ABSTRACT

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

KEYWORDS: Securities regulation, gatekeeper liability, market competitiveness, informational asymmetries, financial intermediaries

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I. Introduction

Securities regulation has come under increased criticism in recent years. Beginning with the major accounting scandals in the United States and Europe in the late 1990s and the first years of the new millennium, a significant increase in the number of financial restatements announced by publicly listed companies over the last decade, the dotcom bubble and the

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1 Names such as Enron, WorldCom, Global Crossing, Cendant, or Tyco in the United States and Parmalat in Europe have come to epitomise the failure of the regulatory system.
disappearance of a whole market segment of the Frankfurt Stock Exchange in 2003, and finally the stock market crash and the demise of the investment bank in 2008, investors have lost their faith in the integrity of the financial markets. The regulatory response to such excesses can operate from two angles. It can stress the role and the competences of the public regulator or fashion a system of private obligations that requires market actors to supervise each other. This essay explores the latter approach: the enhancement of investor protection through private parties. Many articles and treatises that have examined the origins of the regulatory crisis have concluded that the classical tools of corporate governance for the supervision of management – notably the outside director or, in companies with a two-tier board structure, the supervisory board – have lost their effectiveness in light of new incentive structures in the financial markets and an increased fixation of management on short-term share price maximisation. They see as the solution to the regulatory lacunae the utilisation of financial intermediaries and other market participants as gatekeepers, i.e. as agents that ensure compliance of the primary market actor (in the securities sector the issuer) with applicable rules by reviewing its disclosures and withholding their participation in transactions if violations occur. This concept was developed by Rainier Kraakman in the 1980s. Its general usefulness is now widely accepted in the United States. In Europe, on the other hand, the

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3 The Frankfurt Stock Exchange opened an entrance standard for new economy companies in March 1997 that was named the New Market. In the first years of its existence, the New Market enjoyed unprecedented growth; in the time from 1997 to March 2000 the market share index rose from 1,000 points to almost 10,000 points. A few months later the dotcom bubble burst and the first issuers filed for bankruptcy. By October 2002, the share index had fallen to 318 points, annihilating €200 billion of shareholder value. The Frankfurt Stock Exchange discontinued the operation of the New Market shortly thereafter (in June 2003). The ensuing investigations uncovered widespread instances of falsification of financial statements and disclosure of incorrect, often entirely imaginary issuer-related information. The fraudulent behaviour triggered lawsuits associated with names such as EM.TV, Comroad, and Infomatec that have begun to transform German securities regulation.

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


legal community largely ignores the insights developed by the gatekeeper theory when drafting and construing financial market regulation. In addition, in spite of the voluminous literature that exists in the United States, commonly acknowledged contours of gatekeeper liability have not yet emerged. Controversial issues are, in particular, the class of suitable gatekeepers and the standard of care that the gatekeeper should be held accountable for when reviewing the acts of the primary market participant (strict liability, recklessness, or negligence). Furthermore, the investigations often confine themselves to abstract discussions of the advantages and disadvantages of the gatekeeper theory without asking whether the legislative measures that are in force may be construed in a way that facilitates considerations of the theory.

This essay undertakes to remedy the omission. It conducts a comprehensive analysis of the U.S. and European regulation of the market for securities and tries to ascertain whether provisions for the protection of investors are based on, or can be interpreted in light of, the gatekeeper theory. The inquiry first addresses allegations that the potential liability of financial intermediaries is, on the one hand, unnecessary as market forces are capable of ensuring an optimal supervision of the primary market participant by the gatekeeper and, on the other hand, harmful since the risk of liability increases the cost of capital. It then analyses the current regime of securities regulation in the United States and in Europe. As far as the legal situation in Europe is concerned, the essay focuses on English and German national law with references to the applicable EC directives and regulations. The comparative analysis helps to identify provisions that are conducive to investor protection and the gatekeeper theory or that create inefficiencies. It gives an opportunity to address the controversial issue of the adequate standard of care, which is regulated differently in the countries under investigation. In addition, the European regulatory regime may profit from a comparative analysis in view of the high level of detail and enforcement that characterises the U.S. system. In the United States, a plethora of rules, stemming from Congress and from the supervisory authority, the Securities and Exchange Commission (SEC), which has rule-

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making power under the Securities Acts, regulates all aspects of disclosure and governance. The rules have been vigorously enforced for many decades and have, therefore, had the opportunity to stand the test of time – as opposed to certain measures of European provenance that, while dating back as far as the 19th century, have rarely been invoked by investors or applied by the courts. The U.S. practitioner and the legal scholar are able to take recourse to an extensive body of case-law that interprets and develops the codified rules, whereas in Europe litigation has been scarce until recently. Finally, the conclusion (V) will provide a summary of the findings and advance a tentative explanation of certain trends of convergence between U.S. and European regulatory mechanisms that can be observed.

II. The Market for Securities

1. Market competitiveness and transparency

It has been alleged that a regulation of financial intermediaries and, for that matter, the whole financial sector impedes the efficient allocation of risks and thus increases the cost of capital. Market forces, it is argued, constitute a sufficient incentive for market participants to act with due diligence. Intermediaries, for example, rely on their reputation in attracting business. Investment banks that market securities of a low-quality issuer as a high-quality investment will damage their reputation as investors, in relying on the underwriter’s assessment of the issuer’s financial position, suffer a loss. In future offerings, the investment banks will not be able to sell the securities they have underwritten – even those of a high-quality issuer – without a discount. This, in turn, will require the banks to charge the issuers lower fees. Thus, the quality of the underwriters’ due diligence procedures (and, in analogy, the due diligence of other financial intermediaries) has a bearing on their market position and revenue.

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

9 A good example is the German Stock Exchange Act (Börsengesetz) of 22 June 1896, RGBl. [Imperial Law Gazette] at 157, with its rules on prospectus liability (sections 44, 45 of the Act). After the Imperial Court (Reichsgericht) had relied on the provisions in a few cases to accord defrauded investors damages (RG BankArch 1910/11, 123; RGZ 80, 196), the last one dating from 1912, it was to take 70 years for the first major recovery to occur (BGH WM 1982, 862 – Beton- & Monierbau).

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

The degree of competitiveness of a market depends on three factors: (1) the number of firms competing in the market (a highly competitive market requires firms and consumers to be price-takers, i.e. commanding such a small market share that they cannot influence the price by reducing or increasing output or consumption), (2) product homogeneity (the products must be substitutable with one another, i.e. no firm can raise the price of its products above market average without losing much of its business), and (3) the costs of entry to and exit from the market. For the two most important intermediaries in the securities market, the underwriter and the auditor, these factors indicate a low level of competitiveness. The market for auditing services is highly concentrated. After the dissolution of Arthur Andersen in 2002, four major auditing firms remain in the market that audit ca. 80 percent of all public companies in the United States and in Europe. While the market for services provided by underwriters is less concentrated than the audit market, it exhibits oligopolistic tendencies as

12 In the United States, the top four firms (Ernst & Young, Deloitte & Touche, KPMG, and PricewaterhouseCoopers) have audited 78 percent of all public companies, 97 percent of all public companies with sales over $250 mill., and 99 percent of all public company sales in 2002, cf. GOVERNMENT ACCOUNTABILITY OFFICE, PUBLIC ACCOUNTING FIRMS: MANDATED STUDY ON CONSOLIDATION AND COMPETITION (2003), GAO-03-864, at 16, available at http://www.gao.gov/new.items/d03864.pdf. The Hirschman-Herfindahl Index (HHI), a benchmark for market concentration with an HHI of or above 1,800 indicating a highly concentrated market, has increased to 2,566 after the dissolution of Arthur Andersen, id. at 19. In addition, audit firms tend to specialise on industry sectors. Therefore, the concentration in some sectors is even higher, with only two forms auditing more than 80, often up to 90 or 95 percent of the assets in the industry, id. at 110-33; cf. also Robert Bloom & David C. Schirm, CPA JOURNAL, June 2005, available at http://www.nysscpa.org/cpajournal/2005/605/infocus/p22.htm. Finally, due to the high costs associated with the staff, technical expertise, and global reach necessary to audit large and complex national and multinational public companies, barriers to entry into the market for such companies are significant, GOVERNMENT ACCOUNTABILITY OFFICE, supra, at 6.

In Europe, LONDON ECONOMICS, STUDY ON THE ECONOMIC IMPACT OF AUDITORS’ LIABILITY REGIMES (2006), MARKT/2005/24/F, commissioned by the DG Internal Market and Services of the European Commission, has analysed the concentration of the audit market in the EU and concluded that the market is highly concentrated in most Member States. In the majority of EU states, the top four firms audit 90 percent or more of the companies listed in the main index of the national stock exchanges. For the four biggest economies, the rate of concentration was determined as follows (percent of total number of mandates): Germany 97, UK 99, France 73, Italy 100. The HHI for the countries was 4022, 2912, 1818, 2662, respectively, far above competitive levels, id. at 20. If all companies listed on regulated national stock exchanges are considered, the concentration index by number of mandates falls to 60 or below in some cases (e.g., Germany 55, France 42), but remains at 70 or higher on average, id. at 22-23. The degree of concentration is even more pronounced if the index is based on the revenues audited: The top four firms audit more than 90 percent of the revenues of listed companies in most Member States; the HHI is above the concentration threshold in all but three States, id. Barriers to entry into the audit market in Europe are as significant as in the United States, id. at 40-47.
well. The number of firms underwriting large offerings is low; the costs of entry are high.\textsuperscript{13} It is, therefore, questionable whether the degree of competition on the market for underwriting and auditing services allows the market participants to switch between different service providers, thus forcing low-quality providers to reduce their fees or increase the quality of their services.

The second condition – the transparency of the market – is similarly problematic. The issuer will only be able to tailor the fees according to the quality of the services provided if it is able to distinguish between low-quality and high-quality providers. This will often not be possible, at least not ex ante. An issuer can only judge the quality of the services on the basis of the information provided by the intermediary. The provider has more knowledge about the services than the recipient; the latter is not able to confirm their intrinsic value. In this sense, the market for securities is a “market for lemons”. In the absence of institutions that counteract the informational asymmetries market quality is prone to decline.\textsuperscript{14} Of course, already today institutions exist that are designed to counterbalance the effects of quality uncertainty in the financial markets. Most financial intermediaries have to be licensed and are under the supervision of a regulator. Investment banks, auditors and other intermediaries that have, for a longer time, provided services of a good quality, signal that future performance

\textsuperscript{13} In the United States, the five largest investment banks underwrote more than 60 percent of all IPOs and ca. 56 percent of debt offerings in the years 1990 to 2004, cf. Nicola Cetorelli et al., Trends in Financial Market Concentration and Their Implications for Market Stability, 13 FRBNY ECONOMIC POLICY REVIEW 1 (March 2007), at 33, 38, available at http://www.newyorkfed.org/research/epr/07v13n1/0703hirt.pdf. While investment banks actively compete for underwritings, the composition of underwriting syndicates is largely static. HAROLD S. BLOOMENTHAL, GOING PUBLIC HANDBOOK § 3:01 [1][4][c(v) (2008-2009 ed.), points out: “[L]ong-standing relationships tend to develop between [the issuers] and their ‘investment bankers’ who invariably acted as their managing underwriter.” One sentence later, he speaks of “almost historic, relationships.” The investment industry’s capital is equally concentrated. In 2004, the six largest firms accounted for 77.5 percent of the capital, JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION 125 (5th ed. 2006).

The situation in Europe is comparable. The market for underwritings in Germany may serve as an example. In 2006, only three investment houses participated as lead underwriters in five or more offerings of a total of 35 IPOs on the regulated market of the Frankfurt Stock Exchange (namely, Deutsche Bank, Sal. Oppenheim jr. & Cie., and UBS). Based on the total number of lead underwriter positions in these offerings, the three banks had a market share of 31 percent. The concentration index rises to 43 percent if the five largest institutions are taken into consideration, thus crossing the threshold of 40 percent that commonly indicates an oligopolistic market, and to 49 percent for the six largest banks (source: FRANKFURT STOCK EXCHANGE, PRIMARY MARKET STATISTICS 2006, http://deutsche-boerse.com (follow “Listing” hyperlink, then “Reports and Statistics” hyperlink)). As far as IPO volume is concerned, in 2006, the three largest banks underwrote as lead managers (including joint lead and co-lead managers) out of a total volume of €10,315.22 mill. (regulated and open market of the Frankfurt Stock Exchange) €5,147.48, equalling a market share of 49.9%. The five largest banks commanded of a market share of more than 66% (source: FRANKFURT STOCK EXCHANGE, CORPORATE FINANCE RANKING 2006, http://deutsche-boerse.com (follow “Listing” hyperlink, then “Reports and Statistics” hyperlink)). In 2007, in a total of 23 new issues on the regulated market of the Frankfurt Stock Exchange, the three largest banks had a market share of 30%, calculated as the ratio of participation in the offerings as lead underwriter and total number of lead underwriter positions. Again, the concentration index crosses the threshold of 40% if the five largest banks are considered (market share of 44%). The top six banks, finally, comprise 50% of the market (source: FRANKFURT STOCK EXCHANGE, PRIMARY MARKET STATISTICS 2007, http://deutsche-boerse.com).

will be of an equally high standard. However, regulatory supervision is less effective where regulators are ill-equipped to supervise a whole industry, in particular due to understaffing. Past experience has shown that this is a problem even in the United States, where investment in the regulation of the financial markets and enforcement levels have traditionally been high. In Europe, enforcement is rare and anecdotal evidence suggests that questionable behaviour of market participants has repeatedly gone unchecked. The quality of past services is an equally imperfect mechanism to compensate for the informational disadvantages of the issuer. The actual level of quality depends to a great extent on the lead partner who has responsibility for the provision of the services. The integrity and independence of the partner may be compromised, as could be seen in recent, admittedly

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15 See Kraakman, supra note 5, 93 YALE L.J. at 898 (in particular n.124), for other signalling techniques and further references. In the investment industry, the composition of the tombstone that announces an upcoming or completed public offering provides a good example of signalling by means of reputation. The participating underwriters are listed by brackets with the most reputable underwriters – the underwriters that have, accordingly, received the largest allotments – being prominently displayed in the bulge bracket, and less well established banks mentioned in the major bracket and further sub-brackets.

16 See Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications (Harvard Law and Economics Discussion Paper No. 521, 2005), available at http://ssrn.com/abstract=839250. Jackson compared regulatory costs and staff levels in several common law and civil law jurisdictions adjusted for market size (but not for economies of scale, which would have emphasised the lead of the United States even more due to its large financial markets) and came to the conclusion that the United States outstrips all other jurisdictions both as far as total regulatory costs as a percentage of GDP and total regulatory staff as a percentage of population are concerned, id. at 20. Investment in the regulation of the banking sector by far surpasses all other countries. In 2004, U.S. banking regulatory costs were $247,405 per billion dollars of banking assets, almost four times as much as the next most costly jurisdiction, Germany, with $67,815 of costs per billion dollars of banking assets. In the insurance and securities sectors, U.S. costs are comparable to those of other common law jurisdiction but far above the levels reported for civil law countries. Securities regulation costs, for example, amount to $83,943 per billion dollars of stock market capitalisation in the United States ($138,159 in the UK), but only $19,041 in France and $8,896 in Germany (all figures from 2004), id. at 19-20. The number of enforcement actions markedly differs as well. In the years 2002-2006, the SEC (which is responsible for the supervision of the securities sector only) instigated, on average, 624 enforcement actions per year (civil actions, administrative proceedings and 21A reports; not counted are investigations of possible violations). Source: SECURITIES AND EXCHANGE COMMISSION, ANNUAL REPORTS AND MARKET DATA STATISTICS, http://www.sec.gov/about.shtml (follow “Annual Reports and Statistics” hyperlink). In comparison, during the same time, the FSA, the English regulator, opened 206.4 enforcement cases on average per year. Source: FINANCIAL SERVICES AUTHORITY, ANNUAL REPORTS, http://www.fsa.gov.uk/pages/Library/Corporate/Annual/index.shtml. As John C. Coffee, Jr., Law and the Market: The Impact of Enforcement (Columbia Law and Economics Working Paper No. 304, 2007), at 38-39, available at http://ssrn.com/abstract=967482, points out, the U.S. numbers do not take account of private enforcement activities by the NASD and enforcement cases brought by state regulators. Therefore, they underestimate the true level of enforcement in the United States. For further analyses of differences in the level of enforcement with similar results see Coffee, id. at 28-38 and passim; Howell E. Jackson & Mark J. Roe, Public Enforcement of Securities Laws: Preliminary Evidence (2007), http://ssrn.com/abstract=1000086.

17 Cf. the events in the aftermath of the implosion of the New Market of the Frankfurt Stock Exchange. Several surveys conclude that a large number of the issuers listing on the New Market published consolidated statements that violated IAS or GAAP. However, virtually all of the statements received an unqualified audit opinion, see Wolfgang Ballwieser, Rechnungslegung und Prüfung am Neuen Markt, ZFBF 2001, 840; Martin Glaum & Donna Street, Rechnungslegung der Unternehmen am Neuen Markt, 17 STUDIEN DES DAI (2002), available at http://www.dai.de/internet/dai/dai-2-0.nsf/dai_publikationen.htm (follow “Studien” hyperlink, then “2002” hyperlink).
exceptional, cases of securities fraud. Short of securities fraud, the quality may differ depending on the expertise and experience of the lead partner and the other employees of the intermediary who are entrusted with the mandate, and these employees may change from time to time.

The problem is even more pronounced in respect to investors. In order to evaluate the intrinsic value of the securities, the investor needs to be informed about the particulars of the investment, evaluate the financial condition of the issuer and its likely future performance, and assess the possible impact of macro-economic variables. Some of the information necessary to perform such an examination has to be provided pursuant to the disclosure rules of U.S. and European financial market regulation. For example, a public issue of debt or equity securities requires the comprehensive disclosure of information about the issuer (inter alia, a description of its business, investments, organisational and management structure, remuneration policy, capital resources, past financial data and profit forecasts), the securities (rights attached to the securities, conditions of the offer, i.e. plan of allotment and pricing method, arrangements for admission to trading and stabilisation etc.), and risk factors associated with the investment. The admission to trading on a regulated market triggers periodic and ongoing obligations that again require the disclosure of financial data and of current events that materially affect the issuer’s financial position.

On the secondary market, the investment firm that offers investment services has to provide its client with appropriate

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18 * Cf. for example the allegations in the *Enron* case: “Enron’s banks and high-level banker were offered [a highly lucrative] investment opportunity as a reward for their ongoing participation in the Ponzi scheme.” Newby v. *Enron Corp.*, 235 F. Supp. 2d 549, 617 (S.D. Tex. 2002).


21 United States: Exchange traded companies, issuers with 500 or more shareholders and total assets exceeding $10 mill., and issuers that have filed a registration statement under the Securities Act of 1933 have to publish annual and quarterly reports and current reports in case of certain significant events (e.g. the acquisition or disposition of a significant amount of assets or a change in control), sections 12(a), (g), 13, 15(d) Securities Exchange Act 1934, 15 U.S.C. §§ 78l(a), (g), 78m, 78o(d) (2007), Regulation 13A, 17 C.F.R. §§ 240.13a-1 to 240.13a-20 (2008), Forms 8-K, 10-Q, and 10-K, 17 C.F.R. §§ 249.308, 249.308a, 249.310 (2008). EU: Issuers whose securities are admitted to trading on a regulated market within the EU are required to publish annual and half-yearly financial reports and interim management statements, articles 4-6 Directive 2004/109/EC, OJ L 390, December 31, 2004, at 38 (Transparency Directive). Furthermore, article 6 Directive 2003/6/EC, OJ L 96, April 12, 2003, at 16 (Market Abuse Directive), requires issuers to inform the public as soon as possible of inside information that directly concerns the issuers.
information about, *inter alia*, the specific type of financial instrument concerned and the risks associated with that type.\(^{22}\)

In spite of this wide range of information available to the investing public, investors are at a significant informational disadvantage. Investment firms are not required to advise their clients on the value and the risks of a particular financial instrument, e.g. the securities of an individual issuer that the investor wishes to trade in. They satisfy their obligations by giving general and abstract information on the nature of the respective *type* of instrument (debentures, shares, options, futures, money-market instruments etc.).\(^{23}\) While Directive 2004/109/EC (Transparency Directive) has increased the transparency for investors operating on the secondary market, the periodic disclosure requirements likewise do not guarantee a supply of information that is always current and complete. Comprehensive information has to be published on an annual basis, comprising the audited financial statements and a management report that discusses the past and the likely future development of the company’s business.\(^{24}\) In addition, issuers have to make public a half-yearly financial report that contains a condensed balance sheet and profit and loss account, together with explanatory notes and an interim management report.\(^{25}\) The condensed financial statements do not have to be audited.\(^{26}\) During the time between publication of the annual and the half-yearly reports, publicity requirements are reduced: Once in each six-month period of the financial year, the issuer has to publish a statement with an explanation of recent material events and transactions that have an impact on the issuer’s financial position (interim management statement).\(^{27}\) Aside from this requirement, events that occur after the publication of the annual or the half-yearly report do not need to be disclosed unless they result in a change in major holdings that crosses certain thresholds\(^{28}\) or fall within the definition of “inside information” under the Market Abuse


\(^{23}\) Cf. article 31(1), (2)(a) Directive 2006/73/EC. The exact level of detail that has to be provided depends on the circumstances of the case, in particular the experience of the client and the risk profile of the financial instruments. Cf. recital 45 of Directive 2006/73/EC: “It is possible that for some financial instruments only the information referring to the type of an instrument will be sufficient whereas for some others the information will need to be product-specific.”


\(^{25}\) Article 5(2)(a), (3), (4) Transparency Directive. Cf. IAS Standard 34 for the content of the condensed financial statements. However, use of IAS is only mandatory for issuers that are required to prepare consolidated accounts, article 5(3) first subparagraph Transparency Directive.

\(^{26}\) Article 5(5) Transparency Directive.

\(^{27}\) Article 6 Transparency Directive.

\(^{28}\) Specified in article 9 Transparency Directive.
Directive, i.e. constitute information of a precise nature that has not been made public, relates to the issuer, and is likely to have a significant effect on the price of the issuer’s securities.\textsuperscript{29}

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

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

2. \textit{Mechanisms to counteract informational asymmetries}

As pointed out, several mechanisms have been developed in order to alleviate informational asymmetries. The producer of goods or provider of services may grant a guarantee or strive to develop a reputation for high quality products or services.\textsuperscript{30} The first method is not feasible in the securities market: Shares, bonds, and other investment instrument entitle the holder to receive certain payments (dividends, interest payments, premiums, or bonuses). If the issuer/provider defaults on the payments, the guarantees will most likely also not be enforceable. The second method might be suitable for seasoned issuers but, in general, not for firms that wish to conduct an initial public offering. The employment of financial intermediaries therefore serves an important signalling function. By preparing or certifying the public disclosures, the intermediary lends the primary market participant the weight of its expertise and qualifications and confirms that the statements have been drawn up in accordance with applicable laws and regulations, for example with GAAP or IAS/IFRS. By

\textsuperscript{29} Article 6 Market Abuse Directive. The definition of “inside information” is contained in article 1 No. 1 of the Directive.

\textsuperscript{30} Cf. Akerlof, \textit{supra} note 14, at 499-500.
participating in the distribution of securities or the provision of services the intermediary shows that the product is of a sufficiently high quality to tie its own reputation to the success of the operations of the primary market participant.

The employment of financial intermediaries leads to a second informational asymmetry – one between the investor and the intermediary. The investor is, even more than the primary market participant, unable to discern whether the intermediary has performed its verification and certification functions with due care. In the case of certain transactions, the published documents have to contain information on the intermediary. The public offering prospectus or registration statement, for example, has to disclose the name and address of the underwriters, the type of underwriting (firm commitment or best efforts), and the material features of the underwriting agreement, in particular the quotas and the underwriting commission.\(^{31}\) While the type of underwriting constitutes an indication of the underwriter’s valuation of the securities (with a best efforts underwriting generally implying a higher risk), the factors that are of greatest concern to the investor are not disclosed: the methods and standards applied by the intermediary in examining the financial situation of the issuer and the viability of the offer. The investor does not know whether the underwriter performs a full (commercial, financial, technical, legal and tax) due diligence or follows a lower standard, whether it is subject to conflicts of interest that might compromise the objectivity of its analysis or operates at arm’s length. Even if the standards that the intermediary is required to employ are laid down in an accessible and binding body of rules (e.g. in the GAAS), the investor does, in general, not have the possibility to verify compliance with these rules.

Again, the reputation of the intermediary might constitute a signal that is able to counteract the informational disadvantage of the investor. However, reputation is an imprecise signal. In the relationship between intermediary and investor, this imprecision is not only caused by the potential discrepancy between the interests of the intermediary in preserving its reputation and the incentives of the employees that perform the services for the intermediary.\(^{32}\) In addition, two problems frustrate a clear (ex ante and ex post) determination of the level of quality of the intermediary’s services: the multiplicity of causes for market movements and a high interdependence between intermediaries in the financial markets. A drop in the share price after the initial public offering can be caused by various factors – the unsound financial condition of the issuer as well as a general economic downturn or a change

\(^{31}\) Annex III No. 5.4 Prospectus Regulation. Schedule A (28) of the Securities Act 1933 and Item 601(b)(1) of Regulation S-K require the filing of a copy of the underwriting agreement as part of the registration statement.

\(^{32}\) Cf. supra 1.
in particular economic variables that influence the issuer’s industry. The intermediary may claim that the misstatements in the company’s disclosures were disguised by the issuer’s management and could not have been discovered by the due diligence examination. Alternatively, if more than one intermediary has participated in the transaction, the intermediaries may seek to exculpate themselves by alleging deficiencies in the actions of the other parties. The investor does not have the possibility to evaluate such claims and determine the true allocation of responsibilities.

An analysis of the second issue – a high interdependence between intermediaries in the financial markets – can draw from several studies that have examined the interrelations between individual and group reputation, focusing on different markets such as the markets for drugs, cars, wines or airline travel. The main conclusion of the studies is that the behaviour of individual agents may contribute to a collective reputation – the reputation of a group of agents with like characteristics. In the same way that the whole group will profit from members that perform above average, the reputation of all members of the group will be affected by individual firms that produce low quality goods or provide low quality services. This interdependence is the more pronounced, the less well the behaviour of the individual agent can be observed. As shown, in the financial markets, the investor can observe the quality of the intermediary’s performance only with great difficulty. As a consequence, the investor is likely to extrapolate from his experience with a particular intermediary (e.g., the intermediary who has audited the financial accounts that have been “cooked”; the investment bank that has underwritten and distributed a public offering that proves to be highly overvalued) to the whole industry. This intuitive result is corroborated by anecdotal evidence.

After the Great Crash of October 1929 U.S. President Hoover appointed a commission to investigate the causes of the crisis, the Gray-Pecora Commission. The investigations revealed widespread fraud and speculative transactions. Insiders traded on undisclosed

33 This is the reason why Kraakman, supra note 5, 2 J.L. ECON. & ORG. at 97, calls reputation “a noisy signal”.
35 For example, the producers of Bordeaux wines create a collective reputation that is determinative for all sub-appellations, cf. Gergaud & Livat, supra note 34. An airplane crash does not only affect the reputation of the involved airline but also that of competitors, Borenstein & Zimmerman, supra note 34.
37 Vincent P. Carosso, Investment Banking in America 322-51 (1970), and Ferdinand Pecora, Wall Street under Oath (1939), give a detailed account of the Gray-Pecora investigations.
information and realised profits in the millions even as the market was in decline and left outside investors ruined. Issuers and intermediaries engaged in market manipulation in order to create advantageous conditions for the placement of their securities. They falsified financial statements, bribed reporters and analysts and disseminated misleading promotional material describing the business prospects of the venture in glowing terms while omitting facts that were essential for the appreciation of the risks associated with the investment. However, the investigations also showed that the wrongdoing was largely confined to the incorporated banks of deposit that were, at that time, permitted to offer both commercial and investment banking services. The venerable private banks that had dominated the investment industry for many decades and played a crucial role in the rapid growth of the U.S. economy towards the end of the 19th and the beginning of the 20th century had, in general, acted in conformity with established practices of fair dealing, subjected the issuers to meticulous scrutiny and avoided the underwriting of speculative offerings. Nevertheless, when the Gray-Pecora Investigation uncovered the extent of negligent and fraudulent behaviour, the wrath of the investing public was levelled at incorporated banks of deposits and private bankers alike.

A second example is the collapse of the New Market of the Frankfurt Stock Exchange in 2000. Although the fraudulent activities were confined to some of the new technology issuers listed on that market, the uncovering of the balance sheet manipulations and dissemination of incorrect ad-hoc announcements negatively affected the reputation (and,

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38 Insiders were able to realise the profits by short selling, PECORA, supra note 37, at 154.
39 The report of the House of Representatives on the draft of the Securities Act of 1933, for example, complains of “the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise”. Quotation from LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION § 1-A (3d ed. 1993 & supp. 11/2008).
40 Cf., for example, PECORA, supra note 37, at 100: The National City Co., one of the largest and most respected investment houses of those days conducted three offerings of Peruvian government bonds in 1927 and 1928 although internal analysts had described the securities as “an adverse moral and political risk”.
41 As a reaction of the findings of the investigations, Congress passed the Glass-Steagall Act of 1933 (official title: Banking Act of 1933), 12 U.S.C. § 227 and scattered provisions in Ch. 3, that required the separation of commercial and investment banking. The prohibition has partly been repealed by the Gramm-Leach-Bliley Act of 1999 (official title: Financial Services Modernization Act of 1999), Pub. L. 106-102, 113 Stat. 1338.
43 CAROSSO, supra note 37, at 339. The higher standards applied by the private banks may be explained by the fact that they were not incorporated but organised as partnerships, thus allowing less shielding against personal liability than the banks of deposit. In addition, during the first decades of their operation, while the U.S. financial markets were in their infancy, the private banking houses seem to have developed a stringent code of business ethics in order to gain the trust of clients and investors. In spite of the lack of regulatory supervision or a mandatory disclosure regime, this ethical code was, for a long time, instrumental in shaping the conduct of the private bankers. The early days of investment banking in the United States were, accordingly, known as an “era of dignity and mystery”, Morgan, 118 F. Supp. at 645.
44 CAROSSO, supra note 37, at 336-351, 353.
hence, the share price) of all issuers in the technology sector and even issuers from other industries, for example those listed on the regulated market.\textsuperscript{45}

The fact that reputation, accordingly, is not an adequate device to counteract the informational asymmetries makes the case for legislative intervention. Liability rules that hold the intermediary responsible do not only provide the investor with an additional defendant who will, in many cases, be more solvent than the issuer. They also solve both of the problems mentioned above that frustrate the usefulness of the reputation as a signalling device. In the course of the investor’s litigation, the court will discuss, \textit{inter alia}, questions of causality – has the drop in the price of the security been caused by the breach of securities laws or by exogenous factors? – and the standard of care displayed by the defendants. It will determine the allocation of responsibility between several defendants. The investor, therefore, will be in a position to adjust his assessment of the quality of the intermediaries’ services accurately; the intermediaries will not be able to shift responsibility amongst each other and the issuer by means of unsubstantiated claims. The problem of group reputation is alleviated, although it can be expected that the psychological effects that are the consequence of a major crisis in the financial markets will, at least to some extent, still affect uninvolved market participants.\textsuperscript{46} These conclusions are also valid if the proceedings do not end with a final judgement but with a settlement, which is not uncommon in securities litigation. Settlements are preceded by various court orders that grant or dismiss motions. They discuss, in particular in the case of motions to dismiss, the legal situation in great detail and give a clear indication of the responsibility of the different defendants.\textsuperscript{47}

III. Elements of Gatekeeper Liability in Securities Regulation

1. \textit{U.S. Law}

The four most important liability provisions of U.S. securities law for the regulation of the primary and secondary market are probably sections 11, 12(a)(1), and 12(a)(2) of the

\textsuperscript{45} For instance, Lycos and Telegate, two relatively successful issuers of the software and telecommunication sectors that listed on the New Market in 1999 and 2000 and that were not confronted with allegations of misconduct, suffered a decline in their share price not significantly different from that of companies that were under investigation: From a high of €160 in March 2000, the price of Telegate stock sank to €1.35 in August 2001. Lycos stock was offered at €24 in March 2000 and traded at €0.74 in December 2001. The whole New Market declined by ca. 96% between March 2000 and the end of 2002.

\textsuperscript{46} As has happened in the aftermath of crash of 1929, \textit{cf. supra}.

\textsuperscript{47} \textit{Cf.}, for example, the court orders in the WorldCom and Enron proceedings, \textit{inter alia} WorldCom, Inc. Securities Litigation, 346 F. Supp. 2d 628 (S.D.N.Y. 2004); Newby v. Enron Corp., 235 F. Supp. 2d 549 (S.D. Tex. 2002).
Securities Act of 1933\(^{48}\) and section 10(b) of the Securities Exchange Act of 1934,\(^{49}\) which has to be read in conjunction with Exchange Act Rule 10b-5.\(^{50}\) These provisions will be dealt with in turn. In doing so, the essay does not seek to provide a comprehensive analysis of all elements of the causes of action. It will merely address the issues relevant for gatekeeper liability: the class of defendants (the potential gatekeepers) and the standard of care. Sections 11 and 12 of the Securities Act are restricted to the primary market – they penalise false or misleading statements in the registration statement or prospectus, respectively, or a violation of the requirement to register a security with the SEC before it is offered or sold.\(^{51}\) Section 10(b) of the Securities Exchange Act, on the other hand, is a broad “catch all” provision that is triggered by any type of fraudulent behaviour in connection with the purchase or sale of a security on the primary or secondary market.

\(\text{a. Section 11 Securities Act of 1933}\)

Section 11 of the Securities Act is addressed to the signatories of the registration statement, i.e. the issuer and, \textit{inter alia}, its CEO, CFO, and CAO,\(^{52}\) its directors,\(^{53}\) experts (accountants, engineers, appraisers etc.),\(^{54}\) and the underwriters.\(^{55}\) Thus, even though the gatekeeper theory was developed much later than section 11, the provision uses secondary market actors\(^{56}\) to monitor the primary market participant (the issuer) and ensure its compliance with securities regulation. It divides the defendants into three groups: Liability for the issuer is strict.\(^{57}\) The other defendants may escape liability if they show that they have conducted a reasonable investigation of the registration statement and, after such investigation, had reasonable ground to believe that the documents were correct and complete.\(^{58}\) Finally, as regards defendants other than experts who rely on expertised portions of the registration statement (e.g. the audited accounts of the issuer), all that is necessary is that they had “no reasonable ground to believe and did not believe” that anything contained in the expert opinion was untrue. An independent investigation is not required.\(^{59}\) Therefore, section 11 establishes a “sliding scale

\(^{50}\) 17 C.F.R. § 240.10b-5 (2008).
\(^{52}\) Sections 11(a)(1), 6(a) of the Securities Act.
\(^{53}\) Section 11(a)(2), (3).
\(^{54}\) Section 11(a)(4).
\(^{55}\) Section 11(a)(5).
\(^{56}\) The defendants mentioned in section 11(a)(2)-(5).
\(^{57}\) \textit{Cf.} section 11(b): Persons “other than the issuer” may invoke certain defences.
\(^{58}\) So-called \textit{due diligence defence}, section 11(b)(3)(A), (B).
\(^{59}\) Section 11(b)(3)(C).
of responsibility.” The issuer as the primary originator of the registration documents is held to the highest standards. Experts have to apply their expertise when reviewing the registration statement. Other defendants may assume, at least in respect to expertised portions, that the information stemming from third parties is accurate. The courts have further refined this sliding scale. The first important opinion concerning the due diligence defence emphasised: “It is all a matter of degree.” If a defendant is “directly concerned with writing the registration statement and assuring its accuracy, more [is] required of him in the way of reasonable investigation than [can] fairly be expected of [someone] who [has] no connection with this work.” Furthermore, the requisite level of care depends on the cost involved in verifying the issuer’s disclosures: “To require an audit [might] be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable.” This approach has led courts to draw a distinction between corporate insiders (executive directors) and outsiders (non-executive directors and third parties, e.g. the underwriters), imposing stringent requirements on the former and being more lenient in case of the latter. However, this dichotomy does not change the fact that the “sliding scale” is gradual and that within the two groups of insiders and outsiders the standard of care continues to depend on the specific position of the defendant and his access to the issuer. It can be seen that section 11, as interpreted by the courts, anticipates and epitomises the guiding principles of the gatekeeper theory. Essentially, the courts have adopted a cost-benefit analysis that seeks to determine the efficient measure of precautionary or supervisory activity.

60 COX, HILLMAN & LANGEVOORT, supra note 13, at 503.
61 Reliance on the information of third parties is not reasonable if so-called red flags exist, i.e. if the defendant is aware of events or facts that cast doubt on the accuracy of the information, e.g. if the issuer’s E/R ratio is substantially different than that of competitors or if it employs aggressive accounting techniques. The court in the WorldCom proceedings defined red flags as follows: “Any information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag, whether or not it relates to accounting fraud or an audit failure.” WorldCom, Inc. Securities Litigation, 346 F. Supp. 2d 628, 673 (S.D.N.Y. 2004). “If a ‘prudent man in the management of his own property,’ … would have questioned the accuracy of the figures [in the registration statement], then those figures constituted a red flag.” Id. at 679. Cf. also Software Toolworks Inc. Securities Litigation, 50 F.3d 615, 623-24 (9th Cir. 1994).
63 Id.
64 Id. The remarks of the court in BarChris are as relevant today as they were in 1968. Recently, the suitability of underwriter liability pursuant to the principles of BarChris has been questioned in light of modern practices such as shelf registration and competitive bidding. It is beyond the scope of this article to reproduce these controversies; for a summary and further references cf. WorldCom, 346 F. Supp. at 670-71; Coffee, supra note 6, 52 Bus. Law. 1195.
65 Cf., for example, Feit v. Leasco, 332 F. Supp. 544, 578 (E.D.N.Y. 1971): The liability of inside directors “approaches that of the issuer as guarantor of the accuracy of the prospectus.”
b. Rule 10b-5

The second famous liability provision of U.S. securities regulation is section 10(b) of the Securities Exchange Act of 1934 in conjunction with Exchange Act Rule 10b-5. Unlike section 11 of the Securities Act, section 10(b) Securities Exchange Act and Rule 10b-5 do not define the class of defendants, nor do they specify the elements of the cause of action, in particular the standard of care that the defendant is expected to employ. This is not surprising, as section 10(b) and Rule 10b-5 were not designed as a private cause of action. Rather, they were intended to broaden the powers of the SEC and facilitate public enforcement of the securities laws. The courts, through ingenious interpretation, granted defrauded investors an implied remedy based on Rule 10b-5, a development that was vividly described by Justice (later Chief Justice) Rehnquist: “When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn.” However, the development of the private cause of action under the auspices of the judiciary has proven to be a mixed blessing for investors. In order to limit the risk of liability the Supreme Court has overruled decisions of the lower federal courts that had allowed claims in cases of negligence. Instead, it requires the plaintiff to prove that the defendant acted with scienter. Furthermore, the question of who can be sued under Rule 10b-5 belongs to the most controversial issues of U.S. securities regulation. The relevant criteria have always been vague and ambiguous, they have changed over time, and courts in different federal circuits have followed different approaches.

Leading case is the decision of the Supreme Court in Central Bank. The Court overturned a line of circuit court decisions that had held both primary violators, i.e. persons that committed the fraudulent act themselves, and secondary violators, i.e. persons that aided

66 Cf. Milton Freeman et al., Conference on Codification of the Federal Securities Laws, 22 BUS. LAW 793, 922 (1967): “I never thought that twenty odd years later [Rule 10b-5] would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with [fraudulent behaviour]. It had no relation in the Commission’s contemplation to private proceedings.”
67 The first decision to construe Rule 10b-5 in this way was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).
69 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The Court defines scienter as “a mental state embracing intent to deceive, manipulate, or defraud.” Id. at 193 n.12. The lower courts have somewhat relaxed the standard of the Supreme Court and held that recklessness is sufficient, i.e. “those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it”, Broad v. Rockwell Intern. Corp., 642 F.2d 929, 961-962 (5th Cir. 1981). Similar Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977).
and abetted the primary violator (possible gatekeepers), responsible.\textsuperscript{71} It limited liability to primary violators, thus consolidating a trend to restrict the scope of Rule 10b-5.\textsuperscript{72} The main reason for the turnaround of the Court was its fear of vexatious litigation. The unclear principles of aiding and abetting liability made the outcome of lawsuits unpredictable. In addition, the inquiries were highly fact-oriented; a motion for summary judgement was therefore unlikely to be successful. As a result, parties might have found it prudent, “as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial.”\textsuperscript{73} However, in one of the last paragraphs of the judgement the Court opened the door again to the potential liability of gatekeepers: “The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the Securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.”\textsuperscript{74}

The courts have been unsure how to implement the standards established by the Supreme Court. Some purport to apply \textit{Central Bank} literally and require that the defendant actually made the false or misleading statement that gave rise to the claim under Rule 10b-5 (so-called \textit{bright line test}).\textsuperscript{75} However, they somewhat depart from this clear rule by allowing the claim to be brought against a person other than the one who communicated the misleading statement to plaintiffs, provided that the secondary actor “controlled the content of the

\textsuperscript{71} The elements for a cause of action for aiding and abetting were: “(1) the existence of an independent wrong, (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it, and (3) substantial assistance in the wrong.” Roberts v. Peat, Marwick, Mitchell & Co., 857 F.2d 646 (9th Cir. 1988). Similar Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985); Moore v. Fenex, Inc., 809 F.2d 297 (6th Cir. 1987); Rudolph v. Arthur Andersen & Co., 800 F.2d 1040 (11th Cir. 1986). For further references \textit{cf.} THOMAS L. HAZEN, \textsc{Securities Regulation} § 12.25[4] n.103 (5th ed. 2006 & supp. 07/2008). The precise reach of the elements was unclear, \textit{cf. id.} at § 12.25[4][A], [B] (knowledge of the wrong), § 12.25[4][C] (substantial assistance).

\textsuperscript{72} \textit{See infra} IV 1.

\textsuperscript{73} \textit{Central Bank}, 511 U.S. at 189.

\textsuperscript{74} \textit{Id.} at 191.

\textsuperscript{75} Shapiro v. Cantor, 123 F.3d 717 (2d Cir. 1997), quoting In re MTC Elec. Techs. Shareholders Litig., 898 F. Supp. 974, 987 (E.D.N.Y. 1995), and Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226-27 (10th Cir. 1996): “[I]f Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b). … [W]e conclude that in order for [secondary participants] to ‘use or employ’ a ‘deception’ actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.” Similar Seippel v. Sidley, Austin, Brown & Wood, LLP, 399 F. Supp. 2d 283, 292-95 (S.D.N.Y. 2005); In re Rent-Way Securities Litigation, 209 F. Supp. 2d 493, 502-5 (W.D. Pa. 2002).
statement”76 or “knew or should have known that his representation would be communicated to [and relied upon by] investors”77. Other courts approach the legal situation before Central Bank in a more undisguised manner. They hold responsible as primary violator everybody who has “played a significant role”78, “a central role”79, who was “intricately involved”80, who “actively participated”81 in the making, or who can be seen as “the ‘author’ or ‘co-author’ of the statement”82. Issuers may be liable for misleading statements by analysts if they “entangled” themselves in the fraudulent acts of the analysts.83 As opposed to the bright line test, the misrepresentation does not have to be attributable to the defendant. For example, intermediaries that have not signed the prospectus and are not identified in it may be held responsible for incorrect information prepared by them. Finally, in recent decisions courts seem ever more prepared to accept claims against secondary actors. In the Enron proceedings, the court declared: “[W]hen a person, acting alone or with others, creates a misrepresentation . . ., the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter. . . . Provided that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else.”84 The court did not specify when a person can be seen as the “creator” of a misstatement. Although it ostensibly applied Central Bank,85 it held all intermediaries responsible86 that acted with the required scienter.87

77 Anixter, 77 F.3d at 1226 (liability of accountant who issued certifications and opinion letters regarding the issuer’s financial data that were reproduced in prospectuses, annual reports, registration statements, and other promotional material). The court acknowledges itself that, under this interpretation, the Supreme Court’s rule is “far from a bright line”; id. at 1227.
78 In re Software Toolworks, Inc. Securities Litig., 50 F.3d 615, 628 n. 3 (9th Cir.1994).
83 Cf. In re Boston Technology, Inc. Securities Litigation, 8 F. Supp. 2d 43, 55 (D. Mass. 1998); „[A]n issuer may be liable under the statute for failure to correct an analyst statement [if] . . . (1) the issuer ‘entangled’ itself in the making of a statement by the analyst; (2) the issuer knew that the statement (commonly a prediction) was false or lacked a reasonable factual basis when made; and (3) the issuer failed to disclose the falsity or the unreasponsability to investors. . . . The element of entanglement may be satisfied by the issuer having either ‘fostered,’ ‘induced,’ or otherwise caused the statement to be made in the first place, or having adopted, ratified, or otherwise ‘endorsed’ the statement after it was made.” See also Pilarczyk v. Morrison Knudsen Corp., 965 F. Supp. 311, 320 (N.D.N.Y. 1997); Shuster v. Symmetricon, Inc., 1997 WL 269490, at 7 (N.D. Cal. 1997); Weisburgh v. St. Jude Medical, Inc., 158 F.R.D. 638, 644 (D. Minn. 1994).
85 Cf. id. at 585.
86 It should be noted that the decision was an order concerning motions to dismiss of the defendant intermediaries. Therefore, the court did not hear evidence. It had to accept as true all well-pleaded factual allegations in the complaint and decide on that basis whether the plaintiff was entitled to relief, cf. id. at 564 n.3. In a full trial on the merits, the court’s assessment of the intermediaries’ status as primary violators might well have been different. However, the defendants settled before the proceedings could advance to that stage.
even if their participation was not revealed to the public and did not consist in more than providing “advice” in the structuring of certain transactions that constituted a deceptive device within the meaning of section 10(b) or making loans to or investing otherwise in entities that were engaged in illicit activities. These acts come close to classical aiding and abetting behaviour. The border between primary and secondary violators has become blurred, and legal uncertainty has reached, if not surpassed, pre-Central Bank levels.

In light of the ambiguous legal situation it is not surprising that the considerations of the gatekeeper theory are not reflected as clearly in the structure of section 10(b) as they are in that of section 11 of the Securities Act. According to the interpretation of the Supreme Court, gatekeepers can only be liable as primary violators. This is not satisfactory, as gatekeepers are precisely in the position of secondary market participants that verify the acts of the primary participant. The lower courts have realised that adequate results cannot be reached by way of a literal application of Central Bank. All of the opinions outlined above allow for certain exceptions that are intended to bring secondary actors within the reach of section 10(b). However, the courts are hindered in discussing and implementing the principles of gatekeeper liability by the necessity not to contradict the binding holding of the Supreme Court. Thus, the decisions focus on questions such as who can be seen as the “author or co-author” of the misleading statement, who has played “a central role” in drafting it or “controlled its content” rather than trying to identify the intermediaries that are able to monitor the primary actor in the most efficient way. In other words: The criteria that should govern the construction of the liability provision are obscured by the failure of the legislator and the judiciary to acknowledge that the issue at hand is one of gatekeeper liability.

c. Section 12(a) Securities Act of 1933

As opposed to the two provisions that have been discussed supra, section 12(a)(1) of the Securities Act does not constitute an antifraud provision; it does not serve the goal of restitution for the benefit of defrauded investors but deterrence. The structure of the provision is simple: All offerors and sellers of securities are liable for damages if they do not

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87 While the complaint failed to state a securities violation under section 10(b) in respect to three investment banks, the court did not consider the involvement of the banks insufficient to cross the threshold of primary violation but rejected the claims because the subjective element of section 10(b) was not present, id. at 703-704.  
88 Id. at 704 (liability of Enron’s legal counsel).  
89 Id. at 696, 698, and passim (liability of the investment banks).  
90 LOSS & SELIGMAN, supra note 39, § 11-C-2 a (i).
comply with the registration or prospectus delivery requirements of the Securities Act. Accordingly, prima facie section 12(a)(1) is not concerned with gatekeeper liability. It intends to punish a violation of the registration and prospectus requirements by holding responsible the addressees of these requirements, i.e. the primary actors. Again, case-law has obfuscated the seemingly clear rule. Initially, the courts were split on the construction of the terms “offeror” and “seller”. The narrow view required strict contractual privity between seller and buyer, thus shielding most financial intermediaries from liability. The opposing view considered as seller/offeror not only the owner but also a third party who acted as agent for the owner and actively participated in the solicitation or implementation of the agreement or, more restrictively, who set a direct and proximate cause for the injury to the plaintiff or was sufficiently close to the transaction to be able to obtain information relevant to the buyer. The Supreme Court overruled the decisions of the lower federal courts and held in the leading case Pinter v. Dahl: “Seller” within the meaning of section 12(a)(1) “is not limited to an owner who passes title, … but extends to a broker or other person who successfully solicits a

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91 The requirements are stated in section 5 of the Securities Act: An offer to sell a security may only be made after the registration statement has been filed, section 5(c). It may not be transmitted unless in the form of a prospectus within the meaning of section 10, cf. section 5(b)(1). Finally, the sale may not be executed before the registration statement has become effective, section 5(a).

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


94 Lennerth v. Mendenhall, 234 F. Supp. 59, 65 (N.D. Ohio 1964), asks: “But for the presence of the defendant […] in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have materialized without the efforts of that defendant, we must find him guilty.” See also Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). This test, sometimes referred to as the “proximate cause test”, cf. J. William Hicks, Civil Liabilities: Enforcement & Litigation Under The 1933 Act § 5:24 (supp. 11/2008), takes the middle ground between the restrictive view and the participation test. However, it lead to problems when courts, in applying the precedents, defined all actions as “proximate” that were a “substantial factor” in bringing about the securities transaction, Lewis v. Walston & Co., 487 F.2d 617, 622 (5th Cir. 1973). They soon faced the issue of how to give the term “substantial” clear contours: “Mere participation in the events leading up to the transaction is not enough. But beyond the words ‘substantial factor,’ we have no guideposts other than the factual situations presented in [the case law]”, Pharow v. Smith, 621 F.2d 656, 667 (5th Cir. 1980). The test of the Ninth Circuit is similar, cf. S.E.C. v. Murphy, 626 F.2d 633, 649-50 (9th Cir. 1980); Anderson v. Aurotek, 774 F.2d 927, 930 (9th Cir. 1985).

95 By focussing on the position of the defendant in respect to the transaction and, hence, the primary violator (the seller), this approach is in accordance with the considerations of the gatekeeper theory, cf. Wasson v. SEC, 558 F.2d 879, 886 (8th Cir. 1977): “The Securities Act of 1933 was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce. … To accomplish this end, registration and disclosure requirements were imposed on those with access to relevant information. … [O]ne factor which ought to be considered in determining the ‘sale’ or ‘offer to sell’ issue is whether the defendant was uniquely positioned to ask relevant questions, acquire material information, or disclose his findings.”

purchase of securities, so long as he is motivated at least in part by a desire to serve his own financial interests or those of the securities owner.”

The test for third party liability, therefore, consists of two parts: The third party must have solicited the securities transaction, e.g. urged the investor to make a purchase, and expect to receive a financial benefit.

On this basis, some of the potential gatekeepers fall within the scope of section 12(a)(1). The underwriters can be liable if they are in contact with the investors and promote the offering, either by direct personal or telephone contact or by participating in road shows and placing their name on the securities prospectus or other advertising material. The same considerations apply to brokers and dealers. Other parties, however, that might function as gatekeepers, are, in general, not encompassed by the Pinter definition of “seller”, at least not by virtue of their position as directors, officers, lawyers, auditors or experts. Consequently, as in the case of section 10(b) of the Securities Exchange Act, liability under section 12(b) does not depend on the gatekeeper’s capability to ensure compliance with the

97 Pinter, 486 U.S. at 647.
98 Id. But cf. also Wilson v. Saintine Exploration and Drilling Corp., 872 F.2d 1124, 1126 (2d Cir. 1989): Legal counsel for the issuer whose participation in the sale consists solely of “mailing a copy of the private placement memorandum” or who has “performed only [its] usual professional functions in preparing documents for an offering” cannot be held liable as a seller. Likewise, participation in a sales presentation in a subordinate capacity without directly speaking to the investors is not sufficient to establish a claim, In re Gas Reclamation, Inc. Securities Litigation, 733 F. Supp. 713, 723 (S.D.N.Y. 1990). On the other hand, a more active role during an investment seminar, for example recommending investment opportunities, will give rise to liability, Flournoy v. Peyson, 701 F. Supp. 1370, 1373, 1379 (N.D. Ill. 1988).
99 The financial benefit may stem from the proceeds of the transaction, e.g. consist in a share of the profits or a commission, Pinter, 486 U.S. at 654. Alternatively, it may be of a more indirect nature, such as the benefits that shareholders or managers receive from a sale of the corporation’s shares, Cook v. Goldman, Sachs & Co., 726 F. Supp. 151, 155 (S.D. Tex. 1989); In re Keegan Management Co. Securities Litigation, 1991 WL 253003, at 8 (N.D. Cal. 1991) (for instance protection of the manager’s executive positions; enhancement of the value of the defendant’s holding). Finally, the rendering of gratuitous investment advice may support a claim under section 12(a)(1) if the defendant intends to serve the financial interests of the securities owner (not the buyer), Pinter, 486 U.S. at 655. The reach of this qualification is unclear. Any assistance in the sales efforts of the owner furthers the owner’s financial interests; in order for the liability threat not to be limitless, the assistance must reach some level of intensity. However, the Supreme Court is silent on this matter.
100 Both in a firm commitment and a best efforts underwriting.
101 Moore v. Kayport Package Exp., Inc., 885 F.2d 531 (9th Cir. 1989).
102 Depending on the facts of the case, they may, of course, fall under the Pinter definition if they display solicitation efforts and pursue their (or the securities owner’s) financial interests. But the exercise of their professional duties without more does not, according to most courts, constitute a claim under section 12(a)(1). For example, directors and officers who prepare the public offering documents, sign them and cause them to become effective are not statutory “sellers”, In re Infonet Services Corp. Securities Litigation, 310 F. Supp.2d 1080, 1101 (C.D. Cal. 2003); In re Worlds of Wonder Securities Litigation, 694 F. Supp. 1427, 1435 (N.D. Cal. 1988); Jackson v. First Federal Sav. of Arkansas, F.A., 709 F. Supp. 863, 884 (E.D. Ark. 1988). Neither are lawyers or accountants who give legal advice, draft the registration statement, or prepare an audit opinion, Moore v. Kayport Package Exp., Inc., 885 F.2d 531, 538 (9th Cir. 1989); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1114-15 (5th Cir. 1988); In re Worlds of Wonder Securities Litigation, id. For more information see HICKS, supra note 94, § 6:101 (liability of directors and officers), § 6:103 (attorneys), § 6:104 (accountants), § 6:105 (banks and other finance companies).
applicable regulatory requirements (here: section 5 of the Securities Act\textsuperscript{104}) by the securities owner, but on a restrictive construction of the provision that is intended to compensate for the overly broad elements of the cause of action.\textsuperscript{105}

Section 12(a)(2) of the Securities Act provides for liability in case of untrue statements in the securities prospectus. The class of defendants is identical to that of section 12(a)(1).\textsuperscript{106} The gatekeeper problem, however, presents itself in a different fashion. As pointed out, section 12(a)(1) holds liable both the owner and some of the financial intermediaries as offerors or sellers. Since all offerors/sellers are addressees of section 5, all of the defendants can, at least in some formal sense of the term, be described as primary market participants, notwithstanding their role as intermediaries that facilitate the sales efforts of the owner.\textsuperscript{107} In section 12(a)(2), on the other hand, the offeror/seller is in the position of a genuine gatekeeper. Liability attaches to the offer or sale by means of a prospectus that contains an untrue statement or a material omission. The defendant will often be an underwriter, dealer or broker. Accordingly, the statute uses a third party who is not the author to review the accuracy of the prospectus and protect investors by refraining from effectuating the transaction in case the documents do not conform to legal requirements.

However, the principles that ensure the efficiency of gatekeeper liability as a regulatory instrument are only imperfectly embodied in section 12(a)(2). The provision does not distinguish between different types of defendant and does not establish a sliding scale of responsibility comparable to that of section 11 in order to allow for differences as far as access to the source of the information is concerned. Some modicum of case-by-case adjustment in light of the position of the defendant is achieved by means of the so-called \textit{defence of due care} in section 12(a)(2): The defendant shall not be liable if he can prove that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. The courts draw a parallel to the due diligence defence of section 11(b)(3). According to the leading decisions, the required standard of care depends on the type of defendant, its relationship to the source of the information (in particular the issuer) and to the

\textsuperscript{105} Section 12(a)(1) does not require the plaintiff to show more than that the defendant was a seller and that he violated section 5. The defences of section 12(b) or section 11(b) are not at the defendant’s disposal (in exceptional circumstances the courts permit the defendant to invoke in pari delicto, cf. Pinter, 486 U.S. at 632-41; Hazen, supra note 71, § 7.2[1]). Thus, commentators have observed that liability pursuant to section 12(a)(1) is “close to absolute”, LOSS & SELIGMAN, supra note 39, § 11-C-2.
\textsuperscript{106} The majority of lower courts applies the Pinter-principles in an identical way to both subsections, \textit{e.g.} Capri v. Murphy, 856 F.2d 473, 478 (2d Cir. 1988); Craftmatic Securities Litigation v. Kraftsow, 890 F.2d 628, 634-35 (3d Cir. 1989); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1115 (5th Cir. 1988); Smith v. American Nat. Bank and Trust Co., 982 F.2d 936, 941-42 (6th Cir. 1992); Ackerman v. Schwartz, 947 F.2d 841, 844 (7th Cir. 1991); Moore v. Kayport Package Exp., Inc., 885 F.2d 531, 536 (9th Cir. 1989); Ryder Intern. Corp. v. First American Nat. Bank, 943 F.2d 1521, 1527 (11th Cir. 1991).
\textsuperscript{107} The latter defendants could be characterised as secondary market actors, i.e. gatekeepers, in a material sense.
investor, the degree of involvement in the transaction, and the reliance on officers, experts, and others that have drawn up parts of the prospectus. But considerable uncertainty remains. Where section 11(b)(3) specifies that the duty to conduct an independent investigation does not apply in respect to expertised portions of the registration statement, section 12(a)(2) is silent. By allowing exceptions from the requirement to register a security, the Securities Act implies that the level of investor protection should be higher in some transactions than in others. Since section 12(a)(2) comprises registered as well as unregistered securities, the standard of care in that provision is, arguably, lower than that under section 11. However, the precise differences in the contours of gatekeeper liability remain undetermined.

d. Summary

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


Furthermore, the relationship between the different liability provisions under the Securities Act and the Securities Exchange Act is not conclusively resolved.\footnote{Cf. for example Herman & MacLean v. Huddleston, 459 U.S. 375, 380-87 (1983); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-11 and passim (1976).}

2. English Law

a. Prospectus liability

An important feature of the British regulatory system is the employment of sponsors or (when listing on AIM) nominated advisers (nomads), both of them in general investment banks, that monitor the compliance of the issuer with the regulations promulgated by the FSA. On the primary market, the issuer has to appoint a sponsor if it applies for a listing of its equity securities on a regulated market.\footnote{FSA Listing Rules (LR) 8.2.1. An issuer listed on AIM has to retain a nominated adviser at all times, cf. Rule 1 of the AIM Rules for Companies.} The sponsor’s role is to provide assurance to the FSA that the issuer’s responsibilities under the listing rules have been met and to guide the issuer in understanding and meeting its responsibilities.\footnote{LR 8.3.1.} If a prospectus has to be published, the sponsor is expected to make due and careful enquiry that the prospectus conforms to regulatory requirements.\footnote{LR 8.4.2, 8.4.8.} In order to ensure the effectiveness of the sponsor (or nomad) as a tool of securities regulation, the FSA has set up rules on the independence and qualifications of the intermediary.\footnote{Most importantly, an investment bank shall not act as sponsor if it has a significant interest in the equity or debt securities of the issuer or if a director or employee of the sponsor who is involved in the provision of the services has a material interest in the issuer, LR 8.3.6. Criteria for approval as a sponsor are laid down in LR 8.6.} Furthermore, it supervises the sponsor and may impose sanctions if the sponsor is in breach of the applicable regulations.\footnote{LR 8.7.}

Supervision of sponsors by the regulator might not be effective,\footnote{Cf. the critical analysis in COFFEE, GATEKEEPERS, supra note 6, at 338-40.} and secondary market participants other than sponsors may, in certain situations, be in an equally good or better position than investment banks to function as gatekeepers. Consequently, the main avenue for third party enforcement of securities regulation in the UK is, as in the United States, through the adoption of incentive creating liability provisions.\footnote{The FSA has powers to take regulatory action against secondary participants that have been “knowingly concerned” in a contravention of the requirements of the FSMA by a primary addressee of the Act, cf. sections 66(2)(b), 91(2), 97(1)(b), (c), 380(2), (3)(b), 382(1), 384(1) Financial Services and Markets Act 2000. As this essay focuses on private enforcement, the concept of “knowingly concerned” will not be further discussed. For a detailed analysis cf. Eva Z. Lomnicka, Placing Bankers in the Front Line: The Secondary Liability of Bankers for Their Customers’ Regulatory Contraventions, J.F.C. 2005, 12(3), 200.} Liability for misstatements and omissions on the primary market is dealt with by section 90 of the
FSMA\textsuperscript{119} and the implementing legislation.\textsuperscript{120} The provision is structurally comparable to section 11 of the Securities Act of 1933, which does not come as a surprise as the Securities Act is based on the English Companies Act of 1929 that contained the predecessor of section 90 FSMA. Some notable differences, however, exist.

Section 90 applies to misstatements in the prospectus or the listing particulars,\textsuperscript{121} not to advertisements or the admission document required for an AIM listing.\textsuperscript{122} In case of an equity issue, the responsible persons include the issuer, the issuer’s directors, each person who accepts responsibility for the prospectus or authorises its contents, and the offeror if not identical with the issuer.\textsuperscript{123} The enumeration evidently aims at both primary and secondary market participants. However, it does so in a rather obscure manner. Persons who “accept responsibility for the prospectus”\textsuperscript{124} are often the experts, for example the reporting accountants. On the other hand, the prospectus rules stipulate that a person shall not be responsible solely by giving advice in a professional capacity.\textsuperscript{125} This is commonly interpreted to exclude the lawyers, although the precise reach of the provision is unclear. The work of the solicitors could be regarded as consisting not only of rendering advice but also arranging the offering;\textsuperscript{126} conversely, the exception might be extended to other intermediaries, e.g. investment banks that do not underwrite securities but advise on the transaction.

Underwriters as one of the most important types of gatekeeper\textsuperscript{127} are not expressly mentioned as defendants. In theory, three of the above groups of responsible persons are sufficiently broadly drafted to comprise the underwriters: those who accept responsibility for the prospectus,\textsuperscript{128} who authorise its content,\textsuperscript{129} and who offer the securities.\textsuperscript{130} Responsibility can be accepted by a declaration to that effect in the prospectus. In practice, generally only the issuer and its directors accept responsibility. As far as the second alternative (authorisation) is concerned, the prospectus rules state that the defendant must have authorised the contents of the prospectus. This is a change from the legal situation under the Companies Act 1985,

\footnotesize{119 Financial Services and Markets Act 2000 (c. 8).
120 Schedule 10 adopted under section 90(2) and (5) of the FSMA; FSA Prospectus Rules (PR) 5.5 (for prospectuses); FSMA 2000 (Official Listing of Securities) Regulations 2001 (SI 2001/2956), reg. 6 (for listing particulars).
121 Listing particulars have to be published for certain types of securities for which a prospectus is not required under the Prospectus Directive, cf. section 79 FSMA and Schedule 11A, LR 4.
122 This seems to be the prevailing opinion, cf. PAUL L. DAVIES, GOWER & DAVIES’ PRINCIPLES OF MODERN COMPANY LAW para. 25-32 (8th ed. 2008).
123 PR 5.5.3.
124 PR 5.5.3(2)(c).
125 PR 5.5.9.
126 DAVIES, supra note 122, para. 25-34.
127 See infra IV 2.
128 PR 5.5.3(2)(c).
129 PR 5.5.3(2)(f).
130 PR 5.5.3(2)(d)(i).}
which referred to the issue of the prospectus.\textsuperscript{131} Under the old law, signing the prospectus could be qualified as the act of authorisation. Now some relation to the information contained in the prospectus is required. But the extent of the involvement is not defined. According to some commentators, mere participation in the preparation is not sufficient.\textsuperscript{132} This must rule out liability of ordinary members of the underwriting syndicate that do not, in general, exercise much control over the content of the prospectus. Even liability of the lead underwriter or the investment bank that is appointed as sponsor (usually a member of the underwriting syndicate) is questionable.\textsuperscript{133} The last of the groups of possible defendants poses equally intricate problems. Whether the underwriters fall under the term “offeror” is an “unanswered and generally unasked question”\textsuperscript{134}. Offeror is the person who makes the offer to the public.\textsuperscript{135} This will commonly be the underwriters,\textsuperscript{136} unless they do not communicate with investors but use a group of selling agents. The scope of the provision has been restricted through a subsequent amendment,\textsuperscript{137} which stipulates that the offeror is not liable if “the issuer is responsible for the prospectus …; the prospectus was drawn up primarily by the issuer, or by one or more persons acting on behalf of the issuer; and the offeror is making the offer in association with the issuer.”\textsuperscript{138} The amendment fits the underwriters who conduct the offering in collaboration with the issuer. However, the question remains, when is the prospectus “drawn up primarily by the issuer” so as to exclude underwriter liability? In particular the lead underwriter is often extensively involved in the drafting of the offering documents. Guidance on this issue is not available.\textsuperscript{139}

The defences available under section 90(2) FSMA and Schedule 10 to the FSMA exhibit further similarities of the English provision and its U.S.-American counterpart. The

\textsuperscript{131} Section 67(2)(d) Companies Act 1985 (c. 6).
\textsuperscript{135} FSA Handbook Glossary.
\textsuperscript{136} It is not clear whether the underwriters would need to purchase the securities in order to be qualified as offerors (as can happen – but does not necessarily need to happen – in a firm commitment underwriting), or whether acting as an agent, as in a best efforts underwriting, is sufficient. Cf. BARRY A. K. RIDER, CHARLES ABRAMS & MICHAEL ASHE, GUIDE TO FINANCIAL SERVICES REGULATION ¶823 (3d ed. 1997).
\textsuperscript{137} The original provision stems from the Financial Services Act 1986 and the Public Offers of Securities Regulations 1995 (SI 1995/1537), reg. 13, which were amended in 1999 in a way that corresponds to the prospectus rules in force today.
\textsuperscript{138} PR 5.5.7.
\textsuperscript{139} Cf. Gleeson & Bloomenthal, supra note 134, § 36:48, who remark succinctly: “[W]hether a prospectus has been prepared ‘primarily’ by the issuer could raise some interesting questions.”
defendant does not incur liability if he “reasonably believed” that the incorrect statement was
ttrue and not misleading and if he “made such enquiries, if any, as were reasonable” to verify
the correctness of the prospectus.\textsuperscript{140} The standard of care is reduced if the incorrect statement
is contained in an expert’s opinion: \textsuperscript{141} It is sufficient that the defendant “reasonably believed
that the other person [the author] was competent to make or authorise the statement, and had
consented to its inclusion in the form and context in which it was included.”\textsuperscript{142} Interestingly,
the defendant’s belief does not need to relate to the content of the statement, i.e. the provision
does not require that the defendant had reasonable ground to believe that the prospectus was
accurate, as is the law under section 11 of the Securities Act of 1933.\textsuperscript{143} Arguably, belief in
the competence of the expert is a less exacting standard than the requirement to reflect on the
accuracy of the information itself. The person responsible for the prospectus might have been
able to discover the mistake without further enquiries simply by studying the information
provided by the expert. Exculpation in such cases is hardly justified. Neither the regulator nor
the courts have addressed this inconsistency or have endeavoured to define the terms
“reasonable believe” and “reasonable enquiries”.

\textbf{b. Deceit and negligent misrepresentation}

Section 90 FSMA does not exclude remedies that exist under common law.\textsuperscript{144} For
misstatements in publications that fall outside the scope of section 90 (in particular the
admission document for AIM and communications with the investing public that are not made
in the form of a prospectus or listing particulars, for example promotional material or
communications on the secondary market) common law might provide the only remedies.
Historically, the tort of deceit and fraudulent misrepresentation was the exclusive remedy
available to investors that sought relief against a defendant that was not a party to the contract
with the claimant.\textsuperscript{145} While such a claim may be brought against the issuer as well as its
directors, the underwriters, and experts whose reports are included in the prospectus,\textsuperscript{146}
investors face high hurdles to recovery. They have to show that the defendant has knowingly
made a false representation or has been reckless, i.e. careless as to whether the representation

\textsuperscript{140} Schedule 10, section 1(2).
\textsuperscript{141} Definition of “expert” in Schedule 10, section 8.
\textsuperscript{142} Schedule 10, section 2(2).
\textsuperscript{143} ALCOCK, supra note 133, para. 12.4.2.
\textsuperscript{144} Section 90(6).
\textsuperscript{145} Cf. Collins v. Associated Greyhound Racecourses Ltd [1930] 1 Ch. 1 regarding the limits of contractual
remedies.
is true or false.\textsuperscript{147} Belief in the truth of the statement will exculpate the defendant even if the belief is not based on reasonable grounds. Furthermore, where the incorrect statement has been made to a person other than the plaintiff (for example to the original allottees in a case brought by a purchaser in the aftermarket) the claim will only be successful if the defendant intended the claimant to act on the statement.\textsuperscript{148} Finally, the plaintiff needs to show that he relied on the misrepresentation, which the courts hold as meaning that the defendant’s conduct was one of the factors inducing the plaintiff to act as he did.\textsuperscript{149}

The restrictive legal situation under the traditional common law has led the House of Lords to refine \textit{Derry v. Peek} in 1964, holding that liability for misstatements does not only exist in cases of fraud (deceit) but also in cases of negligence.\textsuperscript{150} In accordance with general principles of negligence, the claimant needs to establish that the defendant owed him a duty of care and that he breached that duty.\textsuperscript{151} It is problematic whether and to which extent such a duty exists in the financial markets. As a general rule, the author of the misleading statement must know that the statement will be communicated to the recipient in order that it should be used for a specific purpose and that it is likely to be acted upon by the recipient for that purpose.\textsuperscript{152} Two decisions of the Chancery Division of the High Court have applied this rule in a seemingly contradictory way to offerings of securities. The first, \textit{Al Nakib Investments (Jersey) Ltd v Longcroft},\textsuperscript{153} relating to a rights issue, rejected the notion of a proximate relationship between the issuer and purchasers on the open market because, as the court argued, the prospectus was addressed to the shareholders solely for the purpose of enabling them to consider the rights issue.\textsuperscript{154} The second case, \textit{Possfund Custodian Trustee Ltd. v. Diamond},\textsuperscript{155} decided a few years later, took a broader view: The purpose of a prospectus might have traditionally been the information and encouragement of the original allottees. However, in light of changed market practices the information was now generally also directed at aftermarket purchasers.\textsuperscript{156} Thus, the duty of care recognised by common law

\textsuperscript{147} \textit{Derry v. Peek} (1889) L.R. 14 App. Cas. 337, 374 (misleading statement in a prospectus of a tramway company for the sale of shares).

\textsuperscript{148} \textit{Cf.} \textit{Peek v Gurney} (1873) L.R. 6 H.L. 377 for a case where the claim of a purchaser in the aftermarket was rejected and \textit{Andrews v Mockford} [1896] 1 Q.B. 372 for a case where it succeeded.

\textsuperscript{149} \textit{Cf. SIMON DEAKeIN ET AL., MARKESiNiS AND DeAKeIN’S TORT LAW 504-05 (5th ed. 2003)} for references.

\textsuperscript{150} \textit{Hedley Byrne & Co Ltd v Heller & Partners Ltd} [1964] A.C. 465.

\textsuperscript{151} The duty of care comprises three elements: (1) foreseeability of damage, (2) relationship of proximity between the party owing the duty and the party to whom the duty is owed, and (3) fairness, justice and reasonableness of the imposition of the duty, \textit{cf.} for example \textit{Caparo Industries Plc v. Dickman} [1990] 2 A.C. 605; \textit{ANTHONY M. DUGDALE ET AL., CLERK & LINDSELL ON TORTS} para. 8-15 (19th ed. 2006).

\textsuperscript{152} \textit{Caparo} [1990] 2 A.C. at 638.

\textsuperscript{153} \textit{[1990]} 1 W.L.R. 1390.

\textsuperscript{154} \textit{Id.} at 1399.

\textsuperscript{155} \textit{[1996]} 1 W.L.R. 1351

\textsuperscript{156} \textit{Id.} at 1365-66.
assumed contours that are substantially equivalent to those of the duty under section 90 FSMA.\textsuperscript{157} The court suggested that the rule in \textit{Al Nakib Investments} should be reviewed,\textsuperscript{158} and parts of the academic literature agree that the law as expressed in \textit{Possfund} is more in line with current regulatory demands and philosophies.\textsuperscript{159} If this view is correct, the tort of negligent misrepresentation provides a comprehensive liability provision for communications on the primary market. On the secondary market, it might be possible to establish liability under this notion as well, albeit the requirement that the defendant expected the plaintiff to rely on the communication will provide a greater obstacle as statements will typically not be as all-inclusive as primary market disclosures and will often not have been made with the intention to induce investment decisions.\textsuperscript{160} Notwithstanding this ambiguity, the relevance of the tort of negligent misrepresentation will remain limited for another reason. As opposed to an action under section 90 FSMA, the plaintiff in a claim under common law must show that he relied on the material representation and believed that the defendant intended him to act upon it.\textsuperscript{161}

c. Summary

Section 90 FSMA incorporates some considerations of the gatekeeper theory by including secondary market participants – most notably the underwriters and experts – as potential defendants. However, the provision is characterised by a great degree of legal uncertainty. It is vague in respect to the parameters of gatekeeper liability, and almost every aspect of the prospectus rules defining the class of responsible persons is highly ambiguous.\textsuperscript{162} As has been shown, the torts of deceit and negligent misrepresentation do not constitute genuine gatekeeper provisions. They are addressed to the tortfeasor only, i.e. to the primary actor. A

\begin{itemize}
\item \textsuperscript{157} \textit{Id.} at 1365.
\item \textsuperscript{158} \textit{Id.} at 1366.
\item \textsuperscript{159} DAVIES, supra note 122, para. 25-37; MORSE, supra note 146, para. 5.797.
\item \textsuperscript{160} Pursuant to section 90A(6) FSMA claims based on the tort of negligent misrepresentation against the issuer and other persons are excluded within the scope of section 90A (i.e. if the issuer’s securities are traded on a regulated market and if the misrepresentation is contained in one of the periodic disclosures required under articles 4, 5 or 6 of the Transparency Directive: in the annual or half-yearly financial report or an interim management statement). Liability under section 90A FSMA is restricted to fraudulent acts (section 90A(4): the defendant must have known that the statement was untrue or he must have been reckless to that effect) and to claims against the issuer. The issuer does not need to expect the plaintiff to rely on the disclosure, but the plaintiff must have relied on it and reliance must have been reasonable, section 90A(5). For other communications, for example the episodic (ad-hoc) disclosures required pursuant to article 6 Market Abuse Directive, the torts of misrepresentation and deceit can be invoked against all tortfeasors.
\item \textsuperscript{161} Possfund Custodian Trustee Ltd. v. Diamond [1996] 1 W.L.R. 1351, 1364.
\item \textsuperscript{162} PR 5.5.3.
\end{itemize}
general rule of secondary liability is alien to English tort law.\textsuperscript{163} Accordingly, the situation is comparable to that under section 10(b) of the Securities Exchange Act 1934 after \textit{Central Bank}, albeit without the attempts of the courts to extend the class of defendants to secondary participants. As a result, there is little authority on the question of when an intermediary can be considered as the author or originator of the incorrect statement, an issue that has created considerable confusion in U.S. law.

3. \textit{German Law}

Two provisions shall be discussed that potentially impose liability on primary and secondary participants in the financial markets and that might, accordingly, be used to establish incentive structures conducive to gatekeeper liability: The statutory prospectus liability provision, sections 44, 45 of the Stock Exchange Act (BörsG),\textsuperscript{164} and liability for intentional damage contrary to public policy pursuant to section 826 of the Civil Code (BGB).\textsuperscript{165}

\textbf{a. Statutory prospectus liability}

Section 44 Stock Exchange Act grants a claim for compensation if securities have been admitted to stock exchange trading on the basis of a prospectus that contained a material misstatement. Defendants are “those having assumed responsibility for the prospectus”\textsuperscript{166} and “those initiating the issue of the prospectus”\textsuperscript{167}. The interpretation of these indefinite concepts contains the key to gatekeeper liability pursuant to sections 44, 45. The reach of both elements is controversial. The first – assuming responsibility for the prospectus – is commonly construed as encompassing the signatories of the prospectus and those making a declaration

\textsuperscript{163} Credit Lyonnais Bank Nederland N.V v. Export Credits Guarantee Department [2000] 1 A.C. 486, 497-500 Limited exceptions exist for the economic torts (inducing breach of contract, fiduciary duty, and statutory duty) and for assistance in the breach of trust. References in Lomnicka, \textit{supra} note 118, at 202, and \textit{DEAKIN ET AL.}, \textit{supra} note 149, at 856-58.


\textsuperscript{165} Law of August 18, 1896, RGBl. [Imperial Law Gazette] at 195, as amended and promulgated on January 2, 2002, BGBl. I, at 42. The general provision of German tort law, section 823(1) of the Civil Code, does not give rise to claims for pure economic loss and can therefore not be utilised in this context. Other liability provisions exist that apply when statements directed at the investing public are incorrect, for example sections 37b, c of the Securities Trading Act (WpHG), Law of July 26, 1994, BGBl. I, at 1794, as amended and promulgated on September 9, 1998, BGBl. I, at 2708, for a violation of the ad-hoc disclosure obligations. However, these provisions are, in general, addressed to the primary violator only and are too narrowly drafted to be of use for the gatekeeper theory.

\textsuperscript{166} Section 44(1) Sentence 1 no. 1.

\textsuperscript{167} Section 44(1) Sentence 1 no. 2.
that, to the best of their knowledge, the information contained in the prospectus is accurate.\textsuperscript{168} If admission of the securities to trading on a regulated market is intended, the prospectus needs to be signed by the persons who file the application for admission, i.e. the issuer and at least one financial institution.\textsuperscript{169} In general, the lead underwriter files the application; often – but not always\textsuperscript{170} – the other underwriters also sign the prospectus in order to benefit from the ensuing publicity.

Parts of the literature want to interpret the first alternative of section 44(1) Stock Exchange Act broadly in order to capture anyone who is mentioned in the prospectus and whose inclusion causes investors to rely on the review of the accurateness of the prospectus by that participant.\textsuperscript{171} There are two problems with this suggestion. First, it does not sit easily with the wording of the statute. The mere mention of a person in the documents does not imply that this person wishes to “assume responsibility for the prospectus”. Rather, as the EC Prospectus Regulation shows, the law expects the responsible persons to draft a formal declaration to be included in the prospectus.\textsuperscript{172} Second, it is unclear when the participation of a person or institution in the securities offering creates the effect of heightened reliability of the disclosures. This is presumably not the case if the person has not been extensively involved in the drafting of the prospectus. Accordingly, should outside directors be held responsible? Should all members of the underwriting syndicate be liable or only those that have been actively involved in the drafting of the disclosure materials? Does the investor have to be aware of the degree of involvement of the potential defendant? Case law on these issues is not available.

The second alternative of section 44(1) Stock Exchange Act is equally obscure. It targets those that have not undersigned the prospectus but control its content and publication. The explanatory memorandum to the Third Financial Market Development Act that modernised the prospectus liability provisions states that the market participant, in order to be


\textsuperscript{170} See OLG Frankfurt, WM 1994, 291, 293 (Bond I): Only the lead manager was a signatory to the prospectus.


\textsuperscript{172} Annex I, III, IV, V, no. 1 of the Prospectus Regulation.
liable, needs to pursue his own financial interests with the securities offering. \textsuperscript{173} Examples are the parent company that instructs the subsidiary to conduct an offering or the majority shareholder who orchestrates the transaction to sell his holdings. \textsuperscript{174} Again, parts of the literature seek to go beyond the literal meaning of the statute and the legislative history. They propose to hold responsible all parties who receive some financial advantage due to their participation in the offering, for example in the form of a fee or commission. Thus, all underwriters would qualify as defendants pursuant to section 44(1) Sentence 1 no. 2 Stock Exchange Act, as would experts, e.g. lawyers or auditors who receive remuneration for their services. \textsuperscript{175} However, a construction of the provision that is faithful to its wording and the legislative history has to come to a different conclusion. The requirement that the defendant must have “initiated the issue of the prospectus” suggests that he has to play a prominent role in the realisation of the offering. Auditors and other experts provide assistance, but they are not the driving force behind the transaction. The lead underwriter assumes a more central position, although the offering process does not originate from him either. The other underwriting banks are often not involved in the structuring of the offering and the drafting of the prospectus. \textsuperscript{176} Furthermore, the examples in the explanatory memorandum make clear that an indirect financial interest in the offering such as a selling commission does not suffice. The offering itself (and not a subsequent obligation of the issuer) has to generate the financial advantage for the defendant. Both elements – the assumption of a central role and a direct

\textsuperscript{173} BT-Drs. 13/8933, at 78.

\textsuperscript{174} \textit{Id.}

\textsuperscript{175} Liability of the underwriters: \textit{EKKENGA & MAAS, supra} note 171, at 342; \textit{JÜRGEN ELLENBERGER, PROSPEKTHAFTUNG IM WERTPAPIERHANDEL} [Prospectus Liability in Securities Transactions] 26 (2001). The liability of experts is more controversial. Some authors tentatively support the responsibility of auditors, lawyers etc. (Ulrich Bosch, \textit{Expertenhaftung gegenüber Dritten. Überlegungen aus der Sicht der Bankpraxis} [Liability of Experts to Third Parties. Considerations from the Perspective of the Banking Practice], \textit{ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT} [ZHR] 163 (1999), 274, 279; WOLFGANG GÖRß, KAPITALMARKTRECHT [Capital Markets Law] §§ 44, 45 BörsG, para. 37 (3d ed. 2006)), the majority rejects it (Assmann, \textit{supra} note 168, § 6/224; Ulrich Ehricke, \textit{Deutschland} [Germany], \textit{in PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG} 187, 228 (Klaus J. Hopt & Hans-Christoph Voigt eds., 2005); \textit{EKKENGA & MAAS, supra} note 171, at 304; \textit{ELLENBERGER, supra}, at 28; Markus R. Hauptmann, \textit{Die spezialgesetzliche Prospekthaftung gemäß Börsengesetz und Verkaufsprospektgesetz} [Prospectus Liability Pursuant to the Stock Exchange Act and the Law on the Prospectus for Securities Offered for Sale], \textit{in PROSPEKTHAFTUNG UND ANLAGEBERATUNG} [Prospectus Liability and Investment Advice] § 3/54, 55 (Jürgen Vortmann ed., 2000); SIEGFRIED KUMPEL, \textit{BANK- UND KAPITALMARKTRECHT} [Banking and Capital Markets Law] para. 9.367 (3d ed. 2004)), arguing that sections 44, 45 Stock Exchange Act did not support the notion of liability for a part of the prospectus. Possible defendants were, accordingly, only parties that assumed responsibility for the whole prospectus, not persons such as auditors that supplied individual sections. This view is hardly convincing. If it is accepted that an indirect financial interest in the offering is sufficient to bring the party within the scope of section 44(1) Sentence 1 no. 2 Stock Exchange Act, it follows that experts are in the same position as, for example, underwriters. In addition, the Prospectus Regulation makes it unequivocally clear that responsibility can be assumed for parts of the offering documentation (\textit{cf.}, \textit{inter alia}, Annex I no. 1 of the Regulation).

\textsuperscript{176} It is common that the lead underwriter does not contact the other members of the underwriting syndicate earlier than a few days before the offering commences.
financial interest in the offering – are indispensable for section 44(1) Sentence 1 no. 2. They might be satisfied if a member of the issuer’s management organises the offering to further his own interests.\footnote{177} Other potential gatekeepers, however, will virtually never fall within the scope of the provision.

\subsection*{b. Fraud}

Because of the inapplicability of sections 44, 45 Stock Exchange Act to communications on the secondary market and the difficulties implied by other liability provisions,\footnote{178} the courts have recently, in the wake of the numerous accounting frauds committed by companies listed on the New Market of the Frankfurt Stock Exchange,\footnote{179} begun to make use of a provision of the German Civil Code that is, at first view, not well suited to remedy excesses in the financial markets: section 826.\footnote{180} The provision stipulates that a person “who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage.”\footnote{181} The main advantage of the provision, and the reason why the courts have taken recourse to it, is that it is not excluded within the scope of sections 44, 45 Stock Exchange Act, i.e. when the misleading statements relate to a security listed on a regulated market or offered to the public.\footnote{182}

Liability under section 826 of the Civil Code is not restricted to certain types of defendant. The courts have held auditors,\footnote{183} lawyers,\footnote{184} and tax consultants\footnote{185} responsible. However, recovery is impeded by the fact that the plaintiff has to show a violation of public policy, scienter, and reliance. Thus, a claim based on section 826 is, in general, only feasible in cases clear (profound) mistakes in the disclosures of the defendant, for example if an expert submits an entirely unsubstantiated opinion, does not verify the factual basis of the

\footnotesize{\textsuperscript{177} Similarly GROß, supra note 175, §§ 44, 45 BörsG, para. 35.\textsuperscript{178} In particular general civil law prospectus liability, a concept that has been developed by the courts, e.g. BGHZ 79, 337, 342; 111, 314, 320; 123, 106 (Hornblower Fischer).\textsuperscript{179} Cf. supra note 3.\textsuperscript{180} Three of the most infamous economic scandals of the recent past in Germany – Infomatec, Comroad, and EM.TV – have given the courts ample opportunity to develop their doctrines. Cf. regarding Infomatec: BGHZ 160, 134 = NJW 2004, 2664 = ZIP 2004, 1599 (Infomatec I); BGHZ 160, 149 = NJW-Spezial 2004, 220 = ZIP 2004, 1593 (Infomatec II); BGH NJW 2004, 2668 = ZIP 2004, 1593 (Infomatec III). EM.TV: BGH ZIP 2007, 1407 (reliance); BGH NJW 2005, 2450 = ZIP 2005, 1270. Comroad: BGH WM 2007, 683 = ZIP 2007, 681 (Comroad I); WM 2007, 684 = ZIP 2007, 679 (Comroad II); WM 2007, 486 = ZIP 2007, 326 (Comroad III); WM 2007, 1557 = ZIP 2007, 1560 (Comroad IV); WM 2007, 1560 = ZIP 2007, 1564 (Comroad V); WM 2008, 395 = ZIP 2008, 407 (Comroad VI); WM 2008, 398 = ZIP 2008, 410 (Comroad VII).\textsuperscript{181} Translation by Langenscheidt Translation Service, http://bundesrecht.juris.de/englisch_bgb/.\textsuperscript{182} Section 47(2) Stock Exchange Act.\textsuperscript{183} BGH NJW 1956, 1595.\textsuperscript{184} BGH NJW 1972, 678, 680.\textsuperscript{185} BGH NJW 1986, 180, 181; NJW 1987, 1758. In this context, see also BGH NJW 1992, 3167, 3174 (IBH/Scheich Kamel); NJW 1980, 2460, 2461; NJW 1979, 1599, 1600.}
information and ignores concerns that have arisen during the investigation in an unscrupulous manner, solely in order to further his own financial interest and without taking regard of the interests of the recipient.\textsuperscript{186}

Furthermore, investors need to demonstrate that they knew the incorrect information and relied on it when making their investment decision, a requirement that does not reflect common practice in the financial markets where, in general, only professional participants study all disclosures. Several lower courts acknowledged this and granted relief if the plaintiff was able to show that the misrepresentation had substantially negatively affected the market price of the securities. In such a case, they argued, it was apparent that the plaintiff’s investment decision would have been different had the correct information been revealed: He would not have bought at the unjustified higher price.\textsuperscript{187} Even though the courts did not explicitly refer to the U.S.-American fraud-on-the-market theory, their reasoning makes clear that they adopted its rationale.\textsuperscript{188} However, on appeal, the Federal Court of Justice quashed the decisions.\textsuperscript{189} It stipulated that even in cases of blatant fraud the investor was not entitled to rely on the artificially inflated market price but had to prove actual reliance. The court’s more restrictive interpretation was guided by the desire to prevent section 826 Civil Code from becoming an indiscriminate catch-all provision that would significantly increase the risk of liability for professional market participants. Since section 826 could be invoked by anyone

\textsuperscript{186} BGH NJW 1991, 3282, 3283.
\textsuperscript{187} LG München I, ZIP 2006, 1586 (Comroad); OLG München, ZIP 2005, 1141, 1142-43 (Comroad).
\textsuperscript{188} Major works that have shaped the fraud-on-the-market theory are Eugene F. Fama, \textit{Efficient Capital Markets. A Review of Theory and Empirical Work}, 25 J. Fin. 383 (1970); Eugene F. Fama, \textit{Efficient Capital Markets II}, 46 J. Fin. 1575 (1991); Ronald J. Gilson & Reinier H. Kraakman, \textit{The Mechanisms of Market Efficiency}, 70 VA. L. Rev. 549-50 (1984). It should be noted that the fraud-on-the-market theory often fails in cases of primary market disclosures. The theory requires that the securities are traded in a (semi-) efficient market. Public offers intend to create the market; the issue price does not reflect information already available in the market but generally rests on the assumptions of the bookrunner that evaluates the order book. Thus, the investor cannot argue that he has been disappointed in his expectation that the security’s market price is a reflection of its true value. This problem has been discussed in Freeman v. Laventhal & Horwath, 915 F.2d 193, 198-99 (6th Cir. 1990). For a different approach, the so-called fraud-created-the-market theory, see Ockerman v. May Zima & Co., 27 F.3d 1151, 1159-60 (6th Cir. 1994): “[I]nvestors should be able to rely on the fact that local governments would not authorize, underwriters would not finance and brokers would not offer to sell bonds they knew were unmarketable. … There are at least two possibilities. One view, economic unmarketability, holds that a security is unmarketable if no investor would buy it because, assuming full disclosure, the security is patently worthless. Second, a security is legally unmarketable if, absent fraud, a regulatory agency or the issuing municipality would have been required by law to prevent or forbid the issuance of the security. Under both theories of unmarketability, it is argued that the investment decision is caused by fraud because but for the fraud, the security could not have been proposed, issued, or sold.” In Germany, the Court of Appeal [OLG] Frankfurt, AG 2006, 584, followed a similar path: Reliance of the investor on the issuer’s financial statements was irrelevant if the securities would not have been admitted to trading had the issuer disclosed its true financial condition. The Federal Court of Justice repealed the decision of the OLG Frankfurt, arguing that causality under section 826 Civil Code required more than a mere application of the but-for test (the conditio-sine-qua-non formula), BGH ZIP 2008, 410, 411-12 (Comroad VII); ZIP 2008, 407, 408-09 (Comroad VI).
\textsuperscript{189} BGH ZIP 2008, 410, 411 (Comroad VII); ZIP 2008, 407, 409 (Comroad VI); ZIP 2007, 326 (Comroad III); ZIP 2007, 679, 680 (Comroad II); ZIP 2007, 681, 682 (Comroad I).
against an undefined class of defendants, the necessary limitations had to be achieved by means of a narrow construction of the causality requirement, the court argued.\textsuperscript{190}

c. \textit{Summary}

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

IV. \textbf{Comparative Analysis}

1. \textit{The regulatory structure}

Any system of financial market regulation has to balance two antagonistic objectives: comprehensive investor protection on the one hand and the provision of a regulatory environment that is conducive to economic activity, i.e. that keeps the cost of capital at a low level, on the other hand. Comprehensive investor protection requires that investors have remedies at their disposal if professional market participants sell deficient products or harm the interests of the investing public in another way. The most important case of such harmful activity is the dissemination of incorrect information that affects the investment decisions of the public in a way that causes financial loss.\textsuperscript{191} The publication of misleading or inaccurate information can occur in the primary and the secondary market. Accordingly, remedies should be available in both markets. Furthermore, investor protection is not effective if the hurdles to recovery are too high, in particular if the investor bears the burden of proof for factors that he can only verify with great difficulty. This can be the case if he has to show that he relied on an incorrect piece of information that is possibly phrased in highly technical terms and has been circulated by a party that stands in no legal relationship with the investor, but that has nevertheless influenced the value of the investor’s interest through market operations, or if he has to determine negligence or scienter on the part of a market participant with whose operations he is not familiar. Finally, the investor needs to be protected against a judgement-

\footnotesize{\textsuperscript{190} BGH ZIP 2007, 326.  
\textsuperscript{191} Other important instances of harmful behaviour are insider trading and market manipulation. Both types of behaviour are regulated (in the United States: \textit{inter alia} section 10(b) Securities Exchange Act, Rule 10b-5; in the EU: Directive 2003/6/EC on insider dealing and market manipulation (Market Abuse Directive)) and have been widely discussed in the literature. They shall not be pursued here.}
proof defendant. Major financial scandals often leave a bankrupt issuer behind; if the issuer is the only addressee of liability provisions, investors will frequently not be able to recover their losses.

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

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

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195 Tort of negligent misrepresentation; section 826 of the German Civil Code.
196 Section 10(b) Securities Act.
overarching and coherent regulatory system; they are confined to operating within a given legislative framework and to reacting to specific, separate issues. Their decisions rest on the facts of the individual case and may not provide generally applicable solutions.

The movement towards tort law in Europe is relatively novel.\(^{197}\) In the United States, on the other hand, the first decisions discussing the nature of Exchange Act Rule 10b-5 as a private cause of action go back more than sixty years.\(^{198}\) Therefore, a review of the development of Rule 10b-5 might prove insightful when assessing the case law in Europe. The first decades after the “discovery” of Rule 10b-5 as a private cause of action were characterised by an increasingly expansive interpretation of the elements of the provision. The section was held to apply to securities registered on a national securities exchange as well as securities not traded in a regulated market\(^{199}\) and face-to-face transactions.\(^{200}\) It could be invoked in cases falling within the scope of section 11 Securities Act and any other liability provision of the Securities Act 1933 and the Securities Exchange Act 1934 free of the procedural and other restrictions imposed on the express causes of action.\(^{201}\) The defendant did not need to have acted with scienter; negligence was sufficient.\(^{202}\) If he failed to disclose facts that were material “in the sense that a reasonable investor might have considered them important in the making of [his investment] decision”\(^{203}\) plaintiffs were not required to establish reliance.\(^{204}\) Claims could be brought against the perpetrator of the fraud and those aiding and abetting the violation.\(^{205}\)

In 1975, the Supreme Court began to retreat from this liberal position. The U-turn was prompted by its realisation that a broad construction of Rule 10b-5 opened the door to strike suits, distorted the balance between Rule 10b-5 and the express liability provisions of the Securities Acts, and led to increased litigation expenses and capital costs.\(^{206}\) Thus, the

\(^{197}\) In the UK, it started in the 1990s with Caparo Industries Plc v. Dickman [1990] 2 A.C. 605, in Germany even more recently with the Infomatec decisions of the Federal Court of Justice in 2004, BGHZ 160, 134 (Infomatec I); 160, 149 (Infomatec II); BGH NJW 2004, 2668 (Infomatec III).

\(^{198}\) Cf. supra note 67.

\(^{199}\) Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965).


\(^{202}\) E.g. Myzel v. Fields, 386 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963). The circuits were split regarding the applicable standard, cf. the overview in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).


\(^{204}\) Id.


\(^{206}\) Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742 (1975) (quoting the decision of the Court of Appeals): “The great ease with which plaintiffs can allege the requirements for [standing under a suggested broad interpretation of Rule 10b-5] and the greater difficulty that plaintiffs are going to have proving the
Supreme Court limited the class of plaintiffs to actual purchasers and sellers, rejected the notion that Rule 10b-5 applied to negligent actions or to breaches of fiduciary duties that did not display any element of manipulation or deception, overruled decisions that had allowed claims against secondary violators, and reinstated the traditional elements of causation and loss. However, most of these clarifications have generated a wealth of new problems, and after sixty years of oscillating case law clearly defined parameters of responsibility under Rule 10b-5 have not emerged.

The similarities between Rule 10b-5, the English tort of negligent misrepresentation and section 826 of the German Civil Code are striking. Rule 10b-5 has evolved from the tort of deceit and misrepresentation; it therefore shares common ancestors with its European counterparts. All three provisions started out by imposing high hurdles to a claim for damages – plaintiffs had to show scienter, reliance, loss causation, and an element of fraud, deceit or violation of public policy. All provisions have later been interpreted expansively by the courts in order to make allowance for the specific characteristics of transactions in the capital markets. In all three countries, the case law is contradictory or inconsistent. In the United Kingdom and Germany the development is still in its infancy, but if Rule 10b-5 can serve as allegations [because standing could be based on hypothetical facts – the plaintiff could allege that he would have purchased the securities but for the misrepresentation] will allow a relatively high proportion of ‘bad’ cases into court. The risk of strike suits is particularly high in such cases; although they are difficult to prove at trial, they are even more difficult to dispose of before trial.” Cf. also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 208-10 (1976) (concerning the question whether Rule 10b-5 caught negligent acts): “We … consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct … is subject to significant procedural restrictions not applicable under s 10(b). … We think these procedural limitations indicate that the judicially created private damages remedy under s 10(b) … cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing. Such extension would allow causes of action covered by ss 11, 12(2), and 15 to be brought instead under s 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.”

207 Blue Chip, 421 U.S. 723.
208 Ernst & Ernst, 425 U.S. 185. See supra note 69 for a definition of scienter.
209 Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) (involving a breach of fiduciary duties of the majority shareholder towards the minority with the majority fully disclosing the effects of the transaction).
211 Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005). Accordingly, plaintiffs must prove that the misrepresentation has proximately caused their economic loss. They cannot recover for a loss brought about by other factors influencing market movements.
212 Cf. the discussion concerning the different approaches to an application of Central Bank (supra III 1 b), the exceptions to the Birnbaum rule applied in Blue Chip (e.g. Alley v. Miramon, 614 F.2d 1372 (5th Cir. 1980), affirming the pre-Blue Chip forced seller exception; Gurley v. Documentation Inc., 674 F.2d 253 (4th Cir. 1982), holding that the delayed sale exception did not survive Blue Chip), or the allegation that the Birnbaum rule draws an arbitrary line between actual sellers and purchasers (who have standing) and other parties who might have been affected by the misrepresentation in the same way but, as a result of the fraud, abstained from entering into a transaction, see Lewis D. Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5, 54 VA. L. REV. 268 (1968).
213 Blue Chip, 421 U.S. at 744.
214 This is true for the English tort of deceit that was the antecedent to the tort of negligent misrepresentation.
215 In Germany, the expansive interpretation has in particular been advocated by lower courts, but then to some extent been curtailed by the Federal Court of Justice, cf. supra III 3 b.
an example, the road to legal certainty and a balanced regime of investor protection will be long, and a satisfactory solution may never be achieved without intervention of the legislator.

In spite of the “retrenchment” decisions of the U.S. Supreme Court, investor protection under Rule 10b-5 is more extensive than under the torts of deceit and negligent misrepresentation or section 826 of the German Civil Code. Rule 10b-5 is no longer governed by traditional principles of tort law. While the concept of “recklessness” applied by the U.S. courts is probably identical to that of *Derry v. Peek*, investors do not have to show that the defendant intended them to act on the misrepresentation. Thus, as opposed to the tort of deceit, Rule 10b-5 can be relied upon by anonymous investors in the aftermarket. In addition, plaintiffs can take recourse to the fraud-on-the-market theory in order to establish reliance, which is not possible under either the tort of deceit or the tort of negligent misrepresentation. The main disadvantage of the tort of negligent misrepresentation is the requirement that the defendant owes the plaintiff a duty of care. The relevance of this prerequisite for misrepresentations in public offerings is unclear, and recovery in the secondary market is most likely excluded. Rule 10b-5 does not suffer from these deficiencies. A comparison with German law yields similar results. Section 826 of the Civil

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216 *Cf.* the definitions in Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569 (9th Cir. 1990); Broad v. Rockwell Intern. Corp., 642 F.2d 929, 961-962 (5th Cir. 1981); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) on the one hand, and *Derry v. Peek* (1889) L.R. 14 App. Cas. 337, 369, on the other hand.

217 *Cf.* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969): “[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase ‘in connection with the purchase or sale of any security’ intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation’s securities. … [T]he investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance.” Even more explicit Semerenko v. Cendant Corp., 223 F.3d 165, 176 (3d Cir. 2000): “The purpose underlying § 10(b) and Rule 10b-5 is to ensure that investors obtain fair and full disclosure of material facts in connection with their decisions to purchase or sell securities. … That purpose is best satisfied by a rule that recognizes the realistic causal effect that material misrepresentations, which raise the public’s interest in particular securities, tend to have on the investment decisions of market participants who trade in those securities. … We therefore … hold that the Class may establish the “in connection with” element simply by showing that the misrepresentations in question were disseminated to the public in a medium upon which a reasonable investor would rely, and that they were material when disseminated. We also point out that, under the standard which we adopt, the Class is not required to establish that the defendants actually envisioned that members of the Class would rely upon the alleged misrepresentations when making their investment decisions.” *Cf.* also *AUSA Life Ins. Co.* v. *Ernst and Young*, 206 F.3d 202, 221 (2d Cir. 2000) (holding that scienter does not presuppose that the defendant intended the investors to act on the misrepresentation). The law in England is the converse, *Peek v Gurney* (1873) L.R. 6 H.L. 377, 412-413: “First, … every man must be held responsible for the consequences of a false representation made by him to another, upon which that other acts, and, so acting, is injured or damnedified; Secondly, every man must be held responsible for the consequences of a false representation made by him to another, upon which a third person acts, and so acting, is injured or damnedified, provided it appear that such false representation was made with the intent that it should be acted upon by such third person in the manner that occasions the injury or loss.”


219 *Supra* III 2 b.
Code constitutes a narrower avenue for investors than Rule 10b-5. Plaintiffs need to prove a violation of public policy and, more importantly, actual reliance.

The express liability provisions come with their own problems. Again, U.S. law is characterised by causes of action that are favourable to plaintiffs. Reliance and loss causation either do not constitute elements of sections 11, 12(a)(1), and 12(a)(2) Securities Act, or they are structured as defences, i.e. the defendant bears the burden of proof. Section 12(a)(1) of the Securities Act does not require the plaintiff to show more than a violation of section 5 Securities Act. English and German law do not provide the investors with equally broad causes of action. European counterparts to sections 12(a)(1) and (2) Securities Act do not exist, and sections 90 FSMA and 44, 45 German Stock Exchange, while stipulating shifts in the burden of proof similar to those under U.S. law, are addressed to an obscure class of defendants.

Thus, to summarise, even after the “retrenchment” decisions of the Supreme Court investors in the United States have stronger remedies at their disposal than in Europe. This is true for the primary and even more so for the secondary market. Still, data shows that investor protection in the United States is by no means complete; investors are in general not able to recover more than 5% of the investment loss. Consolidated data for Europe does not exist, but the figure is likely to be lower. Furthermore, the numerous not yet clarified problems of statutory construction that afflict the capital market laws of all three countries are an additional obstacle to effective regulation. Legal uncertainty and, consequently, transaction costs are high, which entails negative effects for both investors and professional market participants. The legislator is called upon to remedy the ambiguities and remove the greatest obstacles to recovery for investors, for example the requirement to show reliance.

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220 Cf. section 45(2) no. 1, 2 German Stock Exchange Act (shift in the burden of proof for reliance and loss causation); under section 90 FSMA, the plaintiff has to show loss causation but not that he relied on the misstatement, see supra note 161.
221 This issue will be discussed in more detail infra at 2.
222 This diagnosis is reflected in the high number of securities lawsuits and the large settlement values in the United States, cf. Stephanie Plancich & Svetlana Starykh, 2008 Trends in Securities Class Actions (NERA Economic Consulting Report, 2008), available at http://www.nera.com/image/PUB_Recent_Trends_Report_1208.pdf. However, it should be noted that the number and value of securities lawsuits depends as much on the substantive liability provisions as on the procedural devices that are available, in particular the contours of the class action mechanism. Thus, the data in the report can only be used with caution to assess the effectiveness of the provisions discussed in this paper. Furthermore, the much lower number of securities lawsuits in Europe might be as much a result of the more restrictive liability provisions as of the less accommodating procedural environment.
224 The fraud-on-the-market theory is an adequate tool to achieve this goal. As the U.S. Supreme Court pointed out in Basic Inc. v. Levinson, 485 U.S. 224, 243-44 (1988): “The modern securities markets, literally involving
The next two sections will address the question of how the existing liability regimes may be modified in light of the gatekeeper theory in order to enhance investor protection.

2. **Defendants**

To reduce the cost of capital, only such third parties should be held responsible as gatekeepers that are well positioned to review the acts and disclosures of the primary market actor. The burden that gatekeeper liability imposes on the third party becomes less the more intimately the gatekeeper is familiar with the primary market participant’s business and the more easily it can verify the accuracy of the relevant information. Applying these considerations to third party actors in the financial markets (executive and non-executive directors, underwriters, accountants and auditors, lawyers\(^225\)), some general observations can be made about the suitability of the parties as gatekeepers.

Inside directors are intimately involved in the drafting of corporate disclosures. However, they are also subject to the most severe conflicts of interest. They are the actors that can gain most from false statements. Their salary might be tied to a high share price, and their career might depend on a seemingly successful running of the business. Consequently, holding only them responsible for violations of securities regulation by the primary market actor is not sufficient.\(^226\) The position of outside directors is ambivalent. On the one hand, they often lack the time and expertise to familiarise themselves with all details of the issuer’s business operations. On the other hand, they participate in regular board meetings and decide on fundamental corporate changes. They will, therefore, be able to function as gatekeepers for certain transactions, whereas they might not be well equipped to review technical and detailed

\(^225\) Other parties may act as gatekeepers, e.g. securities analysts and rating agencies (cf. COFFEE, GATEKEEPERS, supra note 6, at 245-306). However, responsibility of these intermediaries is problematic (id. at 263-70, 302-04); a discussion of the issues is beyond the scope of this article.

\(^226\) Cf. Coffee, supra note 4.
accounts, for example the financial data in the offering prospectus. Experts, such as accountants, lawyers, appraisers or engineers, are best positioned to ensure the correctness of their opinions. However, they have no influence on the content of the parts of the disclosure not prepared by them.

Finally, the underwriters occupy a central position in the process of offering and selling securities. They – or at least the lead underwriter – prepare and structure the offering, conduct a due diligence of the issuer, organise road shows and other marketing activities, draft the offering documents, receive subscriptions for securities, determine the issue price, apply for admission to trading of the securities, and perform stabilisation measures. They possess the necessary expertise to assess even highly technical information. In addition, they are not subject to the same conflicts of interest as issuers or inside directors. Their gain from participation in the offering is smaller – they receive a small percentage (ca. 5-7%) of the proceeds of the offering as underwriting and selling fees. On the other hand, their potential loss from litigation is higher. The success of their business operations generally depends to a high extent on their reputation, which may be tarnished by allegations of fraud and deception. Courts realise this exceptional role of the underwriter in the primary market. They emphasise: „No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter.”

Section 11 Securities Act implements these aspects in a convincing way. All of the actors identified as suitable gatekeepers are caught by the provision. Furthermore, the section allows for the limited contribution of experts, the limited influence of outside directors, and the different roles of defendants in the offering process. The other liability provisions of U.S. law are less well structured. This paper has presented the controversies surrounding

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228 Supra II 1. This view was summarised by John Pierpont Morgan as early as 1933 in the following words: “If, in the exercise of his profession, the private banker disregards [code of professional ethics], which could never be expressed in legislation, but has a force far greater than any law, he will sacrifice his credit. This credit is his most valuable possession; it is the result of years of fair and honorable dealing and, while it may be quickly lost, once lost cannot be restored for a long time, if ever.” Quote from U.S. v. Morgan, 118 F. Supp. 621, 744 (S.D.N.Y. 1953).


230 Experts are only liable for misstatements in their opinion, section 11(a)(4).

231 The liability of outside directors is determined pursuant to sections 11(f)(2)(A) Securities Act, 21D(f) Securities Exchange Act, 15 U.S.C. §§ 77k(f)(2)(A), 78u-4(f) (2007), i.e. it is several (not jointly and several as in section 11(f)(1) Securities Act) and proportionate to the percentage of responsibility of the defendant, provided that the defendant did not knowingly commit the violation.

232 Through a flexible standard of care; details infra 3.
the class of defendants under Rule 10b-5.\textsuperscript{233} The Supreme Court has probably chosen the worst of both worlds. In excluding aiding and abetting liability, it wanted to increase legal certainty and prevent misuse of the Rule in litigation. On the other hand, the courts recognised that a narrow interpretation of Rule 10b-5 would not provide enough flexibility to grant investors a cause of action in all relevant cases and against all perpetrators of fraud. Accordingly, inventive constructions of the term “primary violator” have evolved whose effectiveness in protecting investors is diminished by the requirement to bring them in line with the Supreme Court’s holding in \textit{Central Bank}. As a result, the courts have achieved neither legal certainty nor enhanced investor protection. If gatekeeper liability is desirable, as has been argued \textit{supra}, secondary violators should be brought within the ambit of Rule 10b-5, thus creating a counterpart to section 11 Securities Act that would comprehensively govern the secondary market and supplement liability in the primary market. \textit{De lege lata}, Rule 10b-5 is better suited to fill the gaps in the regulatory system than sections 12(a)(1) or (2) Securities Act. It is more flexible than section 12(a)(1), which requires a violation of section 5 Securities Act, and section 12(a)(2), which does not apply to secondary market transactions and private placements.\textsuperscript{234} At the same time, the risk of excessive liability can be contained more easily through elements such as loss causation or scienter, which are not part of the causes of action under sections 12(a)(1) and (2).

The prospectus liability provisions of English and German law are unsatisfactory. In spite of a catalogue of defendants in the Prospectus Rules that is similar to section 11(a) Securities Act, it is unclear whether and under which conditions experts and underwriters are responsible pursuant to section 90 FSMA 2000. Sections 44, 45 German Stock Exchange Act do not encompass any gatekeepers except the underwriters, and even in respect to them it is questionable whether all or only some members of the underwriting syndicate are caught. Section 11 Securities Act should serve as a model for the interpretation (where possible) of the existing provisions or for amendments. In particular, the legislator should acknowledge that effective incentive structures require the expert to be accountable for misstatements in the opinion provided by him, and the underwriters for the whole prospectus.\textsuperscript{235}

\textsuperscript{233} \textit{Supra} III 1 b.


\textsuperscript{235} Sections 44, 45 Stock Exchange Act do not leave much scope for interpretation to implement these considerations, \textit{cf. supra} III 3 a. The English Prospectus Rules may be broad enough to allow for an inclusion of all experts (by restrictive interpretation of Prospectus Rule 5.5.9, which stipulates that responsibility shall not attach to a “person giving advice … in a professional capacity”) and the underwriters (as “offers” within the meaning of PR 5.5.3(2)(d)(i); however, this approach presupposes that the exception of PR 5.5.7 does not apply, i.e. that the prospectus was not drawn up primarily by the issuer or the underwriters acting on behalf of the
As regards the underwriters, it is important to note that not all underwriters are involved in the offering process to the same degree. Often only the lead underwriter participates in the preparation of the offering. The other underwriters might, therefore, not be as familiar with the financial condition and the business operations of the issuer. Expecting a full-fledged due diligence from them would disproportionately increase the cost of capital. However, these are questions that are better addressed in the context of the applicable standard of care. At least in some cases the members of the underwriting syndicate will be in a position to review parts or all of the information contained in the prospectus, and a rule that excludes the liability of all underwriters except the bookrunner will be too undifferentiated. On the other hand, a general rule restricting the class of defendants is useful as far as other banks are concerned that are engaged in the placement of the securities (sub-underwriters, selling agents, brokers). They contract with the underwriters and not the issuer. Information necessary to verify the correctness of the issuer’s disclosures is not easily available to them; consequently, the increase in the cost of capital caused by the heightened risk of liability of such secondary actors would in general not be offset by the improvement in investor protection.

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

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236 Supra note 176. The problems for the lead underwriter raised by modern techniques such as shelf registration and competitive bidding have been mentioned, see supra note 64.
237 Accordingly, the Securities Act stipulates that the term “underwriter” within the meaning of section 11 shall not include “a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission”, section 2(a)(11) Securities Act, 15 U.S.C. § 77b(a)(11) (2007). On the other hand, section 12(a)(2) Securities Act does not reflect these remarks. It is addressed to any seller or offeror, even those that are not in a position to review the prospectus.
238 Cf. supra notes 3, 17.
3. **Standard of care**

The provisions under survey display a diverse array of liability standards, ranging from strict liability to negligence, gross negligence, and scienter (or recklessness). German law exhibits the most restrictive standard (gross negligence in the case of primary market prospectus liability,\(^{239}\) scienter in all other cases\(^{240}\)), U.S. and English rules differ. In the primary market, U.S. and English securities regulation allows claims based on negligence.\(^{241}\) In the secondary market, English law applies the same standard, but the deficiencies of the tort of negligent representation have been shown.\(^{242}\) The most important U.S. liability provision for the secondary market, Rule 10b-5, requires scienter, but the high standard in respect to the defendant’s state of mind is somewhat compensated for by the flexibility of the rule regarding other elements of the cause of action.\(^{243}\)

Ideally, an efficient system of liability should fix the standard of care at a level where the cost of one additional unit of care equals exactly the reduction in expected accident costs.\(^{244}\) The costs for gatekeepers of reviewing the actions of the primary actor depend on the gatekeeper’s position. The same considerations that have been employed above\(^{245}\) are relevant here. In order to induce an optimal supervision of the primary market participant, the liability provisions should hold third parties to a high standard of care if they are close to the source of the information and can investigate the primary market actor at a low cost. Conversely, if verification is associated with significant costs, less should be expected of the gatekeeper. However, transactions in the capital markets are too complex and multifaceted as that a statutory rule could calculate these different levels and prescribe them for an unlimited number of cases. The legislator necessarily has to operate with flexible and general terms, such as the concept of “reasonableness”\(^{246}\). Notwithstanding this quandary, it should be possible to arrive at certain approximations, which could take the form of gradual standards that differentiate between types of defendant and misstatement.

Again, section 11 Securities Act incorporates these principles appropriately and establishes a sliding scale of responsibility that has been further refined by the SEC and the

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239 Section 45(1) Stock Exchange Act.
240 Section 826 Civil Code.
241 Liability of the directors, experts, and underwriters pursuant to section 11(b) Securities Act; liability pursuant to section 12(a)(2) Securities Act; section 90 FSMA 2000. In some instances, U.S. law even imposes strict liability on market participants: Liability of the issuer pursuant to section 11(b) Securities Act; liability pursuant to section 12(a)(1).
242 Supra III 2 b.
243 Cf. supra 1.
245 Supra 2.
246 Section 11(b)(3) Securities Act.
courts. Schedule 10 to the English Financial Services and Markets Act 2000 distinguishes between statements made by experts and other statements. However, as opposed to the Securities Act, it does not ask whether the defendant had reasonable ground to believe that the expertised opinion was true. Therefore, English law does not give an incentive to review the statement even if that would have been possible at low cost. Furthermore, the statute provides for a uniform standard of care for all defendants, notwithstanding their relationship to the issuer. The terms “reasonable belief” and reasonable enquiries might be sufficiently broad to allow the courts to hold the issuer and its inside directors accountable for a higher degree of care than the outside directors, and the lead underwriters for a higher degree than the other members of the underwriting syndicate. Nevertheless, a more specific statutory differentiation would be desirable and increase legal certainty.

German prospectus liability law is the least adequate of the three provisions. Neither does it distinguish between the types of defendant nor the character of the statement as being expertised or non-expertised. In addition, it requires gross negligence and thus sets the threshold for liability relatively high. Suggestions in the literature that this amounted to a probatio diabolica for the issuer are hardly convincing. Gross negligence is the extreme departure from ordinary care and the disregard of standards of conduct that should have been apparent to anyone. This cannot be construed in a way that would approximate strict liability. In respect to the other defendants, the provision does not provide for the necessary flexibility either. The failure to investigate the issuer’s statements will generally not amount to an “extreme departure from ordinary care” if the defendant (e.g. the underwriter) studies the documents, discusses them with the issuer’s directors and officers, and does not discover any

247 Supra III 1 a.
248 Section 11(a)(3)(C).
249 Schedule 10, section 2(2)(a) merely requires that the defendant reasonably believed that the expert was competent to make the statement, see supra III 2 a.
250 Schedule 10, section 1(2).
251 This is the solution under section 11 Securities Act. Cf., for example, Securities Act Rule 176, 17 C.F.R. § 230.176 (2008): Responsibility depends, inter alia, on “[t]he type of person” to be held liable (subsection (c)) and, when the person is an underwriter, “the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant” (subsection (g)).
252 Cf. section 45(1) Stock Exchange Act.
253 Critical also ELLENBERGER, supra note 175, at 58-59; HOPT, supra note 7, at 87-89; Klaus J. Hopt & Hans-Christoph Voigt, Grundsatz- und Reformprobleme der Prospekt- und Kapitalmarktinformationshaftung [Principal Problems of Prospectus Liability and Liability for Capital Market Disclosures], in PROSPEKT- UND KAPITALMARKTINFORMATIONSHAFTUNG 9, 82-86 (Klaus J. Hopt & Hans-Christoph Voigt eds., 2005).
255 BGHZ 10, 14, 16.
red flags. Thus, the standard is substantially lower than in the United States, where section 11(b)(3) requires a “reasonable investigation”, i.e. the verification of the information through on-site inspections, interviews with the issuer’s employees, customers, and suppliers, an analysis of the respective industry, and comfort letters procured from lawyers or financial analysts. The legislator should increase the standard of care, at least for the issuer, the inside directors, and the lead underwriter.

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

256 Cf. RGZ 80, 196, 199; BGH WM 1982, 862, 864 (BuM); OLG Frankfurt, ZIP 1999, 1005, 1007 (MHM Mode).
257 See for example International Rectifier Securities Litigation, 1997 WL 529600, at 8 (C.D. Cal. 1997), holding that the underwriters’ diligence met the reasonableness standard because they “(1) reviewed [the issuer’s] internal financial forecasts, contracts, and other important documents, and inspected [the issuer’s] major facilities; (2) employed analysts who were knowledgeable of the … industry [in which the issuer operated]; (3) conducted interviews with eleven of [the issuer’s] senior and middle management employees, inquiring about numerous aspects of [the issuer’s] operations; (4) conducted interviews with [the issuer’s] major customers, [the issuer’s] outside quality consultants, the public accounting firm responsible for auditing [the issuer], [the issuer’s] patent attorney, and [the issuer’s] outside environmental counsel; (5) obtained written verification from [the issuer’s] management that the information in the prospectus was correct and a ‘cold comfort’ letter from [the issuer’s] outside accountants indicating that there had been no material changes in [the issuer’s] financial position since its last audit”. Similar Weinberger v. Jackson, 1990 WL 260676, at 3 (N.D. Cal. 1990): “[The] investigation of [the issuer] … was conducted by experienced people, who were assisted by attorneys and accountants. The underwriters reviewed the industry, the company, the company’s management, and the company’s past and projected manufacturing, sales and financial performance. The underwriters had over twenty meetings with various management personnel, covering all aspects of the company’s business. Company personnel were specifically questioned about the development and scheduled availability of products, related operating systems and applications software. The underwriters also contacted many of [the issuer’s] suppliers, customers, and distributors, who were asked extensive questions about the company’s operations. The underwriters reviewed company documents including operating plans, product literature, corporate records, financial statements, contracts, and lists of distributors and customers. They examined trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information. They also made physical inspections of the company’s facilities. When any negative or questionable information was developed as a result of their investigation, the underwriters discussed it with the appropriate persons and arrived at informed decisions and opinions. The underwriters also obtained written representations from the selling stockholders and the company that as of the closing date of the public offering, there were no misstatements or omissions.”

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

259 It is argued that the standard of care for liability in the secondary market should, as a general rule, be lower than that in the primary market in order to prevent over-deterrence and inefficient results, cf. Hans-Bernd Schäfer, Die Dritthaftung des Wirtschaftsprüfers für Vermögensschäden auf Primär- und Sekundärmärkten.
Finally, the duties of the gatekeeper should be less comprehensive if the information exhibits a certain degree of reliability because it stems from an expert opinion. In such a case, requiring a full-fledged second investigation by the gatekeeper would increase the costs of the transaction without generating much benefit for investors, in particular if the gatekeeper lacks the technical qualifications to assess the expert opinion. U.S. law has developed reasonable criteria that may be utilised to solve the controversies that exist in Europe about the definition of “expert opinion” and the consequences for the defendants’ standard of care. A thorough review of the expert opinion by the gatekeeper will not produce significant additional protection for investors if – and only if – the information has been assembled in a way that ensures a high level of accurateness. This is the case if the expert has followed a clearly prescribed procedure (which is known to the gatekeeper) that is structured to produce high quality information. Consequently, statements from experts do not reduce the gatekeeper’s duties simply because they originate from a market actor with particular expertise. To take the most important expert in the financial markets, the auditor, as an example, he may either give positive or negative assurances. The positive assurance attests that the financial information is presented fairly in conformity with generally accepted accounting principles (GAAP). It may only be given if the accountant has audited the information in accordance with generally accepted auditing standards (GAAS). The negative assurance confirms that the data has been reviewed pursuant to the rules set out in AICPA Statement on Auditing Standards (SAS) No. 100, which are less exacting than those under GAAS. Depending

260 Cf. on the one hand Heinz-Dieter Assmann in VERKAUFSPROSPEKTGESETZ [Law on the Prospectus for Securities Offered for Sale] § 13 VerkProspG, para. 93 (Heinz-Dieter Assmann et al. eds., 2001); GROß, supra note 175, §§ 44, 45 BorsG, para. 82; Schwark, supra note 168, §§ 44, 45 BorsG, para. 45 (allowing all information provided by experts to go unchecked, for example legal opinions or comfort letters of accountants, i.e. statements that do not have to conform to the requirements of formal audit opinions); on the other hand Johannes Köndgen, Zur Theorie der Prospekthaftung (II) [On the Theory of Prospectus Liability (II)], DIE AKTIENGESELLSCHAFT [AG] 1983, 120, 127 (expecting the employment of independent financial analysts as a matter of routine, notwithstanding the fact that the expert has furnished a formal audit opinion).

261 This was already pointed out in Escott v. BarChris Construction Co., 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

262 SAS 100, AU § 722 (Interim Financial Information).

263 The procedures are described in § 722.15-24, Appendix A-C. They consist principally of applying analytical procedures (e.g. comparing interim financial information with prior period information and actual interim results with anticipated results) and making inquiries of persons that are responsible for financial and accounting
on the procedures agreed on with the client, the accountant may follow SAS No. 100 when
drafting comfort letters. If the procedures fall short of an SAS 100 review the accountant may
not give a negative assurance.\textsuperscript{264} The SEC has stipulated that only a formal audit shall be
considered as an expertised opinion within the meaning of section 11 Securities Act.\textsuperscript{265} In
Europe, the financial statements in annual financial reports must be audited,\textsuperscript{266} but not those in
half-yearly or quarterly financial reports.\textsuperscript{267} The standards for the auditors’ review or for
comfort letters are comparable to those in SAS No. 100.\textsuperscript{268} They do not give reasonable
assurance that the information does not contain any misstatement and should, therefore, not
lead to a reduction in the duties required of the gatekeeper. On the other hand, if the
accountant has audited the financial statements, an independent investigation by another
market participant is unnecessary. The gatekeeper may content himself with verifying the
consistency and completeness of the disclosure.\textsuperscript{269}

4. Risk shifting

The academic literature has for some time controversially discussed whether a gatekeeper
regime based on strict liability or negligence is preferable.\textsuperscript{270} Interestingly, the different

\textsuperscript{264} Cf. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, STATEMENT ON AUDITING STANDARDS No.
72 (Letters for Underwriters and Certain Other Requesting Parties), SAS 72, AU § 634 (2008), Example O
(Alternate Wording When the Procedures That the Underwriter Has Requested the Accountant to Perform on
Interim Financial Information Are Less Than an SAS No. 100 Review).

\textsuperscript{265} Cf. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING AND REPORTING MANUAL § 14.101 (2009), article 5 Sample Comfort Letter.

\textsuperscript{266} Securities Act Rule 436(c), 17 C.F.R. § 230.436(c) (2008). Cf. also Accountant Liability for Reports on
Unaudited Interim Financial Information under Securities Act of 1933, Securities Act Release No. 6173, 19
S.E.C. Docket 82 (December 28, 1979). In general, year-end financial statements will be audited. Interim
financial statements pursuant to Exchange Act Rule 13a-13, 17 C.F.R. § 240.13a-13 (2008), do not need to be
audited but must be reviewed by an independent public accountant in accordance with SAS No. 100, cf. section

\textsuperscript{267} Article 4(4) Transparency Directive.

\textsuperscript{268} For half-yearly financial reports: Article 5(5) Transparency Directive.

\textsuperscript{269} The duty to undertake further inquiries may arise if red flags exist, cf. supra note 61.

\textsuperscript{270} Proposing a regime of recklessness or negligence: Hamdani, supra note 6, at 113-20 (strict liability for certain
gatekeepers that are expected to be successful in detecting issuer fraud, for example auditors, but then
introducing a due diligence defence, \textit{id.} at 119); Langevoort, supra note 6, at 67-68 (recklessness); Schäfer,
supra note 259, at 175-177; Sher, supra note 6, at 484-85 and passim (negligence). Strict liability: Coffee, supra
note 4, at 349-53 (strict liability that is capped at a realistic level); Partnoy, supra note 6, 84 B.U. L. REV. 365;
Partnoy, supra note 6, 79 WASH. U. L.Q. at 540-46 (arguing that gatekeepers should be able to specify the range
opinions operate with the same argument: Cost efficiency. It is argued that negligence imposes higher costs than strict liability because legislators and courts will have difficulties in defining the precise standard of care that applies in a given situation. Thus, gatekeepers cannot judge what is expected from them. They might over- or under-monitor, in both cases increasing social cost.\textsuperscript{271} In addition, the litigation risk is high and the outcome of a lawsuit unpredictable if standards of care are vague. Conversely, it is pointed out that gatekeepers will, in general, not be in a position to determine compliance of the primary market actor with applicable rules with absolute certainty. Thus, under a regime of strict liability they can control the liability risk less well than under a regime of negligence.\textsuperscript{272} Furthermore, strict liability internalises all damage. All investors who have suffered a loss can recover, whereas negligence restricts the right to recovery to cases where the defendant has acted with fault. As a consequence, strict liability will force gatekeepers to charge higher fees. Depending on the size of the fee increase, issuers may not be able to afford the intermediary’s services and might therefore be prevented from entering the market.

The merits of the two opposing views cannot be evaluated in a theoretical way; rather, an extensive empirical analysis is needed to arrive at a quantification of the different factors that influence the efficiency of negligence based and strict liability regimes. Even if such an analysis was conducted it would be questionable whether it was of much sustainable value in an environment where economic and legal parameters (for example the investment climate or the procedural framework for investor lawsuits) are as volatile as in the financial markets.\textsuperscript{273}

However, the debate might be of less importance than seems at first sight. Under certain conditions the costs associated with negligence and strict liability will converge. This consideration is based on the fundamental insight developed by Ronald Coase that in the absence of transaction costs all legal allocations of property rights are equally efficient.\textsuperscript{274} This rationale applies in the same way to the allocation of liability risks. If parties can freely enter into indemnification agreements, they will allocate the risk in a way that the party that is

\begin{footnotes}
\footnote{of liability as a percentage of the issuer’s liability, subject to a specified minimum percentage). Choi, supra note 6, 92 NW. U. L. REV. at 951-58, proposes a regime of self-tailored liability, i.e. the gatekeeper may specify the standard of care that he will employ and be held accountable for. Purchasers will then value the certified product based on the screening procedures that the certifier has selected.}
\footnote{Cf. Kraakman, supra note 5, 2 J.L. ECON. & Org. at 76. See also Coffee, supra note 4, at 349: “[S]trict liability spares both courts and regulators the need to descend into the Serbonian bog of defining precise standards of care, thereby reducing transaction costs and increasing predictability.”}
\footnote{Kraakman, supra note 5, 2 J.L. ECON. & Org. at 76.}
\footnote{It is telling that the analyses in the law and economics literature are of an entirely theoretical nature, cf. ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 335-64 (5th ed. 2008); POSNER, supra note 244, at 178-82.}
\footnote{The Problem of Social Cost, 3 J. LAW AND ECON. 1 (1960).}
\end{footnotes}
best positioned to control it bears the burden of liability.\textsuperscript{275} Ideally, the market participant that ultimately assumes the risk can control it perfectly well. Thus, the inefficiencies of both strict liability and negligence are eliminated: The additional cost of strict liability and the administrative cost of imprecise standards of care are reduced to zero.

In the real world, some costs will remain. The party that is best positioned to monitor compliance with the regulatory environment is the addressee of the rules (the primary actor, for example the issuer in respect to the disclosure obligations of the securities laws). Even if the issuer contracts to indemnify the gatekeepers, which is common practice,\textsuperscript{276} the events that lead to securities litigation might leave the company insolvent. Accordingly, the claim for indemnification might be unenforceable. The gatekeeper, on the other hand, will never act under complete certainty. Furthermore, a system of liability that is based on negligence and that accords investors a claim against, \textit{inter alia}, the gatekeeper that ultimately has to bear the risk of liability would continue to exhibit the inefficiencies caused by imprecise standards even if it allowed for risk shifting.\textsuperscript{277} Finally, administrative costs can arise from litigating the

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\item \textsuperscript{275} For example, if the auditor can verify the accuracy of the prospectus better than the underwriter, the latter will pay, as consideration for the assumption of the liability risk by the auditor, a fee that is lower than the cost caused by the auditor’s exposure to liability but higher than the other party’s cost of precautionary measures. Consequently, risk shifting will occur.
\item \textsuperscript{276} \textit{Cf.} BLOOMENTHAL, \textit{supra} note 13, app. 2, § 6.01: “The Company agrees to indemnify and hold harmless the Underwriters … against any and all losses, claims, damages or liabilities, joint or several, to which they or any of them may become subject under the Act or any other statute or at common law and to reimburse persons indemnified as above for any legal or other expenses (including the cost of any investigation and preparation) incurred by them in connection with any litigation, whether or not resulting in any liability, but only insofar as such losses, claims, damages, liabilities and litigation arise out of or are based upon any untrue statement or alleged untrue statement of a material fact contained in the Registration Statement or any amendment thereto or any application or other document filed in order to qualify the Stock under the Blue Sky or securities laws of the states where filings were made, or the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading … provided, however, that the indemnity agreement contained in this subsection 6.01 shall not apply … to the Underwriter or any person controlling the Underwriters in respect of any such losses, claims, damages, liabilities or actions arising out of or based upon any such untrue statements or alleged untrue statement, or any such omission or alleged omission, if such statement or omission was made in reliance upon information peculiarly within the knowledge of the Underwriter and furnished in writing to the Company by the Underwriter specifically for use in connection with the preparation of the Registration Statement and Prospectus or any such amendment or supplement thereto.”
\item \textsuperscript{277} The result would be different if the ultimate risk bearer was not held responsible. Assume that gatekeeper 1 (G1) is a defendant under prospectus liability rules. If gatekeeper 2 (G2) is not an addressee of the liability provision but contracts to assume G1’s risk of liability, G1 has an incentive not to employ any precautionary measures. Thus, the negligence rule is transformed into strict liability with G1 being held liable whenever the primary actor has violated applicable rules but, at the same time, with G1 being able to recover from G2. This, in turn, presupposes that (1) G2 is judgement proof, i.e. G1 can enforce his claim for indemnification, and (2) G2 assumes the risk of liability unqualifiedly, i.e. does not impose a certain standard of behaviour on G1 in the indemnification agreement (this is the case in the example \textit{supra} note 276; the reason why the underwriters in practice employ precautionary measures is that condition (1) is not satisfied and that indemnification agreements are not always enforceable under U.S. law; on the other hand, comfort letters of the auditors addressed to the underwriters will generally require the underwriters to invoke the defences that are at their disposal against the investors’ claims, \textit{cf.} Lutz Krämer, \textit{Due Diligence und Prospekthaftung} [Due Diligence and Prospectus Liability], \textit{in} \textsc{Handbuch Börsennotierte AG. Aktien- und Kapitalmarktrecht} [Handbook Stock Exchange Listed Corporation. Corporate and Capital Markets Law] § 10/246 (Reinhard Marsch-Barner & Frank A. Schäfer eds., 2d ed. 2009).
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causes of action under the indemnification agreement, which might require a showing that the defendant has acted negligently. Still, risk shifting leads to an allocation that is, if not perfect, more efficient than a system that entrusts the courts or the legislator with determining the standard of care of each market participant. It can serve as an important means to compensate for a standard that has been set at an inefficient level by the legislator. Consequently, liability regimes should not consider risk shifting as against public policy, as is the view in the United States. Deterrence, if necessary, can be achieved without prohibiting contribution and indemnification agreements. The gatekeeper has to bear the insolvency risk of the counterparty, which should motivate him to act.

V. Conclusion

The investigation has shown that U.S. law provides for the most comprehensive investor protection regime, German law for the most restrictive, and English law takes a middle position. An intuitive explanation for these findings is the following. An analysis that tracks the development of the financial markets in the three countries over the last one hundred years indicates that significant advances in investor protection were preceded by leaps in stock market activity. The stock market in its modern form developed first in the United States, emerging at the beginning of the 20th century and expanding rapidly until 1929. The Great Crash of October 1929 and the ensuing Great Depression triggered the adoption of the Securities Acts that provide the basis for today’s investor protection regime. In the United

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278 Cf. the example supra note 276: The parties allocate the risk of liability according to spheres of knowledge. In other words, the party that is best positioned to monitor the accuracy of the statement shall be liable.


280 Accordingly, in countries such as Germany indemnification agreements are considered as permissible by the academic literature, cf. ELLENBERGER, supra note 175, at 55-56; Schwark, supra note 168, § 45 para. 70. Decisions of the courts do not exist.

Kingdom, Big Bang, i.e. the abolition of fixed commission charges and other reforms that were aimed at modernising the financial markets, precipitated an increase in market activity, which was followed by a replacement of the Financial Services Act 1986 by the Financial Services and Markets Act 2000. In Germany, stock market activity significantly increased not before the mid-1990s. Major reforms of investor protection were introduced by the Second, Third, and Fourth Financial Market Development Acts of 1994, 1998, and 2002.\textsuperscript{282} Thus, in all three countries the movement towards a more sophisticated investor protection regime lagged stock market development. In addition, the degree of sophistication of the regulatory regime mirrors the maturity of the financial markets, implying that the evolvement of an advanced system of capital markets regulation needs time. This assessment would need to be corroborated by means of a formal regression analysis. Provided that it is confirmed, it would call into question the well known claim made by Rafael La Porta and a number of other economists that strong securities markets presuppose a certain, U.S.-American style regime of investor protection.\textsuperscript{283} Rather, the converse would be true. Increased stock market activity changes incentive structures, informational differences, and conflicts of interest. This, in turn, generates demand for a modified system of securities regulation and improved investor protection.\textsuperscript{284}

The legal development in England and Germany is characterised by a movement towards more flexible, open-ended rules that enable the courts to react to fraudulent activity not only in specific situations but in the primary and secondary market in general. Due to a lack of express causes of action, in both countries the judiciary seeks to utilise tort law

\textsuperscript{282} The Second Financial Market Development Act (BGBl. I 1994, at 1749.) prohibited insider trading and enhanced transparency by requiring the disclosure of the acquisition or disposal of major holdings exceeding or falling below certain thresholds. The Third Financial Market Development Act (BGBl. I 1998, at 529) reformed the rules on prospectus liability and shifted the burden of proof for reliance and loss causation. The Fourth Financial Market Development Act (BGBl. I 2002, at 2010) improved supervision over the stock exchanges, introduced directors’ dealings provisions, prohibited market manipulation, and established liability for misleading statements in the secondary market.

\textsuperscript{283} Rafael La Porta et al., \textit{What Works in Securities Laws?}, 61 J. FIN. 1 (2006); Rafael La Porta et al., \textit{Investor Protection and Corporate Governance}, 58 J. FIN. ECON. 3 (2000); Rafael La Porta et al., \textit{Corporate Ownership around the World}, 54 J. FIN. 471 (1999); Rafael La Porta et al., \textit{Law and Finance}, 106 J. POL. ECON. 1152 (1998).

Using the example of Exchange Act Rule 10b-5, the essay has highlighted the dangers of a remedy for incorrect information in the securities markets that is based on judicially reformulated concepts of tort law. Such a remedy will assume definite contours slowly, produce high transaction costs, and possibly never form part of a coherent system of securities regulation.

Likewise, several deficiencies of the existing system of capital markets regulation have been identified. While section 11 Securities Act contains a clearly defined list of defendants and provides for a sliding scale of responsibility in accordance with principles of gatekeeper liability, the English and German prospectus rules are either too ambiguous or too restrictive to constitute effective tools for investor protection. Investor protection in the primary and particularly in the secondary market is underdeveloped. The legislator should establish causes of action that are conducive to legal certainty, addressed not only to the primary violator but also to third party actors, i.e. the issuer’s directors, underwriters, auditors, lawyers, and other experts, and define a standard of care that takes account of the gatekeeper’s position (which determines the cost created by requiring the gatekeeper to monitor the primary market participant) and the degree of reliability of the information that the gatekeeper reviews.

A possible system of liability for incorrect information in the primary market in Europe could be modelled after section 11 of the Securities Act or provide for three layers of liability: strict liability for the issuer, any type of negligence for the parties that are intimately involved in the offering (the inside directors, lead underwriters and experts that prepare or certify parts of the offering documentation), and gross negligence for other participants (e.g. outside directors and the remaining underwriters). Reliance on information provided by third parties reduces the duty of care if the information has been compiled following a procedure that ensures a high level of accuracy. In respect to the auditor, this is only the case if GAAS (or the European equivalent) have been observed, i.e. not for ordinary comfort letters. In all three countries under survey liability for misstatements in the secondary market should be

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285 In England, the first tentative steps in this direction have been taken in Possfund Custodian Trustee Ltd. v. Diamond [1996] 1 W.L.R. 1351 (supra III 2 b), extending the scope of the tort of negligent misrepresentation; in Germany, the development is predicated on section 826 Civil Code (supra III 3 b).

286 Supra IV 1.

287 Legal certainty lacks, in particular, in case of Rule 10b-5 in the United States, section 90 FSMA in the UK, and sections 44, 45 Stock Exchange Act in Germany. Cf. supra III 1 b, 2 a, 3 a.

288 Currently, Rule 10b-5, the tort of negligent misrepresentation, and section 826 German Civil Code do not encompass gatekeeper liability. Sections 44, 45 Stock Exchange Act are addressed to the underwriters but not other gatekeepers. Cf. supra III 1 b, 2 b, 3 a, b.

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

290 Supra IV 3.
extended. In the United States, this can be achieved by reinstating aiding and abetting liability under Rule 10b-5, in Europe the preferable solution would be the creation of express causes of action by the legislator to replace the ill-equipped English tort of negligent misrepresentation and section 826 of the German Civil Code.

Finally, uncertainties regarding the efficiency implications of regimes of strict liability and negligence and – in the case of negligent liability – shortcomings of the legislator or the judiciary in defining the efficient level of care can be (partly) remedied by allowing the market actors to shift the risk of liability. Thus, legal systems that interdict or restrict contribution and indemnification agreements (for example the United States) should reconsider their position.\textsuperscript{291}

\textsuperscript{291} Supra IV 4.