

## CIVIL LIABILITY OF SECURITIES UNDERWRITERS

EUROPEAN STUDIES IN LAW AND ECONOMICS SERIES

1. *Group Litigation in European Competition Law. A Law and Economics Perspective*, Sonja E. Keske
2. *Behavioural Economics in Consumer Policy*, Hanneke Luth
3. *Ex-Post Liability Rules in Modern Patent Law*, Rosa Castro Bernieri
4. *Competition and Innovation in the EU Regulation of Pharmaceuticals: The Case of Parallel Trade*, Claudia Desogus
5. *The Law and Economics of Organ Procurement*, Fırat Bilgel
6. *Law and Economics in the RIA World. Improving the use of economic analysis in public policy and legislation*, Andrea Renda
7. *Regulatory Competition in European Corporate and Capital Market Law*, Lars Hornuf
8. *Economic Criteria for Criminalization: Optimizing Enforcement in Case of Environmental Violations*, Katarina Svatikova
9. *Definition of the Relevant Market. (Lack of) Harmony between Industrial Economics and Competition Law*, Hila Nevo
10. *Patents as Protection of Traditional Medical Knowledge? A Law and Economics Analysis*, Petra Ebermann
11. *Rethinking the New York Convention. A Law and Economics Approach*, Shen Wei
12. *Towards a Better Assessment of Pain and Suffering Damages for Personal Injuries*, Vaia Karapanou
13. *Comparative Analysis of Merger Control Policy. Lessons for China*, Jingyuan Ma
14. *Does Law Matter for Economic Growth? A Re-examination of the 'Legal Origin' Hypothesis*, Guangdong Xu
15. *Committed to Reform. Pragmatic Antitrust Enforcement in Electricity Markets*, Małgorzata Sadowska

CIVIL LIABILITY OF  
SECURITIES UNDERWRITERS

Enforcing the Gatekeeping Function

Olia SKRIPOVA



intersentia

Cambridge – Antwerp – Portland

Intersentia Ltd  
Sheraton House | Castle Park  
Cambridge | CB3 0AX | United Kingdom  
Tel.: +44 1223 370 170 | Email: mail@intersentia.co.uk

*Distribution for the UK:*  
NBN International  
Airport Business Centre, 10 Thornbury Road  
Plymouth, PL6 7 PP  
United Kingdom  
Tel.: +44 1752 202 301 | Fax: +44 1752 202 331  
Email: orders@nbninternational.com

*Distribution for the USA and Canada:*  
International Specialized Book Services  
920 NE 58th Ave. Suite 300  
Portland, OR 97213  
USA  
Tel.: +1 800 944 6190 (toll free)  
Email: info@isbs.com

*Distribution for Austria:*  
Neuer Wissenschaftlicher Verlag  
Argentinerstraße 42/6  
1040 Wien  
Austria  
Tel.: +43 1 535 61 03 24  
Email: office@nwv.at

*Distribution for other countries:*  
Intersentia Publishing nv  
Groenstraat 31  
2640 Mortsel  
Belgium  
Tel.: +32 3 680 15 50  
Email: mail@intersentia.be

Civil Liability of Securities Underwriters. Enforcing the Gatekeeping Function  
Olia Skripova

© 2015 Intersentia  
Cambridge – Antwerp – Portland  
www.intersentia.com | www.intersentia.co.uk

ISBN 978-1-78068-263-1  
D/2015/7849/3  
NUR 820

British Library Cataloguing in Publication Data. A catalogue record for this book is available from the British Library.

No part of this book may be reproduced in any form, by print, photoprint, microfilm or any other means, without written permission from the publisher.

# CONTENTS

<i>Table of Cases</i> .....	xiii
<i>List of Tables</i> .....	xv
<i>List of Abbreviations</i> .....	xvii

<b>Introduction</b> .....	1
1. Why It Matters? .....	1
2. Research Question .....	3
3. Relevance .....	4
4. Methodology .....	5
5. Scope of Research and Limitations .....	6
6. Structure of the Book .....	7

## PART I. FROM PRACTICE TO THEORY

<b>Chapter 1. What Do Underwriters Do?</b> .....	13
1. Where Do Underwriters Operate? .....	13
2. Underwriter Role in Securities Offerings .....	15
2.1. Pre-Contractual Phase .....	15
2.2. Syndication .....	15
2.3. Prospectus and Due Diligence .....	16
2.4. Pricing .....	16
2.5. Allocation .....	20
2.6. Underwriting .....	21
2.7. Listing on the Trading Platform .....	22
2.8. Underwriting Fee .....	23
3. Underwriter Role in Post-Offering Activities .....	24
3.1. Market Making .....	24
3.2. Price Discovery .....	25
3.3. Stabilisation .....	26
3.4. Brokerage .....	29
3.5. Profitability of Underwriter Aftermarket Activities .....	31
3.6. Research Coverage .....	31
3.7. Other Post-Offering Services .....	33

<b>Chapter 2. Underwriter Gatekeeping Function and its Enforcement Mechanisms</b> .....	35
1. Underwriter Gatekeeping Function .....	35
1.1. Asymmetric Information .....	35
1.1.1. Effects on Primary Markets .....	37
1.1.2. Effects on Secondary Markets .....	38
1.1.3. Commitment Problems .....	41
1.2. The Primary Solution to the Failures of Securities Markets and its Limitations .....	42
1.3. The Underwriter as a Gatekeeper .....	43
2. Enforcement of the Underwriter Gatekeeping Function .....	47
2.1. Goals of Enforcement Mechanisms .....	47
2.2. Optimal Monitoring Effort .....	50
2.3. Types and Ranking of Enforcement Mechanisms .....	50
3. Market Enforcement Mechanisms .....	51
3.1. Reputational Sanctions .....	51
3.1.1. Reputational Sanctions in Theory .....	51
3.1.2. Reputational Sanctions in Practice .....	54
3.1.3. Summing Up .....	58
3.2. Economic Risk-Taking .....	59
3.3. Contractual Solutions .....	62
4. Legal Enforcement Mechanisms .....	64
4.1. <i>Ex Post</i> vs <i>Ex Ante</i> Legal Intervention in the Gatekeeping Market ..	64
4.1.1. Types of Legal Intervention .....	64
4.1.2. Criteria for Making a Choice .....	65
4.1.3. Some Caveats .....	67
4.1.4. Summing Up .....	69
4.2. Private vs Public <i>Ex Post</i> Legal Intervention in the Gatekeeping Market .....	69
4.2.1. Types of <i>Ex Post</i> Legal Intervention .....	69
4.2.2. Incentives to Monitor .....	70
4.2.3. Other Impact .....	73
4.2.4. Enforcement by the Stock Exchange .....	74
4.2.5. Summing Up .....	77
4.3. Potential Costs of Gatekeeping and its Enforcement .....	78
4.3.1. General Costs of Gatekeeping .....	78
4.3.2. Specific Costs of Private Enforcement .....	82
4.3.3. Summing Up .....	82

**Chapter 3. Imposition of Civil Liability for Gatekeeping: Impact on Other Functions of the Underwriter** . . . . . 83

1. Underwriter’s Advisory Role . . . . . 83

    1.1. Underlying Problem . . . . . 83

    1.2. Impact of the Imposition of Liability . . . . . 84

2. Sale Intermediation by Underwriters . . . . . 85

    2.1. Underlying Problem . . . . . 85

    2.2. Impact of the Imposition of Liability . . . . . 86

3. Price Discovery (Bookbuilding) by Underwriters . . . . . 87

    3.1. Underlying Problem . . . . . 87

    3.2. Impact of the Imposition of Liability . . . . . 91

4. Underwriting Function of Underwriters . . . . . 93

    4.1. Underlying Problem . . . . . 93

    4.2. Impact of Imposition of Liability . . . . . 94

**PART II. THE LAW ON CIVIL LIABILITY**

**Chapter 4. The Most Important Elements of a Liability Regime** . . . . . 99

1. Parties to a Dispute . . . . . 100

    1.1. Potential Defendants . . . . . 100

    1.2. Potential Plaintiffs . . . . . 101

2. Liability Standard . . . . . 102

3. Measure of Damages . . . . . 103

4. Procedural Rules . . . . . 103

    4.1. Cost-Sharing Rules . . . . . 104

    4.2. Types of Collective Proceedings . . . . . 105

        4.2.1. Main Features of Joinder Proceedings . . . . . 105

        4.2.2. Main Features of Representative Proceedings . . . . . 106

        4.2.3. Other Types of Collective Proceedings . . . . . 106

        4.2.4. Comparison of Collective Proceedings . . . . . 106

    4.3. Choice of Initiator of the Claim . . . . . 108

        4.3.1. Initiation by Any Member of the Class . . . . . 108

        4.3.2. Initiation by a Representative Organisation . . . . . 110

    4.4. Opt-In and Opt-Out . . . . . 111

    4.5. Burdens of Proof . . . . . 112

5. Nature of the Liability Regime . . . . . 113

**Chapter 5. Underwriters’ Civil Liability in the USA** . . . . . 115

1. General Remarks . . . . . 115

2. Registered Prospectus Liability: Section 11 . . . . . 116

2.1. Requirement to Disclose Information .....	116
2.2. Basis for Liability .....	116
2.3. Potential Defendants .....	117
2.4. Potential Plaintiffs .....	118
2.5. Liability Standard .....	119
2.6. Burdens of Proof .....	123
2.7. Definition of Damages .....	124
3. Beyond Prospectus Liability .....	124
3.1. Liability for Other Offering Documents and Oral Statements in Connection to the Distribution: Section 12(a)(2) .....	124
3.2. Underwriter Liability in All Other Cases: Rule 10b-5 .....	127
4. Procedural Rules in the USA .....	135
5. Limitation of Liability .....	137
5.1. Disclaimers and Limitations .....	137
5.2. Indemnification and Contribution .....	138
6. Liability Threat Posed by the US System .....	138
6.1. Law on the Books .....	138
6.1.1. Section 11 .....	138
6.1.2. Section 12(a)(2) .....	142
6.1.3. Rule 10b-5 .....	143
6.2. Law in Practice .....	143
<b>Chapter 6. European Legal Framework. ....</b>	<b>149</b>
1. General Remarks .....	149
2. Underwriters' Gatekeeping Duties and Liability within the EU Regime .....	150
2.1. Requirement to Disclose Information .....	150
2.2. Basis for Liability .....	150
2.3. Possible Defendants .....	151
2.4. Beyond Prospectus Liability .....	153
2.5. Unfair Commercial Practices Directive .....	154
3. Procedural Law in Europe .....	155
<b>Chapter 7. Underwriters' Civil Liability in the Netherlands .....</b>	<b>157</b>
1. Prospectus Liability: Sections 6:193 A, 6:194 and 6:195 .....	157
1.1. Requirement to Disclose Information .....	157
1.2. Basis for Liability .....	157
1.3. Potential Defendants .....	159
1.4. Potential Plaintiffs .....	160
1.5. Liability Standard .....	161



1.6.	Burdens of Proof . . . . .	161
1.6.1.	Burdens of Proof at the Declaratory Judgment Stage. . . . .	162
1.6.2.	Burdens of Proof at the Stage of the Award of Damages . . . .	163
1.7.	Definition of Damages . . . . .	164
2.	Beyond Prospectus Liability . . . . .	165
3.	Procedural Rules in the Netherlands . . . . .	166
4.	Limitations of Liability . . . . .	170
4.1.	Disclaimer and Limitations . . . . .	170
4.2.	Indemnification and Contribution . . . . .	171
5.	Liability Threat Posed by the Dutch Legal System . . . . .	171
5.1.	Law on the Books. . . . .	171
5.2.	Law in Practice. . . . .	176
 <b>Chapter 8. Underwriters' Civil Liability in the UK. . . . .</b>		<b>179</b>
1.	Prospectus Liability: Section 90. . . . .	179
1.1.	Requirement to Disclose Information . . . . .	179
1.2.	Basis for Liability . . . . .	179
1.3.	Potential Defendants. . . . .	180
1.4.	Potential Plaintiffs . . . . .	181
1.5.	Liability Standard . . . . .	181
1.6.	Burdens of Proof . . . . .	182
1.7.	Definition of Damages . . . . .	182
2.	Prospectus Liability: Common Law Causes of Action. . . . .	183
2.1.	Tort of Fraudulent Misrepresentation . . . . .	183
2.2.	Tort of Negligent Misrepresentation. . . . .	184
2.3.	Contractual Liability. . . . .	185
3.	Beyond Prospectus Liability . . . . .	186
4.	Procedural Rules in the UK . . . . .	187
5.	Limitation of Liability . . . . .	189
5.1.	Disclaimers and Limitations . . . . .	189
5.2.	Indemnification and Contribution . . . . .	189
6.	Liability Threat Posed by the British System . . . . .	190
6.1.	Law on the Books. . . . .	190
6.1.1.	As Compared to the USA . . . . .	191
6.1.2.	As Compared to the Netherlands . . . . .	191
6.1.3.	Predicting the Size of Settlements in the UK . . . . .	192
6.1.4.	Probability of Enforcement . . . . .	192
6.2.	Law in Practice. . . . .	193

PART III. POLICY IMPLICATIONS

**Chapter 9. Proposal for Improvement of Underwriters' Civil Liability Regimes in the USA and the Netherlands** ..... 197

1. Underwriter Liability as a Tort. .... 197
2. Negligence vs Strict Liability ..... 198
  - 2.1. Academic Debate on Negligence vs Strict Liability ..... 198
  - 2.2. Application of Shavell Framework to Underwriter Liability ..... 201
    - 2.2.1. Unilateral vs Bilateral Accident. .... 201
    - 2.2.2. The Effect of Mistakes. .... 203
    - 2.2.3. Level of Activity and Residual Liability Risks. .... 204
    - 2.2.4. Problem of Frivolous Litigation. .... 207
  - 2.3. Liability Regimes and Low Settlement Size. .... 209
3. Proposal for a Change ..... 212
  - 3.1. Switch to Strict Liability ..... 212
  - 3.2. Solving the Problem of the Excessive Residual Liability Risk: The Cap on Damages. .... 212
  - 3.3. Solving the Problem of Frivolous Litigation: The Shift of the Burden to Prove Loss Causation ..... 215
4. Application to the US Legal System. .... 218
5. Application to the Dutch Legal System. .... 219

**Chapter 10. The Curious Case of the UK** ..... 223

1. No Private Enforcement ..... 223
2. Alternative Enforcement Mechanisms ..... 225
  - 2.1. Overview of Historical Development: LSE and FSA ..... 225
  - 2.2. Enforcement by the FSA in Practice. .... 228
  - 2.3. Enforcement by the LSE in Practice ..... 229
  - 2.4. Summing Up ..... 229
3. Particularities of the UK Market ..... 230
4. Means to Increase Liability Threat in the UK ..... 232
  - 4.1. Is There a Need for Civil Liability in the UK? ..... 232
  - 4.2. Application of My Proposal to the UK Legal System. .... 233

**Conclusions** ..... 235

1. Main Findings. .... 235
  - 1.1. Underwriters and their Main Functions ..... 235
  - 1.2. Positioning Civil Liability among other Enforcement Mechanisms ..... 236

1.3. Civil Liability in Selected Jurisdictions .....	237
1.4. The Proposal for a Change .....	240
2. Limitations and Suggestions for Further Research.....	241
<i>Bibliography</i> .....	243



## TABLE OF CASES

- ABN AMRO v The Association for the representation of the interests of Coopag Finance BV*, HR 2 December 1994, NJ 1996, 246, n.d.
- Anixter v Home – Stake Production Co.*, 77 F.3d 1215 (10<sup>th</sup> Cir. 1996), n.d.
- Barnes v Osofsky*, 373 F.2d 269, 272 (2<sup>nd</sup> Cir. 1967), n.d.
- Basic, Inc. v Levinson*, 485 U.S. 224, 247, 108 S.Ct. 978, 99 L.Ed.2d. 194 (1988), n.d.
- Broad v Rockwell International Corp.*, 642 F. 2d 929, 961–962 (5<sup>th</sup> Cir.), cert. denied, 454 U.S. 965 (1981), n.d.
- Central Bank, N.A. v First Interstate Bank of Denver*, 511 U.S. 164 (1994), n.d.
- Chiarella v United States*, 445 U.S. 222 (1980), n.d.
- Chris – Craft Industries, Inc. v Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.) cert. denied, 414 U.S. 910, 94 S. Ct. 231, 38 L. ed. 148 (1973);, n.d.
- Cooper v Pickett*, 13f7 F.3d 616 (9<sup>th</sup> Cir. 1997), n.d.
- Converium Holding AG, Hof Amsterdam (tweede meervoudige burgerlijke kamer)* 12 november 2010, nr. 200.070.039/01, LJN BO3908, RF 2011/8, n.d.
- Dura Pharmaceuticals, Inc. v Broudo*, 544 U.S. 336 (2006), n.d.
- Ernst & Ernst v Hochfelder*, 425 U.S. 185 (1975), n.d.
- Escott v BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), n.d.
- Feit v Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y.), n.d.
- First Interstate Bank of Denver, N.A. v Pring*, 969 F.2d 891 (C.A.10 (Colo.) 1992), n.d.
- Globus v Law Research Service, Inc.*, 418 F 2<sup>nd</sup> 1276 (1969), cert. denied, 397 US (1970), n.d.
- Gustafson v Alloyd Co.*, 513 U.S. 561 (1995), n.d.
- Harden v Raffensperger*, 65 F. 3d 1392 (7<sup>th</sup> Cir. 1995), n.d.
- Hoffman v Estbrook & Co.*, 587 F 2d 509, 516 (1<sup>st</sup> Cir. 1978), n.d.
- Howard v Everex Systems, Inc.*, 228 F.3d 1057 (9<sup>th</sup> Cir. 2000), n.d.
- In re College Bound Consolidated Litigation*, 1994 WL 172408, 1994 U.S. Dist. LEXIS 5756 (S.D.N.Y. May 4, 1994), n.d.
- In re MTC Electronic Technologies Shareholder Litigation*, 898 F. Supp. 974 (E.D.N.Y. 1995) and 993 F. Supp. 160 (E.D.N.Y.), n.d.
- In re Mutual Funds Investment Litigation*, 566 F.3d. 111 (4<sup>th</sup> Cir. 2009), n.d.
- In re Software Toolworks, Inc.*, 50 F 3d 615 (9<sup>th</sup> Cir. 1994), n.d.
- In re U.S.A. Classic Securities Litigation*, 1995 WL 363841 (S.D.N.Y.), n.d.
- In re WorldCom, Inc. Securities Litigation*, 2004 U.S. Dist. LEXIS 25155 (S.D.N.Y. 2004), n.d.
- Kiernan v Homeland Inc.*, 611 F. 2d 785, 788 (9<sup>th</sup> Cir. 1984), n.d.
- Kirkwood*, 590 F. Supp. 1375 (D. Minn. 1984), n.d.
- Picard Chemical, Inc. Profit Sharing Plan v Perrigo Co.*, 940 F. Supp, 1101 (W. D. Mich. 1996), n.d.
- Pinter v Dahl*, 486 U.S. 622 (1988), n.d.

*Pollack v Laidlaw Holdings, Inc.*, n.d.  
*Sanders v John Nuveen & Co, Inc.*, F.2d 790 (7<sup>th</sup> Cir. 1977), n.d.  
*SEC v Dain Rauscher*, 254 F. 3d 852 (9<sup>th</sup> Cir. 2001), n.d.  
*SEC v Dolphin and Bradbury, Inc. and Bradbury*, 512 F.3d 634 (D.C. Cir. 2008), n.d.  
*SEC v Falstaff Brewing Co.*, 629 F. 2d 62, 76 (D.C. Cir. 1980), n.d.  
*SEC v Ralston Purina Co.*, 346 U.S. 119 (1953), n.d.  
*SEC v Tambone*, 597 F.3d 436 (1<sup>st</sup> Cir. 2010), n.d.  
*Shapiro v Cantor*, 123 F.2d 717 (2<sup>nd</sup> Cir. 1997), n.d.  
*Sonnenfeld v City and Country of Denver*, 100 F.3d 744, 748 (10<sup>th</sup> Cir. 1996), n.d.  
*Stoneridge Investment Partners v Scientific – Atlanta, Inc.*, 128 S. Ct. 761 (2008), n.d.  
*TSC Indus v Northway, Inc.*, 426 U.S. 438, 449 (1976), n.d.  
*VEB et alia v World Online, ABN AMRO and Goldman Sachs*, LJN: BH2162, Hoge raad  
07/11104, n.d.  
*Weinberger v Jackson*, 1990 WL 260676 (N.D. Cal 1990), n.d.  
*Wright v Ernst & Young LLP*, 152 F. 3d. 169 (2<sup>nd</sup> Cir. 1998), n.d.  
*Ziembra v Cascade International, Inc.*, 256 F. 3d. 1194 (11<sup>th</sup> Cir. 2001), n.d.  
*ZZZZ Best Securities Litigation*, Fed. Sec. L. Rep. (CCH) 94485, 1989 WL 90284 (C.D.  
Cal. 1989), n.d.

## LIST OF TABLES

Table 1. Private securities litigation in the USA 2002–2009 . . . . .	144
Table 2. Private litigation in the USA 2002–2009 . . . . .	146
Table 3. IPO activity . . . . .	224
Table 4. Underwriter liability in the USA, the Netherlands and the UK . . . . .	239





## LIST OF ABBREVIATIONS

AIM	Alternative investment market of the London Stock Exchange
FSMA	UK Financial Services and Markets Act of 2000
FSA	UK Financial Services Authority
GLO	Group Litigation Order
IPO	Initial Public Offering
LSE	London Stock Exchange
MIFID	EU Directive 2004/39/EC on Market in Financial Services
OFT	UK Office of Fair Trading
PSLRA	Private Securities Litigation Reform Act of 1995
SEC	Securities and Exchange Commission
SEO	Seasonal Equity Offering

