889) L.R. 14 App. Cas. 337, 369 (H.L.).

272. *See* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969):

> [I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. . . . [T]he investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance.

Even more explicit is Semerenko v. Cendant Corp., 223 F.3d 165, 176 (3d Cir. 2000):

> The purpose underlying § 10(b) and Rule 10b-5 is to ensure that investors obtain fair and full disclosure of material facts in connection with their decisions to purchase or sell securities. (citation omitted). That purpose is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public's interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities. (citation omitted). We therefore . . . hold that the Class may establish the "in connection with" element simply by showing that the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated. We also point out that, under the standard which we adopt, the Class is not required to establish that the defendants actually envisioned that members of the Class would rely upon the alleged misrepresentations when making their investment decisions.

the tort of deceit, can be relied upon by anonymous investors in the aftermarket. In addition, plaintiffs can take recourse to the fraud-on-the-market theory in order to establish reliance, which is not possible under either the tort of deceit or the tort of negligent misrepresentation.[273]

The main disadvantage of the tort of negligent misrepresentation is the requirement that the defendant owes the plaintiff a duty of care. The relevance of this prerequisite for misrepresentations in public offerings is unclear, and recovery in the secondary market is most likely excluded.[274] Rule 10b-5 does not suffer from these deficiencies. A comparison with German law yields similar results. Section 826 of the German Civil Code constitutes a narrower avenue for investors than the American Rule 10b-5. Plaintiffs need to prove a violation of public policy and, more importantly, actual reliance.

The express liability provisions come with their own problems. Again, U.S. law is characterized by causes of action that are favorable to plaintiffs. Reliance and loss causation either do not constitute elements of sections 11, 12(a)(1), and 12(a)(2) of the Securities Act, or they are structured as defenses, so that the defendant bears the burden of proof. Section 12(a)(1) of the Securities Act does not require the plaintiff to show more than a violation of section 5 of the Securities Act. Neither English nor German law provides investors with equally broad causes of action. European counterparts to sections 12(a)(1) and (2) of the Securities Act do not exist, and sections 90 FSMA and 44 and 45 of the German Stock Exchange Act, while stipulating shifts in the burden of proof similar to those under U.S. law,[275] are addressed to an obscure class of defendants.[276]

Thus, to summarize, even after the "retrenchment" decisions of the Supreme Court, investors in the United States have stronger remedies at their disposal than those in Germany or the United Kingdom.[277] This is true for the primary and even

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See also AUSA Life Ins. Co. v. Ernst and Young, 206 F.3d 202, 221 (2d Cir. 2000) (holding that scienter does not presuppose that the defendant intended the investors to act on the misrepresentation). The law in England is the opposite. *See* Peek v. Gurney (1873) L.R. 6 H.L. 377, 412-13.

> First . . . every man must be held responsible for the consequences of a false representation made by him to another, upon which that other acts, and, so acting, is injured or damnified; Secondly, every man must be held responsible for the consequences of a false representation made by him to another, upon which a third person acts, and so acting, is injured or damnified, provided it appear that such false representation was made with the intent that it should be acted upon by such third person in the manner that occasions the injury or loss.

273. Basic Inc. v. Levinson, 485 U.S. 224, 241 (1988). *But see Stoneridge*, 552 U.S. at 158-162.

274. *See supra* Part III(B)(2).

275. *See* BörsG [Stock Exchange Act], *supra* note 245, § 45(2)(1)-(2) (shifting the burden of proof for reliance and loss causation); FSMA 2000 § 90 (requiring plaintiffs to show loss causation but not that they relied on the misstatement), *see supra* note 199.

276. *See infra* Part IV(B).

277. This diagnosis is reflected in the high number of securities lawsuits and the large settlement values in the United States. *Cf.* Stephanie Plancich & Svetlana Starykh, *2008 Trends in*

more so for the secondary market. Still, data shows that investor protection in the United States is by no means complete; investors in general are not able to recover more than five percent of the investment loss.[278] Consolidated data for Europe does not exist, but the figure is likely to be lower. Furthermore, the numerous and unclarified problems of statutory construction that afflict the capital market laws of all three countries are an obstacle to effective regulation. Legal uncertainty is vast and, consequently, transaction costs are high, entailing negative effects for both investors and professional market participants. The legislature is called upon to remedy the ambiguities and remove the greatest obstacles to recovery for investors, such as the requirement to show reliance.[279]

The next two sections will address the question of how the existing liability regimes may be modified in light of the gatekeeper theory in order to enhance investor protection.

B. Defendants

To reduce the cost of capital, only third parties that are well positioned to review the acts and disclosures of the primary market actor should be held

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Securities Class Actions (NERA Economic Consulting), Dec. 2004, *available at* http://www.nera.com/image/PUB_Recent_Trends_Report_1208.pdf. However, it should be noted that the number and value of securities lawsuits depends as much on the substantive liability provisions as on the procedural devices that are available, in particular the parameters of the class action mechanism. Thus, the data in the report can only be used with caution to assess the effectiveness of the provisions discussed in this paper. The much lower number of securities lawsuits in Europe might be as much a result of the more restrictive liability provisions as of the less accommodating procedural environment.

278. *Id.* at 13-14; Mukesh Bajaj et al., *Securities Class Action Settlements: An Empirical Analysis* (Study of the Stanford Law School Securities Class Action Clearing House), Nov. 16, 2000, at 24-28, *available at* http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf (for data until 1999). The figures vary greatly depending on how investment loss is computed.

279. The fraud-on-the-market theory is an adequate tool to achieve this goal. *See* Basic Inc. v. Levinson, 485 U.S. 224, 243-44 (1988) (pointing out that "[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences"). This consideration applies to Europe as much as to the United States. In securities fraud cases, the market is interposed between the perpetrator of the fraud and the buyer. Market price is the guiding factor for the buyer's investment decision. *See In re* LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980) (the market "transmits information to the investor in the processed form of a market price"). Concerns of European courts that the abandonment of actual reliance could open the floodgates to indiscriminate securities litigation and disproportionately increase the risk of liability seem exaggerated. *See* BGH ZIP 2007, 326. The liberal interpretation of Rule 10b-5 has not caused a drying up of the capital markets in the United States, and an overly broad reach of the fraud provisions can be counteracted by a restrictive construction of other elements, for example scienter (as is already the case in respect to section 826 of the German Civil Code) or loss causation (*e.g.*, pursuant to the principles of *Dura Pharmaceuticals*, *supra* note 265). Conversely, the fate of the express liability provision of section 18 Securities Exchange Act has shown that the requirement of actual reliance can lead to a negation of the investor protection goal of the provision. *See* HAZEN, *supra* note 103, at § 12.18.

responsible as gatekeepers.[280] The burden that gatekeeper liability imposes on the third party decreases the more intimately the gatekeeper is familiar with the primary market participant's business and the more easily it can verify the accuracy of the relevant information. Applying these considerations to third party actors in the financial markets,[281] some general observations can be made about the suitability of the parties as gatekeepers.

Internal directors are intimately involved in the drafting of corporate disclosures. However, they are also subject to the most severe conflicts of interest. They are the actors that can gain most from false statements. Their salary might be tied to a high share price, and their career might depend on a seemingly successful running of the business. Consequently, holding only such directors responsible for violations of securities regulation by the primary market actor is not sufficient.[282] The position of outside directors is ambivalent. On the one hand, they often lack the time and expertise to familiarize themselves with all details of the issuer's business operations. On the other hand, they participate in regular board meetings and decide on fundamental corporate changes. Therefore, they will be able to function as gatekeepers for certain transactions, but they may not be well equipped to review technical and detailed accounts, for example the financial data in the offering prospectus.[283] Experts, such as accountants, lawyers, appraisers or engineers are best positioned to ensure the correctness of their opinions. However, they have no influence on the content of the parts of the disclosure not prepared by them.

Finally, underwriters occupy a central position in the process of offering and selling securities. They—or at least the lead underwriter—prepare and structure the offering, conduct a due diligence of the issuer, organize road shows and other marketing activities, draft the offering documents, receive subscriptions for securities, determine the issue price, apply for admission to trading of the securities, and perform stabilization measures.[284] They possess the necessary expertise to assess even highly technical information. In addition, they are not subject to the same conflicts of interest as issuers or inside directors. Their gain from participation in the offering is smaller—they receive a small percentage

280. *See generally* GERNER-BEUERLE, *supra* note 176, at 536-42.

281. These actors include executive and non-executive directors, underwriters, accountants, auditors, and lawyers. Other parties may act as gatekeepers, e.g. securities analysts and rating agencies. *See* COFFEE, GATEKEEPERS, *supra* note 6, at 245-306. However, responsibility of these intermediaries is problematic. *Id.* at 263-70, 302-04. A discussion of the issues is beyond the scope of this article.

282. *See* Coffee, *supra* note 4.

283. *See e.g.* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864 (1993); Ran Duchin et al., *When Are Outside Directors Effective?* (USC CLEO Research Paper No. C07-13, 2008), available at http://ssrn.com/abstract=1026488 (arguing that outside directors can be effective when the cost of acquiring information is low). *Compare* the account of the failure of the outside directors composing Enron's audit committee given by COFFEE, GATEKEEPERS, *supra* note 6, at 25-26.

284. *See* GERNER-BEUERLE, *supra* note 176, at 54.

(roughly between five and seven percent) of the proceeds of the offering as underwriting and selling fees. However, their potential loss from litigation is higher. The success of their business operations generally depends to a high extent on their reputation, which may be tarnished by allegations of fraud and deception.[285] Courts realize the exceptional role of the underwriter in the primary market. They emphasize that "[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter."[286]

Section 11 of the Securities Act implements these aspects in a convincing way. All of the actors identified as suitable gatekeepers are caught by the provision. Furthermore, the section allows for the limited contribution of experts,[287] the limited influence of outside directors,[288] and the different roles of defendants in the offering process.[289] The other liability provisions of U.S. law are less well structured.[290] This paper has presented the controversies surrounding the class of defendants under Rule 10b-5.[291] The Supreme Court has probably chosen the worst of both worlds. In excluding aiding and abetting liability, it wanted to increase legal certainty and prevent misuse of Rule 10b-5 in litigation. Yet, the courts recognized that a narrow interpretation of Rule 10b-5 would not provide enough flexibility to grant investors a cause of action in all relevant cases and against all perpetrators of fraud. Accordingly, inventive constructions of the term "primary violator" have evolved whose effectiveness in protecting investors is diminished by the requirement to bring them in line with the Supreme Court's holding in *Central Bank*. As a result, the courts have achieved neither legal certainty nor enhanced investor protection.

If gatekeeper liability is desirable, as argued above, secondary violators should be brought within the ambit of Rule 10b-5, thus creating a counterpart to section 11 of the Securities Act that would comprehensively govern the secondary market and supplement liability in the primary market. *De lege lata*, Rule 10b-5 is better suited to fill the gaps in the regulatory system than sections 12(a)(1) or (2) of the Securities Act. It is more flexible than section 12(a)(1), which requires a violation of section 5 Securities Act, and section 12(a)(2), which does not apply to

285. *See supra* Part II(A); *see also* U.S. v. Morgan, 118 F. Supp. 621, 744 (S.D.N.Y. 1953) (quoting John Pierpont Morgan: "[I]f, in the exercise of his profession, the private banker disregards [his code of professional ethics], which could never be expressed in legislation, but has a force far greater than any law, he will sacrifice his credit. This credit is his most valuable possession; it is the result of years of fair and honorable dealing and, while it may be quickly lost, once lost cannot be restored for a long time, if ever.").

286. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973); *accord* BGHZ 139, 225 (230) (Elsflether Werft).

287. *See* 15 U.S.C. § 77k(a)(4) (2007) (holding experts liable only for misstatements in their opinions).

288. *Id.* § 77k(f)(2)(A) (determining liability for outside directors in accordance with 15 USC § 78u-4(f), which holds defendants liable jointly and severally if they acted knowingly and proportionately to the respective percentage of responsibility if they did not act knowingly).

289. *See infra* Part IV(C) (providing for a flexible standard of care).

290. *See supra* Part III(A)(2), (3).

291. *See supra* Part III(A)(2).

secondary market transactions and private placements.[292] At the same time, the risk of excessive liability can be contained more easily through elements such as loss causation or scienter, which are not part of the causes of action under sections 12(a)(1) and (2).

The prospectus liability provisions of English and German law are unsatisfactory. In spite of a catalogue of defendants in the Prospectus Rules that is similar to section 11(a) of the Securities Act, it is unclear whether and under what conditions experts and underwriters are responsible pursuant to section 90 of the FSMA 2000. Sections 44 and 45 of the German Stock Exchange Act do not encompass any gatekeepers except the underwriters, and it is questionable whether all or only some members of the underwriting syndicate are caught. Where possible, section 11 of the Securities Act should serve as a model for amendments or the interpretation of the existing provisions. In particular, the legislature should acknowledge that effective incentive structures require that the expert be accountable for misstatements in the opinion provided by him, and the underwriters for the whole prospectus.[293]

It is important to note that not all of the underwriters are involved in the offering process to the same degree. Often only the lead underwriter prepares the offering.[294] Therefore, the other underwriters may not be as familiar with the financial condition and the business operations of the issuer. Expecting a complete due diligence from them would disproportionately increase the cost of capital. However, these are questions that are better addressed in the context of the applicable standard of care. In some cases the members of the underwriting syndicate will be in a position to review parts or all of the information contained in the prospectus, and a rule that excludes the liability of all underwriters except the bookrunner will be too undifferentiated.

A general rule restricting the class of defendants is useful for banks that are engaged in the placement of the securities as sub-underwriters, selling agents and brokers. These agents contract with the underwriters, rather than the issuer. Information necessary to verify the correctness of the issuer's disclosures is not

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292. *See* Gustafson v. Alloyd Co., Inc., 513 U.S. 561 (1995) (holding that the term "prospectus," for purposes of the Securities Act, refers only to "a document that describes a public offering of securities by an issuer or controlling shareholder" to the exclusion of other documents); *see also* Elliot J. Weiss, *Securities Act Section 12(2) after Gustafson v. Alloyd Co.: What Questions Remain?*, 50 BUS. LAW. 1209, 1225 (1995).

293. The Börsengesetz [Stock Exchange Act] does not leave much scope for interpretation to implement these considerations. *Supra* Part III(C)(1). The English Prospectus Rules may be broad enough to allow for an inclusion of all experts (by restrictive interpretation of Prospectus Rule 5.5.9, which stipulates that responsibility shall not attach to a "person giving advice … in a professional capacity") and the underwriters (as "offerors" within the meaning of PR 5.5.3(2)(d)(i); however, this approach presupposes that the exception of PR 5.5.7 does not apply, i.e. that the prospectus was not drawn up primarily by the issuer or the underwriters acting on behalf of the issuer, which might be difficult to argue). In any case, a clarification of the ambiguous terms of section 90 FSMA and the Prospectus Rules by the legislator would be preferable.

294. *Supra* notes 224, 284.

easily available to them. Consequently, the increase in the cost of capital caused by the heightened risk of liability of such secondary actors would not be offset by an improvement in investor protection.[295]

In the secondary market, investor protection is even less developed. The tort of negligent misrepresentation does not apply to secondary violators. While section 826 of the German Civil Code has been invoked against directors, only a few actions were successful in exceptional cases of blatant fraud.[296] Furthermore, the courts have not shown any inclination to broaden the scope of the provision and hold the financial intermediaries liable. As a consequence, investors were left without a remedy in some instances of accounting fraud and dissemination of incorrect ad-hoc announcements and other statements.[297] The legislature should establish liability of the actual authors of misleading statements, i.e. the issuer's directors, and those secondary actors that have participated in the drafting or reviewing of the statement, such as the auditors.

C. Standard of Care

The provisions under survey display a diverse array of liability standards, ranging from strict liability to negligence, gross negligence, and scienter (or recklessness). German law exhibits the most restrictive standard: gross negligence for primary market prospectus liability[298] and scienter in all other cases.[299] U.S. and English rules for the primary market allows claims based on negligence.[300] In the secondary market, English law applies the same standard, but the deficiencies of the tort of negligent representation have been shown.[301] The most commonly used U.S. liability provision for the secondary market, Rule 10b-5, requires scienter; but the high standard in respect to the defendant's state of mind is somewhat compensated for by the flexibility of the rule regarding other elements of the cause of action.[302]

Ideally, an efficient system of liability should fix the standard of care at a level where the cost of one additional unit of care equals the reduction in expected

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295. Accordingly, the Securities Act stipulates that the term "underwriter" shall not include "a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission," 15 U.S.C. § 77b(a)(11) (2007). On the other hand, section 12(a)(2) Securities Act does not reflect these remarks. It is addressed to any seller or offeror, even those that are not in a position to review the prospectus.

296. *See supra* Part III(C)(2).

297. *See supra* notes 3, 28.

298. Börsengesetz [BörsG] [Stock Exchange Act], *supra* note 245, § 45(1).

299. Bürgerliches Gesetzbuch [BGB] [Civil Code], *supra* note 247, § 826.

300. Liability of the directors, experts, and underwriters pursuant to section 11(b) of the Securities Act; liability pursuant to section 12(a)(2) Securities Act; section 90 FSMA 2000. In some instances, U.S. law even imposes strict liability on market participants: Liability of the issuer pursuant to section 11(b) Securities Act; liability pursuant to section 12(a)(1).

301. *See supra* Part III(B)(2).

302. *See supra* Part IV(A).

costs of accidents.[303] The costs for gatekeepers of reviewing the actions of the primary actor depend on the gatekeeper's position. The same considerations that have been employed above[304] are relevant here. In order to induce an optimal supervision of the primary market participant, the liability provisions should hold third parties to a high standard of care if they are close to the source of the information and can investigate the primary market actor at a low cost. Conversely, if verification is associated with significant costs, less should be expected of the gatekeeper. However, transactions in the capital markets are too complex and multifaceted for a statutory rule to calculate these different levels and prescribe them for an unlimited number of cases. The legislature necessarily has to operate with flexible and general terms, such as the concept of "reasonableness."[305] Notwithstanding this quandary, it should be possible to arrive at certain approximations, which could take the form of gradual standards that differentiate between types of defendant and misstatement.

Section 11 Securities Act incorporates these principles appropriately and establishes a sliding scale of responsibility that has been further refined by the SEC as well as the courts.[306] Schedule 10 to the English FSMA 2000 distinguishes between statements made by experts and the statements of others. However, as opposed to the Securities Act,[307] Schedule 10 does not ask whether the defendant had reasonable ground to believe the expert opinion to be true.[308] Therefore, English law does not give an incentive to review the statement even if review would have been possible at low cost. Furthermore, the statute provides for a uniform standard of care for all defendants, notwithstanding their relationship to the issuer. The terms "reasonably believed" and "reasonable [i]nquiries"[309] might be sufficiently broad to allow the courts to hold the issuer and its inside directors accountable for a higher degree of care than the outside directors, and the lead underwriters for a higher degree than the other members of the underwriting syndicate.[310] Nevertheless, a more specific statutory differentiation would be desirable and would increase legal certainty.

German prospectus liability law is the least adequate of the three jurisdictions. Neither does it distinguish between the types of defendant nor the character of the

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303. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 167-71 (7th ed. 2007) (explaining the so-called marginalized Learned Hand formula).

304. *See supra* Part IV(B).

305. 15 U.S.C. § 77k(b)(3).

306. *See supra* Part III(A)(1).

307. 15 U.S.C. § 77k(a)(3)(C).

308. FSMA, *supra* note 155, at sched. 10, § 2(2)(a) (requiring only that a defendant "reasonably believed" that the other person "was competent to make or authorise the statement"); *see supra* Part III(B)(1).

309. FSMA, *supra* note 155, at sched. 10, §1(2).

310. *Cf. e.g.* Securities Act Rule 176, 17 C.F.R. § 230.176 (2008) (assigning responsibility depending on, *inter alia*, "[t]he type of person" to be held liable and, "when the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant").

statement as being expertised or non-expertised.[311] In addition, it requires gross negligence, thus setting the threshold for liability relatively high.[312] Suggestions in the literature that this amounted to a *probatio diabolica*[313] for the issuer[314] are hardly convincing. Gross negligence is the extreme departure from ordinary care and the disregard of standards of conduct that should be apparent to anyone.[315] This cannot be construed in a way that would approximate strict liability.

With respect to the other defendants, the provision does not provide for the necessary flexibility either. The failure to investigate the issuer's statements will generally not amount to an "extreme departure from ordinary care" if the defendant studies the documents, discusses them with the issuer's directors and officers, and does not discover any red flags.[316] Thus, the standard is substantially lower than in the United States, where section 11(b)(3) requires a "reasonable investigation," consisting of the verification of the information through on-site inspections, interviews with the issuer's employees, customers, and suppliers, an analysis of the respective industry, and comfort letters procured from lawyers or financial analysts.[317] The legislature should increase the standard of care, at least for the issuer, the inside directors, and the lead underwriter.

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311. Börsengesetz [BörsG] [Stock Exchange Act], *supra* note 245, § 45(1).

312. *Critical also* ELLENBERGER, *supra* note 219, at 58-59; HOPT, *supra* note 7, at 87-89; Klaus J. Hopt & Hans-Christoph Voigt, *Grundsatz- und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung* [Principal Problems of Prospectus Liability and Liability for Capital Market Disclosures], *in* PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG 9, 82-86 (Klaus J. Hopt & Hans-Christoph Voigt eds., 2005).

313. Latin: devil's proof.

314. Holger Fleischer, *Empfiehlt es sich, im Interesse des Anlegerschutzes und zur Förderung des Finanzplatzes Deutschland das Kapitalmarkt- und Börsenrecht neu zu regeln?* [Is it Advisable to Reform the Capital Markets and Stock Exchange Law with a View to Increasing Investor Protection and the Attractiveness of Germany as a Financial Center?], in 1 VERHANDLUNGEN DES 64. DEUTSCHEN JURISTENTAGES BERLIN 2002 [1 Proceedings of the 64th German Lawyers' Day Berlin 2002] F 1, 62 (Ständige Deputation des Deutschen Juristentages ed., 2002).

315. BGHZ 10, 14 (16).

316. *Cf.* RGZ 80, 196 (199); BGH WM 1982, 862 (864) (BuM); OLG Frankfurt, ZIP 1999, 1005 (1007) (MHM Mode).

317. *See e.g.*, *In re* Int'l Rectifier Sec. Litig., No. CV91-3357-RMT, 1997 WL 529600, at *8 (C.D.Cal. 1997) (holding that the underwriters' diligence met the reasonableness standard because they:

> (1) reviewed [the issuer's] internal financial forecasts, contracts, and other important documents, and inspected [the issuer's] major facilities; (2) employed analysts who were knowledgeable of the . . . industry [in which the issuer operated]; (3) conducted interviews with eleven of [the issuer's] senior and middle management employees, inquiring about numerous aspects of [the issuer's] operations; (4) conducted interviews with [the issuer's] major customers, [the issuer's] outside quality consultants, the public accounting firm responsible for auditing [the issuer], [the issuer's] patent attorney, and [the issuer's] outside environmental counsel; (5) obtained written verification from [the issuer's] management that the information in the prospectus was correct and a 'cold comfort' letter from [the issuer's] outside accountants indicating that there had been no material changes in [the issuer's] financial position since its last audit).

See also Weinberger v. Jackson, No. C-89-2301-CAL, 1990 WL 260676, at *3 (N.D. Cal. 1990):

In conclusion, a sensibly staggered scale of responsibility in the primary market could, for example, consist of strict liability for the issuer, any type of negligence for the inside directors, the lead underwriter and the experts (for incorrect statements in their opinions), and gross negligence for the remaining members of the underwriting syndicate.[318] The same principles should guide liability in the secondary market. The author of the incorrect statement should be held to the highest standard (for example the issuer and the inside directors for false periodic disclosures), and secondary parties that were involved in the preparation, dissemination, or verification of the statement should be held to a lesser degree of care depending on their position in relation to the primary violator.[319]

> [The] investigation of [the issuer] . . . was conducted by experienced people, who were assisted by attorneys and accountants. The underwriters reviewed the industry, the company, the company's management, and the company's past and projected manufacturing, sales and financial performance. The underwriters had over twenty meetings with various management personnel, covering all aspects of the company's business. Company personnel were specifically questioned about the development and scheduled availability of products, related operating systems and applications software. The underwriters also contacted many of [the issuer's] suppliers, customers, and distributors, who were asked extensive questions about the company's operations. The underwriters reviewed company documents including operating plans, product literature, corporate records, financial statements, contracts, and lists of distributors and customers. They examined trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information. They also made physical inspections of the company's facilities. When any negative or questionable information was developed as a result of their investigation, the underwriters discussed it with the appropriate persons and arrived at informed decisions and opinions. The underwriters also obtained written representations from the selling stockholders and the company that as of the closing date of the public offering, there were no misstatements or omissions.

318. Thus, provided that red flags do not exist, the remaining members of the underwriting syndicate would not need to conduct independent investigations that are as far reaching as described in the previous footnote. This is appropriate since a duplication of the lead manager's duties would be inefficient. *See infra* note 321.

319. *See* Hans-Bernd Schäfer, *Die Dritthaftung des Wirtschaftsprüfers für Vermögensschäden auf Primär- und Sekundärmärkten* [Auditor Liability to Third Parties for Financial Loss in the Primary and Secondary Market], *in* PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG 161, 164-75 (Klaus J. Hopt & Hans-Christoph Voigt eds., 2005) (arguing that the standard of care for liability in the secondary market should, as a general rule, be lower than that in the primary market in order to prevent over-deterrence and inefficient results). This argument goes back to a famous article by William Bishop, *Economic Loss in Tort*, 2 OXFORD J. LEGAL STUD. 1 (1982), claiming that in cases of pure economic loss the cost to society may be less than the private economic loss suffered by the victim and that, accordingly, full liability would give an incentive to implement precautionary measures that do not minimize total social cost and that are therefore not efficient (examples *id.* at 5-6 and *passim*). This argument may serve as justification to adhere to the requirement of scienter or gross negligence that can be found in secondary market liability provisions in all three countries under survey (Rule 10b-5, section 90A of the English FSMA, §§ 37b, c of the German Securities Trading Act). However, it cannot serve as justification for the restriction of defendants to primary

Finally, the duties of the gatekeeper should be less comprehensive if the information exhibits a certain degree of reliability because it stems from an expert opinion. In such a case, requiring a full-fledged second investigation by the gatekeeper would increase the costs of the transaction without generating tangible benefits for investors, particularly if the gatekeeper lacks the technical qualifications to assess the expert opinion. U.S. law has developed reasonable criteria, which may be utilized to solve the controversies that exist in Europe about the definition of "expert opinion" and the consequences for the defendants' standard of care.[320]

A thorough review of the expert opinion by the gatekeeper will not produce significant additional protection for investors if the information has been assembled in a way that ensures a high level of accuracy. This is the case if the expert has followed a clearly prescribed procedure, known to the gatekeeper, which is structured to produce high quality information. Consequently, statements from experts do not reduce the gatekeeper's duties simply because they originate from a market actor with particular expertise.[321] Using the auditor, the most important expert in the financial markets, as an example, he may give either positive or negative assurances. The positive assurance attests that the financial information is presented fairly in conformity with generally accepted accounting principles ("GAAP"). Positive assurance may only be given if the accountant has audited the information in accordance with generally accepted auditing standards ("GAAS"). Negative assurance confirms that the data has been reviewed pursuant to the rules set out in AICPA Statement on Auditing Standards ("SAS") No. 100,[322] which are less exacting than those under GAAS.[323] Depending on the

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violators, as is also the case in all three countries. The economic considerations are complex, and a detailed review of the voluminous literature cannot be presented at this point.

320. *Compare* Heinz-Dieter Assmann, VERKAUFSPROSPEKTGESETZ [Law on the Prospectus for Securities Offered for Sale] § 13 VerkProspG, para. 93 (Heinz-Dieter Assmann et al. eds., 2001); GROß, *supra* note 221, §§ 44, 45 BörsG, para. 82; Schwark, *supra* note 209, §§ 44, 45 BörsG, para. 45 (allowing *all* information provided by experts to go unchecked, for example legal opinions or comfort letters of accountants, i.e. statements that do not have to conform to the requirements of formal audit opinions) *with* Johannes Köndgen, *Zur Theorie der Prospekthaftung (II)* [On the Theory of Prospectus Liability (II)], DIE AKTIENGESELLSCHAFT [AG] 1983, 120, 127 (expecting the employment of independent financial analysts as a matter of routine, notwithstanding the fact that the expert has furnished a formal audit opinion).

321. *See* Escott v. BarChris Construction Co., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

322. Interim Financial Information, SAS 100, AU § 722.

323. *Id.* § 722.15-24. The procedures consist principally of applying analytical procedures (e.g. comparing interim financial information with prior period information and actual interim results with anticipated results) and making inquiries of persons that are responsible for financial and accounting matters. *See also* § 722.25 ("A review of interim financial information is not designed to obtain reasonable assurance that the interim financial information is free of material misstatement. However, based on the review procedures performed, the accountant may become aware of likely misstatements."); SECURITIES AND EXCHANGE COMMISSION, ACCOUNTING AND REPORTING MANUAL § 14.101 (2009), article 5 Sample Comfort Letter (the accountant will generally formulate: "Nothing came to our attention . . . that caused us to believe that: a. (i) Any material modifications should be made to the unaudited condensed consolidated financial statements . . . for them to be in conformity with generally accepted accounting principles . . . ").

procedures agreed upon with the client, the accountant may follow SAS No. 100 when drafting comfort letters.[324] If the procedures fall short of an SAS 100 review the accountant may not give a negative assurance.[325]

The SEC has stipulated that only a formal audit shall be considered as an expert opinion within the meaning of section 11 of the Securities Act.[326] In Europe, the financial statements in annual financial reports must be audited,[327] but not those in half-yearly or quarterly reports.[328] The standards for the auditors' review or for comfort letters are comparable to those in SAS No. 100.[329] Since the reviews do not give reasonable assurance that the information does not contain any misstatement, they do not lead to a reduction in the duties required of the gatekeeper. However, if the accountant has audited the financial statements, an independent investigation by another market participant is unnecessary. The gatekeeper may content himself with verifying the consistency and completeness of the disclosure.[330]

D. Risk Shifting

Scholars have for some time controversially discussed whether gatekeeper liability based on strict liability or negligence is preferable.[331] Interestingly, the

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324. A comfort letter is "[a] letter given to organizations or persons of interest by external auditors regarding statutory audits, statements and reports used in a prospectus. The comfort letter will be attached to the preliminary statements as assurance that it will not be materially different from the final version." http://www.investopedia.com/terms/c/comfort_letter.asp.

325. *Cf.* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS NO. 72 (Letters for Underwriters and Certain Other Requesting Parties), SAS 72, AU § 634 (2008), Example O (Alternate Wording When the Procedures That the Underwriter Has Requested the Accountant to Perform on Interim Financial Information Are Less Than an SAS No. 100 Review).

326. Securities Act Rule 436(c), 17 C.F.R. § 230.436(c) (2008). *See also* Accountant Liability for Reports on Unaudited Interim Financial Information Securities Act of 1933, Release No. 6173, 19 S.E.C. Docket 82 (December 28, 1979). In general, year-end financial statements will be audited. Interim financial statements pursuant to Exchange Act Rule 13a-13, 17 C.F.R. § 240.13a-13 (2008), do not need to be audited but must be reviewed by an independent public accountant in accordance with SAS No. 100, *see* Securities Act Regulation S-X, 17 C.F.R. §210.10-01(d)(2008).

327. EU Transparency Directive, *supra* note 35, at Art. 4(4).

328. *Id.* at Art. 5(5).

329. *See e.g.* Institut der Wirtschaftsprüfer Prüfungsstandard 900 (IDW PS 900) [Institute of Chartered Accountants Review Standard 900], Grundsätze für die prüferische Durchsicht von Abschlüssen [Principles For Auditors' Reviews], DIE WIRTSCHAFTSPRÜFUNG [WPG] 2001, 1078; IDW PS 910, Grundsätze für die Erteilung eines Comfort Letter [Prinicples for Comfort Letters], WPG 2004, 342.

330. The duty to undertake further inquiries may arise if red flags exist*, see supra* note 91.

331. Proposing a regime of recklessness or negligence: Hamdani, *supra* note 6, at 113-20 (strict liability for certain gatekeepers that are expected to be successful in detecting issuer fraud, for example auditors, but then introducing a due diligence defense, *id.* at 119); Langevoort, *supra* note 6, at 67-68 (recklessness); Schäfer, *supra* note 319, at 175-77; Sher, *supra* note 6, at 484-85 and passim (negligence). Proposing strict liability: Coffee, *supra* note 4, at 349-53 (strict liability

different opinions operate with the same argument: cost efficiency. Some argue that negligence imposes higher costs than strict liability because legislatures and courts will have difficulty in defining the applicable standard of care. Thus, gatekeepers cannot judge what is expected from them. They might over or under-monitor and, in either case, increase social cost.[332] In addition, the litigation risk is high and the outcome of a lawsuit is unpredictable when the standard of care is vague.

Conversely, it is pointed out that gatekeepers generally will not be in a position to determine compliance of the primary market actor with applicable rules with absolute certainty. Thus, under a regime of strict liability, they are less able to control the liability risk than under a regime of negligence.[333] Furthermore, strict liability internalizes all damage. All investors who have suffered a loss can recover, whereas negligence restricts the right to recovery to cases where the defendant has acted with fault. As a consequence, strict liability will force gatekeepers to charge higher fees. Depending on the size of the fee increase, issuers may not be able to afford the intermediary's services and might therefore be prevented from entering the market.

The merits of the two opposing views cannot be evaluated in a theoretical way; rather, an extensive empirical analysis is needed to arrive at a quantification of the different factors that influence the efficiency of negligence based and strict liability regimes. Even if such an analysis were conducted, it would be questionable whether it was of much sustainable value in an environment where economic and legal parameters (such as the investment climate or the procedural framework for investor lawsuits) are as volatile as in the financial markets.[334] However, the debate might be of less importance than it first seems. Under certain conditions, the costs associated with negligence and strict liability will converge. This consideration is based on the fundamental insight developed by Ronald Coase that in the absence of transaction costs all legal allocations of property rights are equally efficient.[335] Coase's rationale applies in the same way to the allocation of liability risks. If parties can freely enter into indemnification agreements, they will allocate the risk in the way that the party best positioned to control the risk bears

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that is capped at a realistic level); Partnoy, *supra* note 6, 84 B.U. L. REV. 365; Partnoy, *supra* note 6, 79 WASH. U. L.Q. at 540-46 (arguing that gatekeepers should be able to specify the range of liability as a percentage of the issuer's liability, subject to a specified minimum percentage). Choi, *supra* note 6, 92 NW. U. L. REV. at 951-58, proposes a regime of self-tailored liability, i.e. the gatekeeper may specify the standard of care that he will employ and be held accountable for. Purchasers will then value the certified product based on the screening procedures that the certifier has selected.

332. *Cf.* Kraakman, Gatekeepers, *supra* note 5, at 76. *See also* Coffee, *supra* note 4, at 347 ("[S]trict liability spares both courts and regulators the need to descend into the Serbonian bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.").

333. Kraakman, Gatekeepers, *supra* note 5, at 76.

334. It is telling that the analyses in the law and economics literature are of an entirely theoretical nature, *see e.g.* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 335-64 (5th ed. 2008); POSNER, *supra* note 303, at 178-82.

335. R.H. Coase, The Problem of Social Cost, 3 J. L. & ECON. 1 (1960).

the burden of liability.[336] Ideally, the market participant that ultimately assumes the risk is able to control it perfectly well, thus eliminating the inefficiencies of both strict liability and negligence. The additional cost of strict liability and the administrative cost of imprecise standards of care are reduced to zero.

In reality, some costs will remain. The party best positioned to monitor compliance with the regulatory environment is the addressee of the rules (the primary actor).[337] Even if the issuer contracts to indemnify the gatekeepers, as is common practice,[338] the events that lead to securities litigation may leave the company insolvent. Accordingly, the claim for indemnification might be unenforceable. The gatekeeper, on the other hand, will never act under complete certainty. Furthermore, a system of liability based on negligence, which accords investors a claim against the gatekeeper who ultimately has to bear the risk of liability, would continue to exhibit the inefficiencies caused by imprecise standards, even if it allowed for risk shifting.[339] Finally, administrative costs can

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336. For example, if the auditor can verify the accuracy of the prospectus better than the underwriter, the latter will pay, as consideration for the assumption of the liability risk by the auditor, a fee that is lower than the cost caused by the auditor's exposure to liability but higher than the other party's cost of precautionary measures. As a result, risk shifting will occur.

337. For example, the issuer is best positioned to monitor compliance with the disclosure obligations of the securities laws..

338. *Cf.* BLOOMENTHAL, *supra* note 21, app. 2, § 6.01:

> The Company agrees to indemnify and hold harmless the Underwriters . . . against any and all losses, claims, damages or liabilities, joint or several, to which they or any of them may become subject under the Act or any other statute or at common law and to reimburse persons indemnified as above for any legal or other expenses (including the cost of any investigation and preparation) incurred by them in connection with any litigation, whether or not resulting in any liability, but only insofar as such losses, claims, damages, liabilities and litigation arise out of or are based upon any untrue statement or alleged untrue statement of a material fact contained in the Registration Statement or any amendment thereto or any application or other document filed in order to qualify the Stock under the Blue Sky or securities laws of the states where filings were made, or the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading . . . provided, however, that the indemnity agreement contained in this subsection 6.01 shall not apply . . . to the Underwriter or any person controlling the Underwriters in respect of any such losses, claims, damages, liabilities or actions arising out of or based upon any such untrue statements or alleged untrue statement, or any such omission or alleged omission, if such statement or omission was made in reliance upon information peculiarly within the knowledge of the Underwriter and furnished in writing to the Company by the Underwriter specifically for use in connection with the preparation of the Registration Statement and Prospectus or any such amendment or supplement thereto.

339. The result would be different if the ultimate risk bearer was not held responsible. Assume that gatekeeper 1 (G1) is a defendant under prospectus liability rules. If gatekeeper 2 (G2) is not an addressee of the liability provision but contracts to assume G1's risk of liability, G1 has an incentive not to employ any precautionary measures. Thus, the negligence rule is transformed into strict liability with G1 being held liable whenever the primary actor has violated applicable rules but, at the same time, with G1 being able to recover from G2. This, in turn, presupposes that (1) G2 is not judgment proof, i.e. G1 can enforce his claim for indemnification,

arise from litigating the causes of action under the indemnification agreement, which may require a showing that the defendant has acted negligently. Still, allowing parties to independently shift risk is more efficient than entrusting responsibility to the courts or the legislature to determine the standard of care for each market participant.[340] Risk shifting can serve as an important means to compensate for a standard that has been set at an inefficient level by the legislator. Consequently, liability regimes should not consider risk shifting to be against public policy, as is the view in the United States.[341] Deterrence, if necessary, can be achieved without prohibiting contribution and indemnification agreements. The gatekeeper has to bear the insolvency risk of the counterparty, which should motivate him to act.[342]

V. CONCLUSION

This investigation has shown that U.S. law provides for the most comprehensive investor protection regime and German law for the most restrictive, while English law takes a middle position. An intuitive explanation for these

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and (2) G2 assumes the risk of liability unqualifiedly, i.e. does not impose a certain standard of behavior on G1 in the indemnification agreement (this is the case in the example *supra* note 338; the reason why the underwriters in practice employ precautionary measures is that condition (1) is not satisfied and that indemnification agreements are not always enforceable under U.S. law; on the other hand, comfort letters of the auditors addressed to the underwriters will generally require the underwriters to invoke the defenses that are at their disposal against the investors' claims, *cf.* Lutz Krämer, *Due Diligence und Prospekthaftung* [Due Diligence and Prospectus Liability], *in* HANDBUCH BÖRSENNOTIERTE AG. AKTIEN- UND KAPITALMARKTRECHT [Handbook Stock Exchange Listed Corporation. Corporate and Capital Markets Law] § 10/246 (Reinhard Marsch-Barner & Frank A. Schäfer eds., 2d ed. 2009).

340. *See* the agreement, *supra* note 338: The parties allocate the risk of liability according to spheres of knowledge. In other words, the party that is best positioned to monitor the accuracy of the statement shall be liable.

341. Most U.S. courts hold that indemnification agreements are, in general, not enforceable. There is considerable uncertainty as to the reach of the prohibition. Some courts restrict the rule to agreements that provide for indemnification notwithstanding intentional or reckless conduct of the claimant. *See* Heizer Corp. v. Ross, 601 F.2d 330, 334 (5th Cir. 1981); Globus v. Law Research Serv., Inc., 394 F. Supp. 946, 956-57 (S.D.N.Y. 1975). Others interdict indemnification agreements whenever the party that seeks indemnification has acted at least negligently, Eichenholtz v. Brennan, 52 F.3d 478, 484-85 (3d Cir. 1995); Odette v. Shearson, Hammill & Co., Inc., 394 F. Supp. 946, 956-57 (S.D.N.Y. 1975); Gould v. Am.-Hawaiian S.S. Co., 387 F. Supp. 163, 167-68 (D. Del. 1974). Moreover, the permissibility of contribution agreements is unclear, at least in case of partial settlements. *See e.g.* Singer v. Olympia Brewing Co., 878 F.2d 596, 599-601 (2d Cir. 1989) (so-called pro-tanto rule); *Eichenholtz*, 52 F.3d at 487; Franklin v. Kaypro Corp., 884 F.2d 1222, 1230-31 (9th Cir. 1989) (relative responsibility standard). Now both approaches are combined in Securities Exchange Act of 1934, § 21D(f)(7)(B) for private class actions arising under the Exchange Act. For other actions, e.g. those pursuant to section 11 of the Securities Act, the controversy is still of relevance, *see* Gerber v. MTC Electronic Technologies Co., Ltd., 329 F.3d 297, 309 (2d Cir. 2003); *In re* WorldCom, Inc. Securities Litig. 2004 WL 2591402, at 6 (S.D.N.Y. 2004); *In re* WorldCom, Inc. Securities Litig., No. Civ 3288 WL 2005 (S.D.N.Y. 2005); *In re* Cendant Corp. Securities Litig., 139 F. Supp. 2d 585 (D.N.J. 2001).

342. Accordingly, in countries such as Germany, indemnification agreements are considered as permissible by the academic literature. *See* ELLENBERGER, *supra* note 219, at 55-56; Schwark, *supra* note 209, § 45 para. 70. Decisions of the courts do not exist.

findings is the following: an analysis that tracks the development of the financial markets in the three countries over the last one hundred years indicates that significant advances in investor protection were preceded by leaps in stock market activity. [343] The stock market in its modern form developed first in the United States, emerging at the beginning of the 20th century and expanding rapidly until the Great Crash of October 1929 and the ensuing Great Depression triggered the adoption of the Securities Acts that provide the basis for today's investor protection regime.

In the United Kingdom, Big Bang of 1986, i.e. the abolition of fixed commission charges and other reforms that were aimed at modernizing the financial markets, precipitated an increase in market activity, which was followed by a replacement of the Financial Services Act of 1986 with the Financial Services and Markets Act 2000. In Germany, stock market activity did not significantly increase before the mid-1990s. Major reforms of investor protection were introduced by the Second, Third, and Fourth Financial Market Development Acts of 1994, 1998, and 2002.[344] Thus, in all three countries, the movement towards a more sophisticated investor protection regime lagged behind stock market development. In addition, the degree of sophistication of the regulatory regime mirrors the maturity of the financial markets, implying that the evolvement of an advanced system of capital markets regulation needs time. This assessment would need to be corroborated by means of a formal regression analysis. If confirmed, it would call into question the well-known claim made by Rafael La Porta and a number of other economists that strong securities markets presuppose a certain, American style regime of investor protection.[345] In reality, the converse would be true. Increased stock market activity changes incentive structures, informational

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343. *E.g.* Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5, 15 (2003) (computing the evolution of stock market development over GDP).

344. The Second Financial Market Development Act (BGBl. I 1994, at 1749) prohibited insider trading and enhanced transparency by requiring the disclosure of the acquisition or disposal of major holdings exceeding or falling below certain thresholds. The Third Financial Market Development Act (BGBl. I 1998, at 529) reformed the rules on prospectus liability and shifted the burden of proof for reliance and loss causation. The Fourth Financial Market Development Act (BGBl. I 2002, at 2010) improved supervision over the stock exchanges, introduced directors' dealings provisions, prohibited market manipulation, and established liability for misleading statements in the secondary market.

345. *See* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285 (2008) (summarizing previous investigations); Rafael La Porta et al., *What Works in Securities Laws?* 61 J. FIN. 1 (2006) (finding, after examination of 49 different countries, that mandatory disclosure and private enforcement laws benefit stock markets); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) (finding that, across the world, strong investor protection often leads to dispersed ownership); Rafael La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471 (1999) (investigating ownership structures of large corporations in 27 wealthy economies); Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (finding, after an extensive global study, that common law countries generally have the strongest legal protection of investors).

differences, and conflicts of interest. This, in turn, generates demand for a modified system of securities regulation and improved investor protection.[346]

The legal development in England and Germany is characterized by a movement toward more flexible, open-ended rules, which enable the courts to react to fraudulent activity not only in specific situations but in the primary and secondary market in general. Due to a lack of express causes of action in both countries, the judiciary seeks to utilize tort law principles.[347] Using the example of Exchange Act Rule 10b-5, this comment has highlighted the dangers of a remedy for incorrect information in the securities markets based on judicially reformulated concepts of tort law. Such a remedy will assume definite contours slowly, produce high transaction costs, and possibly never form part of a coherent system of securities regulation.[348]

Likewise, several deficiencies of the existing system of capital markets regulation have been identified. While section 11 of the Securities Act contains a clearly defined list of defendants and provides for a sliding scale of responsibility in accordance with principles of gatekeeper liability, the English and German prospectus rules are either too ambiguous or too restrictive to constitute effective tools for investor protection. In general, investor protection in the securities markets, particularly in the secondary market, is underdeveloped in England and Germany. The legislature should establish causes of action that are conducive to legal certainty,[349] addressed not only to the primary violator but also to third party actors (i.e. the issuer's directors, underwriters, auditors, lawyers, and other experts),[350] and define a standard of care that takes account of the gatekeeper's

346. *Compare supra* note 345 *with* Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459 (2001); John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L. J. 1, 64-71 (2001); Alan Dignam & Michael Galanis, *Corporate Governance and the Importance of Macroeconomic Context*, 28 OXFORD J. LEGAL STUD. 201, 223-25 (2008); Ajit Singh et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis* (Centre for Business Research, University of Cambridge Working Paper No. 358, 2007), *available at* http://www.cbr.cam.ac.uk/pdf/WP358.pdf; Ajit Singh et al., *Legal Origin, Shareholder Protection and the Stock Market: New Challenges From Time Series Analysis* (Centre for Business Research, University of Cambridge Working Paper No. 343, 2007), *available at* http://www.cbr.cam.ac.uk/pdf/wp343.pdf.

347. In England, the first tentative steps in this direction were taken in Possfund Custodian Trustee Ltd. v. Diamond [1996] 1 W.L.R. 1351 (*supra* Part III(B)(2)), extending the scope of the tort of negligent misrepresentation. In Germany, the development is predicated on section 826 Civil Code (*supra* Part III(C)(2)).

348. *See supra* Part IV(A).

349. Legal certainty lacks, in particular, in case of Rule 10b-5 in the United States, § 90 FSMA in the U.K., and §§ 44, 45 Stock Exchange Act in Germany. *See supra* Parts III(A)(2), III(B)(1), III(C)(1).

350. Currently, Rule 10b-5, the tort of negligent misrepresentation, and § 826 German Civil Code do not encompass gatekeeper liability. §§ 44, 45 Stock Exchange Act are addressed to the underwriters but not to other gatekeepers. *See supra* Parts III(A)(2), III(B)(2), III(C)(1), (2).

position[351] and the degree of reliability of the information that the gatekeeper reviews.

A possible system of liability for incorrect information in the primary market in Europe could be modeled after section 11 of the Securities Act or provide for three layers of liability: strict liability for the issuer, any type of negligence for the parties that are intimately involved in the offering (the inside directors, lead underwriters and experts that prepare or certify parts of the offering documentation), and gross negligence for other participants (such as outside directors and the remaining underwriters). Reliance on information provided by third parties reduces the duty of care if the information has been compiled following a procedure that ensures a high level of accuracy. In respect to the auditor, this is only the case if GAAS (or the European equivalent) has been observed, not for ordinary comfort letters.[352] In all three countries surveyed, liability for misstatements in the secondary market should be extended. In the United States, this can be achieved by reinstating aiding and abetting liability under Rule 10b-5. In Europe, the preferable solution would be the creation of express causes of action by the legislator to replace the ill-equipped English tort of negligent misrepresentation and section 826 of the German Civil Code.

Finally, uncertainties regarding the efficiency implications of regimes of strict liability and negligence and, in the case of negligent liability, shortcomings of the legislature or the judiciary in defining the efficient level of care can be remedied by allowing market actors to shift the risk of liability. Therefore, legal systems that restrict contribution and indemnification agreements, including the United States, should re-evaluate their position.[353]

351. This is currently only reflected in section 11 Securities Act and—to a minor extent—in the case law on section 12(a)(2) Securities Act and prospectus liability in Germany.

352. *See supra* Part IV(C).

353. *See supra* Part IV(D).