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Adequacy of Disclosure of Restrictions on Flipping IPO Securities

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Over $40 billion were raised in initial public offerings (IPOs) during 1998. Stock sold in an IPO, on average, quickly trades significantly above its initial offering price, providing quick gains to the initial purchasers. Investment banks that underwrite IPOs are taking a number of actions to discourage purchasers of stock in IPOs from quickly reselling their stock, called "flipping." Some underwriters have refused to permit those who flip stock purchased in an IPO to purchase in subsequent IPOs. These penalties for flipping, however, are imposed selectively, with favored customers not punished (or punished less severely), and with different brokerage firms requiring differing holding periods to avoid the adverse consequences. This Article examines the implications of this practice under the disclosure obligations imposed by federal securities laws and concludes that the current disclosure is materially misleading, particularly in light of the failure to disclose the selective application of the penalties. Moreover, the selective application of the penalties casts significant doubt on whether these offerings can be considered "fixed price" offerings, which would mean that cursory disclosure of the practice would not suffice.

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Large sums are annually raised in initial public offerings (IPOs). Sales of securities in IPOs in 1998 alone were nearly $44 billion.[1] On average, stock sold in an IPO shortly thereafter trades at about a fifteen percent premium from the IPO price.[2] Recent trading in stock of Internet-related firms has been particularly volatile.[3]

The prospects for a material short-term return creates great interest in purchasing stock sold in an IPO. As suggested by the average short-term return, the demand for stock sold in an IPO at the initial public offering price frequently exceeds the number of shares offered.[4] Underwriters participating in the distribution of stock in an IPO therefore need to ration the shares to prioritize investors who have previously expressed indications of interest. Issuers create lists of acquaintances of management to whom the underwriters give priority.[5] Underwriters participating in an IPO, in a practice called "spinning," also may grant priority to investors in a position to influence the extent to which the underwriters receive future business.[6]

Some investors who purchase stock in an IPO quickly resell the stock, known as "flipping," to realize the short-term gains.[7] Flipping

1. *See* Brian Garrity, *Despite Hyper-Volatility, U.S. Stock Underwriting Drew Nearly Even with '97*, INVESTMENT DEALERS' DIG., Jan. 11, 1999, at 19, 19.

2. *See, e.g.*, Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced*, 41 UCLA L. REV. 17, 18 (1993) (describing a 16.09% average profit from 1980 to 1987); *see also* Laurie Krigman et al., *The Persistence of IPO Mispricing and the Predictive Power of Flipping*, 54 J. FIN. 1015, 1020 tbl.1 (1999) (noting a sample of large IPOs from 1988 to 1995 had average first-day returns of 12.3%); Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 970-71 (1995) (describing a sampling from 1975 to 1984 that showed an average 10.9% initial return); Clifford W. Smith, Jr., *Investment Banking and the Capital Acquisition Process*, 15 J. FIN. ECON. 3, 20 tbl.5, 21 (1986) (collecting evidence from various studies, with a lowest sample average of 11.4%, and stating, "[T]he average underpricing appears to exceed 15 percent."). A portion of the IPOs consummated annually involves issuers, such as firms having no prior business operations, that are unlikely to have significant first-day returns, which are excluded from the discussion in this Article.

3. *See* Dunstan Prial, *IPO Outlook: Balance of Power Shifts in Market on Surge in Retail Investors*, WALL ST. J., Dec. 7, 1998, at B7A ("New Internet stocks now are all but expected to triple in value.... Anything less is reason to sell.").

4. *See supra* note 2.

5. *See* Mark Liebovich, *Issue a Hot New Stock, and the World Is Your Friend*, INT'L HERALD TRIB., June 8, 1999, at 1 (discussing "friends and family" lists, which are lists of personal acquaintances of employees of the issuer given preferred access to purchase in IPOs).

6. *See* 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 6.2, at 97 (practitioner's ed., 3d ed. Supp. 1999). Spinning may be inconsistent with the rules of the National Association of Securities Dealers (NASD). *See* 1 *id.*

7. *See* ALLAN H. PESSIN & JOSEPH A. ROSS, THE COMPLETE WORDS OF WALL STREET: THE PROFESSIONAL'S GUIDE TO INVESTMENT LITERACY 270 (1991) (defining a "flipper"); Shayne & Soderquist, *supra* note 2, at 976. Contexts in which the original retail sales price of property is below the equilibrium price are not confined to the offering of stock

stock acquired in an IPO, if done before the initial distribution of the IPO is complete, can adversely affect that initial distribution by providing an alternative source of the stock.[8] To the extent stock in an IPO is priced below the equilibrium price in order to assure that the underwriters will be able to resell the stock at the IPO price,[9] flipping increases the risk that the underwriters will be unable to resell all the stock, producing a "sticky" offering.[10]

Underwriters have developed tools to discourage flipping of stock purchased in an IPO. A typical IPO is offered in a fixed price, firm commitment offering.[11] In such an offering, a group of underwriters, called the underwriting syndicate, purchases the securities from the issuer (and any selling shareholders) and resells them to the public.[12] The investment bank organizing and managing the syndicate is called the "managing underwriter."[13] The terms of the agreement among the underwriters for an IPO may allow the managing underwriter to recapture from broker-dealers who place stock that is flipped fees otherwise earned by those broker-dealers in respect of the securities flipped.[14] Those arrangements, which encourage syndicate members to place securities with investors who intend to hold the securities,[15] are called "penalty bids."[16]

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in an IPO. *See, e.g.*, Robert L. Simison, *Beating the Wait List for the Hottest Wheels*, WALL ST. J., June 4, 1999, at W1 (describing "car flipping," in which dealers who are seeking to avoid censure from manufacturers for selling trendy cars above the suggested prices offer a quick profit to those who purchase a vehicle and resell that vehicle, which has never left the showroom, thus allowing the dealer to then sell the "preowned" vehicle at an even higher price).

8. *See* David B. Rea & William J. Grant, Jr., *The Syndicatiòn and Marketing Process*, *in* SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE 277, 291 (Kenneth J. Bialkin & William J. Grant, Jr. eds., 1985); *cf.* Richard B. Carter & Frederick H. Dark, *Underwriter Reputation and Initial Public Offers: The Detrimental Effects of Flippers*, 28 FIN. REV. 279, 296 (1993) ("[P]articipation by flippers in an IPO offering is damaging to the after-market price performance of that offering."); Krigman et al., *supra* note 2, at 1016-17 (citing market participants to this effect but stating that flipping represents a "rational response").

9. *See infra* notes 63-68 and accompanying text.

10. *See* PESSIN & ROSS, *supra* note 7, at 685-86 (defining a "sticky deal" as "an underwriting that will be difficult to market").

11. *See* Jay R. Ritter, *The Costs of Going Public*, 19 J. FIN. ECON. 269, 272 tbl.2 (1987) (citing data indicating that firm commitment contracts are used in most IPOs that raise over $2 million). The discussion in this Article is limited to IPOs of significant size. Small IPOs are more likely to be offered on a "best efforts" basis. *See id.*

12. *See* Order Approving Proposed Rule Change, Exchange Act Release No. 17,371, 45 Fed. Reg. 83,707, 83,709 (Dec. 12, 1980).

13. *See* PESSIN & ROSS, *supra* note 7, at 407.

14. *See* Review of Antimanipulation Regulation of Securities Offerings, Securities Act Release No. 7057, 59 Fed. Reg. 21,681, 21,689-90 (Apr. 26, 1994).

15. *See* Trading Practices Rules Concerning Securities Offerings, Securities Act Release No. 7282, 61 Fed. Reg. 17,108, 17,124-25 (Apr. 18, 1996) [hereinafter Trading

The negative impact of penalty bids is not limited to the adversely affected underwriters. The terms of the agreement between the underwriter and its customer may impose an additional fee on those who flip stock purchased in an IPO.[17] It has been reported, for example, that Wit Capital charges an additional five percent fee in connection with any sale of securities purchased in an IPO made not more than sixty days after the initial purchase.[18] Additionally, the investment bank may simply refuse to allocate to that customer securities offered in subsequent IPOs.[19]

Of course, if no securities sold in IPOs were flipped, there would be no immediate aftermarket trading in the securities, since there generally is no other source for the securities that are sold in market transactions. Yet a recent study found the median trading volume on

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Practices Release]. "Enforcement of penalty bids typically continues for as long as 30 days." *Id.* at 17,125. Since 1997, through a system developed by the Depository Trust Company, managing underwriters have been able to identify the investment bank that placed stock subsequently flipped. *See* Gregg Wirth, *Syndicates Want IPO Tracking System Expanded*, INVESTMENT DEALERS' DIG., Dec. 1, 1997, at 6, 7 (identifying a year-long trial period prior to the commencement of full operations on June 2, 1997). *See generally* Order Approving a Proposed Rule Change Implementing the Initial Public Offering Tracking System, Exchange Act Release No. 37,208, 61 Fed. Reg. 25,253, 25,253 (May 13, 1996) (approving the proposed rule change to allow implementation of an IPO tracking system). Prior to that time, this tracking involved a more cumbersome process of tracing physical certificates. *See id.*

16. SEC rules define a "penalty bid" as "an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions." 17 C.F.R. § 242.100(b) (1999). This arrangement is sometimes called a "penalty syndicate bid." *See* PESSIN & ROSS, *supra* note 7, at 513.

An underwriting syndicate may sell more securities than are actually being offered, obligating the managing underwriter to "cover" the "short position" with aftermarket purchases. *See* Trading Practices Release, *supra* note 15, at 17,124. It is through this mechanism that flipped securities could be purchased by the syndicate in a "covering" transaction.

The practice of imposing penalty bids was introduced in the late 1980s. *See* Michael Siconolfi & Patrick McGeehan, *Wall Street Brokers Press Small Investors to Hold IPO Shares*, WALL ST. J., June 26, 1998, at A1; *cf.* National Ass'n of Sec. Dealers, Inc., Request for Comments on Proposed Revisions to Schedule D of the NASD By-Laws, NASD Notice to Members No. 86-55 (July 30, 1986), *available in* 1986 NASD LEXIS 376, at *39 (indicating that stabilizing bids entered in the NASDAQ system are to be identified as penalty-free bids or penalty bids).

17. *See* Michael Siconolfi & Patrick McGeehan, *Wall Street Boosts Penalty on IPO 'Flips'*, WALL ST. J., July 31, 1998, at C1.

18. *See id.*

19. *See, e.g.*, Michael Siconolfi, *Massachusetts Nears Pact in IPO Probe*, WALL ST. J., Dec. 3, 1998, at C1 ("Joseph Charles, in response to a subpoena, said in August it had 'an informal corporate policy' that mandated if a broker's customers quickly sold their IPO shares, they will be 'rendered ineligible' to buy future IPOs from the firm."); Michael Siconolfi, *On-Line Firms Move to Quash IPO 'Flipping'*, WALL ST. J., Aug. 13, 1998, at C1 (stating clients of Fidelity and Schwab who flip "risk being banned from future deals"); Siconolfi & McGeehan, *supra* note 17 (noting the similar policy of Wit Capital).

the day of an IPO to be thirty-three percent of the number of shares issued in the IPO.[20] Thus, underwriters do not contemplate that no IPO securities will be flipped. Rather, they seek to limit flipping, particularly in circumstances in which it would adversely affect the initial distribution of the securities.[21]

It has been reported that, in balancing these interests, investment banks discriminate against individual investors.[22] Favored customers—institutional investors and certain prominent individual purchasers—are less likely to be excluded from participating in future IPOs as a consequence of flipping.[23] A 1998 article in *The Wall Street Journal*, highlighting this discriminatory treatment of investors, prompted an investigation of this practice by state securities regulators.[24]

Prospectuses for IPOs make some disclosure of these practices. A typical disclosure is set forth in the following prospectus language, which follows a discussion of stabilization:[25]

> The Underwriters . . . may impose a penalty bid, whereby selling concessions allowed to syndicate members or other broker-dealers in respect of the securities sold in the offering for their account may be reclaimed by the syndicate if such shares of Common Stock are repurchased by the syndicate in stabilizing or covering transactions. These activities may stabilize, maintain or otherwise affect the market price of the Common Stock which may be higher than the price that might otherwise prevail in the open market; and these activities, if commenced, may be discontinued at any time.[26]

Notwithstanding the huge potential dollar impact of penalty bids, the practice of implementing penalty bids and the cursory disclosure currently provided, has received minimal attention in the legal literature[27] and has not yet been addressed by the courts.[28] This Article analyzes the adequacy of this disclosure under federal securities laws.

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20. *See* Krigman et al., *supra* note 2, at 1026.

21. *See* Siconolfi & McGeehan, *supra* note 17.

22. *See* Siconolfi & McGeehan, *supra* note 16.

23. *See, e.g., id.* ("'There's been a substantial amount of anecdotal information' about the alleged discriminatory use of penalty bids, says Larry Bergmann, the SEC's senior associate director of market regulation, but the agency doesn't yet have 'a clear view.'").

24. *See* Michael Siconolfi, *SEC Launches Probe into Efforts to Block Flipping of IPOs in U.S.*, ASIAN WALL ST. J., Aug. 21, 1998, *available in* 1998 WL-WSJA 12984804.

25. Stabilization is "the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or maintaining the price of a security." 17 C.F.R. § 242.100(b) (1999).

26. EBAY INC., PROSPECTUS at U-2 (Sept. 24, 1998), *available in* LEXIS, Fedsec Library, Prosp File.

27. Attorney Jonathan Shayne and Professor Larry Soderquist have suggested, in a conclusory fashion, that the practice could be manipulative in violation of federal securities

The rules governing disclosure required in public offerings are bifurcated. There is a general obligation to disclose in the offering document for an IPO all material information. That obligation is most prominently set forth in sections 11 and 12 of the Securities Act of 1933 (1933 Act).[29] Sections 11 and 12 respectively provide remedies against (1) certain persons associated with the sale of securities by means of a registration statement that "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading,"[30] and (2) one who offers or sells securities using a prospectus, or with an oral statement, that "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission)."[31] In addition to these general duties not to sell securities by means of false or misleading offering documents, the SEC has promulgated specific rules identifying items that are required to be included in registration statements.[32] Liability may be imposed if the prospectus omits a fact necessary to make the prospectus not

laws and argue, prior to the relevant amendments to Regulation S-K, *see infra* notes 34-36 and accompanying text, that the SEC should require "the use ... [to] be disclosed." *See* Shayne & Soderquist, *supra* note 2, at 983-84. Additionally, another law review article briefly discussed the current requirement to disclose penalty bids when the current rules were in the proposal stage. *See* Daniel A. Braverman, *U.S. Legal Considerations Affecting Global Offerings of Shares in Foreign Companies*, 17 J. INT'L L. & BUS. 30, 62 (1996).

28. The closest authority seems to be the settlement of a state administrative proceeding alleging, in addition to more serious charges, a disclosure violation on this basis. *See* Rachel Witmer, *Mass. Securities Division Charges Fraud Against Firm, Manager, Broker over Flipping*, 30 Sec. Reg. & L. Rep. (BNA) 1257 (Aug. 21, 1998). In August 1998, the Massachusetts Securities Division initiated proceedings against Joseph Charles & Associates, Inc., a broker-dealer, for various unlawful practices. *See id.* The allegedly wrongful conduct included failing to disclose a policy of refusing to sell IPO securities to investors who had previously flipped IPO securities, in addition to the more serious claims that the broker refused to allow investors to sell securities purchased in an IPO and made false or misleading statements to convince investors not to sell those securities. *See id.* In a subsequent settlement, Joseph Charles agreed to withdraw from the Massachusetts market and to pay a fine, without admitting or denying the charges. *See* Martha Kessler, *Firm Agrees to Two-Year Withdrawal from Mass., Fine over IPO Flipping Policy*, 31 Sec. Reg. & L. Rep. (BNA) 31 (Jan. 8, 1999).

29. 15 U.S.C. §§ 77k-77*l* (1994 & Supp. III 1997).

30. *Id.* § 77k(a) (1994).

31. *Id.* § 77*l*(a)(2) (Supp. III 1997). Paragraph (b) of section 12 was added in 1995. *See* Private Securities Litigation Reform Act of 1995 § 105, Pub. L. No. 104-67, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. § 77*l*). As part of that amendment, former sections 12(1) and 12(2) of the 1933 Act were redesignated as sections 12(a)(1) and 12(a)(2), respectively. *See id.* For consistency, references in this Article to paragraphs of section 12 of the 1933 Act prior to that amendment have been revised to reflect the current designations.

32. *See* 17 C.F.R. pts. 228, 229 (1999).

misleading, even if the registration statement and the corresponding prospectus include all the items specifically called for by the form on which the offering has been registered.[33]

In late 1996, effective early 1997, the SEC adopted rules expressly requiring the disclosure of penalty bids.[34] Those rules now require that prospectuses for registered offerings of securities describe "information on stabilizing transactions, syndicate short covering transactions, penalty bids, or any other transaction that affects the offered security's price."[35] Prospectuses must "[d]escribe the nature of the transactions clearly and explain how the transactions affect the offered security's price."[36] It is in response to these requirements that the sample disclosure set forth above was used.[37]

This illustrative disclosure addresses the adverse impact on an *underwriter* of a subsequent flip of stock that the underwriter placed. This typical disclosure presents some information that a prospective purchaser might find material. The disclosure provides information indirectly bearing on the aftermarket performance of the stock, although the information is not necessarily adverse to one who purchases in an IPO. It suggests an increased likelihood that the stock will be placed in the hands of purchasers who will not quickly resell the stock. If those purchasing stock in an IPO are generally less willing to resell the stock promptly, there would be decreased availability of the stock immediately following the offering. That fact indicates an increased likelihood that prices immediately following the IPO may rise.

Nevertheless, this form of disclosure does not identify issues of more immediate concern to the initial purchaser in an IPO. The

33. *See id.* § 230.408 ("In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."); *id.* § 240.12b-20 (same, as to a "statement" or "report"); *see also* Degulis v. LXR Biotech., Inc., 928 F. Supp. 1301, 1314 (S.D.N.Y. 1996) ("[N]o authority suggests that Regulation S-K is preemptive of the materiality requirement."); *cf.* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1209 (1st Cir. 1996) (rejecting the argument that "disclosure requirements of the Securities Act and regulations, including Item 11(a) of Form S-3, should be interpreted so that they would *never* mandate the provision of current information about a company's performance in the quarter in progress at the time of a public offering, so long as the company satisfies its quarterly and annual periodic disclosure obligations under the Exchange Act").

34. *See* Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 7375, 62 Fed. Reg. 520, 543 (Jan. 3, 1997) (adding 17 C.F.R. §§ 228.508(j), 229.508(*l*)).

35. 17 C.F.R. §§ 228.508(j)(1), 229.508(*l*)(1) (1999).

36. *Id.*

37. *See supra* note 26 and accompanying text.

disclosure is entirely silent concerning certain direct, adverse consequences to the purchaser itself—that the broker will or may, in the future, refuse to sell stock in an IPO to the purchaser. This Article argues that this omission is inconsistent with the federal securities laws.

A careful examination of the legal principles governing flipping securities purchased in IPOs should incorporate and reflect market factors that create incentives to flip those securities. Part I provides that background by discussing theories rationalizing the extraordinary short-term returns available to those who purchase stock in IPOs. Part I further discusses recent developments in the marketing of IPOs that may, in the future, partially mitigate flipping in some IPOs.

Parts II and III examine the application of federal securities laws to the failure to disclose in prospectuses these restrictions on flipping. Whether these omissions are permissible depends in large measure on whether the restrictions are "material," as that term is used in the federal securities laws.[38] Part II examines three general principles governing materiality relevant in this context: *First*, there is some authority to the effect that materiality is limited to information that is "firm-specific."[39] Because restrictions on flipping are imposed by persons other than the issuer and they are widespread within the IPO market, that authority, if applicable, could eliminate liability for the omission. Part II examines the authority holding that materiality is limited to firm-specific information. Part II concludes that authority is inconsistent with other longstanding authority and, in any case, is based on assumptions not applicable to IPOs. *Second*, Part II discusses the insight that can be provided into materiality by an examination of the reasons for the incomplete or inaccurate disclosure. *Third*, Part II examines whether quantification of the impact of a misstatement or omission is a precondition to a finding of materiality, concluding there is no such precondition.

Part III then applies the principles developed in Part II to the context of a failure to disclose restrictions on flipping. As noted in Part II, materiality is generally a question of fact for the jury.[40] The examination in Part III indicates that there is sufficient evidence to allow a jury to determine that a failure to disclose these restrictions is material and therefore actionable. Part III further examines the discriminatory application of these restrictions. Part III, relying on

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38. *See* 15 U.S.C. § 77q(a)(2) (1994); 17 C.F.R. § 240.10b-5 (1999); *infra* notes 84-97 and accompanying text.

39. *See* discussion *infra* Part II.A.

40. *See infra* text accompanying note 95.

National Association of Securities Dealers (NASD) rules and case law, closes by arguing the discriminatory application of these restrictions makes offering documents misleading as a matter of law, by creating a false impression that the offering is a "fixed price" offering. Following Part III, some concluding remarks are provided.

I. TRADING IMMEDIATELY FOLLOWING AN IPO

The average initial rate of return available on IPOs is substantial.[41] In general, finance theorists view the stock market (at least when one excludes the "penny stock" market) as efficient, in the sense of promptly reflecting all publicly available information.[42]

That does not mean the expected return on all stock should be the same. Stock having a nondiversifiable risk greater than that of the market should have a rate of return greater than that of the market as a whole.[43] However, under that theory, one would expect arbitrage generally to prevent an investor from earning above-market returns, holding risk constant and absent possession of nonpublic information. This view, however, is not inconsistent with being able to earn above-market returns, holding risk constant, by purchasing stock in an IPO.[44]

There are a number of theories addressing the reasons why there is a large average increase in the price of stock immediately following an IPO. Under one prominent theory, this run-up reflects an intentional underpricing of the stock.[45] This theory assumes that, although an issuer may have unique information concerning its future profitability, investors are "asymmetrically well informed about factors outside the issuing firm."[46] The theory postulates that stock sold in an IPO is intentionally underpriced in order to provide some compensation to those who purchase stock in the IPO for revealing the

41. *See supra* note 2 and accompanying text.

42. *See* Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 21 n.68 (1994) ("This proposition has been called the 'semi-strong' version of market efficiency. According to this version, investors not only react quickly to new information, they also react in an *unbiased* manner—that is, they do not make systematic mistakes in interpreting the information. The semi-strong version of market efficiency is widely accepted by financial economists." (citation omitted)); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1081-82 (1990).

43. *Cf.* STEPHEN A. ROSS ET AL., FUNDAMENTALS OF CORPORATE FINANCE 315 tbl.10.3 (1991) (noting varying risk premiums for common stocks and "small stocks").

44. *See infra* note 206 and accompanying text.

45. *See* Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343, 344 (1989).

46. *Id.*

information bearing on valuation.[47] Thus, under this theory, the underpricing reflects a method by which this consideration is provided.[48]

The nature of a fixed price offering limits the ability of an issuer to use this mechanism to compensate those investors who provide the desired information. Access to certain financial information fundamental to making an accurate assessment of the value of stock to be sold in an IPO—projections—is not given to all investors.[49] Issuers historically have omitted projections from offering documents for IPOs but disseminated that information (although not in tangible form) at "road shows," to which not all investors are invited, or through selective conversations with the underwriters' salesmen.[50] Moreover, possession of projections, by itself, is insufficient to permit one to

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47. *See id.*

48. There are various alternative, or complementary, theories. For example, the excess return may reflect a "lemons" problem. *See* Kevin Rock, *Why New Issues Are Underpriced*, 15 J. FIN. ECON. 187, 188 (1986). Where some but not all investors are informed and purchases by both informed and uninformed investors are necessary to consummate the offering, the issuer may need to underprice the offering to entice uninformed bidders to purchase. *See id.* Otherwise, the uninformed purchasers may receive large allocations in overpriced offerings and small or no allocations in underpriced offerings. *See id.* However, this model incorporates a curious assumption. The model assumes that the issuer is "uninformed" relative to a set of investors who are assumed to be informed, putatively because, inter alia, "the firm gives up its informational advantage by revealing its proprietary knowledge to the market. The firm discloses 'material information' about its plans and activities directly through the prospectus." *Id.* at 190. Crucial information is not required to be, and generally is not, included in the prospectus—projections. Although prospective investors will learn something about the projections at the road show, the issuer will necessarily remain better informed concerning the propriety of crucial assumptions and the sensitivity of the projections to the various assumptions. The underlying assumption—that uninformed investors are allocated materially higher percentages of overpriced IPOs—also has been empirically called into question. *See* Kathleen Weiss Hanley & William J. Wilhelm, Jr., *Evidence on the Strategic Allocation of Initial Public Offerings*, 37 J. FIN. ECON. 239, 247, 252 (1995).

Alternatively, the underpricing may reflect the equivalent of "insurance" against future lawsuits, by decreasing the likelihood that a lawsuit will be filed and limiting future damages. *See, e.g.*, Alexander, *supra* note 2, at 19, 25 (criticizing that theory).

49. The importance of projections is illustrated by the fact that large institutional investors insist on the provision of projections. *See* CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 133 (2d ed. 1997).

The SEC recently proposed rules that would limit issuers' ability to disclose material nonpublic information selectively. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7787, 64 Fed. Reg. 72,590 (Dec. 28, 1999). Under the proposal, where an issuer discloses material nonpublic information to any person who does not owe "a duty of trust or confidence" to the issuer, the issuer will be required to disclose the information publicly. *See id.* at 72,610-11. However, this obligation would not, under the proposed rule, apply to an issuer in the process of marketing its IPO. *See id.* at 72,598.

50. *See* JOHNSON & MCLAUGHLIN, *supra* note 49, at 133. As an administrative matter, it may well be that the projections are disseminated indirectly, through the employees of the managing underwriter. *See id.* at 134.

derive an estimate of value. This determination requires that one also have comparable revenue and stock price information for similar alternative investments.[51] Even where that information is public, obtaining and processing it can involve insurmountable costs for individual investors. An individual investor would be required to identify comparable firms and make appropriate adjustments for material differences such as different accounting conventions. Based on these and similar reasons, there are certainly some prospective investors who determine to purchase stock in an IPO without making a thorough investigation of the information available to prospective purchasers.[52]

Two sets of investors—those not competent or willing to make an analysis of the value of the firm and those competent to do so but who lack crucial information—do not provide the issuer and its underwriters the same information that can be provided by other, more informed investors. Nevertheless, in a traditional fixed price, firm commitment IPO, the issuer (or, perhaps more accurately, the underwriter) cannot charge varying prices.[53] Thus, even if the underpricing is at an appropriate market rate, a pro rata payment, in the form of underpricing, also generally must be made to those who do not provide the same level of information. Consequently, persons who provide lesser information to the issuer can earn above-market, risk-adjusted returns.

There are other theories bearing on this underpricing. One of the factors that affects a corporation's decision to consummate an IPO is an estimate of the price that will be realized on the stock to be sold. Prospective issuers obtain estimates from the investment banks that they choose to manage their offerings, and issuers consider differences in estimates provided by various investment banks courting an issuer

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51. *See* Abby M. Alderman & Kenneth Y. Hao, *The Initial Public Offering Process*, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1995, at 405, 411 (PLI Corporate Law & Practice Course Handbook Series No. B-904, 1995); William J. Grant, Jr., *Overview of the Underwriting Process*, *in* SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE, *supra* note 8, at 25, 26-27 (describing the IPO pricing process); *cf.* Manuel A. Utset, *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, 74 OR. L. REV. 275, 284 (1995) (suggesting that the value of an asset that has no market can be ascertained by reference to the value of similar investments).

52. *See* Robert J. Shiller, *Speculative Prices and Popular Models*, 4 J. ECON. PERSP. 55, 61 (1990) (noting that individuals purchasing in IPOs are more likely to make a purchase decision based on factors other than a "theory about fundamentals such as profits or dividends").

53. Investment banks have a limited ability to evade this requirement through "soft dollar" arrangements. *See infra* text accompanying note 315.

in selecting the investment banks to manage their respective IPOs.[54] As the IPO process proceeds, underwriters obtain indications of interest from potential purchasers, which permit the managing underwriter to revise the offering price to reflect actual demand for the securities to be offered.[55] However, economic evidence indicates that underwriters only partially adjust their estimates.[56] The average initial return for IPOs priced above initial estimates is greater than that of IPOs as a whole; similarly, the average initial return for IPOs priced below initial estimates is less than that of IPOs as a whole.[57] This process would also be consistent with the potential availability of excess returns by purchasing stock sold in an IPO.[58]

An additional explanatory factor briefly sketched in prior legal literature identifies a mechanism, relevant to newly developed practices in pricing stock sold in IPOs, that can account for a portion of the postoffering price increase.[59] In a customary IPO, the managing underwriter, in negotiations with the issuer, prices the offering based on indications of interest solicited from institutional investors and other customers.[60] The underwriters have strong incentives to distribute the securities as quickly as possible after the offering has commenced.[61] Once the offering begins, in general, the underwriters proportionately bear market risk—the risk that the entire market will decline, which would decrease their ability to sell the securities at the indicated price—as well as issuer-specific risk.[62] The underwriting agreement will provide for "market outs," conditioning the

54. *See* Alderman & Hao, *supra* note 51, at 411; Grant, *supra* note 51, at 26-27.

55. *See* Alderman & Hao, *supra* note 51, at 418-19.

56. *See* Kathleen Weiss Hanley, *The Underpricing of Initial Public Offerings and the Partial Adjustment Phenomenon*, 34 J. FIN. ECON. 231, 232 (1993).

57. *See id.* at 233-34.

58. *See id.*

59. *See* Alexander, *supra* note 2, at 69; Royce de R. Barondes, *Dynamic Economic Analyses of Selected Provisions of Corporate Law: The Absolute Delegation Rule, Disclosure of Intermediate Estimates and IPO Pricing*, 7 DEPAUL BUS. L.J. 97, 136-39 (1994). Professor Jay Ritter also considers the implications of having informed and uninformed investors. *See* Ritter, *supra* note 11, at 276-80. He, however, examines the effect this bifurcation of the investing public has on the choice of an offering method. *See id.* He argues that a "best efforts" offering, an atypical offering method, *see supra* note 11 and accompanying text, in which the underwriters do not assume the risk that the offering cannot be sold at the offering price, *see* PESSIN & ROSS, *supra* note 7, at 60, will be used in circumstances where the valuation of the issuer is more uncertain. *See* Ritter, *supra* note 11, at 276-77. His argument is somewhat curious, because it requires that the uninformed investor be sufficiently informed to distinguish among levels of uncertainty concerning an appropriate value for the issuer's securities. *See id.*

60. *See* Barondes, *supra* note 59, at 137.

61. *See id.*

62. *See id.*

underwriters' respective obligations to purchase on substantial adverse developments in the markets as a whole, or the prospectus becoming materially misleading as of the closing.[63] However, the underwriters rarely exercise market outs—they are willing to do so only in truly extreme cases—meaning that the underwriters generally bear a substantial portion of the market risk.[64] On the other hand, the underwriters' upside profit is limited, in that they cannot lawfully make additional profit by placing the stock with themselves and their affiliates for immediate resale at a price above the IPO price.[65] That the underwriters have significant downside risk without corresponding potential upside reward imposes incentives on the underwriters to sell the offering as quickly as possible. Even hours can be important.[66] This fact creates incentives for the underwriters to sell securities in large blocks-generally to institutional purchasers. Investment banks thus may (1) discount retail demand for stock to be sold in an IPO because the distribution will be primarily institutional and (2) reflect in the pricing a downward bias to assure that the offering does not become "sticky."[67] Consistent with these incentives, institutional purchasers typically acquire on the order of seventy percent of the shares offered in an IPO, with retail purchasers receiving the remainder.[68] This general outcome—that underpricing may reflect the underwriters' desire to assure that the offering is sold, in light of asymmetry in risk—is identified by Professors John Affleck-Graves and Robert Miller[69] and by Professor Janet Cooper Alexander.[70] To

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63. *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 331, 332 & n.17 (3d ed. 1998).

64. *See* 1 *id.* at 331-32.

65. Such an action would violate the "withholding" rules of the NASD. *See* NATIONAL ASS'N OF SEC. DEALERS, INC., CONDUCT RULES IM-2110-1(b), *in* N.A.S.D. Manual (CCH) ¶¶ 4112-4115 (1997) [hereinafter NASD MANUAL].

66. Consistent with this notion, in an offering not under Rule 430A, 17 C.F.R. § 230.430A (1999), the underwriters typically will not be bound prior to the effectiveness of the registration statement. *See* John S. D'Alimonte & Linda G. Schechter, *Underwriting Documents: Their Purpose and Content*, *in* MECHANICS OF UNDERWRITING 1995, at 213, 257 (PLI Corporate Law & Practice Course Handbook Series No. B-879, 1995). The underwriters desire not to assume the risk of a few-hour delay in their ability to sell the securities that could arise were administrative reasons to postpone slightly the effectiveness of the registration statement in such a context.

67. For discussion of a "sticky deal," see *supra* note 10 and accompanying text.

68. *See* Hanley & Wilhelm, *supra* note 48, at 240.

69. *See* John Affleck-Graves & Robert E. Miller, *Regulatory and Procedural Effects on the Underpricing of Initial Public Offerings*, 12 J. FIN. RES. 193, 199 (1989).

70. *See* Alexander, *supra* note 2, at 69 ("[U]nderwriters underprice not to avoid distant and speculative future losses from lawsuits under the securities laws, but to avoid the more immediate and certain costs of having to stabilize the market price, being stuck with

the extent this factor accounts for the postoffering price run-up, two recent developments in the method by which IPOs are sold may significantly decrease the postoffering run-up in IPO prices that otherwise could occur.

An underwriter could incorporate individual investor demand in determining an IPO price if the underwriter could obtain, before pricing, binding commitments from individual investors. One solution could be a binding "at the market" offer from the investor, in which the retail investor would agree to purchase at whatever price the underwriters selected. An underwriter could seek to achieve the same result by soliciting revocable offers to purchase. Offers to buy may be made prior to the effectiveness of a filed registration statement.[71] An underwriter could seek offers specifying a maximum price. Because the underwriter can control dissemination of the actual price chosen, such offers would have the same effect as binding offers, where the offers could be accepted without prior dissemination of the actual offer price. Alternatively, the underwriter could price the securities through a "Dutch auction."[72]

Although Dutch auctions have been used in certain debt offerings, for a variety of reasons neither of these methods has been traditionally used in selling IPOs.[73] However, two investment banks, W.R. Hambrecht & Company and Wit Capital, have each started incorporating these practices in offerings of IPOs. The first was W.R. Hambrecht & Company, a newly formed investment bank, which conducts a quasi-Dutch auction for IPOs. The process created by W.R. Hambrecht & Co. is referenced here as a quasi-Dutch auction, because the outcome of the Dutch auction procedure is not binding on either the issuer[74] or, it appears, the purchasers.[75] Rather, the results of

unsold inventory, and suffering damage to their reputations among customers and other underwriters.").

71. *See* 15 U.S.C. § 77e(c) (1994).

72. In a Dutch auction, as implemented in connection with a sale of securities, bids by interested parties are placed specifying a quantity and a maximum price. The shares are sold at an identical price equal to the highest price at which the aggregate bids for shares at or above that price equals at least the number of shares to be sold. *See* Exxon Corp., SEC No-Action Letter, *available in* 1977 SEC No-Act. LEXIS 1245, at *2 (May 9, 1977); PESSIN & ROSS, *supra* note 7, at 216.

73. *See generally* Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 13 (1998) (asserting that Dutch auctions are "promising" as a mechanism to price securities for which there is no public market).

74. *See* RAVENSWOOD WINERY, INC., PROSPECTUS 57 (Apr. 9, 1999), *available in* LEXIS, Fedsec Library, Prosp File.

the processing of those indications of interest is considered in setting the fixed public offering price.[76]

Most recently, procedures designed by Wit Capital, described in a no-action letter released in July 1999, allow for conditional offers to purchase that can be accepted without prior dissemination of the IPO price.[77] Under these procedures, investors, in advance of the pricing, place "conditional orders."[78] The orders either specify a maximum price the purchaser is willing to pay or include an implied maximum consisting of the high end of the estimated offering range disclosed in the prospectus.[79] After the offering is priced, Wit Capital allocates shares to those investors who have bid at or above the actual offering price, based on a modified "first come, first served" priority.[80] The prospective investors are free to withdraw bids before they are accepted.[81] It appears, however, that the investors are not informed of the actual offering price before any acceptance of their bids.[82] Thus, although the investors are free to withdraw their conditional offers at any time before acceptance, there is no mechanism by which they will learn of the actual price until Wit Capital has determined whether to accept their offer.

Both the W.R. Hambrecht and the Wit Capital methodologies allow for greater incorporation of actual retail demand for IPO stock when IPOs are priced. It is too early to tell whether these methods, or other refinements, will be used successfully. But to the extent they are used and the mechanism described by Professors Affleck-Graves and Miller accounts for the postoffering run-up, one would expect to see the use of this offering methodology decreasing the short-term return from purchasing stock in an IPO and perhaps partially mitigate the concerns addressed by this Article. Confirmation, however, awaits future empirical research.[83]

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75. The bids are referenced as mere "indications of interest," and the prospectus for one of the offerings references "offering" stock to those who submit indications of interest at or above the clearing price. *See id.* at 57-58.

76. *See id.*

77. *See* Wit Capital Corp., SEC No-Action Letter, *available in* 1999 SEC No-Act. LEXIS 620 (July 14, 1999).

78. *See id.* at *25.

79. *See id.* at *25-*26.

80. *See id.* at *34.

81. *See id.* at *29.

82. *See id.* at *34-*35 (indicating that the price is included in an "Acceptance E-mail").

83. That research may be complicated by a potential selection bias in the firms that choose to make offerings through W.R. Hambrecht or Wit Capital.

II. GENERAL PRINCIPLES OF MATERIALITY: FIRM-SPECIFIC INFORMATION, REASONS FOR THE OMISSION, AND QUANTIFICATION

Liability for misstatements or omissions under sections 11, 12(a)(2), and 17(a)(2)[84] of the 1933 Act and Rule 10b-5[85] under the Securities Exchange Act of 1934 (1934 Act)[86] is limited to material misstatements or omissions.[87] Any assessment of the adequacy of disclosure typically provided in prospectuses for IPOs concerning the consequences of flipping securities purchased thus must begin with an understanding of "materiality" in the context of public offerings.

The seminal case concerning materiality under the federal securities laws is *TSC Industries, Inc. v. Northway, Inc.*[88] In that case, the United States Supreme Court stated: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[89] *TSC Industries* involved an allegedly actionable omission from a proxy statement, which is the reason the opinion references a decision to vote.[90] In other contexts, such as whether an offering document omits a material fact, this same test, modified to reflect the different context,[91] is applied to assess materiality.[92] Applying this standard in the context of an omission concerning the purchase of a security, the omission need not address a matter that, were it disclosed, would *change* the

84. 15 U.S.C. § 77q(a)(2) (1994).

85. 17 C.F.R. § 240.10b-5 (1999).

86. 15 U.S.C. §§ 78a-78mm (1994 & Supp. III 1997).

87. The SEC has recently taken the position, however, that under section 13 of the 1934 Act, 15 U.S.C. § 78m (1994), the intentional making of immaterial misstatements in financial statements can be actionable. *See* SEC Staff Accounting Bulletin No. 99, *available in* 1999 SEC LEXIS 1599, at *22 (Aug. 12, 1999) [hereinafter Staff Accounting Bulletin No. 99].

88. 426 U.S. 438 (1976).

89. *Id.* at 449.

90. *See id.*

91. Where the fraud pertains to a purchase of a security, the reference to "deciding how to vote" is changed to "contemplating the purchase of securities." *See, e.g.*, Decker v. Kraftsow (*In re* Craftmatic Sec. Litig.), 890 F.2d 628, 639 (3d Cir. 1990).

92. *See* Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988) (applying the test in the context of Rule 10b-5); *Decker*, 890 F.2d at 641 n.18 ("Other courts have held that the definition of materiality from *TSC Industries* applies to actions under both § 11 and § 12[(a)(2)]."); Isquith v. Middle S. Utils., Inc., 847 F.2d 186, 207 n.16 (5th Cir. 1988) (applying the test to section 11 claims); Kronfeld v. Trans World Airlines, Inc., 832 F.2d 726, 731 (2d Cir. 1987) (applying the test to section 11); 4 LOSS & SELIGMAN, *supra* note 63, at 2063 (3d ed. 1990 & Supp. 1999).

purchaser's investment decision.[93] It need only be "important" to a "reasonable" investor in making the investment decision.[94]

Determination of the materiality of a misstatement or omission is usually reserved for the trier of fact.[95] Similarly, adequacy of disclosure is a mixed question of fact and law, and therefore normally left to the trier of fact.[96] Nevertheless, in some contexts, the resolution is so clear that courts have determined materiality as a matter of law.[97]

A. *Information That Is Not Issuer-Specific*

The actions that are taken by underwriters to deter flipping are not issuer-specific; these activities represent market practices not peculiar to a particular issuer. Moreover, these actions are taken by the underwriters and are not necessarily within the control of the issuers. It is not clear whether issuers would be able to compel underwriters to cease these practices were issuers inclined to pursue the issue. Additionally, these practices are, in light of recent press reports, public knowledge.[98] These facts might be considered to eliminate any obligation to disclose these practices in prospectuses. There certainly is some authority that issuers are not required to disclose information that is not issuer-specific. However, a thoughtful reading of relevant precedent indicates that any obligation to disclose this information is not terminated by the fact that the information is not issuer-specific or is otherwise publicly available.

The court in *Wielgos v. Commonwealth Edison Co.* discussed the liability of an issuer under section 11 of the 1933 Act for estimates,

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93. *See TSC Indus.*, 426 U.S. at 449; Quincy Co-Operative Bank v. A.G. Edwards & Sons, Inc., 655 F. Supp. 78, 85 (D. Mass. 1986).

94. *See TSC Indus.*, 426 U.S. at 449-50.

95. *See id.* at 450.

96. *See* Durning v. First Boston Corp., 815 F.2d 1265, 1268 (9th Cir. 1987).

97. In *TSC Industries*, the Court stated:

> The issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts. In considering whether summary judgment on the issue is appropriate, we must bear in mind that the underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality. The determination requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact. Only if the established omissions are "so obviously important to an investor, that reasonable minds cannot differ on the question of materiality" is the ultimate issue of materiality appropriately resolved "as a matter of law" by summary judgment.

TSC Indus., 426 U.S. at 450 (footnotes omitted) (quoting Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970)).

98. *See supra* notes 15-19 and accompanying text.

incorporated by reference into a prospectus, to complete nuclear power stations.[99] In affirming summary judgment in favor of the issuer on the claim that the estimates were actionable for underestimating the costs, the court said:

> Issuers need not "disclose" Murphy's Law or the Peter Principle, even though these have substantial effects on business. So too issuers need not estimate the chance that a federal agency will change its rules or tighten up on enforcement. Securities laws require issuers to disclose *firm-specific* information; investors and analysts combine that information with knowledge about the competition, regulatory conditions, and the economy as a whole to produce a value for stock. Just as a firm needn't disclose that 50% of all new products vanish from the market within a short time, so [the issuer] needn't disclose the hazards of its business, hazards apparent to all serious observers and most casual ones.[100]

The court further noted, in discussing December 1982 estimates of costs to complete the stations, which were incorporated by reference into prospectuses for an offering in December 1983:

> It was no secret that the estimate prepared in December 1982 was too low. The firm said so in September 1983. Proceedings in the [Atomic Safety and Licensing Board], including the staff's demand for re-inspections of [a reactor's] plumbing—costly to perform, costly because of delay—were public knowledge. The market price of the firm's stock, which [the plaintiff] and his class paid in the shelf offering,

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99. 892 F.2d 509, 510 (7th Cir. 1989).

100. *Id.* at 515 (citation omitted). The Supreme Court's opinion in *TSC Industries* may in part be to blame for this view. The Court, after setting forth the definition of materiality quoted above, *see supra* text accompanying note 89, stated:

> What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC Indus., 426 U.S. at 449. In the context of a public offering, the reference to "total mix" can be read to reference all public information, as opposed to the total mix of information in the prospectus. The Supreme Court has indicated that the reference to the "total mix" allows companies not to disclose information that would be "essentially useless." *See* Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) ("The role of the materiality requirement is not to 'attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations,' but to filter out *essentially useless* information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision." (citation omitted) (emphasis added) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987))). For the reasons expressed *infra* notes 124-201 and accompanying text, the better reading understands the reference to be to the information in the prospectus.

reflected this information. Prompt incorporation of news into stock price is the foundation for the fraud-on-the-market doctrine and therefore supports a truth-on-the-market doctrine as well. Knowledge abroad in the market moderated, likely eliminated, the potential of a dated projection to mislead. It therefore cannot be the basis of liability.[101]

This position—that firms need to disclose, or should be required only to disclose, firm-specific information—has been reiterated in a number of cases and by commentators.[102] A review of cases illustrates that this proposition has been extended to contexts beyond inaccurate projections.[103]

Industry trends represent one form of information relevant to an investment decision that is not issuer-specific. *In re F&M Distributors, Inc. Securities Litigation* involved the failure to disclose in a prospectus an industry trend that had already appeared and was continuing at the time the prospectus was issued.[104] The issuer sold health and beauty aids and household supplies at discount prices.[105] Historically, the issuer had used "deal" buying (i.e., purchases at times

101. *Wielgos*, 892 F.2d at 516 (citations omitted).

102. *See, e.g.*, Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 594 (1997) ("Issuers . . . should face a duty only to disclose firm-specific information that is necessary for the market to interpret intelligibly the forward-looking statements and that the market does not already possess."); Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 775 (1995) ("[S]ince the process of disclosing information is costly to the issuer, the issuer's obligation to disclose should be focused on the information as to which it does have a comparative advantage—value-relevant information about the issuer's own business."); *cf.* Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class*, 84 GEO. L.J. 2319, 2322 (1996) ("Under the traditional disclosure paradigm, an entity subject to mandatory disclosure is required to focus on information about itself and its securities, focusing on what can be referred to loosely as 'firm specific' information. Non-firm specific information, such as publicly available information about the history or prospects of the industry the entity happens to be in, is secondary." (footnote omitted)). *But see* Lawrence A. Cunningham, *"Firm-Specific" Information and the Federal Securities Laws: A Doctrinal, Etymological, and Theoretical Critique*, 68 TUL. L. REV. 1409, 1411 (1994) ("[T]his Article embraces the more immediate goal of arresting the spread of the line of cases embracing the firm-specific approach, which is deeply infected by doctrinal and etymological flaws."); Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1025-26 (1992) (describing *Wielgos* as having "unfortunate" implications).

103. Cases involving projections present special issues. Where a lawsuit alleges that projections were actionable, in light of the fact that the projections proved inaccurate, the lawsuit necessarily concerns the basis for the projections. Even information that otherwise need not be disclosed could become relevant in light of the assumptions made in preparing the projections.

104. 937 F. Supp. 647, 650 (E.D. Mich. 1996).

105. *See id.* at 649.

of the year when manufacturers offered large-volume discounts) and "contract" buying (i.e., purchases providing consistently low prices based on volume) to realize low inventory costs, which allowed it to underprice its competitors.[106] As of the date of the prospectus, within the relevant industry as a whole, there allegedly was an inadequately disclosed decline in the availability of deal buying.[107] The court, in considering a motion to dismiss the complaint for failure to state a claim upon which relief can be granted, referenced "the rule which proscribes that publicized industry trends need not be disclosed."[108]

A similar assessment is presented in *Phillips v. Kidder, Peabody & Co.*[109] In a discussion of potential liability under sections 11 and 12(a)(2) of the 1933 Act for incomplete disclosure of adverse industry trends, the court stated: "Even if the Prospectus had not explicitly revealed the conditions in the industry, however, the defendant could not have been held liable for such an omission[] because . . . it had no duty to report readily available industry trends."[110]

General economic data, although not issuer-specific, can be relevant to an investment decision. That type of information was at issue in *Hershey v. MNC Financial, Inc.*[111] The plaintiffs were persons who had purchased the issuer's stock during certain periods, including persons who had acquired the stock, registered pursuant to a registration statement, in a merger.[112] The plaintiffs alleged, inter alia, violations of Rule 10b-5 and sections 11 and 12.[113] One deficiency pertained to a favorable statement in periodic reporting, incorporated by reference into the registration statement, concerning the strength of the economy in the area where the issuer, a bank holding company, made a large portion of its loans.[114] The court stated:

> Some of these misrepresentations [identified by the plaintiffs] may not be actionable as a matter of law. For example, statements to the effect that the Baltimore/Washington regional economy is strong are not "firm-specific" and pertain to a matter as to which a potential investor

106. *See id.* at 649-50.

107. *See id.* at 652.

108. *Id.* at 654. This portion of the court's opinion examines the applicability of Rule 10b-5. *See id.* at 652-55. It does not clarify the extent to which this analysis applies to actions under section 11 or 12 of the 1933 Act.

109. 933 F. Supp. 303, 321 (S.D.N.Y. 1996), *aff'd*, 108 F.3d 1370 (2d Cir. 1997).

110. *Id.*

111. 774 F. Supp. 367, 372 (D. Md. 1991).

112. *See id.* at 368, 371-72.

113. *See id.* at 372, 374.

114. *See id.* at 369-70, 372.

could reach an independent judgment after consulting with his financial advisor.[115]

In re RAC Mortgage Investment Corp. Securities Litigation also involved disclosure concerning general economic data—in that case, in connection with two stock offerings by a real estate investment trust that profited by issuing collateralized mortgage obligations and retaining the residuals.[116] One of the allegedly actionable violations was the failure to disclose in the prospectuses that long-term interest rates could fall contemporaneous with an increase in short-term interest rates.[117] Both those events could adversely affect the value of the residuals retained by the issuer and, therefore, the value of the issuer's stock.[118] The court, relying on *Wielgos*, held that this non-firm-specific information concerning possible changes in the form of the yield curve need not have been disclosed in the prospectus.[119]

F&M Distributors, *Phillips*, and *Hershey* extend the application of *Wielgos*, because the omitted information in those cases did not pertain to projections. Rather, it pertained to developments affecting the respective issuer's market as a whole prior to the time the prospectus was issued. The holding of *RAC Mortgage Investment* also required an extension of *Wielgos*, because the omitted information did not pertain to a disclosed forward-looking statement.

Other cases, on a similar theory, have held as follows: (1) a firm issuing interests in mutual funds owning government-guaranteed securities need not disclose that comparable products created by competitors had lower fees,[120] (2) an investment bank need not disclose to a customer that the customer would be required to deliver additional funds to the investment bank if securities purchased on

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115. *Id.* at 372. This statement was made in a discussion of a claim under Rule 10b-5 and the requirements to plead fraud with particularity. *See id.* The case does not explicitly state whether the same test would apply under section 11 of the 1933 Act.

116. 765 F. Supp. 860, 861-63 (D. Md. 1991). The court described "residuals" as follows:

> [The issuer] then issues collateralized mortgage obligations ("CMOs") which are, in essence, several series of bonds. The interest rates on the CMOs are set at a level where payments under them are less than what is anticipated to be the income received from the pool of mortgages. The "residual" is the difference between what is taken in and what is paid out.

Id. at 862.

117. *See id.* at 864.

118. *See id.* at 862. A decrease in long-term interest rates could increase refinancings, thereby decreasing cash flow received from the mortgages, whereas some of the CMOs which it issued, representing debt obligations of the issuer, floated at short-term rates. *See id.*

119. *See id.* at 864.

120. *See* Castillo v. Dean Witter Discover & Co., No. 97 Civ. 1272, 1998 U.S. Dist. LEXIS 9489, at *7, *25 (S.D.N.Y. June 25, 1998).

margin decreased in value,[121] and (3) a brokerage firm need not disclose to a customer that the brokerage firm would retain earnings on collateral posted in respect of the customer's short sales.[122] In a fourth case, a court indicated that it would not be actionable under Rule 10b-5 for a reporting company to fail to disclose, in connection with an announcement of quarterly results, information concerning a regulatory action adverse to the company's industry, where the plaintiffs alleged the adverse regulatory action was widely anticipated in the industry.[123]

For a variety of reasons, however, it is untenable to assert that only firm-specific information can be material.[124] That position conflicts with (1) the nature of information expressly required by the SEC to be disclosed, (2) information generally included in prospectuses, (3) other lower court opinions that examine misstatements or omissions concerning information that is publicly known or not firm-specific, (4) administrative actions of the SEC extending back over half a century, and (5) two United States Supreme Court cases that implicitly contradict this aspect of *Wielgos*.

A wide range of information that is not, or need not be, issuer-specific is required to be disclosed in prospectuses for registered offerings. Issuers are required to disclose "sources and availability of raw materials";[125] "[t]he extent to which the business . . . is or may be seasonal";[126] "[c]ompetitive conditions in the business involved including, where material, . . . an estimate of the number of competitors and the registrant's competitive position, if known or reasonably available to the registrant";[127] material risks to the issuer arising from the potential failure of third parties, for example,

121. *See* Zerman v. Ball, 735 F.2d 15, 21 (2d Cir. 1984) (not citing *Wielgos*).

122. *See* Levitin v. PaineWebber, Inc., 159 F.3d 698, 702-04 (2d Cir. 1998) (not citing *Wielgos*), *cert. denied*, 119 S. Ct. 1039 (1999).

123. *See In re* Glenayre Techs., Inc. Sec. Litig., 982 F. Supp. 294, 296-97 (S.D.N.Y. 1997).

124. *Cf.* Cunningham, *supra* note 102, at 1418 ("[T]he concept of 'firm-specific information' has no meaning under the federal securities laws—indeed, except in *Wielgos* and its progeny, the concept simply does not exist in federal securities law jurisprudence.").

125. 17 C.F.R. § 229.101(c)(iii) (1999).

126. *Id.* § 229.101(c)(v).

127. *Id.* § 229.101(c)(x); *see* Division of Corporation Finance, SEC, Updated Staff Legal Bulletin No. 7, *available in* 1999 SEC No-Act. LEXIS 554, at *14-*15 (June 7, 1999) [hereinafter Staff Legal Bulletin No. 7] (providing a sample disclosure of a risk factor concerning competition that describes actions taken by a competitor when it recently expanded); *cf.* Securities Act Industry Guide 2, Disclosure of Oil and Gas Operations, 1 Fed. Sec. L. Rep. (CCH) ¶ 3826, at item 8(C)(iv) (July 14, 1999) (requiring, in respect of oil and gas operations, disclosure of "competition for the acquisition of reserves and supplies").

customers and suppliers, to address "Y2K" issues;[128] and certain tax consequences arising from the ownership of the securities being offered.[129] The SEC may require that a prospectus define terms in common use among investors of ordinary sophistication.[130] As part of administrative review of registration statements, the SEC will require that definitions accompany indispensable technical terms "understood only by industry experts."[131] Additionally, the SEC requires that the following legend (or a similar legend) appear on the cover of a prospectus: "Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representation to the contrary is a criminal offense."[132] That legend merely restates applicable law; it adds no new information about the issuer or any investment in its securities. These items are merely illustrative; they do not represent an exhaustive catalog. That the information to be disclosed is available elsewhere, even if generally known to sophisticated persons, cannot eliminate an issuer's obligation to disclose the information. Were that the case, SEC rules would not require this level of disclosure.

Current practice in drafting prospectuses also entails inclusion of information that is not firm-specific. For example, the recent prospectus for the IPO of Conoco Inc. included disclosure of the following risk factors, among others: (1) the volatility of the market price for natural gas, crude oil, and refined products, including the impact of Organization of Petroleum Exporting Counties; (2) risks associated with operating in markets outside the United States; (3) uncertainties

128. *See* Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers, Securities Act Release No. 7558, 63 Fed. Reg. 41,394, 41,399-400 (Aug. 4, 1998).

129. *See* 17 C.F.R. § 229.202(b)(9) (1999) (requiring disclosure of tax effects on holders of bonds sold at original issue discount); *id.* § 229.202 instruction 2(B)-(D) (requiring, in connection with offerings of foreign issuers, disclosure of legal limits on distributions by the respective issuer to U.S. residents and tax consequences to U.S. residents under foreign law and U.S. taxation treaties); *see also* Securities Act Industry Guide 5, Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships, 1 Fed. Sec. L. Rep. (CCH) ¶ 3829, at item 12(A) (July 14, 1999) (requiring disclosure of "all material Federal income tax aspects of the offering" in documents pertaining to real estate limited partnerships).

130. *See* Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests, Securities Act Release No. 6900, 56 Fed. Reg. 28,979, 28,980 (June 25, 1991) ("Registrants should not presume that the investor understands the import of terms such as 'best-efforts,' 'minimum-maximum offering,' 'dissenters' or appraisal rights.' These terms, when used, should be clearly explained.").

131. Staff Legal Bulletin No. 7, *supra* note 127, at *36.

132. 17 C.F.R. § 229.501(b)(7) (1999).

inherent in computing "proved" oil and gas reserves; (4) hazards of operating in Conoco's lines of business; and (5) risks of Y2K noncompliance, which included reference to potential risks arising from noncompliance by third parties.[133] The process by which the SEC makes comments on registration statements prior to their effectiveness creates a high likelihood that some of the comments given by the SEC, for inclusion in the prospectus, will not be firm-specific. Because the SEC does not hold its own due diligence meetings with employees of the issuer, the SEC is not in a position to raise issues for inclusion in IPO prospectuses other than those raised by publicly available information or the disclosure itself.

A number of lower court cases are consistent with the position that materiality is not limited to firm-specific information. The *Wielgos* court justified the conclusion that disclosure obligations are limited to firm-specific information on the basis that publicly available information is incorporated into securities prices independent of the disclosure of the information by the issuer.[134] If misstatements or omissions concerning publicly available information can be material, the premise underlying this aspect of *Wielgos* is flawed. Yet the language of a number of other lower court opinions contradicts this premise, stating that the mere fact that information is publicly available does not necessarily mean that an omission of the information from a disclosure document is immaterial.[135]

133. *See* CONOCO INC., PROSPECTUS 16-20 (Oct. 21, 1998), *available in* LEXIS, Fedsec Library, Prosp File.

134. *See supra* notes 100-101 and accompanying text.

135. *See, e.g.*, United Paperworkers Int'l Union v. International Paper Co., 985 F.2d 1190, 1199-1200 (2d Cir. 1993) (holding that disclosure in a firm's 10-K did not cure incomplete disclosure in a proxy statement, concluding, "[T]he district court correctly ruled that . . . the Company's 10-K Report to the SEC [was] not part of the total mix of information reasonably available to shareholders," but stating, "The 'total mix' of information may also include 'information already in the public domain and facts known or reasonably available to the shareholders.'" (quoting Rodman v. Grant Found., 608 F.2d 64, 70 (2d Cir. 1979))); Schneider v. Vennard (*In re* Apple Computer Sec. Litig.), 886 F.2d 1109, 1114 (9th Cir. 1989) ("Ordinarily, omissions by corporate insiders are not rendered immaterial by the fact that the omitted facts are otherwise available to the public."); Kronfeld v. Trans World Airlines, Inc., 832 F.2d 726, 736 (2d Cir. 1987) ("There are serious limitations on a corporation's ability to charge its stockholders with knowledge of information omitted from a document such as a proxy statement or prospectus on the basis that the information is public knowledge and otherwise available to them."); Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1123 (W.D. Mich. 1996) ("In a case where plaintiffs allege fraud on the market, 'the defendant's failure to disclose material information may be excused where the information has been made credibly available to the market by other sources.' *While it normally does not matter if the market is aware of certain facts if the plaintiff remains unaware*, where a plaintiff alleges fraud on the market he is implicitly asserting reliance on the integrity of the market." (citation omitted) (emphasis added) (quoting *Schneider*, 886 F.2d at 1115)); Endo v. Albertine, 863 F. Supp. 708, 720 (N.D. Ill. 1994) (quoting *Schneider*, 886

Other cases are inconsistent with this aspect of *Wielgos* in holding that material information may encompass information that is publicly available or not firm-specific. For example, failure to disclose legal rights relevant to the audience to which a disclosure document is directed can be material. One case held that the omission from tender offer documents of disclosure concerning appraisal rights available to dissenting shareholders was material as a matter of law.[136] This omission is akin to imposing liability on a firm for failing to act as legal counsel to the recipients of the disclosure. Nevertheless, the omission was actionable.

Numerous district court cases provide authority for the proposition that information is not rendered immaterial by virtue of public knowledge of the relevant information. For example, in *Monetary Management Group of St. Louis, Inc. v. Kidder, Peabody & Co.*, the court considered an investment bank's misrepresentation that bonds it was selling were marginable.[137] Although federal law required that for the bonds to be marginable there needed to be at least $25 million in principal amount of the bonds outstanding, only $15 million in principal amount of the bonds were outstanding.[138] Other investment banks knew that the bonds were not marginable; when the purchaser transferred the bonds to another investment bank, that investment bank refused to margin the bonds.[139] Nevertheless, the court held the misrepresentation to be material.[140] Another case supporting this view is *Dimeling v. Tucker Anthony and R.L. Day, Inc.*, in which the court held that misstatements concerning the taxability of interest on a series of municipal bonds were material, notwithstanding

F.2d at 1114); Fisher v. Plessey Co., 559 F. Supp. 442, 446 (S.D.N.Y. 1983) ("[T]here may well be instances in which the offeror's duty to disclose information in the offering materials is not relieved by the public availability of the same information.").

That some of these cases involve proxy statements does not provide a basis for distinguishing the cases. One could argue that there should be a different test of materiality in the context of proxy rules, relative to trading in securities. There may be an efficient market in the prices of securities without an efficient market in the exercise of voting rights of securities. The United States Supreme Court, however, has held the test of materiality is the same in actions under the proxy rules and under Rule 10b-5 (as applied to sales of securities). *See supra* notes 91-92 and accompanying text.

136. *See* Valente v. PepsiCo, Inc., 454 F. Supp. 1228, 1239 (D. Del. 1978).

137. 615 F. Supp. 1217, 1220 (E.D. Mo. 1985). Marginal bonds are bonds that can be purchased in part on credit provided by the investment bank. *See* PESSIN & ROSS, *supra* note 7, at 410 (defining "margin security").

138. *See Monetary Management Group*, 615 F. Supp. at 1219-20.

139. *See id.* at 1220.

140. *See id.* at 1222-23.

that a Moody's manual, a reference commonly used by investment banks, disclosed the correct information.[141]

Similarly, the court in *Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co.*, in an opinion that referenced *Wielgos*, held to be potentially material a failure by the issuer, a manufacturer of pharmaceutical and personal care products, to disclose that Wal-Mart, a customer or potential customer, preferred regional suppliers.[142] *Schamber v. Aaberg* is a comparable case addressing the materiality of misstatements concerning customers of the issuer.[143] In that case, the court, in a bench trial, held to be materially misleading a false statement that there was an established market for the issuer's principal product, where in fact there was no current market "of any consequence" for the product.[144]

Dickey v. Carter is yet another pertinent case.[145] The dispute arose from the sale of stock of a newly formed insurance company.[146] The purchaser was advised that the insurance company would use a "heretofore unused technique for mass marketing fire and automobile insurance."[147] The court, in a bench trial, found to be material the seller's failure to disclose that a large underwriter of automobile insurance "had already announced its intention to mass market insurance."[148]

A common fact pattern giving rise to liability involves brokers who solicit purchases of types of securities more risky than their customers' disclosed investment goals. Brokers exercising discretionary authority are subject to agency duties not generally relevant to assessing materiality of misstatements or omissions. However, omissions or misstatements concerning terms of securities, or industries, being *recommended* have been held to be actionable even where the customer ultimately determined to make the investment, that is, trading not in a discretionary account.[149]

Some of the above cases involve circumstances in which the misstatement or omission was made in face-to-face communications,

141. No. 80-909, 1982 U.S. Dist. LEXIS 13259, at *10, *27 (E.D. Pa. Apr. 8, 1982).
142. 940 F. Supp. 1101, 1112, 1123-25 (W.D. Mich. 1996).
143. 186 F. Supp. 52, 56 (D. Colo. 1960).
144. *See id.*
145. 392 F. Supp. 1055 (D. Mass. 1975).
146. *See id.* at 1056-57.
147. *Id.* at 1056.
148. *Id.* at 1057.
149. *See, e.g.*, Lukovich v. E.F. Hutton & Co., Civ. No. 85-1651-FR, 1986 U.S. Dist. LEXIS 26496, at *9 (D. Or. Apr. 21, 1986) (holding material, inter alia, a failure to disclose "the risk connected with convertible preferred stock and also with purchasing oil and gas stocks which could decline in value suddenly due to unstable oil and gas prices").

or other communications outside a prospectus forming part of a registration statement. That fact does not affect the relevance of those cases to assessing the materiality of misstatements in, or omissions from, prospectuses included in registration statements. Just as the test of materiality does not vary depending on whether insiders were trading,[150] a statement that would be materially misleading when made orally in one-on-one communication cannot lose its materiality by being placed in a prospectus.

Each of the preceding cases is inconsistent with treating as immaterial as a matter of law information that is not issuer-specific. Some directly contradict that principle. Others contradict the premise underlying that principle. Additional support is provided by the substantial authority indicating that a disclosure document can be actionable, even if it discloses all relevant information, where the mere placement of the unfavorable information within the disclosure document obscures its impact, commonly referenced as "buried disclosure."[151] A representative case is *Kennedy v. Tallant*, which involved an appeal from a judgment finding that disclosure made in connection with sales of stock violated Rule 10b-5.[152] The shares sold to the public were class A shares entitled to elect a minority of the issuer's board, whereas the officers and directors retained ninety percent of the class B shares, which, as a class, were entitled to elect a majority of the board.[153]

One of the omissions found to be material by the district court was that the promoters had "gained control of [the issuer] by the purchase of class B common stock, thereby enabling them to perpetuate themselves in office and control as long as they desired."[154] The appellate court described the relevant prospectus disclosure as follows:

> The following pieces of information were included in each prospectus: class B stockholders controlled a majority of the board of directors; the officers and directors owned ninety percent of the outstanding class B

150. *See infra* notes 213-214 and accompanying text.

151. *See, e.g.*, Kas v. Financial Gen. Bankshares, Inc., 796 F.2d 508, 516 (D.C. Cir. 1986); Gillette Co. v. RB Partners, 693 F. Supp. 1266, 1286-87 (D. Mass. 1988); Fradkin v. Ernst, 571 F. Supp. 829, 849 n.30 (N.D. Ohio 1983); Kohn v. American Metal Climax, Inc., 322 F. Supp. 1331, 1362-63 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir. 1972); 1 Loss & Seligman, *supra* note 63, at 582-83 (3d ed. 1998); *cf.* 17 C.F.R. § 230.421(a) (1999) ("The information required in a prospectus . . . shall not . . . be set forth in such fashion as to obscure any of the required information or any information necessary to keep the required information from being incomplete or misleading.").

152. 710 F.2d 711, 714-15 (11th Cir. 1983).

153. *See id.* at 714, 720.

154. *Id.* at 719.

> stock for which they paid forty-five hundred dollars, but owned only 2.75 percent of the outstanding class A and class B stock combined; the charter and bylaws of [the issuer] could be amended only upon the consent of a majority of class A stockholders and the consent of a majority of class B stockholders. These statements were *separated by several pages* in each prospectus. The ultimate conclusion, i.e., that appellants would always control [the issuer], was never disclosed even though this was precisely appellants' intent in organizing [the issuer].[155]

The court of appeals affirmed the judgment as to this omission.[156] The court of appeals stated: "Full and fair disclosure cannot be achieved through piecemeal release of subsidiary facts which if stated together might provide a sufficient statement of the ultimate fact."[157]

It is difficult to discuss carefully the sufficiency of disclosure based solely on a description of the disclosure. Nevertheless, it appears that *Kennedy* holds actionable the failure to summarize information, or provide a conclusion that appears self-evident, based on the fact that the information in question was spread out over a few pages. If the knowledge and effort required to assimilate that information is sufficiently substantial to make disclosure misleading, it follows *a fortiori* that the general availability of information in the market does not necessarily eliminate the materiality of its omission. The SEC's recent requirement that prospectuses be drafted in "plain English" similarly indicates the importance of the manner in which disclosure is made.[158]

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155. *Id.* at 720 (emphasis added).

156. *See id.*

157. *Id.*

158. *See* Plain English Disclosure, Securities Act Release No. 7497, 63 Fed. Reg. 6370 *passim* (Feb. 6, 1998) (requiring "plain English" in various portions of prospectuses). The importance placed on this matter is illustrated by the fact that a substantial portion—in some cases, over half—of the SEC comments on recent IPO prospectuses have concerned stylistic matters. *See* Bridget O'Brian, *Paper Chase: SEC Is Tough Grader*, WALL ST. J., July 6, 1999, at C1.

One might argue, however, that the SEC's vigor in this effort is excessive. Recent SEC comments on prospectuses have included the following: (1) the required substitution of personal pronouns for "Company," *see id.*; (2) "'[t]he use of small Roman numerals in parentheses is legalistic and should be avoided throughout your document,'" *id.*; (3) that "such" not be used as a synonym for "this," "these" or "the," *see* Staff Legal Bulletin No. 7, *supra* note 127, at *20; (4) that "defeased" not be used, *see id.* at *24; and (5) that the cover page not use cascading margins, *see id.* at *26, a stylistic touch that market professionals identify with particular investment banks, *see* O'Brian, *supra* (quoting a description of one prohibited layout as being "as distinctive 'as Tide coming in an orange plastic container'" (quoting William Wright, Managing Director of Client Services, Morgan Stanley Dean Witter & Co.)).

In implementing its views on drafting, however, the SEC seems to be a machine that "'go[es] of itself.'" *See* Donald P. Board, *Retooling "A Bankruptcy Machine That Would Go of Itself"*, 72 B.U. L. REV. 243, 243 n.* (1992) (applying the phrase, which he attributes to

The United States Supreme Court has stated that disclosure that would mislead a reasonable person remains misleading even if it would not be misleading to a sophisticated securities analyst:

> But not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow. The point of a proxy statement, after all, should be to inform, not to challenge the reader's critical wits. Only when the inconsistency would exhaust the misleading conclusion's capacity to influence the reasonable shareholder would a § 14(a) action fail on the element of materiality.[159]

In the context of the effect of disclosure on the market price of a security, the principles expressed in *Wielgos* would indicate that disclosure sufficient to inform market professionals should suffice.[160] Nevertheless, the Court indicated disclosure that is misleading to a reasonable person is actionable, even if it would not be misleading to a sophisticated person.[161]

James Russell Lowell, in the context of bankruptcy law) (book review). Other SEC disclosure comments or requirements have included:

(1) that references to "certain circumstances" or "certain extraordinary matters," which are terms frequently used to identify exceptions described elsewhere (either within the particular filing or in filed exhibits), be replaced with brief descriptions of the qualifications, *see* Staff Legal Bulletin No. 7, *supra* note 127, at *23;

(2) that the phrase "joint book-running manager" be removed from a prospectus, notwithstanding that the phrase has meaning, the underwriters argued, to institutional investors, *see* O'Brian, *supra*; and

(3) that the cover page not include text written in all capital letters, allegedly because that typography impedes legibility, *see* Staff Legal Bulletin No. 7, *supra* note 127, at *26, even though until 1998, SEC rules expressly required the use of precisely this type of legend, *see* Adoption of Integrated Disclosure System, Securities Act Release No. 6383, 47 Fed. Reg. 11,380, 11,421 (Mar. 16, 1982) (adding 17 C.F.R. § 229.501(c)(5)), *amended by* Plain English Disclosure, Securities Act Release No. 7497, 63 Fed. Reg. 6370, 6383 (Feb. 6, 1998).

A fourth example involved draft disclosure that used the term "e-commerce," which the SEC required to be clarified. *See* O'Brian, *supra*. In the original filing, the term "e-commerce" was used throughout the prospectus. *See* VERTICALNET INC., REGISTRATION STATEMENT, *passim* (Nov. 27, 1998), *available in* LEXIS, Fedsec Library, Filing File. A definition of "e-commerce" was provided. *See id.* at 3. Nevertheless, it would appear that SEC comments caused the phrase to be ultimately removed in its entirety from the prospectus and replaced with the phrase "electronic commerce," conveniently defined as "the buying and selling of goods and services over the Internet." VERTICALNET INC., PROSPECTUS 1 (Feb. 10, 1999), *available in* LEXIS, Fedsec Library, Prosp File.

159. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097-98 (1991) (citations omitted).

160. *See supra* notes 99-103 and accompanying text.

161. *See Virginia Bankshares*, 501 U.S. at 1097-98. The fact that *Virginia Bankshares* involved a proxy statement, as opposed to disclosure in a prospectus, should not affect the conclusion. *See supra* note 135.

Administrative actions also are consistent with the notion that publicly available information, or information that is not issuer-specific, is not per se immaterial.[162] In issuing a "stop order" suspending the effectiveness of a registration statement, the SEC relied in part on the registration statement's failure to disclose that shares being offered at one dollar per share under the registration statement were actively trading over-the-counter at a substantial discount to that price.[163] The SEC has also ruled that the registration statement for an issuer in the oil and gas business was materially misleading in failing to disclose that "drilling rules," which appear to have been similar to zoning ordinances, limited the issuer to drilling only one well per forty acres.[164] In another administrative action, the SEC found that a registration statement for a newly organized corporation formed to invest in insurance companies was materially misleading in its failure to disclose "the extent to which the insurance business [was] highly competitive in the area [it] intend[ed] to operate" and that "many recently organized insurance companies [were] operating at a loss."[165]

When issuing a stop order suspending the effectiveness of a registration statement filed by American Finance Company, the SEC stated that the registration statement for a firm that financed the sales of automobiles purchased primarily by U.S. government employees located overseas should disclose "the risks inherent in a finance business and the effect thereon of [the] registrant's practice of making loans primarily to enlisted military personnel outside the United States."[166] The SEC further stated:

> Moreover, in view of the fact that over 95% of [the] registrant's business originates overseas, the summary statement should call attention to and explain the extent to which [the] registrant's business is subject to the restrictions and laws of the governments of the United States and of foreign nations and to changes in them, as for example,

162. *Cf.* Denial of Petition for Rulemaking Concerning the Need for Consistent Disclosure, Exchange Act Release No. 17,390, 21 SEC Docket 1117, 1117-18 (Dec. 18, 1980) (indicating that information concerning estimates by reporting companies of expenses to comply with proposed regulations, prepared for presentation to other regulatory authorities, may be required to be disclosed).

163. *See* Cristina Copper Mines, Inc., Securities Act Release No. 3439, *available in* 1952 SEC LEXIS 7, at *9-*10 (May 1, 1952).

164. *See* Shawnee Chiles Syndicate, Securities Act Release No. 2665, *available in* 1941 SEC LEXIS 227, at *6 (Sept. 19, 1941).

165. American Investors Corp., Securities Act Release No. 3771, *available in* 1957 SEC LEXIS 664, at *8 (Apr. 5, 1957), *stop order lifted*, Securities Act Release No. 3810, *available in* 1957 SEC LEXIS 302 (July 9, 1957).

166. American Finance Co., Securities Act Release No. 4465, *available in* 1962 SEC LEXIS 632, at *10-*11 (Mar. 19, 1962), *stop order lifted*, Securities Act Release No. 4538, *available in* 1962 SEC LEXIS 153 (Oct. 2, 1962).

> the recent adoption of governmental regulations discontinuing the privilege of free transportation to this country. of foreign-made automobiles acquired by military personnel.[167]

This information is not issuer-specific. Nevertheless, the SEC indicated that its inclusion was required.

In suspending the effectiveness of a registration statement filed by Republic Cement Corporation, a newly formed issuer that proposed to engage in cement manufacturing, the SEC stated the registration statement was deficient in failing to disclose differences in use and cost to manufacture between types of cement the issuer was intending to produce.[168] Disclosure unlikely to mislead any but the most unsophisticated investor also has been found to be materially misleading.[169] These illustrative administrative actions identify the

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167. *Id.* at *11. This concern with disclosure of legal matters is not unique. *See, e.g.*, Securities Act Industry Guide 2, Disclosure of Oil and Gas Operations, 1 Fed. Sec. L. Rep. (CCH) ¶ 3826, at item 8(C)(iii) (July 14, 1999) (requiring brief disclosure of relevant federal and state price regulation by firms in the oil and gas industry); Securities Act Industry Guide 5, Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships, 1 Fed. Sec. L. Rep. (CCH) ¶ 3829, at item 7(C)(v) (July 14, 1999) (requiring disclosure of risks associated with rent stabilization programs).

168. *See* Republic Cement Corp., Securities Act Release No. 3816, *available in* 1957 SEC LEXIS 672, at *8 (July 26, 1957).

169. The SEC made the following observations concerning an advertisement issued by an investment adviser, in examining whether the advertisement complied with Rule 206(4)-1, 17 C.F.R. § 275.206(4)-1(a)(5) (1999), which renders unlawful the use by an investment adviser of an advertisement "[w]hich contains any untrue statement of a material fact, or which is otherwise false or misleading":

> Another advertisement, after describing the outstanding increase in the price of Zenith Radio Corporation stock made the following ostensibly sobering qualification[:] "But by and large, *experience has taught us that it is more prudent to set modest goals for special situations . . . perhaps a 100% profit in 18 months. Then, if developments turn out more favorably* than we *conservatively anticipated, and if a stock turned out to be a long-term fortune-builder (of the nature of Zenith), then your surprise would be a pleasant one.* Far better, we believe, to try and set modest goals and exceed them occasionally, than to set unrealistic goals and fall short of them continuously." This language, rather than modifying [the] registrant's optimism, suggested to the reader that the "modest" and "conservative" goal of a 100% profit in 18 months was surely attainable under [the] registrant's "prudent" securities selections. In our view [the] registrant's optimism was so extravagant that even an explicit caveat could not have brought this advertisement up to the statutory standard.

Spear & Staff, Inc., Investment Advisers Act Release No. 188, [1964-1965 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,216, at 82,305 (Mar. 25, 1965) (footnote omitted) (omission in original).

Similarly, although the fraudulent elements of a pyramid scheme are apparent to a moderately sophisticated person once the terms of the arrangement are disclosed, it is no defense to a fraud action against promoters of pyramid schemes that the essential elements of the scheme are made known to the victims. *See* Multi-Level Distributorships and Pyramid Sales Plans, Securities Act Release No. 5211, 36 Fed. Reg. 23,289, 23,291 (Dec. 8, 1971) ("It further appears to the Commission that the pyramid sales promotions that are often employed long history of requiring disclosure of information that is not firm-specific. As an administrative agency charged with enforcing a specialized field, the SEC's views on materiality are entitled to deference.[170]

Moreover, two additional United States Supreme Court decisions concerning materiality under the federal securities laws also indirectly contradict the view that material information is limited to information that is firm-specific.[171] Those cases imply that omissions of information that is publicly available can be material, which is inconsistent with rationale articulated in *Wielgos* for limiting materiality to firm-specific information.

The case in which the Supreme Court formulated the test for materiality, *TSC Industries, Inc. v. Northway, Inc.*, involved allegedly misleading disclosure addressing two matters: (1) the extent of an acquiring firm's control over a target corporation at the time proxies were solicited and (2) the favorableness of the terms of the acquisition to shareholders of the target.[172] As to the first matter, the court of appeals held that three omissions from the proxy statement were material *as a matter of law*: (1) that the chairman of the board of the target was the president and CEO of the bidding firm, (2) that the chairman of the target's executive committee was an officer of the bidder, and (3) that "in filing reports required by the SEC, both [the target] and [the bidder] had indicated that [the bidder] 'may be deemed to be a "parent" of [the target] as that term is defined in the Rules and

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in connection with the sale of securities of the types described above may be inherently fraudulent."); *see also* Davis v. AVCO Fin. Servs., Inc., 739 F.2d 1057, 1062, 1068 (6th Cir. 1984) (affirming in part liability under the predecessor to section 12(a)(2) in connection with a pyramid scheme where a review of the terms promptly disclosed "the inherent fallacy of the . . . scheme[,] indicat[ing] that its defects were obvious"); SEC v. Glenn W. Turner Enters., Inc., 348 F. Supp. 766, 771 (D. Or. 1972) (noting that pyramid schemes are "inherently unstable" and analogizing them to "chain letters" that are actionable under 18 U.S.C. § 1341), *aff'd*, 474 F.2d 476 (9th Cir. 1973).

170. *See* Basic Inc. v. Levinson, 485 U.S. 224, 239 n.16 (1988) ("The SEC's insights are helpful, and we accord them due deference."); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 n.10 (1976) ("In defining materiality under Rule 14a-9, we are, of course, giving content to a rule promulgated by the SEC pursuant to broad statutory authority to promote 'the public interest' and 'the protection of investors.' Under these circumstances, the SEC's view of the proper balance between the need to insure adequate disclosure and the need to avoid the adverse consequences of setting too low a threshold for civil liability is entitled to consideration." (citations omitted)); *cf.* Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 Nw. U. L. REV. 555, 611 (1981) ("[C]ourts often defer to the Commission's expertise by requiring disclosure of qualitatively material information specifically called for by Commission rules.").

171. *See TSC Indus.*, 426 U.S. at 450-51; Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

172. 426 U.S. at 450-51.

Regulations under the Securities Act of 1933.'"[173] The Supreme Court reversed the holding that these omissions were material as a matter of law, and remanded the case for trial.[174]

This omitted information concerning the relationship between the bidder and the target would appear to have been public. One of the allegedly improper omissions was, it appears, the failure to repeat in the proxy statement information included in other documents filed with the SEC. It is difficult to construe that information as nonpublic. The other information pertained to the other affiliations of two officers of the target, a public company, with the bidder created nine months before the date of the proxy statement, in connection with the purchase by the bidder of thirty-four percent of the target's voting securities.[175] It is difficult to imagine that this information was not generally known to market professionals who followed the target's stock. Were this public information immaterial as a matter of law, the Court could have so stated. That the case was remanded, without an indication that these statements were immaterial as a matter of law, indicates that this type of information can be material.

One might object to this characterization of *TSC Industries* as reflecting too fine a parsing of its language. Yet, subsequent discussion of the case by the Supreme Court in *Virginia Bankshares, Inc. v. Sandberg* seems to confirm that reading.[176] *Virginia Bankshares* involved a proxy statement for a freeze-out merger.[177] The *Virginia Bankshares* Court examined the potential actionability of the following language in a proxy statement: "The Plan of Merger has been approved by the Board of Directors because it provides an opportunity for the [target's] public shareholders to achieve a high value for their shares."[178] The proxy statement at issue described the acquisition price as exceeding both book value and market value, although the plaintiffs presented evidence indicating a per share going-concern value of the target substantially higher than the price contemplated in the merger.[179] In holding that "a specific statement of reason knowingly false or misleadingly incomplete" may be actionable, the Court, stated:

> This analysis comports with the holding that marked our nearest prior approach to the issue faced here, in *TSC Industries*. There, to be

173. *Id.* at 451.
174. *See id.* at 463-64.
175. *See id.* at 440-41.
176. 501 U.S. 1083, 1095 (1991).
177. *See id.* at 1087-88.
178. *Id.* at 1090 (internal quotations omitted).
179. *See id.* at 1094.

> sure, we reversed summary judgment for a . . . plaintiff who had sued on a description of proposed compensation for minority shareholders as offering a "substantial premium over current market values." But we held only that on the case's undisputed facts the conclusory adjective "substantial" was not materially misleading as a necessary matter of law, and *our remand for trial assumed that such a description could be both materially misleading within the meaning of Rule 14a-9 and actionable under § 14(a).*[180]

This language indicates the remand in *TSC Industries* reflected a judgment that the allegedly misleading statements at issue in *TSC Industries* could be found by a jury to be materially misleading.[181]

One of the omissions considered actionable in a second Supreme Court case, *Affiliated Ute Citizens v. United States*, was even more strikingly "public."[182] The claims in that case included, inter alia, that persons making a market in an unusual security violated Rule 10b-5 in connection with purchases made by, or facilitated by, them at prices materially below the prevailing market prices.[183] The Court stated, "The sellers had the right to know . . . that their shares were selling for a higher price in that market."[184]

A review of relevant precedent thus discloses a series of cases and administrative decisions extending back half a century inconsistent with the notion that materiality is limited to firm-specific

180. *Id.* at 1095 (citation omitted) (emphasis added) (Souter, J.).

181. The use of the word "assumed," in lieu of "implied," is unfortunate. It could mean "assumed, without deciding," but that reading would divest the paragraph of meaning.

As noted above, *see supra* text accompanying note 172, there were two types of statements that the plaintiffs in *TSC Industries* alleged to be actionable: (1) omissions concerning the relationship between the bidder and the target and (2) an inaccurate characterization of the favorableness of the terms of the transaction. Although the *Virginia Bankshares* Court indicated the remand in *TSC Industries* implied a jury could find the second type of misstatement materially misleading, it did not make a similar statement about the other information at issue in *TSC Industries*—the relationship between the bidder and the target. *See Virginia Bankshares*, 501 U.S. at 1087. That fact does not undermine the conclusion that *TSC Industries* means publicly available information can be material. The terms of the remand in *TSC Industries* do not indicate that only one of these two types of information can be actionable. The analysis applies equally to both types of information at issue in *TSC Industries.*

182. 406 U.S. 128 (1972).

183. *See id.* at 144-45, 153.

184. *Id.* at 153; *cf.* SEC v. United Fin. Group, Inc., 474 F.2d 354, 358 n.9 (9th Cir. 1973) (holding that the SEC made a prima facie case of fraud and citing, inter alia, offering materials for a mutual fund that "failed to disclose to prospective investors that the market price for its shares was nonexistent and that the price was arbitrarily fixed"). Although the holding in *Affiliated Ute Citizens* is consistent with the shingle theory, under which brokers can be held liable to customers for charging unreasonable prices, *see* 8 LOSS & SELIGMAN, *supra* note 63, at 3777, 3779 (3d ed. 1991), the Court noted that its decision was not based on a theory that the defendants were broker-dealers. *See Affiliated Ute Citizens*, 406 U.S. at 154 n.16.

information. Reference in *Wielgos* to the "truth-on-the-market" defense, as a basis for asserting that issuers need only disclose firm-specific information,[185] is inapposite. The truth-on-the-market defense represents a basis on which firms may avoid liability under Rule 10b-5 for misstatements.[186] That defense is relevant to proof of reliance, a required element of a cause of action under Rule 10b-5.[187] The fraud-on-the-market theory allows investors to create a presumption of reliance, thereby avoiding the need to prove actual reliance, where there is an active market in the securities in question.[188] The underlying principle is that an efficient market promptly reflects all available information. Thus, if one purchases securities in a fully developed market, expecting that the stock price reflects all available information, where allegedly misleading favorable information is available to the market, one purchasing at the market price would be purchasing at an excessive price, *ceteris paribus*. The truth-on-the-market defense represents one manner in which defendants can negate the presumption of reliance—in that case, by proving information indicating that the market price was not affected by the misstatement in question.[189]

However, a plaintiff need not prove reliance in order to prevail under section 11 or section 12(a)(2) of the 1933 Act.[190] Issuer defendants can limit their liability under those sections by proving all or a portion of the loss was not caused by the defendants' misstatements or omissions.[191] But that the efficient capital markets hypothesis yields a *presumption* of reliance in a Rule 10b-5 action does not fairly imply that public dissemination of otherwise material information omitted from a prospectus *proves* a defense of loss causation *as a matter of law*.[192] And the availability of these defenses

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185. *See supra* text accompanying note 144.

186. *See* 2 HAZEN, *supra* note 6, § 13.5B, at 538 (practitioner's ed. 3d ed. 1995).

187. *See* 2 *id.* § 13.2.1, at 466.

188. *See* 2 *id.* § 13.5B, at 534-37.

189. *See* 2 *id.* § 13.5B, at 538.

190. *See, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) ("If a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case [under section 11]. Liability against the issuer of a security is virtually absolute, even for innocent misstatements." (footnote omitted)); 9 LOSS & SELIGMAN, *supra* note 63, at 4202 (§ 12(a)(2)), 4249-50 (§ 11) (3d ed. 1992). A minor caveat is that under section 11 a plaintiff must prove reliance where the purchase is made after the issuance of "an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement." 15 U.S.C. § 77k(a) (1994).

191. *See* 15 U.S.C. § 77k(e); *id.* § 77*l*(b) (Supp. III 1997).

192. *Cf.* Basic Inc. v. Levinson, 485 U.S. 224, 249 n.29 (1988) ("We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-

does not directly bear on the *materiality* of the omitted statement.[193] Rather, these defenses provide that even where material information is omitted, there may be no remedy to a private plaintiff where the misstatement caused no damage. *Wielgos* confuses materiality for causation or reliance.

The history of section 12 of the 1933 Act confirms that conclusion. Prior to 1995, there was no loss causation defense to an action under section 12 alleging the sale of a security by means of a false or misleading prospectus.[194] The issuer could only defend on the basis that (1) it did not know, and with reasonable diligence could not have known, of the misstatement or omission, or (2) the victim was aware of the untruth or omission.[195] This language in section 12(a)(2), which renders actionable sales by means of an "untrue statement of a material fact,"[196] and the correlative terms concerning omissions, were not changed by that 1995 amendment.[197] The remedy formerly provided was recission; no decrease in the remedy was available as a consequence of other factors having adversely affected the market price.[198] That investors other than the plaintiff were not misled was not relevant.[199] If "truth-on-the-market" did not negate materiality prior to that amendment, it cannot negate materiality subsequent to that amendment, as that amendment by its terms does not purport to modify the definition of materiality.[200] Moreover, that a private plaintiff cannot prove damages does not render the activity lawful—

developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial.... Thus, we see no need to engage in the kind of factual analysis the dissent suggests that manifests the 'oddities' of applying a rebuttable presumption of reliance in this case." (citations omitted)).

193. *Cf.* 2 HAZEN, *supra* note 6, § 13.5B, at 536 (practitioner's ed., 3d ed. 1995) (stating that materiality does not trigger the presumption of reliance absent evidence that "the market reacted to the misstatements"). *But see* Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp 1101, 1124 n.15 (W.D. Mich. 1996) (disagreeing with Hazen and stating that the existence of truthful information bears on materiality by affecting the "total mix" of available information).

194. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 105, 109 Stat. 737, 757 (1995) (codified at 15 U.S.C. § 77*l* (Supp. III 1997)).

195. *See* 15 U.S.C. § 77*l*(2) (1994).

196. *Id.*

197. *See* Private Securities Litigation Reform Act § 105, 109 Stat. at 757.

198. *See* 15 U.S.C. § 77*l* (Supp. III 1997).

199. *See id.*

200. *See* Private Securities Litigation Reform Act § 105, 109 Stat. at 757.

enforcement proceedings, in which courts have held the SEC need not prove reliance, would still be available.[201]

The preceding discussion indicates the principle that only firm-specific information is material, on the basis that other publicly available information is necessarily incorporated into the price at which securities trade, is not well founded. SEC rules expressly require disclosure of some such information.[202] Numerous cases and administrative decisions have reached holdings inconsistent with that principle.[203] The view that only firm-specific information is material would appear, then, to represent merely another fallacious doctrinal development arising from a single-minded pursuit by a portion of the United States Court of Appeals for the Seventh Circuit of personal notions of efficiency, based on entirely speculative assessments of costs and benefits, in cavalier disregard of precedent.[204] Nevertheless, even if one were persuaded by the general principle that a failure to disclose information that is not firm-specific cannot be a material omission, for the reasons set forth below, the rationale for that principle is inapplicable in the context of IPOs and the principle, therefore, cannot rationally be applied to disclosure in the context of an IPO.

In general, there is, by definition, not a "well-developed" market in a security immediately before it is first sold to the public in an IPO—there is no public market at all.[205] The price at which the stock is initially sold is not the product of a process that can be considered efficient—the price need not "represent" all publicly available information.[206] That this market is not efficient means disclosure to

201. *See* SEC v. Rana Research, Inc., 8 F.3d 1358, 1359, 1363-64 (9th Cir. 1993); SEC v. North Am. Research & Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970); 2 HAZEN, *supra* note 6, § 13.5B, at 109 (practitioner's ed., 3d ed. Supp. 1999).

202. *See supra* notes 125-129 and accompanying text.

203. *See supra* notes 136-184 and accompanying text.

204. *See generally* Basic Inc. v. Levinson, 485 U.S. 224, 234, 235 & n.11 (1988) (rejecting the rationale of Flamm v. Eberstadt, 814 F.2d 1169, 1177-78 (7th Cir. 1987), in which the Seventh Circuit reasoned "backwards from a goal of economic efficiency" to support the conclusion that disclosure of acquisition transactions need not be made prior to an agreement on the terms of the transaction).

205. There is a narrow exception to this statement. A public trading market could subsequently develop in the common stock of an issuer that undertook one or a series of private placements of its stock. In such a case, the issuer would be required to file periodic reports under the 1934 Act, if it had assets exceeding $10 million and at least 500 shareholders of record. *See* 15 U.S.C. § 78*l*(g)(1) (1994); 17 C.F.R. § 240.12g-1 (1999). For ease of exposition, that unusual pattern is disregarded in this discussion.

206. *See* Robert A. Prentice & John H. Langmore, *Beware of Vaporware: Product Hype and the Securities Fraud Liability of High-Tech Companies*, 8 HARV. J.L. & TECH. 1, 49 n.242 (1994); Shayne & Soderquist, *supra* note 2, at 965. In recognition of this fact, some lower courts have developed a related principle, applicable in the context of IPOs, sometimes

the market as a whole cannot be relied upon to substitute for disclosure that should be in a prospectus.[207]

Moreover, the process of gathering and analyzing disparate pieces of publicly available information, for purposes of valuing stock to be sold in an IPO, is not costless.[208] As noted above, finance theorists argue that stock sold in an IPO is intentionally priced below the equilibrium price to induce prospective investors to reveal information bearing on the value of the stock to be sold in an IPO.[209] The information being revealed is derived from non-firm-specific sources—"*factors outside the issuing firm*" such as "*information about an issuing firm's competitors.*"[210] This postulate directly contradicts the application of *Wielgos* to IPOs. To the extent one believes this finance theory, the substantial amount of money annually represented by the short-term returns on IPOs—ten percent or fifteen percent of $40 billion is a large number—necessarily implies that there are material costs to orchestrating the use of publicly available information, or information that otherwise is not firm-specific, to the extent required to value securities to be sold in an IPO. Requiring firms to facilitate this process by extending the disclosure obligations in IPOs beyond firm-specific information can decrease costs because (1) those firms might not be at a cost disadvantage to investors in assembling this information and (2) imposing that obligation on a

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referenced as the "fraud-created-the-market" theory. Under this theory, a plaintiff seeking to meet the reliance element of a Rule 10b-5 action can demonstrate that, absent fraud, the securities in question would not have been marketed. *See, e.g.*, Carlon v. Thaman (*In re* NationsMart Corp. Sec. Litig.), 130 F.3d 309, 321 (8th Cir. 1997) ("Some courts recognize a 'fraud-created-the-market' theory, where reliance may be presumed if the defendants' fraudulent activity is 'so pervasive that it goes to the very existence of the [securities] and the validity of their presence on the market.' Not all courts have accepted the fraud-created-the-market theory." (alteration in original) (citation omitted) (quoting Ross v. Bank South, N.A., 885 F.2d 723, 729 (11th Cir. 1989))).

207. *Cf.* Ballan v. Wilfred Am. Educ. Corp., 720 F. Supp. 241, 251 (E.D.N.Y. 1989) ("A plaintiff must in the end choose between the fraud-on-the-market theory and a contention that published information did not reach him because it was 'buried' or revealed only to the SEC. The two are logically inconsistent.").

208. *Cf.* F.H. Buckley, *When the Medium Is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493, 528 (1990) ("[M]arkets cannot be perfect if information is costly. This is not, however, a fundamental criticism of market efficiency, because markets are uninteresting unless information is costly. Without search costs, a knowledge of market price would be valueless for uninformed free riders. What is important is not perfect efficiency and costless information, but relative efficiency and costly information. In such markets, search costs still represent a deadweight efficiency loss to the extent that they can be reduced by signalling policies." (footnote omitted)); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 685 (1984) (stating, in the disclosure context, "searching out . . . information is costly").

209. *See supra* text accompanying notes 45-48.

210. Benveniste & Spindt, *supra* note 45, at 344 (emphasis added).

single firm avoids duplicative costs.[211] The heuristic argument in *Wielgos* supporting the efficiency of nondisclosure is not applicable to IPOs.

This is not to say that issuing firms should be required to disclose all potentially relevant information—there needs to be some end to the process by which an issuer educates its investors. All relevant information would be essentially infinite. Rather, the more restrained point is as follows: even if one believes the economic argument against requiring the disclosure of information that is not firm-specific, that argument has no application to IPOs because the premise—that the relevant market is efficient—is confutable.[212]

B. *Reasons for the Omission*

Occasionally, some insight into the materiality of an omission can be gained by examining the reasons for the omission. If the omission arose from an expectation or concern that disclosure could affect the purchase decision or the process by which the security would be marketed, that fact would be consistent with the omission being material. If the omission were inadvertent—and thus the fact in question would have been disclosed absent an oversight—that pattern is also consistent with materiality, although less strongly so. One may intend generally to disclose information, even though it is immaterial, solely because it is practice to do so or for other reasons independent of materiality.

There is some authority bearing on the efficacy of this perspective. The Supreme Court stated in *Basic Inc. v. Levinson*, "We recognize that trading (and profit making) by insiders can serve as an indication of materiality."[213] One of the cases cited by the Court, in discussing proxy rules, stated:

211. *See* Easterbrook & Fischel, *supra* note 208, at 674-75 (noting that reliance on investigation by investors produces duplicative expenditures).

212. *See supra* note 206 and accompanying text.

213. 485 U.S. 224, 240 n.18 (1988) (emphasis omitted); *accord* SEC v. Geon Indus., Inc., 531 F.2d 39, 48 (2d Cir. 1976) (stating insiders "demonstrated the importance they attached to the information by purchasing shares"); SEC v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974) ("But we need not merely speculate as to how a reasonable investor might have received this information. The behavior of the appellant, his partner ... and others who knew of the merger, all of whom were sophisticated investors, demonstrates empirically that the information was material."); SEC v. Ingram, 694 F. Supp. 1437, 1441 (C.D. Cal. 1988) ("[T]he fact that significant purchases were made after years of only marginal trading indicates that the information was material."); 4 LOSS & SELIGMAN, *supra* note 63, at 2081 (3d ed. 1990) ("In insider trading cases, a purchase by a defendant of stock or options when the defendant does not have a history of securities trading (or an increased level of trading activity by one who does) often has been cited as useful circumstantial evidence.").

> A fact does not become more material to the shareholder's decision because it is withheld by an insider, or because the insider might profit by withholding it.
>
> ... [A]lthough § 14(a) requires any party soliciting proxies, regardless of his status or interest in the transaction, to disclose all material information, a self-dealing insider may have a "heavier burden of disclosure" in the sense that he will find it more difficult to convince the court that he has met the requirements of § 14(a).[214]

The reason why trading by insiders "can serve as an indication of materiality" is that the actions of insiders, in this context, may manifest insiders' assessments of undisclosed information. Insiders are in a unique position to assess the relevance and importance of information to their respective firms. They have distinctive access to other relevant information. That they often have disproportionate investments tied to the results of their firms makes clear their bias—an interest in assuring positive stock performance.[215] Where a decision not to disclose information is based on an anticipated negative impact of that information on the market for the firm's securities, such a decision similarly implies materiality.

It must be conceded that there may be factors not bearing on materiality that cause firms not to disclose information. That fact does not eliminate the value of examining motives for omissions in assessing materiality. Rather, just as in the case of insider trading, this possibility merely means that the results of this perspective are not necessarily incontrovertible. For example, omission of information that the seller reasonably expects to be already known by the purchaser would be benign. That view would be less persuasive, however, where disclosure is avoided because the information would be unfavorable. As a consequence of the economic bias of insiders, it is suspect for insiders to assert that negative information was not disclosed because the information was already public. A second rationale that does not imply materiality would be an omission of details where complete disclosure would produce a document whose length could obscure more important information.[216]

214. Pavlidis v. New Eng. Patriots Football Club, Inc., 737 F.2d 1227, 1231 (1st Cir. 1984).

215. Section 16(c) of the 1934 Act renders unlawful short sales by insiders. *See* 15 U.S.C. § 78p(c) (1994).

216. *See* White v. Melton, 757 F. Supp. 267, 269-70, 273 (S.D.N.Y. 1991) (involving a mutual fund prospectus which "incorporated by reference" information included in a publicly available "Statement of Additional Information," where the SEC had previously expressed concern that mutual fund prospectuses had become too lengthy, *see* Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 6479, 48 Fed. Reg. 37,928, 37,929 (Aug. 22, 1983)); Insurance Underwriters Clearing House, Inc. v.

These circumstances can be contrasted with other fact patterns in which this perspective–the reason for the omission–indicates that the omission should be actionable. Paradigmatic would be an omission made because it was believed that a complete description would adversely affect the marketing of the security. Yet even omissions arising from inadvertence would be consistent with the materiality of the omission. Consider, for example, *McMahan & Co. v. Wherehouse Entertainment, Inc.*, a case involving a "poison put" provision in a series of bonds, which authorized the holder to put the bonds to the issuer in the event of certain changes in control.[217] The terms of the poison put required the issuer to offer to repurchase bonds upon the taking of certain extraordinary corporate actions.[218] As described in the prospectus, the repurchase rights were not triggered, however, when the "Independent Directors" approved the transaction.[219] "The offering materials defined an 'Independent Director' as 'a director of the Company' who was not a recent employee but who was a member of the board of directors on the date of the offering or who was subsequently elected to the board by the then-Independent Directors."[220]

One and one-half years after the bonds were issued, the issuer sought to enter into a leveraged buyout.[221] The Independent Directors approved the transaction, thereby relieving the issuer from its obligation to offer to repurchase the bonds.[222] Bondholders alleged that the prospectus was misleading, in violation of sections 11 and 12(a)(2) of the 1933 Act and Rule 10b-5 under the 1934 Act, on the

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Natomas Co., 228 Cal. Rptr. 449, 454 (Ct. App. 1986) (involving an incomplete description of voting provisions of preferred stock); *supra* note 100.

217. 900 F.2d 576, 577-78 (2d Cir. 1990). A "poison put" is "a provision in a bond indenture that permits the bondholder to tender the security to the issuer at par (or at a premium, as determined) if: (1) there is a hostile takeover proposal or (2) the bond is downgraded by a national rating service." PESSIN & ROSS, *supra* note 7, at 529.

218. The indenture set forth the following circumstances:

> (a) A person or group . . . shall attain the beneficial ownership . . . of an equity interest representing at least 80% of the voting power . . . unless such attainment has been approved by a majority of the Independent Directors;
>
> (b) The Company . . . consolidates or merges . . . unless approved by a majority of the Independent Directors;
>
> (c) The Company . . . incurs . . . any Debt . . . excluding . . . Debt which is authorized or ratified by a majority of the Independent Directors, immediately after the incurrence of which the ratio of the Company's Consolidated Total Debt to its Consolidated Capitalization exceeds .65 to 1.0.

McMahan, 900 F.2d at 577-78 (omissions in original) (quoting the indenture).

219. *See id.*

220. *Id.* at 578 (quoting the indenture).

221. *See id.*

222. *See id.*

basis that the prospectus failed to disclose the extent to which the right to require the repurchase of the bonds was illusory.[223] The bondholders alleged that referring to "Independent Directors" created a false impression that the "Independent Directors" would not approve a transaction, and thereby eliminate the bondholders' right to have their bonds repurchased, when the transaction was not in the best interests of the bondholders.[224] They further alleged that oral statements made in selling the bonds—that the repurchase right constituted a "protective covenant for the debentureholders"—were misleading.[225] Their theory was:

> [B]y representing that this special right to tender was the key selling feature of otherwise low-value debentures, defendants could be found to have implied that debentureholders would be protected against takeovers hostile to their own interests, regardless of the interests of shareholders, and thus to have misled plaintiffs as to the true nature of the right.[226]

The United States Court of Appeals for the Second Circuit reversed summary judgment in favor of the defendants on claims alleging violation of sections 11 and 12(a)(2) and Rule 10b-5.[227] This determination is consistent with examining the omission from the perspective of the reasons for the omissions. It is certainly easiest for one drafting the disclosure document to merely recreate the terms of the contract in the disclosure document. Doing so limits potential liability by minimizing the possibility of affirmative misstatements, but as alleged by the *McMahan* plaintiffs, it may not fully disclose the *consequences* of the described terms.[228] Limiting the potential liability of an issuer, at the expense of complete disclosure to prospective purchasers, weighs in favor of a finding of actionability. The plaintiffs' assertions in *McMahan* of a more malignant reason—that the issuer affirmatively intended to offer illusory rights—are, of course, even more suggestive of the materiality of the omission.[229]

One might have some sympathy for the issuer, if the omission resulted from the issuer's desire to limit liability by merely transcribing the terms of the security. Issuers are required to describe the terms of the securities being offered.[230] Issuers' obligations to

223. *See id.*
224. *See id.* at 580.
225. *Id.* at 581 (internal quotations omitted).
226. *Id.*
227. *See id.* at 581-82.
228. *See id.* at 578-79, 581.
229. *See id.*
230. *See* 17 C.F.R. §§ 228.202, 229.202 (1999).

describe contractual obligations, however, are not limited to the obligation to disclose the material terms of securities sold in public offerings. An issuer is required to disclose terms of other contracts, where material, such as relevant licenses, franchises, and concessions;[231] rights of customers to return products;[232] contracts terminable at the election of the government;[233] commitments reasonably likely to result in a material change in the issuer's liquidity;[234] material commitments for capital expenditures;[235] relationships between the issuer and affiliates;[236] and the plan of distribution of securities being offered.[237] Be it by intent or through inadvertence, contracts frequently are either ambiguous or contain latent consequences. If federal securities laws require the explanation of the import of material contract terms, and the mere disclosure of the terms of the contracts is inadequate, then an issuer can be placed in the awkward position of disclosing that it is uncertain of the import of various contract terms. Where ambiguity is inadvertent, one could argue that it would be unfair to hold an issuer liable for failing to disclose a material ambiguity. The self-interest of a firm generally will provide adequate incentive to identify and correct undesired ambiguity or latent consequences.

Moreover, where the relevant contract provisions are disclosed, requiring further discussion of the significance of relevant contract provisions could be considered unnecessary on a basis similar to that on which some courts have held that disclosure obligations are limited to firm-specific information.[238] In the capacity of describing the import of a disclosed contract provision, an issuer would seem to be acting as special legal counsel to the public.

These concerns would appear particularly acute where the omission arose from inadvertence.[239] Nevertheless, issuers are subject to strict liability for false statements in offering documents under

231. *See id.* §§ 228.101(b)(7), 229.101(c)(1)(iv).
232. *See id.* § 229.101(c)(1)(vi).
233. *See id.* § 229.101(c)(1)(ix).
234. *See id.* § 229.303(a)(1).
235. *See id.* §§ 228.303(b)(1)(iii), 229.303(a)(2).
236. *See id.* §§ 228.404, 229.404.
237. *See id.* §§ 228.508, 229.508.
238. *See supra* notes 99-123 and accompanying text.
239. *Cf.* Lucia v. Prospect St. High Income Portfolio, Inc., 36 F.3d 170, 172, 177 (1st Cir. 1994) (affirming summary judgment against the plaintiffs in respect of claims that a prospectus for junk bonds was deficient in failing to disclose that junk bond default rates were understated (because the computations did not account for "aging" of the bonds) but not clearly indicating whether the claims dismissed were under section 11 or section 12(a)(2)).

section 11 of the 1933 Act,[240] notwithstanding that liability under both section 12(a)(2) and Rule 10b-5 is dependent on some degree of fault.[241] That an issuer inaccurately or inadequately described the import of a contractual provision, despite its exercise of some care, should not vitiate its liability.[242]

C. *Quantification*

Subparts A and B above examine generally applicable matters concerning materiality: disclosure of firm-specific information and the insight into the materiality of an omission provided by an examination of the reason for the omission. This subpart examines a third general aspect of materiality—the degree to which materiality is affected by the extent to which one can quantify the impact of a misstatement or omission.

Assessing materiality would be facilitated if a numerical value could be ascribed to the misstatement or omission.[243] Some cases have held immaterial as a matter of law readily quantifiable misstatements or omissions having a de minimis impact. Illustrative cases have

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240. *See* 15 U.S.C. § 77k(b) (1994) (providing that an issuer is not entitled to a due diligence defense).

241. *See id.* § 77*l*(a)(2) (Supp. III 1997) (limiting liability to those defendants unable to prove the misstatement could not have been remedied with the exercise of reasonable care); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (holding that negligence is insufficient to create liability under Rule 10b-5). Whether there is a private cause of action under section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1994), is unclear. *See* 2 HAZEN, *supra* note 6, § 13.13 at 654-58 (practitioner's ed., 3d ed. 1995).

242. *Harris v. Union Electric Co.*, 787 F.2d 355, 364-65 (8th Cir. 1986), would appear to be an example. *See generally* Lucas v. Florida Power & Light Co., 765 F.2d 1039, 1043-44 (11th Cir. 1985) (affirming a judgment in favor of the issuer as to claims that the issuer, inter alia, inadequately disclosed its ability to redeem bonds by depositing cash, in lieu of property, into a replacement fund); Associated Builders, Inc. v. Alabama Power Co., 505 F.2d 97, 99, 102 (5th Cir. 1974) (holding that a prospectus for bonds was, as a matter of law, not misleading, where the plaintiffs alleged that the prospectus misleadingly suggested that the bonds could not be redeemed in anticipation of refunding at a lower interest rate); Morgan Stanley & Co. v. Archer Daniels Midland Co., 570 F. Supp. 1529, 1532-33, 1538 (S.D.N.Y. 1983) (not granting a preliminary injunction against a redemption of bonds benefiting from protection from redemptions funded by lower-cost debt where the issuer had recently borrowed funds at a lower cost and intended to use the proceeds of stock offerings to redeem the bonds in question); Franklin Life Ins. Co. v. Commonwealth Edison Co., 451 F. Supp. 602, 608-09 (S.D. Ill. 1978) (ruling in favor of the issuer on a claim under Rule 10b-5 that an offering document was misleading in failing to disclose that the issuer interpreted protection limiting refinancing with lower-cost debt as not preventing redemption with funds from a stock offering, notwithstanding the issuer's other lower-cost borrowing, on the basis of absence of proof of scienter), *aff'd*, 598 F.2d 1109 (7th Cir. 1979); *cf.* Staff Legal Bulletin No. 7, *supra* note 127, at *36-*37 (requiring that verbatim disclosure of contractual terms in a prospectus be accompanied by an explanation of their meaning).

243. *Cf.* 4 LOSS & SELIGMAN, *supra* note 63, at 2080 (3d ed. 1990) ("[I]t is common to urge that a statement was 'quantitatively material.'").

included the following: the failure to disclose that an additional fee would be required to expedite delivery of proceeds at maturity of a $102,000, six-month treasury bill otherwise available by check sent by regular mail;[244] the characterization as transaction fees of amounts ranging from $2.35 to $4.85, where those fees allegedly exceeded actual costs incurred by brokers;[245] the failure to disclose a claim of less than $2,000 against a firm whose stock was being purchased for $650,000;[246] and an allegedly improper failure to write down by almost $1.3 million the assets of a firm having quarterly net income of $234 million.[247]

Yet there is no precise numerical test for assessing whether a misstatement or omission is material.[248] Moreover, quantification of the impact is not *required* to assess the materiality of a misrepresentation or omission; an inability to quantify the effects is not necessarily fatal to a finding of materiality.[249] Case law, including *Monetary Management Group of St. Louis, Inc. v. Kidder, Peabody & Co.*, summarized above, identifies circumstances in which a

244. *See* Press v. Chemical Inv. Servs. Corp., 166 F.3d 529, 532-33, 538-39 (2d Cir. 1999). *But cf.* NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION: PRIVATE RIGHTS OF ACTION § 2.3.1, at 141 (1995) ("It *may* also be a breach for a brokerage firm to pay its customers by checks drawn on geographically distant banks, a practice that delays the customers' receipt of funds from the broker and increases the 'float' available to the broker." (emphasis added)).

245. *See* Feinman v. Dean Witter Reynolds, Inc., 84 F.3d 539, 540-41 (2d Cir. 1996).

246. *See* Kohner v. Wechsler, No. 72 Civ. 1898, 1972 U.S. Dist. LEXIS 13314, at *2, *7 (S.D.N.Y. June 10, 1972), *modified on other grounds*, 477 F.2d 666 (2d Cir. 1973).

247. *See In re* Westinghouse Sec. Litig., 90 F.3d 696, 715 (3d Cir. 1996).

248. *See id.* at 714 n.14; *In re* Kidder Peabody Sec. Litig., 10 F. Supp. 2d 398, 410 (S.D.N.Y. 1998) (holding that a jury could find material misstatements, most of which would have individually affected the issuer's profits by less than one percent); Staff Accounting Bulletin No. 99, *supra* note 87, at *7-*13; 2 LOSS & SELIGMAN, *supra* note 63, at 677 (3d rev. ed. 1999); 4 *id.* at 2080 (3d ed. 1990).

249. *See* Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1175 n.260 (1987) (arguing that sole use of a numerical criterion could not accommodate certain important factors); *cf.* Implementation of Section 10A of the Securities Exchange Act of 1934, Exchange Act Release No. 38,387, 62 Fed. Reg. 12,743, 12,745 n.13 (Mar. 18, 1997) (stating auditors "should consider both ... quantitative and qualitative materiality" in assessing whether an illegal action has a material effect on the issuer's financial statements of a type that the auditors would be required to report to the company's board); 4 LOSS & SELIGMAN, *supra* note 63, at 2081 (3d ed. 1990) (asserting that quantitative measures are inappropriate to test materiality of conflicts of interest or criminal violations).

This question is distinct from whether information, such as matters of management integrity, can be material, even where their impact is quantitatively immaterial. The materiality of such issues, sometimes referenced as "qualitative materiality," is fully explored in Ferrara et al., *supra* note 170.

misstatement or omission can be material where the impact of this inaccuracy has not been quantified.[250]

For example, *Acacia National Life Insurance Co. v. Kay Jewelers, Inc.* involved a consent solicitation/tender offer for a series of bonds issued by Kay Jewelers.[251] The tender offer was made in connection with an agreement under which Kay Jewelers was to be acquired.[252] In order to tender bonds, a bondholder was required to consent to an amendment to the indenture eliminating a poison put—a covenant that otherwise would have required the issuer to offer to repurchase all the bonds, at par plus accrued interest, upon a change in control.[253] The tender offer was essentially a mechanism by which an inducement for consenting to the amendment could be offered to bondholders. In the tender offer, an affiliate of the firm that had agreed to purchase Kay Jewelers offered to purchase the bonds for cash, at a price substantially above the price at which they had been trading, although below par plus accrued interest.[254] A bondholder brought suit, alleging, inter alia, that the prospectus under which the bonds had been issued did not adequately describe the ability to amend the indenture to eliminate the poison put.[255] The court, on a motion to

250. 615 F. Supp. 1217 (E.D. Mo. 1985); *see supra* notes 135-140 and accompanying text (concerning misstatements of the marginability of bonds).

251. 610 N.Y.S.2d 209, 211 (App. Div. 1994). A consent solicitation is undertaken where an issuer seeks to enter into a transaction that is prohibited by the covenants in one or more series of outstanding bonds. In this process, the issuer seeks the consent of the requisite percentage of holders of the bonds in question for an amendment or waiver of the covenants. The requisite percentage will be specified in the indenture under which the bonds were issued. *See generally* Royce de R. Barondes, *An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds*, 63 FORDHAM L. REV. 749, 749-50 (1994) (describing consent solicitations).

252. *See Acacia Nat'l Life Ins. Co.*, 610 N.Y.S.2d at 211.

253. *See id.*

254. *See id.* at 211, 213.

255. The prospectus stated:

> The obligations of the Company and the rights of the Noteholders may be modified under the Indenture with the consent of the Company and of the holders of a majority in outstanding principal amount of the Notes issued thereunder, provided that no reduction in the rate or extension of time of payment of interest on the Notes, no reduction of the principal amount thereof or premium thereon, no extension of the fixed maturity thereon, no reduction of the percentage required for any such modification, no alteration of the redemption provisions of the Indenture, no change with respect to the subordination provisions which adversely affects the rights of any holder, no change in the holder's right to receive payments of the principal of or interest thereon and to waive an existing Default and no modification changing the currency that the Notes are payable in, will be effective against any Noteholder without such holder's consent.

KAY JEWELERS, INC., PROSPECTUS 28 (July 28, 1989) (on file with author).

dismiss filed by the issuer, held that the plaintiff adequately claimed a violation of section 11 of the 1933 Act.[256]

The value of the omission at issue in *Acacia National Life Insurance Co.* is not easily quantifiable—no quantification of that value was discussed in the opinion, which is not entirely surprising.[257] One method to quantify that omission would require an assessment of the likelihood, as of the time the bonds were issued, that there would be a change in control of the issuer and of the market value of the bonds at the time of a change in control. Neither of those factors could be assessed easily.[258] But because the court did not seek to quantify the value of the omission, the case indicates that an omission is not immaterial merely as a consequence of an inability to quantify the value of the difference between the securities as described and the securities as issued.

A second relevant case is *Quincy Co-Operative Bank v. A.G. Edwards & Sons, Inc.*, which arose from the October 1983 sale by a broker-dealer of $500,000 in face amount of bonds.[259] Prior to the sale, the individual broker who placed the securities falsely represented that the bonds could not be called (i.e., prepaid) before April 1987.[260] The purchaser was further advised that any call of the bonds at that time would require payment of 105.91% of the face value.[261] In fact, the issuer was authorized to call the bonds at face value before 1987, if the issuer sold particular real estate under certain conditions.[262] Those conditions were subsequently satisfied, and the issuer called the bonds in 1984.[263]

The purchaser, a bank, alleged, inter alia, that the sale violated section 12(a)(2) of the 1933 Act.[264] On the broker-dealer's motion for

256. *See Acacia Nat'l Life Ins. Co.*, 610 N.Y.S.2d at 213.

257. One could attempt to assign a value by comparing offering prices for bonds containing different types of event-risk protection.

258. Alternatively, one could attempt to provide an upper bound on the materiality of the omission by attempting to assess the value of the poison put. The decrease in value arising from the improper description of the poison put necessarily would not be more than the value of a poison put having the described terms. However, even if one could value poison puts as a whole, perhaps by reference to varying interest rates on bonds issued with different levels of "event-risk" protection, it seems highly likely that one would conclude that event-risk protection can be material. Thus, it is unlikely one could conclude that an inaccurate description of a poison put is necessarily immaterial.

259. 655 F. Supp. 78, 82 (D. Mass. 1986).

260. *See id.* at 81.

261. *See id.*

262. *See id.* at 82.

263. *See id.*

264. *See id.* at 81. This transaction was a "secondary" transaction—it did not arise from the original sale of the securities in question. *See id.* For reasons unrelated to the

summary judgment, the court held that the failure to disclose the contingent right to call the bonds upon a sale of certain real estate was a material omission.[265] In reaching that holding, the court did not attempt to ascribe a value to the undisclosed right to call the bonds. The court summarily concluded:

> Neglecting to tell the [purchaser] about the early call provision was certainly an omission of a material fact since it was information about which the "average prudent investor ought reasonably to be informed before purchasing" the bonds. Whether to invest in the bonds depended on the expected return which turned on when the bonds could be redeemed and at what price.
>
> ....
>
> ... Where, as here, the facts in question[] were so obviously important to the [purchaser] that reasonable minds could not differ as to their materiality, summary judgment is appropriate.[266]

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materiality of the false statement, today, a lawsuit in such circumstances alleging solely a violation of section 12(a)(2) would be unsuccessful. The United States Supreme Court subsequently held that section 12(a)(2) of the 1933 Act does not apply to secondary sales of securities. *See* Gustafson v. Alloyd Co., 513 U.S. 561, 567-68, 576 (1995) (holding, "[T]he term 'prospectus' relates to public offerings by issuers and their controlling shareholders," and noting agreement that the restrictions on misleading oral statements are limited to oral statements relating to prospectuses).

265. *See Quincy Co-Operative Bank*, 655 F. Supp. at 82. However, there is some somewhat contradictory precedent in a similar context. For example, *Vogel v. Brown*, No. 74 Civ. 2111, 1974 U.S. Dist. LEXIS 6402, at *3 (S.D.N.Y. Oct. 8, 1974), involved incomplete disclosure of the antidilution provisions in a series of convertible debentures. Debentures that are convertible into stock typically include provisions that adjust the conversion rights in various contexts. *See generally Model Simplified Indenture*, 38 BUS. LAW. 741, 765-67 (1983) (setting forth a model indenture providing various circumstances in which the conversion rights would be adjusted). Thus, for example, if a two-for-one stock split of an issuer's common stock occurs, it would be customary to provide that bonds convertible into one share of the issuer's common stock before the split would be convertible thereafter into two shares of common stock. *See id.* at 765-66. These provisions are similar to poison puts, in that they provide protection to bondholders from certain extraordinary corporate actions that otherwise would harm the bondholders.

Vogel involved a prospectus for convertible bonds that disclosed the conversion rights were "'subject to adjustment', [and] then enumerated 'a series of exceptions to the said right of adjustment', but omitted 'the [allegedly] material fact that a spinoff or other distribution by [the issuer] of its assets or shares of its subsidiary companies were among those exceptions.'" *Vogel*, 1974 U.S. Dist. LEXIS 6402, at *3 (quoting the plaintiff's complaint). The issuer announced that it would spin off the shares of a subsidiary, *see id.* at *4, that is, distribute the subsidiary's stock to shareholders of the parent corporation, giving rise to the dispute. The court held it was not false or misleading for the prospectus to omit that a spin-off of a subsidiary was not a circumstance giving rise to an adjustment in conversion rights, *see id.* at *5-*7, which necessarily means that the omitted fact was not material.

266. *Quincy Co-Operative Bank*, 655 F. Supp. at 84-85 (citation omitted); *accord* Durning v. First Boston Corp., 815 F.2d 1265, 1268 (9th Cir. 1987) ("The parties agree that callability of a bond is a material fact.").

There is no significant indication in the opinion that call protection was particularly important to the purchaser. The opinion does note that the purchaser was reassured "several" times concerning the call protection on the bonds.[267] That the purchaser made the inquiry several times, however, does not indicate an idiosyncratic need for call protection—the bonds were sold at thirteen percent above their face value.[268]

III. APPLICATION OF GENERAL PRINCIPLES TO A FAILURE TO DISCLOSE CONSEQUENCES OF FLIPPING

Part II discussed certain principles generally applicable to understanding the materiality of a misstatement or omission under the federal securities laws. In general, in order to be deemed material, there must be a substantial likelihood that a statement or omission is one that a reasonable investor would consider important.[269] Although there is some lower court precedent for the proposition that material information is limited to information that is firm-specific, that precedent is dubious, in light of Supreme Court authority and other long-standing authority, and is based on assumptions not applicable in the context of IPOs.[270] Part II has further indicated that the reason for an omission can assist in determining the materiality of information and that an inability to quantify the impact of a misstatement or omission need not be fatal to a finding of materiality.[271] This Part applies those principles to the particular context of a failure to disclose in a prospectus for an IPO the adverse consequences to a purchaser from flipping stock purchased in the IPO. For this purpose, this Part examines the failure to disclose that the underwriter may not allow such a purchaser to purchase in future IPOs.[272]

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267. *See Quincy Co-Operative Bank*, 655 F. Supp. at 81.

268. *See id.* at 82.

269. *See supra* notes 88-97 and accompanying text.

270. *See generally supra* notes 99-212 and accompanying text.

271. *See supra* notes 213-268 and accompanying text.

272. Other punishments, for example, the additional fee imposed by Wit Capital, *see supra* note 18, not disclosed in the prospectus compound the potential to mislead. Those other fees are not discussed, as information concerning their extent is less readily available. Note, however, that, as discussed *infra* pp. 938-39, the fact that an investment bank discloses to its customer the punishment that will result from flipping does not necessarily eliminate the obligation to disclose the information in the prospectus.

Investors do not have a contractual right to participate in IPOs. Investment banks are allowed to exercise discretion in allocating IPOs. *See infra* text accompanying notes 307-308. This "punishment" involves changes in how investment banks would exercise this discretion, based on whether an investor flipped in a prior IPO. One could argue that as investors have no contractual right to participate in IPOs, investment banks need not disclose that certain actions will affect how the investment banks will exercise their discretionary

A. Liquidity Restrictions

Depriving an investor of an opportunity to purchase stock in future IPOs eliminates its ability to earn an extraordinary (or above-market) return.[273] Eliminating those future opportunities is economically equivalent to imposing a penalty, or exercise fee, on any quick resale of stock purchased in an IPO equal to the above-market return available from purchasing in future IPOs. Thus, one could model these investment bank actions as being equivalent to incorporation of an additional term in stock purchased during an IPO—the imposition of a restriction on the resale of the stock during the blackout period, subject to an option in the holder to remove the restriction on payment of a fee. Under this view, the fee would equal the discounted value of the ability to earn extraordinary returns by purchasing stock in future IPOs.

In this model, the materiality of the omission would depend on the materiality of both the "fee" and the right to resell stock during the blackout period. The excessive returns available from flipping IPOs indicates that the fee is material. It is simply implausible that an investor aware of these excessive returns would not find an inability to purchase in subsequent IPOs to be important. More difficult is assessing the materiality of requiring that any flipping be done after the blackout period.[274]

A first step in assessing the materiality of the omission of restrictions on flipping IPO securities is to attempt to quantify the value of the undisclosed restrictions. Unfortunately, the methodology

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authority. The test of materiality, however, does not support that view. The *TSC Industries* test, by its terms, does not limit materiality to changes in contractual rights. *Cf.* Account Management Corp., Exchange Act Release No. 36,314, 60 SEC Docket 962, 963-64 (Sept. 29, 1995) (accepting an investment adviser's offer of settlement concerning a failure to disclose a practice of allocating hot IPOs to favored accounts).

Moreover, this discretion in allocating shares in IPOs is not unfettered. There are limits on the ability of an investment bank to condition an allocation of IPO securities on other actions. *See generally* Sanders v. Gardner, 7 F. Supp. 2d 151, 164 n.10 (E.D.N.Y. 1998) (describing as manipulative, fraudulent, or deceptive a broker's requiring an investor to agree to purchase in the aftermarket as a condition to being allocated securities in an IPO).

273. *See supra* note 2 and accompanying text.

274. Outside the context of federal securities law, support for this conclusion is provided by the Uniform Commercial Code, which conditions the enforceability of transfer restrictions imposed by an issuer on its certificated securities upon either actual knowledge of the security holder or the prominent reference to the restrictions on the certificate. *See* U.C.C. § 8-204(1) (1998). The absence of a de minimis exception indicates the importance—the materiality—of restrictions on transfer. Of course, the actions of underwriters are not actions by an issuer and may not necessarily impede the sale of stock purchased in an IPO—such a sale may merely have adverse consequences in respect of transactions in other securities.

to value such a restriction is not clear. There is some empirical evidence, however, that bears on this issue. Professor William Silber has examined the price at which "restricted" stock is sold relative to "unrestricted" stock.[275] Restricted stock is stock that has been acquired, directly or indirectly, from the issuer or an affiliate of the issuer in a transaction, or a series of transactions, not involving a public offering.[276] The liquidity of the stock is therefore impaired, because it cannot be resold absent either registration of the sale under the 1933 Act or the availability of an exemption from that registration requirement, such as Rule 144,[277] section 4(1) of the 1933 Act,[278] or "section 4(1½)."[279]

Professor Silber found that restricted stock was sold by issuers in private placements, on average, at approximately a one-third discount to the public market price for the stock.[280] That evidence strongly supports the conclusion that it is material to omit the fact that stock being sold is restricted. Case law, not relying on this empirical evidence, is to a similar effect, including cases addressing: the failure to disclose that stock is restricted;[281] a false statement that stock being sold is not restricted;[282] misstatements concerning intentions to register

275. *See* William L. Silber, *Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices*, FIN. ANALYSTS J., July/Aug. 1991, at 60, 60 (finding private placements of stock, in a sample of 69 issuers, were, on average, at a 33.75% discount from the price at which the stock traded publicly); *cf.* Michael Hertzel & Richard L. Smith, *Market Discounts and Shareholder Gains for Placing Equity Privately*, 48 J. FIN. 459, 478 tbl.VI (1993) (finding average discounts of about 35% for placements of up to $25 million, decreasing to single percentage points for offerings above $75 million). Two finance theorists, however, have argued that any such discrepancy may be attributable, at least in part, to factors other than a decrease in value arising from absence of liquidity. *See id.* at 460 ("[P]rivate placement discounts reflect costs incurred by private investors to assess firm value . . . ."). *See generally* Rowe v. Maremont Corp., 850 F.2d 1226, 1235-36 (7th Cir. 1988) (affirming a judgment in a bench trial and stating that a purchaser's willingness to purchase a substantial block of restricted stock at the prevailing per share market price was not inconsistent with holding that sellers reasonably relied on a buyer's misstatements and omissions concerning intentions to seek control of the issuer).

276. *See* 17 C.F.R. § 230.144(a)(3) (1999) (defining the term "restricted securities").

277. *Id.* § 230.144.

278. 15 U.S.C. § 77d(1) (1994).

279. This term is used to reference exempt resales in private placements by persons who could be considered underwriters. *See* 1 HAZEN, *supra* note 6, § 4.26.1, at 295-97 (practitioner's ed., 3d ed. 1995).

280. *See* Silber, *supra* note 275, at 60.

281. *See* Korber v. Lehman, 245 N.Y.S.2d 830, 831-32 (Sup. Ct. 1963).

282. *See* Stone v. Fossil Oil & Gas, 657 F. Supp. 1449, 1459-60 (D.N.M. 1987) (finding defendants liable for violating section 12(a)(2) of the 1933 Act for selling restricted stock by means of a false representation that the stock was registered). If the stock being sold in a transaction has never been sold in a registered transaction but it can be freely resold by the purchaser without registration, a failure to disclose that the stock had never been sold in a registered transaction would be immaterial, as that fact would imply no legal consequences.

the stock;[283] and an issuer's representation that it would take steps to secure an exemption under Regulation A for a subsequent resale of securities being sold, while failing to disclose a criminal conviction of a promoter of the issuer that made the issuer ineligible for Regulation A.[284]

Although case law and empirical evidence indicate that a failure to disclose that stock being sold is restricted may be material, that precedent does not compel the conclusion that limiting the ability to flip stock purchased in an IPO would be material. The time periods are not comparable. The process of registering stock can take months and requires additional expenditures. An exemption from registration under Rule 144 typically requires that the seller has held the security for at least one year.[285] This authority thus directly supports the actionability of omissions more significant than those at issue in flipping IPO securities, but leaves unresolved the materiality of the restrictions imposed on persons purchasing in IPOs.

As an alternative, one can examine case law assessing the materiality of matters that would appear to have a lesser impact on a potential purchaser than the restrictions imposed in IPOs. Such an examination is necessarily imprecise. Reasonable minds could differ as to the relative importance of different types of information. Nevertheless, this approach represents the best alternative.

Of the various cases assessing materiality discussed above, the alleged deficiencies at issue in *McMahan & Co. v. Wherehouse Entertainment, Inc.*[286] and *Acacia National Life Insurance Co. v. Kay Jewelers, Inc.*[287] appear most relevant. Both cases involved accurate descriptions of rights applicable in a contingency; in each case, the description, although literally accurate, omitted a discussion of actions that could be taken to frustrate the rights that appeared to be granted.

See Murray v. Thompson McKinnon Auchincloss, Kohlmeyer, Inc., No. 76 Civ. 3028, 1981 U.S. Dist. LEXIS 10991, at *14 (S.D.N.Y. Feb. 11, 1981); Northrop v. duPont, 173 S.E.2d 839, 842 (Va. 1970).

283. *See* Ohashi v. Verit Indus., 536 F.2d 849, 851-54 (9th Cir. 1976) (reversing a dismissal for failure to state a claim, where the plaintiff alleged the seller of securities misrepresented efforts to remove transfer restrictions on restricted stock); American Mobile Communications, Inc. v. Nationwide Cellular Serv., Inc., No. 91 Civ. 3587, 1992 U.S. Dist. LEXIS 13156, at *9, *14-*15 (S.D.N.Y. Sept. 3, 1992) (denying a motion to dismiss under Federal Rule of Civil Procedure 9(b) claims that persons involved in selling restricted securities violated section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), by failing to disclose an intent to dishonor an obligation promptly to register the securities).

284. *See* Moore v. Gorman, 75 F. Supp. 453, 454-56 (S.D.N.Y. 1948). Regulation A is currently set forth at 17 C.F.R. §§ 230.251-.263 (1999).

285. *See* 17 C.F.R. § 230.144(d)(1) (1999).

286. 900 F.2d 576 (2d Cir. 1990).

287. 610 N.Y.S.2d 209 (App. Div. 1994).

As discussed above, one alleged deficiency at issue in *McMahan* arose from a defined term—"Independent Directors"—that was allegedly misleading in creating the impression that the "Independent Directors" would act on behalf of the bondholders.[288] *Acacia National Life Insurance Co.* involved the failure to disclose the manner in which the provisions of an indenture governing amendments to the indenture, which were fully summarized, could be used to terminate a "poison put."[289]

In both cases, the court indicated that these matters could be material.[290] Both seem to involve matters less material than the restrictions on flipping IPOs. They both pertain to rights applicable in certain contingent events. The restrictions on flipping securities acquired in an IPO, on the other hand, limit a choice that would otherwise be freely available to a shareholder and that shareholders frequently exercise—as noted above, all aftermarket trading in stock in the weeks immediately following an IPO by definition is in shares that have been flipped.

Additionally, the disclosure in *McMahan* and *Acacia National Life Insurance Co.* appears less misleading than disclosure omitting the consequences of flipping. The disclosure documents in *McMahan* and *Acacia National Life Insurance Co.* addressed the relevant topic and were literally accurate. IPO prospectuses, on the other hand, are silent concerning the consequences of flipping stock acquired in an IPO.

This analysis is necessarily imprecise. That is the nature of the inquiry. Nevertheless, this precedent implies that it would at least be a jury question to determine the materiality of an omission from a prospectus for an IPO of the consequences of flipping.

Whether such an omission would be material as a matter of law is a more difficult question. That restricted stock trades on the order of a one-third discount[291] suggests that the value one could ascribe to a thirty-day limitation on the sale of stock could be on the order of single percentage points or lower. In 1991, Rule 144 allowed resale of restricted securities, in broker transactions and in limited amounts, after a two-year holding period.[292] If one assumes that there is a linear

288. *See supra* notes 217-229 and accompanying text.
289. *See supra* notes 251-256 and accompanying text.
290. *See supra* notes 227, 256 and accompanying text.
291. *See* Silber, *supra* note 275, at 60.
292. From 1972 to 1997, the applicable holding period for resales subject to volume restrictions was two years. *See* Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 Fed. Reg. 9242, 9242 (Feb. 28, 1997).

relationship between the period over which securities cannot be sold and the value of the restriction, that would imply an estimated value on the order of a few percentage points for the right to resell stock over the immediately following thirty days.[293] Nevertheless, an omission implicating a change in value on the order of one percentage point would seem material in the context of a large institutional purchase of securities.

As noted above, additional insight into materiality in some cases can be realized by reviewing the reasons for the misstatement or omission.[294] The reasons why prospectuses do not include this information are not entirely clear. As indicated above, prospectuses currently disclose the possibility of penalty bids—punishment that may be imposed on an underwriter that places IPO securities that are flipped.[295] The disclosure of that aspect of the offering process appears to have been the result of explicit SEC rule making, which in 1996, effective early 1997, required that IPO prospectuses disclose, if applicable, the possibility that penalty bids would be imposed.[296] The practice of using penalty bids preceded this rule.[297] Nevertheless, disclosure of the practice in the prospectus seems not to have occurred prior to that rule. The first prospectus or preliminary prospectus referencing penalty bids in EDGAR, the SEC's electronic filing system, was filed in February 1997.[298] Yet even today, the disclosure is not what could be described as "full." The illustrative disclosure set forth above merely identifies the possibility that there may be penalty bids.[299] It conveys no information bearing on the likelihood of penalty bids. Moreover, the focus of the disclosure is directed at the impact penalty bids may have on the market price of the affected security.

There are a number of plausible reasons why prospectuses do not disclose this information: *First*, the issuer may not be independently

293. The estimated value of the right to resell can be computed as follows:

$$.33\frac{30}{365 \times 2} = .014$$

294. *See supra* notes 213-242 and accompanying text.

295. *See supra* notes 25-26 and accompanying text.

296. *See* Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 7375, 62 Fed. Reg. 520, 543 (Jan. 3, 1997) (adding 17 C.F.R. §§ 228.508(j), 229.508(*l*)).

297. *See supra* note 16.

298. Search of LEXIS, Fedsec Library, Reg File (July 27, 1999) (search terms were "(penalty w/3 bid) and date(<3/1/97)") (locating THERMEDICS DETECTION INC., AMENDMENT NO. 1 TO REGISTRATION STATEMENT ON FORM S-1, at 57 (Feb. 5, 1997) (referencing penalty bids)). It is possible that one or more prospectuses filed in paper form before February 6, 1997, referenced "penalty bids."

299. *See supra* text accompanying note 26.

aware of the practice, and the underwriters may not advise the issuer of the practice.[300]

Second, disclosing this information on an underwriter-specific level could lead to competition among underwriters on this basis. *Ceteris paribus*, a prospective purchaser would prefer to purchase stock in an IPO from an underwriter who would not punish that purchaser for flipping stock. Omitting the information inhibits competition on this basis, because it is not easy for a prospective purchaser to acquire the information from each syndicate participant. Moreover, making those inquiries may signal a likelihood that the prospective purchaser is more likely to flip stock, which can be expected to diminish the willingness of underwriters to place stock with that prospective purchaser.

Third, the practice may not be disclosed merely because it is not practicable to do so. Underwriters are not required to impose these punishments on customers. It is entirely plausible that, at the time the prospectus for a particular offering is drafted, the underwriters may not know the extent, if any, to which they would punish those who flip the IPO securities in question. Moreover, disclosing this information in respect of the entire underwriting syndicate could be logistically difficult. Members of an underwriting syndicate who are neither managers nor comanagers typically do not send employees to meetings in which the registration statement is drafted. The recent, very large IPO for Conoco Inc. included forty-one underwriters in the United States, in addition to the international underwriters.[301] This large number of underwriters, in addition to the other participating brokers, may substantially impede disclosure of the relevant information.

Were the information disclosed on an investment-bank-specific basis, so that there would be different information provided in respect of each investment bank, the disclosure would be of limited benefit unless it were disclosed in the preliminary prospectus required to be circulated before the offering.[302] Yet a preliminary prospectus generally does not include the entire underwriting syndicate—

300. Underwriters' counsel usually is primarily responsible for preparing the plan-of-distribution section of a prospectus. *See* D'Alimonte & Schechter, *supra* note 66, app. B at 320 (identifying those portions of a prospectus describing the plan of distribution as being provided on behalf of the underwriters).

301. *See* CONOCO INC., *supra* note 133, at 127.

302. Rule 15c2-8 under the 1934 Act, 17 C.F.R. § 240.15c2-8 (1999), requires the delivery of a preliminary prospectus to a person expected to receive a confirmation of a sale of securities in an IPO. The preliminary prospectus is required to be delivered at least 48 hours before sending a confirmation of a sale. *See id.* § 240.15c2-8(b).

typically, only the managing underwriter and the comanagers are listed. Thus, disclosure of this information on an investment bank-specific basis is inhibited by customary syndicate-building methods.

Fourth, the information may be omitted because underwriters would prefer to avoid publicizing the disparity in treatment between individual investors and institutional investors. Detailed disclosure would presumably indicate the extent to which the punishment is imposed on individual and institutional investors. A desire to avoid publicizing this disparate treatment is entirely understandable. Adverse regulatory consequences could result.

The first possible rationale is consistent with the actionability of the omission under section 11 against the issuer. An omission born of the issuer's ignorance is consistent with liability, because the issuer's liability under section 11 is strict.[303] Since the underwriters are aware of the omission, they would have no due diligence defense under section 12(a)(2) or absence of scienter for purposes of Rule 10b-5.

The second possible rationale, to avoid competition among underwriters, also would support the materiality of the omission. That rationale would represent a desire to take advantage of market inefficiency as part of a process designed to deprive investors of certain rights they otherwise would have. When the federal regulatory scheme relies on disclosure, in lieu of more intrusive regulation, on the theory that market forces functioning in an environment of full disclosure will protect investors, including unsophisticated investors, omissions made for purposes of suppressing market competition are fundamentally material.

One aspect of varying treatment by various underwriters merits brief exposition. Investors choose the investment banks that they use to make their investments. They need not use only one investment bank. Consider an investor contemplating an investment in an IPO through one of two investment banks, one of which imposed a penalty on flipping and the other of which did not. If an investor who sought to invest in IPOs had complete information, *ceteris paribus*, it could well decide to make the investment through the investment bank that promised no punishment if the investor flipped the stock. That is, this information could determine the choice of the investment bank selected.

That disclosure could change an investment decision—in this case, by changing the investment bank used—does not compel the conclusion that the information is material. That argument would

303. *See supra* note 240 and accompanying text.

prove too much. At a theoretical level, a variation of $10 on a $100,000 investment might be similarly deterministic. Given two choices identical but for $10, few would intentionally forego the $10. However, trivial amounts can nevertheless be immaterial.[304] At some level, trivial amounts are lost in the "noise" component of information available to investors. The more appropriate view is whether one can envision fully informed actual investors in practice choosing between brokers in whole or in part on the basis of the varying punishment imposed as a result of flipping, and one would expect so.

The third possible rationale could militate against the materiality of the omission, were there no practicable method by which this information could be disclosed. However, the information could practicably be conveyed by the underwriter to its customer on or before the time preliminary prospectuses are disseminated.[305] Were the identical information disclosed outside the prospectus, its omission from the prospectus would seem benign (absent a desire to limit competition on this basis). It is difficult to ascertain the extent to which this information is disclosed to prospective purchasers by the underwriters themselves, because those communications need not be made publicly available.

The import of the fourth possible rationale—fear of future regulatory revision—is ambiguous. Regulatory reform arising from public pressure need not be rational. That an industry would prefer not to present a possible focus that could cause public concern to coalesce does not necessarily bear on the merits of the activities that could become subject to increased scrutiny.

A review of the possible rationales for these omissions is not dispositive; some but not all would imply that additional disclosure is required. None, however, would clearly negate a finding of materiality.

B. Conclusions Concerning Liquidity Restrictions

The element of the plan of distribution, the description of which is omitted from prospectuses, is equivalent to a limitation on transfer, subject to a right to pay for a transfer in exchange for a fee of an uncertain value. This relationship is similar to a term of a security, and the materiality of its omission can be examined from the perspective of the materiality of the omission of the equivalent security term.

304. *See supra* notes 244-247 and accompanying text.
305. *See supra* note 302.

There is no incontrovertible, conclusive analysis of the materiality of a similar security term. Yet some of the most persuasive evidence is the trading volume that takes place during that period. The existence of this trading strongly suggests the right to resell should be considered material.

Terms of securities traditionally have been fully disclosed in offering documents, in part because counsel responsible for the drafting does not wish to take responsibility for assessing the extent to which omitting a particular term results in a material omission. One could argue that ease of description should probably not affect one's conclusion concerning whether the omission of information is material. There is a virtually infinite amount of information concerning an issuer and its securities that could be provided to a prospective investor. Every investor would find it necessary that the information to be conveyed be limited or filtered in some way. The amount of information that can be processed by an investor in making a decision is finite. In that light, that information can be simply conveyed would support its disclosure, as ease of comprehension should increase the likelihood that a reasonable shareholder would process the relevant information, increasing the likelihood that a reasonable shareholder would consider it "important."

A partial description could be easily provided. One example of that type of disclosure is as follows:

> The managing underwriter has advised the issuer that the underwriters may decline to sell securities in subsequent initial public offerings to persons who resell within thirty days stock purchased in the initial public offering made by this prospectus. A prospective purchaser contemplating selling within thirty days securities purchased in this offering should obtain information from its brokerage firm concerning its applicable policies, prior to purchasing the securities being offered by this prospectus.

Because some relevant information concerning these practices can be provided in a few lines, a bias in favor of some disclosure of the relationship is appropriate.

A more revealing prospectus discussion, addressing the extent to which the specific underwriters enforce these provisions, would be more difficult to provide. However, it seems unlikely that competitive forces could be brought to bear on these disparate practices absent a requirement that there be collected in a single place the various policies of investment banks on punishing customers who flip. The effort required of individual investors to check with various investment banks is prohibitive. Moreover, making that inquiry may signal a likelihood of flipping, which could result in the investor who makes the investigation not being allocated a portion of an IPO. As investment banks do not impose these restrictions uniformly, competitive forces at the institutional level may not inure to the benefit of retail investors.

The federal securities laws regulating public offerings reflect an intentional choice to avoid "merit" regulation. Rather, they focus on requiring full disclosure, leaving it to market forces to achieve the desirable outcomes. In that context, it is not appropriate to argue against assembling the relevant information in a single place—the prospectus—on the basis that disclosing this information would be costly, where a failure to assemble the information in the prospectus would not be remedied by competitive forces.

C. *Disparate Treatment of Investors*

As noted above, it has been reported that underwriters do not treat equally investors who wish to flip securities purchased in IPOs.[306] Favored customers are more likely to be permitted to participate in subsequent IPOs, whereas disfavored customers, particularly individual customers, are more likely to have their relationship with their brokerage firm disadvantaged as a consequence of flipping IPO securities. This disparate treatment presents additional issues.

There is sparse authority addressing whether the mere disparate treatment of customers of a brokerage firm is, by itself, actionable. The process by which securities are allocated in IPOs manifests disparate treatment. Favored customers are allocated more shares.[307] This fact, by itself, is not actionable, although favoring affiliates of the underwriter or the issuer could be actionable.[308]

One could argue, based on tangentially relevant authority concerning the settlement of administrative proceedings, that a

306. *See supra* text accompanying notes 22-23.

307. *Cf.* 1 HAZEN, *supra* note 6, § 6.2, at 87 (practitioner's ed., 3d ed. Supp. 1999) ("As a result of these and other ways in which firms favor their larger customers, most investors do not have access to hot issues in the new issues market.").

308. *See* 1 *id.* § 6.2, at 360 (practitioner's ed., 3d ed. 1995). Allocating shares to persons likely to direct future business to the broker also may be unlawful. *See supra* note 6. In addition, discriminatory allocation of "hot" IPOs by a registered investment adviser to particular accounts may be unlawful. *See* McKenzie Walker Inv. Management, Inc., Investment Advisers Act Release No. 1571, 62 SEC Docket 1010, 1010-11 (July 16, 1996) (accepting an offer of settlement concerning a disparate allocation of hot IPOs in favor of accounts paying the adviser performance-based fees); Account Management Corp., Exchange Act Release No. 36,314, 60 SEC Docket 962, 963-64 (Sept. 29, 1995) (accepting an offer of settlement concerning a failure to disclose a practice of allocating hot IPOs to favored accounts).

broker's inconsistent imposition of penalties for flipping, by itself, is actionable. For example, the SEC accepted an offer of settlement involving Merrill Lynch's disclosure to favored customers of nonpublic information acquired by its employees during the course of preparing to underwrite a public offering.[309] The SEC accepted Merrill Lynch's offer of settlement of administrative proceedings alleging violation of antifraud provisions of the 1933 Act and the 1934 Act.[310] In accepting the offer of settlement, the SEC stated: "And, aggravating the inherent unfairness of the disclosure to certain customers was the fact that, at the same time, [the] registrant was effecting purchases of the stock for other customers to whom the adverse information was not available."[311]

This settlement provides only minor support for the actionability of disparate treatment of investors who flip stock purchased in IPOs. It indicates that, in the SEC's view, disparate treatment of investors can increase the likelihood that an activity would be considered fraudulent and therefore actionable. But it does not by any means compel the conclusion that disparate treatment of investors in IPOs is fraudulent and actionable. Other authority is provided by attorney Arnold Jacobs, who asserts that it violates Rule 10b-5 for a broker-dealer to "deliver[] securities to preferred customers when the broker is not in compliance with the SEC's capital requirements and is insolvent."[312]

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309. *See* Merrill Lynch, Pierce, Fenner, & Smith, Inc., Exchange Act Release No. 8459, *available in* 1968 SEC LEXIS 261, at *4-*5 (Nov. 25, 1968).

310. *See id.* at *2-*4.

311. *Id.* at *9.

312. 5C ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 212.04, at 9-184 (2d ed. 1981 & Release #55 Dec. 1997). Yet the cited authority for this proposition, Doores Sec. Corp., Exchange Act Release No. 10,342, 2 SEC Docket 291, 291 (Aug. 15, 1973), is not compelling, because it is merely an announcement of the institution of administrative proceedings, which were subsequently settled without explicit reference to this particular issue. *See* Doores Sec. Corp., Exchange Act Release No. 10,577, 3 SEC Docket 304, 305 (Dec. 28, 1973).

Other tangential authority is provided by Lehman Brothers Inc., Exchange Act Release No. 36,104, 59 SEC Docket 2567, 2568, 2571 (Aug. 15, 1995), in which the SEC censured Lehman Brothers for actions taken in bidding for preferred stock bearing dividends at a rate reset periodically by Dutch auction. Lehman Brothers violated the bidding procedures pertaining to the resetting of the dividend rates, which were outlined in the prospectus. *See id.* at 2570. These violations had the effect, inter alia, of giving preferential treatment to clients of Lehman Brothers. *See id.* at 2568-70. The SEC, in censuring Lehman Brothers, stated that in favoring Lehman Brothers' clients, Lehman Brothers' practices "involved the making of false statements in connection with the purchase of securities, in violation of . . . Rule 10b-5." *Id.* at 2570. As Rule 10b-5 renders unlawful only the making of *materially* misleading statements, this language indicates disparate treatment of customers, at least in this context, could be material. Dissemination of a misleading *immaterial* statement would not violate Rule 10b-5. *See* 2 HAZEN, *supra* note 6, § 13.5A, at 506 (practitioner's ed., 3d ed. 1995).

However, this disparate treatment of customers who purchase in IPOs may violate NASD rules and such a violation could provide persuasive evidence that this practice is fraudulent. Specifically, NASD Rule 2740 limits the ability of an investment bank participating in a fixed price offering, the normal method by which substantial IPOs are offered,[313] to share with a purchaser a portion of the commission earned for participating in the offering.[314] The Rule provides:

> In connection with the sale of securities which are part of a fixed price offering:
>
> (a) A member may not grant or receive selling concessions, discounts, or other allowances except as consideration for services rendered in distribution and may not grant such concessions, discounts or other allowances to anyone other than a broker or dealer actually engaged in the investment banking or securities business; provided, however, that nothing in this Rule shall prevent any member from (1) selling any such securities to any person, or account managed by any person, to whom it has provided or will provide bona fide research, if the stated public offering price for such securities is paid by the purchaser; or (2) selling any such securities owned by him to any person at any net price which may be fixed by him unless prevented therefrom by agreement.[315]

This provision limits the ability of an investment bank participating in the distribution of an IPO to place the securities, in the initial distribution, at varying net prices. It prevents an investment bank from reallowing to anyone other than a broker-dealer any portion of its commission for participating in the distribution.[316] The rules also proscribe indirect reallowances, by banning contracts between the investment bank and the customer for other products or services at prices to the customer below full compensation.[317]

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313. *See supra* text accompanying note 11.

314. *See* NASD MANUAL, *supra* note 65, Rule 2740.

315. *Id.* Rule 2740(a).

316. *See id.* IM-2740.

317. *See id.* According to the *NASD Manual*:

> A member who, itself or through its affiliate, supplies another person with services or products which fail to qualify as bona fide research, or which, in the case of services or products other than bona fide research, are provided by the member or its affiliate to such person or others for cash or for some other agreed upon consideration, and also retains or receives selling concessions, discounts or other allowances from purchases by that person or its affiliate of securities from a fixed price offering is improperly granting a selling concession, discount or other allowance to that person unless the member or its affiliate has been, or has arranged and reasonably expects to be, fully compensated for such services or products from sources other than the selling concession, discount or allowance retained or received on the sale.

Id.

The disparate enforcement by investment banks of punishment for flipping IPO securities could, and, it can be argued, should, be considered to violate these provisions. There is no consideration, necessarily not fair value, provided by the favored purchasers who are released from any punishment for flipping. The favored purchasers are essentially compensated for participating in the distribution, which appears to be at the core of the type of conduct proscribed by this Rule. The exception for "bona fide research" would not apply to this factual pattern.[318]

There also is a nebulous NASD rule potentially violated by this activity in IPOs. Rule 2110 provides, "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."[319] It has been recently disclosed that underwriters may allocate a portion of an IPO to persons expected to be able to influence the choices that other corporations make in future IPOs.[320] The NASD has issued a notice to members indicating that such allocations may violate NASD rules, unless the broker-dealer can demonstrate the following:

> [T]he securities were sold to such persons in accordance with their normal investment practice, . . . the aggregate of the securities so sold is insubstantial and not disproportionate in amount as compared to sales to members of the public and . . . the amount sold to any one of such persons is insubstantial in amount.[321]

This notice to members could signal a heightened concern by the NASD over disparate treatment of investors in IPOs. Rule 2110 appears sufficiently flexible to permit the NASD to impose discipline for disparate treatment of investors in IPOs, were the NASD inclined to do so, regardless of the applicability of Rule 2740. Moreover, this Rule could be applied even though the practice is common.[322]

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318. The NASD has manifested a restrictive interpretation of the safe harbor for research. According to NASD staff, the exception for "services in distribution" or "bona fide research" does not extend to the broker-dealer's provision of "securities custodial, clearance and settlement services." *See* Lee A. Pickard, NASD Interpretive Letter (Dec. 9, 1997) (visited Jan. 24, 2000) <http://www.nasdr.com/2910/2740_02.htm>.

319. NASD MANUAL, *supra* note 65, Rule 2110.

320. *See supra* text accompanying note 6.

321. National Ass'n of Sec. Dealers, Inc., NASD Reminds Members of Obligations Under Free-Riding and Withholding Interpretation, NASD Notice to Members No. 97-91, *available in* 1997 NASD LEXIS 110, at *2-*3 (1997) (quoting NASD MANUAL, *supra* note 65, IM-2110-1(b)(5)).

322. *Cf.* Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 273-74 (3d Cir. 1998) (holding a jury could determine that a broker-dealer was required, in executing customer transaction orders, to utilize various sources over and above those typically used in the industry, stating, "Even a universal industry practice may still be fraudulent."), *cert.*

A review of NASD Rules 2110 and 2740 indicates that there is adequate authority for the NASD to take action against investment banks solely on the basis of discriminatory enforcement of punishments on those who flip securities purchased in an IPO. A strong case can be made that Rule 2740 proscribes this conduct. And, even if that Rule did not prohibit this conduct, the NASD, were it inclined to do so, could use Rule 2110 in this context. That an administrative enforcement action is available does not necessarily mean private parties would have a basis for a remedy. The current trend is to hold that violations of NASD rules do not, by themselves, give rise to a private cause of action.[323] However, violation of an NASD rule may shed light on the contours of other ambiguous obligations. Professors Louis Loss and Joel Seligman state, "[T]here is the possibility also of the court's considering applicable self-regulatory organization rules in measuring a member's duty in a common law action."[324] Similarly, that a practice is sufficiently significant to be prohibited by an NASD rule suggests that a failure to disclose the practice, in a context where there is a duty to disclose all material information—where there is a duty to speak—should be material and therefore actionable.

Significant changes were made to the NASD rules as a result of the decision in *Papilsky v. Berndt*.[325] As a consequence of that case, the NASD proposed a number of revisions to its rules of fair practice

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denied, 119 S. Ct. 44 (1998); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1970); SEC v. Rauscher Pierce Refsnes, Inc., 17 F. Supp. 2d 985, 1001 (D. Ariz. 1998).

323. *See* 2 HAZEN, *supra* note 6, § 10.14, at 141 (practitioner's ed., 3d ed. 1995); 9 LOSS & SELIGMAN, *supra* note 63, at 4444 (3d ed. 1992). *See generally* Eunice A. Eichelberger, Annotation, *Private Federal Right of Action Against Brokerage Firm for Violation of Exchange or Dealer Association Rule*, 54 A.L.R. FED. 11 (1981) (collecting cases). That the rule in question is a "catch-all" rule, such as NASD Rule 2110, militates against the rule, by itself, giving rise to a private cause of action. *See* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir. 1966). Although this principle, as expressed in *Colonial Realty Corp.*, would seem to remain viable, the general framework for analyzing implied rights of action was subsequently reworked by the United States Supreme Court, commencing with *Cort v. Ash*, 422 U.S. 66 (1975).

324. 9 LOSS & SELIGMAN, *supra* note 63, at 4446 (3d ed. 1992); *cf.* Grandon v. Merrill Lynch & Co., 147 F.3d 184, 193 (2d Cir. 1998) (holding that a court should reference the rules of a self-regulatory organization, the Municipal Securities Rulemaking Board, defining excessive markups in determining whether a markup was excessive in violation of Rule 10b-5); United States v. Bilzerian, 926 F.2d 1285, 1298 (2d Cir. 1991) ("[W]e decline to hold that the information required to be disclosed in 13D is material *per se* for purposes of § 10(b) simply because such disclosure is required under the securities laws. But the fact that the information is required to be revealed under § 13(d) is evidence of its materiality.").

325. No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442 (S.D.N.Y. June 24, 1976).

in 1977.[326] The proposals were subsequently amended and became effective upon approval by the SEC.[327] In approving the revisions, the SEC described the reasons the NASD identified for changes now set forth in Rule 2740:

> The NASD stated that this section was intended (i) to prevent unfair discrimination against customers who were not able to generate sufficient business to receive products or services that could be offset by selling concessions and (ii) to prevent misrepresentations by members that the public offering price was fixed when in fact certain customers had received a discount.[328]

The second rationale identifies a belief that certain acts to be proscribed by the rules, as amended, were not consistent with a "fixed price" offering, as that term would be understood by purchasers. That is, it would be misleading to describe as a "fixed price" offering one that included those activities to be proscribed. This background, then, indicates that if the actions of brokers in attempting to restrain flipping by disfavored customers violate NASD Rule 2740, the failure to disclose those practices would be material as a matter of law.

Additional authority, independent of the applicability of NASD rules, indicates the materiality of a failure to disclose varying terms on which securities offered are being sold. One such case is *Schott v. Maidsville Coal Mining Partnership*, which arose from the sale of limited partnership interests to a variety of purchasers, including the plaintiff.[329] As part of the sale of partnership interests, the corporate parent of the sole general partner, apparently without additional compensation,[330] granted "puts" to some purchasers.[331] These puts provided some purchasers the right to require the corporate parent of the limited partnership to repurchase the limited partnership interests. The plaintiff, however, was not offered or given a put.[332]

After making its purchase, the plaintiff became aware of the puts granted to other investors when he received a letter indicating that the partnership's accounting firm was of the view that the issuance of puts

326. *See* National Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 17,371, 45 Fed. Reg. 83,707, 83,707-08 (Dec. 12, 1980). The numbering of NASD rules was substantially revised subsequent to the decision in *Papilsky*. For ease of exposition, this Article refers to NASD rules under their current designations.

327. *See id.* at 83,723.

328. *Id.* at 83,713.

329. No. 78 Civ. 6248, 1979 U.S. Dist LEXIS 9965, at *1 (S.D.N.Y. Sept. 7, 1979), *aff'd*, 636 F.2d 1204 (2d Cir. 1980).

330. The opinion is not entirely clear on this point; it merely indicates that some interests "were being sold with an option to resell." *Id.* at *2.

331. *See id.*

332. *See id.* at *3.

"raises questions as to the fairness of presentation" of the partnership's audited financial statements.[333] The plaintiff subsequently brought suit, alleging, inter alia, a violation of section 12(a)(2).[334]

In discussing the materiality of the omission, and granting the purchaser summary judgment on a claim under section 12(a)(2), the court stated:

> Under the *TSC* test, we are to ask only whether or not the knowledge that some limited partners in the Partnership could sell their interests at will would have assumed actual significance in the deliberations of the reasonable Partnership investor at the time the plaintiff purchased his Partnership units. The self-evident answer to that question is "yes," and none of the facts alleged by the defendants suggest a contrary response.[335]

One significant element of this case is that the omitted information had no direct bearing on the value of the investment.[336] It would not be unusual for a limited partnership agreement to allow the admission of an assignee of a limited partnership interest upon the consent of the general partner.[337] Thus, it is not uncommon for limited partners not to have a right to require that unaffiliated persons maintain

333. *Id.* at *3-*4.

334. *See id.* at *4.

335. *Id.* at *7-*8 (citation omitted) (emphasis added); *accord* Hidell v. International Diversified Invs., 520 F.2d 529, 533, 535-36 (7th Cir. 1975) (holding that the omission of a put granted to one of eight investors, who had provided $25,000 of $190,000 invested, was material, where the funds to effect the repurchase were ultimately provided to the corporation by another investor); *cf.* Valente v. PepsiCo, Inc., 454 F. Supp. 1228, 1235, 1244-45 (D. Del. 1978) (addressing tax gross-ups given to key employees holding stock options, in disclosure concerning a tender offer for stock, bonds, and stock purchase warrants, and stating, "[I]t is not inconceivable that a reasonable shareholder might have considered the payments to the option holders to be unfair preferential treatment, which should have been matched by an increase in the tender offer price, and that such a consideration might have assumed importance in his decision.").

336. The language quoted from *Schott* suggests the possibility that the plaintiff had a cause of action because the puts rendered the financial statements materially misleading. A close reading of the case indicates that the outcome was not dependent on the accounting treatment or the accuracy of the financial statements. The case nowhere indicates that the financial statements were, in fact, not prepared in accordance with generally accepted accounting principles. That the auditors raised the question, by itself, would not support granting summary judgment in favor of the purchaser. Thus, the case appears to support the proposition that an undisclosed disparity of treatment of purchasers of securities in a single offering—granting some rights not granted others—can be actionable on its own.

337. *See generally* Hal J. Liebowitz & Sarah Rothermel, *Computer Company Limited Partnership* § 6.01(b), *in* 2 DRAFTING COMMERCIAL DOCUMENTS SERIES 937, 1083-85 (Mass. Continuing Legal Educ., Inc., No. 96-04.15, 1996) (providing a sample agreement that grants only the managing general partner the authority to disapprove the substitution of an assignee as a limited partner). Even when an assignee is not permitted to be substituted as a limited partner, the assignment of the right to receive distributions would suffice to terminate risk of liability of the assignor, absent future financial distress of the assignee.

a specified amount at risk in the partnership. The put rights merely made more likely a substitution of a type to which investors in the plaintiff's position often will have no right to object. Nevertheless, the court held that the materiality of the omission was "self-evident."[338] Additional authority is consistent with this conclusion.[339]

The "self-evident" rationale for materiality merits exposition. Even if the granting of put rights to some purchasers did not decrease the value of the plaintiff's investment, it might be relevant for purposes of assessing the value of the securities being purchased. On that basis, then, the omission could be considered material, that is, important to a reasonable prospective purchaser. One might feel confident in the propriety of the price of securities being purchased in an offering if other, sophisticated individuals also make substantial purchases in the offering at the same price.[340] In such a circumstance, a purchaser can

338. *See Schott*, 1979 U.S. Dist. LEXIS 9965, at *8.

339. *See* E.P. Seggos & Co., Exchange Act Release No. 11,167, 6 SEC Docket 51, 51 (Jan. 8, 1975) (finding a registered broker-dealer and one of its officers had violated antifraud provisions of the 1933 Act and the 1934 Act by, inter alia, making material misstatements concerning "the nature and composition of investors to whom . . . stock would be sold"); First Detroit Sec. Corp., Exchange Act Release No. 10,943, 4 SEC Docket 689, 690 (Aug. 5, 1974) (relying, inter alia, on the fact that a salesman of a broker-dealer falsely stated a large, well-known brokerage firm was buying securities the salesman recommended to customers, in accepting an offer of settlement admitting the salesman had violated antifraud provisions of the 1933 Act and the 1934 Act); Batkin & Co., Exchange Act Release No. 5709, *available in* 1958 SEC LEXIS 269, at *30 (June 9, 1958) (referencing false statements by a broker-dealer's salesman, who claimed he had invested his own funds in the securities, in finding that he willfully violated antifraud provisions of the 1933 Act and the 1934 Act); *cf.* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1116-17 (5th Cir. 1988) (holding a jury could conclude that an offering document was materially misleading in creating a false impression that a promoter had invested a substantial amount of his own funds in the issuer), *vacated on other grounds and remanded sub nom.* Fryar v. Abell, 492 U.S. 914 (1989).

340. *See* Banc One Capital Partners Corp. v. Kneipper, 67 F.3d 1187, 1193 (5th Cir. 1995) (quoting Svalberg v. SEC, 876 F.2d 181, 183 (D.C. Cir. 1989)); *Svalberg*, 876 F.2d at 183 ("The all-or-nothing provision serves not only to ensure that the issuing firm has sufficient funds to complete its project, but also to give investors some reasonable indication that they are paying a fair market price for their investment."); C.E. Carlson, Inc. v. SEC, 859 F.2d 1429, 1431, 1434 (10th Cir. 1988) (referring to a part-or-none offering in stating, "The potential return of investor subscriptions, should the market judge the terms of the offering unsatisfactory and not purchase the minimum number of shares, offers some protection to investors. Some protection is afforded because the offering, if it is to succeed, must attract capital in excess of that paid by each subscriber. Failure to sell the minimum number of shares may reflect the market's judgment that the risk is too great (i.e. the potential return is too speculative) or that the valuation placed on the offering by the issuer is too great." (citations omitted)). *See generally* 17 C.F.R. § 240.10b-9 (1999) (defining as manipulative or deceptive the making of certain misrepresentations concerning required aggregate subscriptions in all-or-none or part-or-none offerings); 1 HAZEN, *supra* note 6, § 6.3, at 364 (practitioner's ed., 3d ed. 1995) ("[T]he courts have recognized an implied right of action by a subscriber to a securities offering who can show an injury as a result of a Rule 10b-9 violation.").

"free ride" on the investigation made by the sophisticated individuals. The issuance of put rights to some of those purchasers, at issue in *Schott*, limited the risk of those selected purchasers in investing in the limited partnership and therefore diminished the value of the information conveyed by the fact that they purchased limited partnership interests.

Administrative proceedings present consistent outcomes in similar factual patterns, which have involved, in whole or in part, various omissions from the plan of distribution, including failures to disclose that "left over" stock was purchased by affiliates of a broker-dealer in order to disguise the weakness of an offering,[341] that the offering was not adequately coordinated,[342] and that some shares in the offering were given away.[343]

This authority is compelling. Retail investors cannot practicably investigate on their own whether stock to be sold in an IPO is properly priced. They must free ride on the investigation of institutional investors. No pejorative connotation is intended; the structure of the federal securities laws is designed to allow uninformed investors to rely on the integrity brought to the securities markets by competitive forces operating in full and complete disclosure. These inadequately disclosed restrictions impede the functioning of market forces. It is

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341. *See* Mountain Pac. Inv. Co., Exchange Act Release No. 19,650, 27 SEC Docket 730, 730 (Apr. 4, 1983) (accepting an offer of settlement and issuing an order imposing remedial sanctions).

342. *See* American Fin. Co., Securities Act Release No. 4465, *available in* 1962 SEC LEXIS 632, at *19 (Mar. 19, 1962) (issuing a stop order) ("In view of the large number of shares proposed to be offered in relation to the limited floating supply of shares, the apparent lack of cohesiveness in the selling group and the absence of a prior market, the registration statement should have identified the sellers and their relationships to each other . . . and should have disclosed that such distribution would not be coordinated or controlled by a managing underwriter and that the selling group had not provided the contractual safeguards for the protection of buyers and sellers usually provided in a conventional distribution. In a conventional distribution of securities the activities of underwriters and other participants are normally governed by underwriting agreements which provide a controlled procedure designed to accomplish an orderly marketing of securities in accordance with the registration and prospectus requirements and free from manipulative and fraudulent practices prohibited by the securities acts." (footnote omitted)), *stop order lifted* Securities Act Release No. 4538, *available in* 1962 SEC LEXIS 153 (Oct. 2, 1962). *But cf.* Application of Rule 10b-6 Under the Securities Exchange Act of 1934 to Persons Participating in Shelf Distributions, Exchange Act Release No. 23,611, 36 SEC Docket 595, 598 (Sept. 11, 1986) (announcing an SEC interpretation that, in the context of sales by shareholders under a shelf, restrictions on purchasing securities applicable to persons engaged in a distribution would not apply to a shareholder solely by virtue of contemporaneous sales by other shareholders covered by the shelf).

343. *See* Stephen D. Replin, Securities Act Release No. 6939, 51 SEC Docket 826, 827-28 (May 28, 1992) (accepting an offer of settlement and issuing a cease and desist order).

difficult to imagine an investor finding this discriminatory treatment unimportant. Finding material the failure to disclose these restrictions on flipping is unavoidable.

D. Conclusions Concerning Disparate Treatment

There is substantial support for the proposition that the discriminatory enforcement of penalties for flipping renders prospectuses misleading as a matter of law. A prospectus misleading on this theory probably could not be remedied merely by disclosing the discriminatory treatment of customers somewhere in the body of the prospectus. It is inherent in the normal type of offering that the same price is to be offered to all investors. That is a fundamental aspect of a traditional offering. Any attempt to continue to reference as a fixed price, firm commitment offering one that allows for price differences, or arrangements equivalent to price differences, beyond those contemplated by NASD rules, simply is not a fixed price offering. "Curative" disclosures cannot suffice.

IV. CONCLUSION

There are a variety of theories under which the prospectus disclosure concerning restrictions on flipping can be challenged. Some appear compelling. It is not at all clear, however, that there is a sufficient incentive for a private plaintiff to assert these theories. The unfettered remedy formerly provided by section 12(a)(2), essentially a one-year put in the case of a misleading prospectus, is now subject to substantial additional limitations; the loss causation defense recently added to section 12 may make this disclosure violation one for which there is no practicably available remedy.[344] One has to suspect that the mysterious process by which stock in IPOs is allocated would not reward an investor who previously asserted this theory in a private cause of action, even if successfully. It may be that this theory will be argued in some future case by a private plaintiff as an alternative basis for relief. Absent that development, however, it would seem that this circumstance is one in which administrative enforcement is warranted.

344. *See supra* text accompanying note 191.