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Underwriter Due Diligence: It's [Not] A Whole New Ballgame

Eric Seitz

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I. INTRODUCTION

On December 27, 2007, the Securities and Exchange Commission ("Commission") gave many smaller public companies a late Christmas present by announcing regulatory amendments that make it easier for them to issue securities in a public offering. This announcement culminated twenty-five years of rapid change within securities-offering regulation. Many factors and forces have combined to account for this change. Technological advances simultaneously have increased the amount of information available to potential securities investors and decreased the time it takes to disseminate this information. The efficient securities marketplace now reacts almost instantaneously to this continual influx of information. As a result, the amount of time issuers have to coordinate a securities offering with favorable market conditions is constantly shortening.

Over the years, the Commission has responded to this trend by allowing issuers to "incorporate by reference" certain registration documents as well as to file "shelf" registrations which they can "pull down" on very short notice. Both options allow issuers to get properly registered offerings to the marketplace very quickly, which decreases the chance that market conditions will change drastically during the registration process. Concurrent with these accelerated registration options, competition between underwriters has become fiercely intense as the underwriting industry has moved from a "relationship" to a "transactional" model. This competition has squeezed both underwriters' margins as well as the time they have to "get to know" a client.

These factors have created a "perfect storm" for underwriters. Securities issuers, who underwriters do not know as well as they used to, seek increasingly shorter registration periods. Underwriters have less time to conduct due diligence on securities offerings. In many ways, this both has reduced the willingness and the ability of underwriters to conduct thor-
ough due diligence investigations. Despite repeated admonitions from industry and academia, the Commission has been slow to the rescue, only going as far as suggesting that "underwriters may elect to apply somewhat different, but equally thorough, investigatory practices."1 While several of these practices are explored in this Comment, none have proven to be particularly effective because the Commission refuses to "adapt the [due diligence] standard to the circumstances of modern [securities] offerings."2 Due diligence standards for underwriters largely remain unchanged from when they were enacted over seventy years ago. This Comment examines the history and development of the securities registration/underwriting dichotomy, explores the problems that exist, and suggests several solutions to realign underwriting requirements with the realities of modern securities offerings.

II. HISTORICAL BACKGROUND

Prior to the enactment of the Securities Act of 19333 ("Securities Act") and the Securities Exchange Act of 19344 ("Exchange Act"), "the capital markets were in complete disarray."5 "[H]alf of the $ 50 billion of new securities offered during the decade following World War I [ultimately] proved to be worthless."6 "The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment . . . of . . . standards of fair, honest, and prudent dealing . . . ."7 President Roosevelt called for legislation that would put "the burden of telling the whole truth" on the seller.8 Congress passed the Securities Act to ensure full disclosure and governmental review of securities offerings and to provide civil liabilities for material misstatements and omissions.9 The Securities Act is simple and narrowly focused, but provides a serviceable mechanism to ensure these goals are met.10 The Exchange Act was passed one year later for the purpose of regulating securities markets, brokers, and dealers.11 Unlike

7. Id.
8. Greene, supra note 5, at 767. Interestingly, essentially the same burden was placed on the underwriter as well.
9. McLaughlin & Williams, supra note 6, at 1190.
11. Id. at 1340-41.
the Securities Act, which is applicable to a large number of companies but only on relatively rare occasions, the Exchange Act affects a relatively small number of companies on a regular basis, with considerably fewer "supporting mechanisms and sanctions."12

A. THE SECURITIES ACT OF 1933

Pursuant to the Securities Act, when a securities offering is issued by means of interstate commerce or use of the mails (which almost is a certainty), it must be registered by means of a registration statement.13 The purpose of the registration statement is two-fold: (1) to provide information on the offering itself (e.g. underwriting and distribution arrangements, offering price, costs, intended use of proceeds, etc.); and (2) to provide information on the issuer's business (e.g. history, management, property, material contracts, financial condition, etc.).14 There are two major exceptions to the registration requirement.15 If securities are issued via an exempted transaction, no registration is required.16 Examples of exempted transactions include those by "any person other than an issuer, underwriter, or dealer,"17 those not involving a public offering,18 or certain transactions by a dealer.19 Moreover, certain classes of securities are exempted from registration.20 Examples include certain short-term promissory notes, securities issued by local, state, or federal governmental entities, and securities issued by non-profit and charitable organizations.21

Registration is perfected by filing a registration statement with the Commission, paying a registration fee, and making information contained in the registration statement available to the public "under such regulations as the Commission may prescribe."22 Generally, no securities can be sold until a registration statement is "effective."23 Unless the Commission deems the registration statement to include inaccurate or incomplete information, the registration statement becomes effective twenty

12. Id. at 1341.
15. Such exceptions pertain to registration requirements promulgated under the Securities Act only. Some securities fall under the supervisory and oversight umbrella of other statutory regimes, including, for example, the Comptroller of the Currency, for securities issued by national banks. See MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW 37 (4th ed. 2007).
17. Id. § 77d(1).
18. Id. § 77d(2).
19. Id. § 77d(3).
23. Id. § 77f(a). Issuers who have filed periodic reports under the Exchange Act for at least twelve months and have a "public float" of at least $700 million—so called "well-known seasoned issuers"—may sell securities prior to the effective date of the registration statement. See Securities Offering Reform, Securities Act Release No. 33-8591, 85 SEC Docket 2871, 2882-85 (July 19, 2005).
days after filing, or earlier as the Commission may determine. While the process of registering a securities offering is fairly straightforward, it is far from a simple, ministerial endeavor. The registration statement is complex and exhaustive, and can cost an issuer tens if not hundreds of thousands of dollars to prepare. Moreover, the time taken to complete a registration statement is properly measured in weeks, not hours or days. Such costs are financially prohibitive for many companies.

B. The Securities Exchange Act of 1934

The Exchange Act established a “continuous disclosure system for issuers of most of the important corporate securities traded in the nation’s markets.” The regime requires these issuers to file an initial registration statement as well as periodic reports and proxy solicitations. The main difference, then, between the financial data available to the investing public under the Securities Act and under the Exchange Act relates to the currency of the data. Reports under the Securities Act only are accurate as to the date of the last securities offering, whereas Exchange Act reports are updated at least partially on a quarterly basis and completely on an annual basis. With the advent of integrated disclosure, the Exchange Act came to play a major role in the registration and underwriting process.

III. EVOLUTION OF THE SECURITIES REGISTRATION PROCESS

A. Integrated Disclosure

The Securities and Exchange Acts operate independently, but their respective disclosure requirements came to be viewed by issuers and underwriters as somewhat duplicative and unnecessary. For example, much of the information required in Securities Act registration statements can be found in Exchange Act reports. In 1966, Commission-insider Milton Cohen proffered that some sort of integrated disclosure was in order, stating: “[I]t is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 [Exchange] Act and treating ‘1933 [Securities] Act’ disclosure needs

25. STEINBERG, supra note 15, at 38.
29. Such a statement would include essentially the same information found in a Securities Act registration statement less any information pertaining to a particular offering. Id. at 1356.
30. Id. at 1355-56.
31. Id. at 1356.
32. Frerichs, supra note 26, at 387.
33. Id.
on this foundation." Cohen proffered that the Commission add "needed flesh" to the Exchange Act requirements and cut "unneeded fat" from the Securities Act requirements, while recognizing that a balance must be struck between the view that "more disclosure . . . [is] better" and the concern over the significant cost of disclosure.35

The Commission responded a year later by temporarily adopting "short-form" registration, where issuers with a substantial history of filing reports under the Exchange Act could rely on certain information contained in Exchange Act reports to satisfy certain Securities Act registration requirements.36 While this was a positive step, it affected only a small percentage of all reporting companies.37 The Commission formally adopted integrated disclosure in 1982,38 stating that the goal of the system was "to eliminate overlapping and unnecessary disclosure and dissemination requirements where possible, thereby reducing burdens on issuers, while at the same time ensuring that the investing public was receiving meaningful, nonduplicative information on which to base investment decisions."39 Then-Commissioner John Shad declared the day "an historic occasion."40 The Commission's rationale for integrated disclosure stemmed from the "efficient market hypothesis," which theorizes that the securities markets are completely efficient and that "new information about a security is almost instantaneously assimilated in the marketplace and reflected in the security's price."41 Accordingly, if an issuer has filed periodic reports with the Commission, the information contained therein automatically is incorporated in a security's price on behalf of potential investors.42

Under the current integrated disclosure system, issuers are divided into two tiers.43 Each tier determines what information must be included in the registration statement and which information can be incorporated by reference from periodic reports.44 Regardless of the origin, each issuer

34. Cohen, supra note 10, at 1342.
35. Id. at 1367.
36. Greene, supra note 5, at 782.
38. See id.
40. Frerichs, supra note 26, at 388.
41. Nicholas, supra note 37, at 4-5.
42. Id. at 5.
43. Id. In one regard, market efficiency has a negative, rather than positive, effect on the quality of information that is assimilated into the price of securities. Because of the instant availability of information via the Internet, underwriters have a more difficult time "scrubbing" information upon which investors ultimately should rely. Additionally, underwriters have no control over the dissemination of relevant, if not entirely correct, information upon which investors may unwittingly rely. See Craig Chapman, Underwriters' Due Diligence Revisited, 35 REV. SEC. & COMMODITIES REG. 207, 209 (2002).
44. Frerichs, supra note 26, at 388.
45. Id.
“makes available” the same information—whether it be found in the registration statement or periodic reports.  

B. SHELF REGISTRATION

On December 31, 1983, the Commission permanently adopted “shelf registration” via the Securities Act Rule 415. Shelf Registration, Securities Act Release No. 33-6499, 29 SEC Docket 138, 138 (Nov. 17, 1983). Rule 415 allows a qualified issuer to register a securities offering and then sell the registered securities either continuously or periodically during the ensuing three-year period after the effective date of the registration statement. Each time an issuer makes an offering, any material changes to the registration information (whether contained in the registration statement or incorporated by reference from Exchange Act reports) that have occurred when the securities are sold must be updated.

IV. THE UNDERWRITER

A. UNDERWRITER AS ADVISER AND ADVISOR

In a securities offering, the basic role of an underwriter is to act as an intermediary between the issuer and the investor. For a portion of the proceeds of the sale of securities, an underwriter assumes the responsibility and risk inherent in selling securities in a public offering. Such responsibility requires an underwriter to “exercise a high degree of care in investigation and independent verification of the company’s representations” and to ensure the truth of registration statements and prospectuses. In this regard, the position of the underwriter and the issuer are adverse. Underwriters are expected to uncover exaggerations and overly optimistic statements made by issuers. “The underwriter must question, probe, investigate, verify—play ‘devil’s advocate’ with the issuer.” The Feit court summarized the important, while tenuous, role of underwriters when it stated:

[C]ourts must be particularly scrupulous in examining the conduct of underwriters since they are supposed to assume an opposing posture with respect to management. . . . In light of this adverse position they must be expected to be alert to exaggerations and rosy outlooks and chary of all assurances by the issuer. Their duty is to the investing

46. Id.
48. Id. See also Delayed or Continuous Offering and Sale of Securities, 17 C.F.R. § 230.415 (2008).
49. Frerichs, supra note 26, at 390-91.
51. Id.
54. Id. at 696.
56. Nicholas, supra note 37, at 10.
public under Section 11 as well as to their own self-interest and that duty cannot be taken lightly.\textsuperscript{57}

Given the short amount of time an underwriter has to respond to any problems that are uncovered during the due diligence process, often the underwriter's only recourse is to refuse to "close" an offering.\textsuperscript{58} In this regard, an underwriter wields tremendous power. An underwriter rarely uses this arrow in its quiver, however, because of the competitive environment in which underwriters operate. As a result, most will move forward in all but the most serious instances of disclosure problems.\textsuperscript{59}

The underwriter has interests aligned with the issuer as well. The underwriter assists the issuer in pricing the offering and structuring financing.\textsuperscript{60} Because of the invaluable services an underwriter provides to both the issuer and the investing public, the role traditionally has been revered as instrumental in the proper and efficient functioning of the securities markets.\textsuperscript{61} As the Second Circuit noted:

No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter. He is most heavily relied upon to verify published materials because of his expertise in appraising the securities issue and the issuer, and because of his incentive to do so. He is familiar with the process of investigating the business condition of a company and possesses extensive resources for doing so. Since he often has a financial stake in the issue, he has a special motive [to] thoroughly . . . investigate the issuer's strengths and weaknesses. Prospective investors look to the underwriter . . . to pass on the soundness of the security and the correctness of the registration statement and prospectus.\textsuperscript{62}

Several permutations of the issuer-underwriter relationship exist that merit noting. In a "firm commitment" arrangement, the underwriter agrees to purchase all or most of the securities offered and assumes the duty (and accompanying risk) of selling the securities to the public.\textsuperscript{63} By contrast, a "best efforts" arrangement only requires the underwriter to act as an agent of the issuer and diligently attempt to sell the securities.\textsuperscript{64} The risk of loss remains with the issuer.\textsuperscript{65}

Two types of distribution arrangements exist within the underwriting industry: the "negotiated" approach and the "competitive bidding" approach.\textsuperscript{66} With the negotiated approach, the "rules of engagement" be-

\textsuperscript{57} Feit, 332 F. Supp at 581.
\textsuperscript{58} Interests of Named Experts and Counsel, 17 C.F.R. § 229.509 (2008).
\textsuperscript{59} Id.
\textsuperscript{60} Municipal Securities Disclosure, Exchange Release No. 34-26100, 41 SEC Docket 1131, 1144 (Sept. 22, 1988).
\textsuperscript{61} Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir. 1973).
\textsuperscript{62} Id.
\textsuperscript{63} Greene, supra note 5, at 762.
\textsuperscript{64} Id.
\textsuperscript{65} Id.
\textsuperscript{66} Id.
between the issuer and underwriter generally are contemplated and agreed upon after a series of meetings. The underwriter determines if any other underwriters will be brought into the deal—but only after an agreement first has been struck with the issuer. If a consortium of underwriters is formed (a "purchase group"), the firm that negotiated with the issuer becomes the "managing underwriter" and charges a fee for its services. The managing underwriter then is responsible for executing a separate underwriting agreement on the purchase group's behalf. In the "competitive bidding" environment, underwriters form purchase groups before any issuer is identified and then bid on an offering once it is announced. Another key difference between these two distribution arrangements is the timing of the underwriter's due diligence. While due diligence responsibilities and expectations remain the same, the time in which to complete them can drastically be different. With negotiated arrangements, the underwriter and the issuer work together to prepare the registration material. Under a competitive bidding scenario, the underwriter is engaged much later in the process and typically relies on underwriter's counsel to begin due diligence.

B. UNDERWRITER AS GATEKEEPER

The role of a gatekeeper is defined as an "intermediary who provides verification and certification services to investors by pledging its professional reputation and by withholding... support, block[ing] admission through the gate." The strategy of gatekeeping is a device for utilizing third parties in an enforcement effort against private actors in the public marketplace. The enforcement sought is achieved through the passive refusal of support of the third party. In the securities setting, the term "gatekeeper" long has been used to describe independent professionals who indirectly serve the investing public by preparing, scrutinizing, and vouching for the accuracy of information they receive. Ex-

67. Id.
68. Id. The underwriter determines if it wants to allocate some of its risk by bringing in additional underwriters.
69. Id. at 763. Generally, the lead underwriter performs the majority of the due diligence functions on behalf of the underwriting syndicate. See Gretchen Morgenson, WorldCom Teaches a Pricey Lesson, N.Y. TIMES, Mar. 13, 2005, § 3, at 1.
70. Greene, supra note 5, at 763.
71. Id.
72. Id.
73. Id. at 764.
74. Id.
77. Id. at 54.
amples of gatekeepers include auditors, debt rating agencies, securities analysts, underwriter’s counsel, and underwriters themselves.\textsuperscript{79}

The "accountability" theory behind the effectiveness of a gatekeeper is that a party independent of the issuer is positioned so that if it withholds consent or approval, the issuer may be unable to move forward in some desired manner.\textsuperscript{80} At the same time, the gatekeeper is insulated to the point that it will receive little or nothing from corporate misconduct.\textsuperscript{81} Thus, a gatekeeper will not be tempted to engage in or consent to criminal activity in order to achieve a particular result or status.\textsuperscript{82} Of major value to a gatekeeper is its reputation for thoroughness, fairness, and impartiality. The theory postulates that a gatekeeper will not risk the value of its reputation to further the goals of any client, especially one that represents a relatively small portion of its revenues.\textsuperscript{83} Gatekeepers are less likely to acquiesce to fraud if they are more likely to be "repeat players."\textsuperscript{84}

As the role of underwriters transformed from a relationship model to a transactional model (where a smaller percentage of a firm’s revenue generally came from any individual issuer), underwriters fell neatly into the gatekeeping role. However, this development has turned out to be tenuous. For example, the indiscretions of Arthur Anderson, a quintessential gatekeeper, and the resulting collapse of Enron, left in its wake a serious blow to the reputation of many “well-established intermediaries,” including underwriters.\textsuperscript{85} As a result, preservation of reputation as motivation to perform the gatekeeping role seriously was undermined.

\textbf{V. MAJOR SOURCES OF UNDERWRITER LIABILITY}

Congress views underwriters as bearing a "moral responsibility to the public [that] is particularly heavy."\textsuperscript{86} As a result, legislation governing the accountability of underwriters has been "designed to assure compliance with the disclosure provisions . . . by imposing a stringent standard of liability on the parties who play a direct role in a registered offering."\textsuperscript{87} Major sources of underwriter liability can be found in Sections 11 and 12 of the Securities Act and Section 10 of the Exchange Act. Liability also can accrue under common law fraud and breach of fiduciary duty principles.

\textsuperscript{79} Id.
\textsuperscript{80} Id. at 1295.
\textsuperscript{81} Id. at 1298.
\textsuperscript{82} Id.
\textsuperscript{83} Id. at 1297-98.
\textsuperscript{87} Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983).
A. Securities Act Section 11

Section 11 of the Securities Act imposes liability "[i]n case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading" on "every underwriter with respect to such security."88 Whether a statement or omission is "material" is a question of fact based on whether a "reasonable investor" would find the information significant.89 A misstatement or omission may be deemed immaterial if it is trivial, already well-known in the marketplace, or accompanied by cautionary language.90 The thrust of the protection Section 11 provides stems from its potential effect on the issuer, underwriters, and other parties.91 As Milton Cohen boasted, "[t]he liability provisions have had the in terrorem effect of creating an extraordinarily high sense of care and responsibility in the preparation of registration statements."92

B. Securities Act Section 12(a)(2)

Section 12(a)(2) imposes liability on "any person who offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading."93 Thus, in a "firm commitment" underwriting arrangement, the underwriter (as the seller of securities) can be liable under Section 12.94 Pursuant to Securities Act Rule 159, only information conveyed to investors up to and at the time of sale will be examined for Section 12 purposes.95

C. Exchange Act Section 10(b)96

While Sections 11 and 12 of the Securities Act essentially impose a negligence standard on underwriters, Section 10(b) of the Exchange Act imposes liability for using or employing "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission

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90. Id. at 658.
91. Nicholas, supra note 37, at 8.
92. Cohen, supra note 10, at 1355.
94. See Lone Star Ladies Inv. Club v. Schlotzky's Inc., 238 F.3d 363, 370 (5th Cir. 2001); WorldCom, 346 F. Supp. 2d at 659.
96. For the purposes of this Comment, Section 10(b) and Rule 10b-5 promulgated thereunder are treated analogously.
may prescribe. . ." In *Kardon v. National Gypsum Co.*, a federal court found an implicit private right of action under Section 10(b). To successfully make a claim under Section 10(b), a plaintiff must establish (1) a misstatement or omission; (2) of material fact; (3) made with scienter; (4) on which the plaintiff relied; and (5) that proximately caused his injury. While Section 10(b) provides no affirmative due diligence defense akin to that provided under Section 11 or Section 12, it is "virtually impossible" to find that an underwriter who invokes an effective Section 11 or Section 12 due diligence defense possessed the scienter required under Section 10(b).

 Paramount to an underwriter's potential liability under Section 10(b) is the question of aiding and abetting liability. After nearly six decades of speculation and uncertainty, the Supreme Court finally held in 1994 that no private right of action exists under Section 10(b) for aiding and abetting securities fraud, and secondary actors are not subject to liability. However, a seemingly secondary actor can be deemed primary—and thus liable under a Section 10(b) private action—if he "employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies . . . assuming all of the requirements for primary liability under [Exchange Act] Rule 10b-5 are met." This somewhat circular reasoning—"a secondary actor might be liable as a primary actor"—has caused a split in the circuits concerning ultimate secondary actor liability in fraud cases.

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99. Id. at 802.
101. In the instance of a material omission, reliance is established if a "reasonable investor" would have considered the withheld information to be important in making an investment decision. See *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 374 (2d Cir. 1973). In the instance of a material misstatement, causation can be established through the "fraud on the market theory . . . hypothes[izing] that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . ." *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988) (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (3d Cir. 1986)).
103. *McLaughlin & Williams, supra* note 6, at 1189 n.14.
Some circuits utilize a "bright-line" test, holding that an actor is "primary" only if he is identified to the investor as an author of the fraudulent statement at issue, reasoning that absent an investor's knowledge of the actors involvement, there can be no reliance. Other circuits apply the "substantial participation" rule, under which an actor can be deemed "primary" if he substantially is involved in committing the fraud, regardless of whether his participation is formally announced to investors. The reliance element is satisfied if there was reliance on the misstatement itself.

D. CONGRESSIONAL ACTS AFFECTING UNDERWRITER LIABILITY

1. The Private Securities Litigation Reform Act & The Securities Litigation Uniform Standards Act

The threat of liability under the Securities and Exchange Acts was significantly reduced with the passing of the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). The PSLRA instituted a stay on discovery pending a motion to dismiss, while at the same time requiring plaintiffs to plead scienter in 10(b) actions with particularity. Additionally, it provided a safe harbor for forward-looking statements that were accompanied by appropriate cautionary language. Moreover, the SLUSA preempted the majority of state-law securities fraud claims by requiring class actions involving securities traded in interstate commerce to be brought in federal court. "The combined effect of the PSLRA and the SLUSA was to make it much less likely for a plaintiff to prevail in a securities fraud claim anywhere in the United States."

2. The Sarbanes-Oxley Act

After the financial implosion of several high profile companies such as Enron, WorldCom, and Tyco cost the U.S. securities markets billions of dollars, Congress enacted "the most sweeping and comprehensive overhaul of federal corporate governance since the securities laws of 1933..."
and 1934" by passing the Sarbanes-Oxley Act of 2002 ("SOX"). The purpose of the legislation was to restore confidence in the integrity of the securities markets, to restore them to a "model of transparent capitalism," and to provide Congress with an opportunity to address and clarify the defendant-friendly anti-fraud provisions of the PSLRA and the SLUSA. As enacted, however, SOX seeks to maintain integrity in the securities markets by regulating accountability on the part of corporate insiders rather than by removing barriers to litigation.

SOX requires Exchange Act reporting companies and issuers who have filed registration statements to, inter alia, establish independent "audit committees" for the purposes of overseeing auditing processes and procedures and ensuring the integrity of the company's financial information. SOX also requires that both the CEO and the CFO of Exchange Act reporting companies personally certify the fairness and accuracy of the company's financial disclosures as well as acknowledge responsibility for establishing and maintaining disclosure controls throughout the organization. Moreover, pursuant to Section 307, the Act requires attorneys who practice before the Commission to report any evidence of securities laws violations "up" to the general counsel, chief executive officer, or board of directors. Failure to do so can preclude the attorney from practicing securities law.

VI. THE DUE DILIGENCE DEFENSE

Under both Securities Act Sections 11 and 12, an underwriter may absolve itself of liability by establishing an affirmative "due diligence" defense. To properly invoke this defense, Section 11 requires that an underwriter prove "after reasonable investigation, [it had] reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Similarly, Section 12 requires that an underwriter show it "did

120. Id. at 807.
121. Id. at 836-37. SOX does, however, aid plaintiffs by extending the statute of limitations for private securities fraud claims to two years after discovery or five years after the violation occurred. See 28 U.S.C. § 1658 (Supp. V. 2005).
123. STEINBERG, supra note 15, at 145-46.
125. 15 U.S.C. § 7245 (2006); see also Morrissey, supra note 104, at 844-45.
126. Morrissey, supra note 104, at 845.
127. In re Software Toolworks, Inc., 50 F.3d 615, 621 (9th Cir. 1994).
128. Id. (citations omitted). For expertised (i.e. audited) portions of the registration statement, the underwriter need only prove he had "no reasonable ground to believe and
not know, and in the exercise of reasonable care, could not have known, of [the] untruth or omission."129 The "reasonable investigation" standard of Section 11 and "reasonable care" standard of Section 12 are analyzed in the same way,130 and the appropriate standard of care is that of a "prudent man in the management of his own property."131 Thus, due diligence is essentially a negligence standard.132

While underwriters are not expected to possess the same level of "intimate" knowledge of a company's operations as the issuer, "[n]evertheless they are expected to exercise a high degree of care in investigation and independent verification of the company's representations."133 What is expected of an underwriter to satisfy a due diligence standard that lies somewhere between a "high degree of care" and "intimate knowledge" has led to confusion and uncertainty for underwriters. The Northern District of California attempted to clarify as follows:

After reviewing the record, this court concludes . . . that the underwriters did meet the standards required of them by section 11. . . . Their investigation . . . 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 . . . 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

did not believe" that the expertised portion was materially false or misleading. 15 U.S.C. § 77(k) (2006).
129. Software Toolworks, 50 F.3d at 621 (citation omitted).
130. Id.
131. Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 683 (S.D.N.Y. 1968). This issue was brought before the Supreme Court in John Nuveen & Co. v. Sanders, where the petition for a writ of certiorari was denied. 450 U.S. 1005, 1005 (1981). However, Justices Powell and Rehnquist dissented and would have granted certiorari, believing that by definition "reasonable investigation" was a higher standard than "reasonable care." Nuveen, 450 U.S. at 1008-09 (Powell, J., dissenting).
132. Software Toolworks, 50 F.3d at 621 (citation omitted).
and the company that as of the closing date of the public offering, there were no misstatements or omissions.

As a result of that investigation and due diligence, the underwriters reasonably believed the accuracy of the information contained in the prospectus, including the information alleged to be misrepresented or omitted here. The underwriters had no knowledge of any misrepresentations or omissions, and their work met the standard of the due diligence and reasonable investigation required by [section] 11. . . . 134

Even if a reasonable investigation would not uncover material misstatements or omissions, an underwriter will prevail on the due diligence defense only if such a futile investigation was made. 135

An underwriter's duty of investigation is not as stringent for "expertised" portions of the registration statement, such as audited financial reports. The seminal case of Escott v. BarChris Construction Corporation 136 explained that an underwriter meets his due diligence requirement with respect to expertised portions of a registration statement if he "had no reasonable ground to believe and did not believe that there were any untrue statements or material omissions . . . ." 137 Nevertheless, confusion and uncertainty exist for underwriters here as well. The standard requires more than a cursory glance at expertised material, and may "encompass[ ] many modes of inquiry between obtaining comfort letters from an auditor and doing little more, on one hand, and having to re-audit a company's books on the other." 138 If "aggressive or unusual" procedures or information come to light, an underwriter may need to consult with its own experts regarding the expertised information in question to satisfy the elements of due diligence. 139

The cost to underwriters—and ultimately to the investing public whom they protect—of uncertainty in terms of standard of care can be staggering. A good example lies in the rash of settlements that occurred after the WorldCom collapse in 2002. Citigroup agreed to pay $2.575 billion, J.P. Morgan settled for $2 billion, and Bank of America settled for $460.5 million. 140 Another four investment banks—Lehman Brothers, Credit Suisse, Goldman Sachs, and UBS Warburg—settled for approximately $100 million. 141 These firms settled in response to fraud allegations re-

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137. Id. at 683.
138. WorldCom, 346 F. Supp. 2d at 684.
139. Id.
lated to the sale of WorldCom bonds levied against the underwriters under Sections 11 and 12.142

VII. THE EVOLUTION OF DUE DILIGENCE

A. THE EFFECT OF INTEGRATED DISCLOSURE & SHELF REGISTRATION ON DUE DILIGENCE

Traditionally, the preparation of a registration statement and accompanying prospectuses took place over a relatively long period of time, commencing several weeks or months before an anticipated securities offering.143 This generally provided underwriters with adequate time to properly complete their due diligence activities prior to the filing of the registration statement.144 With the advent of integrated and short-form registration, registration statements rely on information contained in reports that have already been filed with the Commission per Exchange Act periodic reporting requirements.145 The underwriter merely reviews the information to be incorporated and does not participate in the drafting of the documents.146 Normally, the only “new” information contained in the registration statement pertains to details about the offering itself, the use of the proceeds, and any necessary updates on incorporated information.147 As a result, preparation time significantly is reduced, which necessarily reduces the time an underwriter has to perform necessary due diligence activities.148

Moreover, time constraints notwithstanding, much of the information contained in the registration statement—whether in the statement itself or by incorporation—is written without any involvement by an underwriter whatsoever.149 The underwriter nevertheless may be held to a higher standard of care regarding the veracity of the information than the party who writes or provides it.150 Assuming, arguendo, that the information was correct to begin with, there is always the possibility that time

142. Id. The settlements came after the investment banks lost their motion for summary judgment argument concerning reliance on the work-product of experts. See infra notes 244-46.
143. Determination of What Constitutes Reasonable Investigation, supra note 1, at 403.
144. Id.
145. Id.
146. Chapman, supra note 43, at 209. According to Chapman, the “incorporation” process is not as effective as the “review” process for two reasons. First, the issuer will generally resist amending public documents, especially when such an amendment is not required but nevertheless would be beneficial to investors. Second, the “give and take” process of drafting is an important exercise to strike a balance between issuer optimism and underwriter prudence.
147. Determination of What Constitutes Reasonable Investigation, supra note 1, at 403.
148. This time constriction is exacerbated—perhaps even exponentially—the shorter the time frame is between the decision to issue securities and the offering date.
149. Determination of What Constitutes Reasonable Investigation, supra note 1, at 403.
renders some of the information inaccurate—for which the underwriter becomes liable.\textsuperscript{151} 

For over twenty years, the Securities Industry Association, leading investment banks, and law firms repeatedly have articulated to the Commission their concerns over these effects.\textsuperscript{152} Sullivan and Cromwell commented that “in the ease and speed of offerings, integrated disclosure may have countervailing costs in what may be expected of underwriters.”\textsuperscript{153} The Bar of the City of New York intimated that “[i]t is unrealistic to expect underwriters to conduct the same type of due diligence investigation as they are able to undertake when they participate in the preparation of a long-form registration statement.”\textsuperscript{154} Merrill Lynch warned that “all of these factors lead to the conclusion that underwriters are simply not able to perform the type of investigation envisioned by the Commission.”\textsuperscript{155} 

Despite these concerns and a call to relax underwriter due diligence requirements, the Commission has not acquiesced, “specifically reject[ing] the suggestion that the underwriter needs only to read the incorporated materials and discuss them with representatives of the registrant and named experts. Because the registrant would be the sole source of virtually all information, this approach would not . . . include the element of verification required . . . .”\textsuperscript{156} With regard to time constraints, the Commission has noted that the underwriter is “never compelled to proceed with an offering until he has accomplished his due diligence.”\textsuperscript{157} “In sum, the Commission strongly affirms the need for due diligence and its attendant vigilance and verification.”\textsuperscript{158} Indeed, as late as 1998, the Commission reaffirmed its express rejection of the consideration of competitive timing and pressures when evaluating an underwriter’s due diligence efforts.\textsuperscript{159} 

The securities community’s fears have not been assuaged. Many believe that integrated disclosure seriously undermines underwriter due diligence efforts because (1) underwriters normally do not participate in the drafting of disclosures incorporated by reference; (2) they probably will not have much success persuading issuers to change information in such disclosures; (3) they have limited time in which to conduct due diligence; and (4) they face increasing competition from other underwriters.\textsuperscript{160} Many in the industry think the integrated disclosure system has “ren-
dered untenable the underwriter’s traditional role and responsibilities in securities distributions.”

Shelf registration provided by Rule 415 merely has exacerbated the situation. Shelf registration is attractive because of the flexibility it provides to issuers in properly “timing” increasingly volatile markets, and issuers generally are anxious to pull an offering “off the shelf” quickly, leaving the chosen underwriter little time to perform due diligence without raising the ire of its client.

The Commission also changed certain internal procedures designed to “curtail time in registration” and speed the time to market securities offerings. First, it began to review registration information based on one of three levels, “cursory,” “summary,” or “customary”; then it further condensed its oversight to two levels, “full review” and no review at all. Under this protocol, short-form registration statements are rarely reviewed. The absence of review removes another opportunity underwriters traditionally had to perform due diligence—the time spent waiting for the Commission staff to issue comments subsequent to review of the registration statement. Furthermore, the Commission sped up the “acceleration” of the effective date of registration statements, permitting short-form integrated disclosure statements to become effective within forty-eight hours after filing. Again, the effect has been to reduce the time underwriters have to perform due diligence.

B. THE COMMISSION RESPONDS THROUGH RULEMAKING

The Commission finally acknowledged and addressed “anticipatory and continuous due diligence programs” in 1981 and promulgated Securities Act Rule 176 to “identify certain of the circumstances bearing upon the reasonableness of the investigation and the determination of what constitutes reasonable ground for belief under section 11(b) of the Securities Act.” According to Rule 176, relevant circumstances to be considered for underwriter due diligence include the “type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant.”

161. Id. (quoting Greene, supra note 5, at 797).
162. Id. § 5.04[5].
163. Nicholas, supra note 37, at 20-21.
164. Id. at 20.
165. Id.
166. Id. at 20-21.
167. Id. at 21. Pursuant to Section 8(a) of the Securities Act, registration statements by default become effective on the twentieth day after filing. Id. (citing 15 U.S.C. § 77h(a) (2006)). However, the Commission may “accelerate” this process if it deems the information provided is adequate and accessible enough to do so. Nicholas, supra note 37, at 21.
168. Shelf Registration, supra note 47, at 143.
though the rule ostensibly provides minimal guidelines by which an underwriter can gauge the appropriateness of its due diligence efforts, it does not lessen the due diligence requirement on underwriters, nor does it provide a safe harbor.\textsuperscript{171} The Commission merely "acknowledged that different investigatory methods would be needed 'in view of the compressed preparation time and the volatile nature of the capital markets.'"\textsuperscript{172} In 1998, the Commission proposed to amend Rule 176 to expound on the guidance provided to underwriters.\textsuperscript{173} Under the proposal, the Commission set forth six factors that are indicative of proper underwriter due diligence. These factors include:

1. "Whether the underwriter reviewed the registration statement and conducted a reasonable inquiry . . . that would cause a reasonable person to question" the veracity of the registration statement;
2. whether the underwriter discussed the registration statement with the relevant officers of the issuer who certified no material misstatements or omissions exist;
3. whether the underwriter received a Statement on Auditing Standards;
4. whether the underwriter received a favorable opinion letter from issuer's counsel;
5. whether the underwriter retained counsel that issued a favorable opinion; and
6. whether the underwriter employed or consulted a research analyst that followed the issuer and the issuer industry for at least six months prior to the commencement of the offering.\textsuperscript{174}

The Commission recognized that all of the factors mentioned in the proposal currently were being used by underwriters for "expedited offerings."\textsuperscript{175} Unfortunately, in 2005 the Commission decided not to adopt the proposed revisions to Rule 176.\textsuperscript{176} The Commission recognized that market forces would continue to dictate "alternative" due diligence exercises, but was quick to point out that such alternatives needed to be "equally thorough."\textsuperscript{177} Essentially, nothing was accomplished as a result of the seven-year proposal period.

One of the alternatives contemplated by the Commission was the use of "periodic due diligence sessions," where issuers hold meetings after the release of periodic reporting to provide prospective underwriters with an opportunity to discuss the information contained therein, as well as to

\begin{itemize}
  \item \textsuperscript{171} WorldCom, 346 F. Supp. 2d at 670.
  \item \textsuperscript{172} Id.
  \item \textsuperscript{173} STEINBERG, supra note 15, at 204 (discussing the Regulation of Securities Offerings, Securities Act Release No. 33-1167A, 68 SEC Docket 1427, 1512 (Nov. 13, 1998)).
  \item \textsuperscript{174} Regulation of Securities Offerings, supra note 173, at 1512.
  \item \textsuperscript{175} Id. at 1513.
  \item \textsuperscript{176} 17 J. WILLIAM HICKS, CIVIL LIABILITIES: ENFORCEMENT & LITIGATION UNDER THE 1933 ACT 4:108 (2008).
  \item \textsuperscript{177} Determination of What Constitutes Reasonable Investigation, supra note 1, at 406.
\end{itemize}
explore business trends and financial developments. Some issuers also allow underwriters to schedule *ad hoc* meetings with company management to discuss the same information. Another alternative is the use of "drafting sessions," where a prospective underwriter is invited to participate in the preparation of disclosure documents before they are filed.

The major disadvantage to underwriters with respect to each of these practices, especially when used in conjunction with shelf registration, is that they both require a significant amount of time and involvement on the part of the underwriter, perhaps hundreds or thousands of hours, generally before a firm is chosen to underwrite an offering. Thus, a participating firm proceeds on the notion that it will be the highest bidder. Typically, no such assurance exists. Another point that militates against these solutions is that an issuer can—and often does—solicit bids from underwriters with the intent of distributing securities on the same day.

**C. The Changing Relationship Between Underwriters and Issuers**

The nature of the relationship between issuers and underwriters has evolved from one founded on long-lasting personal relationships to a fiercely competitive field where each underwriter is only "as good as his last deal." Investment banking has changed from a "relationship" to a "transactional" perspective. Even after an underwriting announcement is made, it has become commonplace for underwriters to continue to vie for the issuer's business by putting together a "better deal." The "high ceremony of capitalism" has morphed into a series of "bargain-basement brawls." Integrated disclosure and shelf registration, when combined with an increasingly competitive underwriting environment, "do not permit underwriters' due diligence to improve the disclosure on which investors rely and puts more pressure on underwriters to limit their due diligence to the minimum [levels] necessary to defend themselves..."
against Securities Act liabilities."\textsuperscript{188} The few innovations suggested by the Commission largely have proven to be ineffective.

\section*{D. Underwriter's Counsel}

Because many underwriters are unwilling (because of cost) or unable (because of time) to participate in due diligence or drafting sessions, and because competitive forces often bring underwriters to the due diligence table "late in the game," issuers began appointing a single law firm to act as "underwriter's counsel." Designating underwriter's counsel allows continual access to the issuer on the (eventual) underwriter's behalf and thus facilitates continuous due diligence such as formal due diligence interviews and participation in document drafting.\textsuperscript{189} It also assures continuity throughout the effective life of the shelf registration, which is important if more than one underwriter is used during the period.\textsuperscript{190} "[T]he Commission believes [this] to be a sound practice because it provides for due diligence investigations to be performed continually throughout the effectiveness of the shelf registration statement."\textsuperscript{191}

The role played by underwriter's counsel can be extensive and varied. Generally, underwriter's counsel assumes the due diligence function of ensuring the veracity and completeness of all registration material.\textsuperscript{192} More specifically, underwriter's counsel may assist in the preparation and execution of the agreements between the issuer and underwriter, meet with accounting experts to review financial information required by the Exchange Act, review any applicable blue sky laws to ensure compliance thereof, examine registration material prior to final printing and filing, and assist with post-filing duties, including preparing press releases, issuing stock certificates, reviewing accounting "comfort letters," updating prospectuses, and preparing newspaper and NASD quotations.\textsuperscript{193} Since the underwriter possesses the expertise—and ultimately assumes the risk of liability—for performing due diligence on a securities offering, underwriter's counsel's effectiveness is limited, however, during those times when there is no client to serve.\textsuperscript{194}

Regardless of who chooses the underwriter's counsel, the client is the underwriter. There is implicit but conflicting authority whether the securities laws impose a special duty on underwriter's counsel to non-clients

\begin{thebibliography}{99}
\bibitem{188} Chapman, supra note 43, at 210. For example, one common practice is for underwriters to greatly expand risk factor disclosure to take advantage of the safe-harbor for forward-looking statements under the PSLRA without a concomitant modification of the relevant business or financial disclosures. \textit{Id.}
\bibitem{189} See, \textit{e.g.}, \textit{id.} at 209.
\bibitem{190} See McLaughlin & Williams, supra note 6, at 1221.
\bibitem{191} Shelf Registration, \textit{supra} note 47, at 143.
\bibitem{192} Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124 (5th Cir. 1988).
\bibitem{193} 1 \textsc{Thomas Lee Hazen}, \textsc{The Law of Securities Regulation} 233-38 (5th ed. 2002). Underwriting agreements include information specific to the offering itself (number of shares to be offered, the offering price, and basic underwriting terms) as well as agreements for the "selling group" which may include a consortium of underwriters. \textit{Id.} at 234.
\bibitem{194} McLaughlin & Williams, \textit{supra} note 6, at 1222.
\end{thebibliography}
such as issuers.\textsuperscript{195} According to the Fifth Circuit, such counsel would be liable to other parties only if it prepares documents based explicitly on the underwriter's counsel's opinion with the knowledge that the non-client will rely on or benefit from the information.\textsuperscript{196} However, there is an earlier Northern District of Mississippi decision—neither discussed nor cited in \textit{Abell}!\textsuperscript{197}—holding that issuer's counsel "owed a special duty of diligent investigation and disclosure."\textsuperscript{198} The holdings arguably are reconcilable based on the extent of counsel's fraudulent involvement in \textit{Felts} versus the relatively benign action in \textit{Abell}.\textsuperscript{199}

The effectiveness of utilizing underwriter's counsel as a solution to the challenges imposed by short-form and shelf registration also is tempered by money. The underwriter is responsible for paying the underwriter's counsel's fees, including those incurred during the start-up of the shelf facility.\textsuperscript{200} The significant fees involved, combined with the inevitable squeeze on underwriting compensation resulting from increased competition, has led many underwriters to examine the role of underwriter's counsel on an \textit{a la carte} basis.\textsuperscript{201} Even a fundamental task such as examining a corporate minute book no longer is immune from cost-benefit scrutiny.\textsuperscript{202}

Professional responsibility issues can arise with regard to whom underwriter's counsel is really serving. After all, frequently underwriter's counsel is hired by the issuer and begins work on behalf of a yet-to-be-named underwriter.\textsuperscript{203} In such cases, underwriter's counsel needs to be cognizant of and careful not to run afoul of the widely-adopted tenets of proper client representation held in the American Bar Association's Model Rules of Professional Conduct ("MRPC").\textsuperscript{204} The MRPC widely

\textsuperscript{196} \textit{Abell}, 858 F.2d at 1132.
\textsuperscript{197} See id.
\textsuperscript{198} \textit{Felts}, 469 F. Supp. at 68.
\textsuperscript{200} \textit{McLaughlin} & \textit{Williams}, \textit{supra} note 6, at 1221.
\textsuperscript{201} \textit{Id.} at 1222.
\textsuperscript{202} \textit{Id.} at 1222-23.
\textsuperscript{203} Lewis D. Lowenfels et al., \textit{Attorneys As Gatekeepers: SEC Actions Against Lawyers in the Age of Sarbanes Oxley}, 37 U. TOL. L. REV. 877, 923-28 (describing SEC action against underwriter's counsel who consented to entry of final judgment permanently enjoining underwriter's counsel from violating Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and ordering underwriter's counsel to pay disgorgement in the amount of $152,500 for, \textit{inter alia}, failing to disclose a conflict of interest created when underwriter's counsel entered into an agreement to share part of its fees with the issuer).
\textsuperscript{204} Only relevant duties to clients and conflict-of-interest applications of the MRPC are explored for the purposes of this Comment. There exist a host of rules governing duties to report fraudulent and illegal conduct, but they largely are mooted by the application of Securities Act Sections 11 and 12 and Exchange Act Section 10(b), since the underwriter's counsel's knowledge of illegal or fraudulent conduct by the issuer likely would give rise to liability under these sections.
have been used as the basis for state and federal regulation in the area of professional responsibility.\footnote{205}{JOHN S. DZIENKOWSKI, PROFESSIONAL RESPONSIBILITY STANDARDS, RULES & STATUTES 3-4 (2006-2007 ed.).}

Receiving fees from an entity other than a client is not a per se violation of the MRPC.\footnote{206}{MODEL RULES OF PROF'L CONDUCT R. 1.8(f) (2007).} The MRPC require, however, that such an arrangement creates "no interference with the lawyer’s independence of professional judgment or with the client-lawyer relationship,"\footnote{207}{MODEL RULES OF PROF'L CONDUCT R. 1.8(f)(2) (2007).} that confidential information pertaining to the client is protected, and that the client consents to the fee-paying arrangement.\footnote{208}{MODEL RULES OF PROF'L CONDUCT R. 1.8 (f)(1)-(3).} An interesting question—and one that apparently has not been litigated—is how an underwriter-client who has not yet been named can give such consent. Even if underwriter's counsel is paid nothing until an underwriter is named, that counsel has incurred expenses and accrued fees, leaving an underwriter with little choice but to give retroactive informed consent if it hopes to get the business from the issuer.

Conflicts of issues can arise under the MRPC where "there is a significant risk that the representation of [a] client[ ] will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer."\footnote{209}{MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(2) (emphasis added).} A lawyer may represent a client notwithstanding such a risk if:

1. the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
2. the representation is not prohibited by law;
3. the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
4. each affected client gives informed consent, confirmed in writing.\footnote{210}{MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(1)-(4).}

The same informed consent argument comes into play in this example as well. Conflict-of-interest concerns are most acute in cases where the issuer is a current or former client of the underwriter's counsel. While such an occasion does not necessarily preclude representation of an underwriter by counsel,\footnote{211}{The requirements of MRPC 1.7(b) would apply in this instance as well. See id.} it brings into play obvious concerns over confidentiality of information. According to the MRPC, a lawyer "shall not" reveal information relating to the representation of a current client without informed consent of the client,\footnote{212}{MODEL RULES OF PROF'L CONDUCT R. 1.6(a).} nor shall a lawyer "use information relat-
ing to the representation to the disadvantage of [a] former client except as [the MRPC] would permit. It is unlikely that the issuer would give informed consent to underwriter’s counsel to share negative—and potentially “issue-stalling”—information with an underwriter. In any event, if counsel has worked with an issuer before on any securities-related matter, it must get the issuer’s informed consent before representing a potentially adverse underwriter.

Although the mores of legal professional conduct do not prohibit properly informed “cohabitation” between issuer, underwriter, and underwriter’s counsel, disclosure requirements to the investing public exist that condition the relationship as well. For example, any underwriter’s counsel who performs services on a contingent basis or will be given a security interest greater than $50,000 in the issuer in connection with the offering is required to “furnish a brief statement of the nature of such contingent basis, interest, or connection.”

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In light of this legislation, underwriters now should review disclosures submitted by the CEO and CFO under Sections 302 and 906, as well as discuss with the CEO and CFO the company’s internal controls over disclosure. Moreover, the underwriter should meet with the audit committee to discuss and explore its effectiveness in ensuring accurate financial information and proper internal controls.

VIII. RECENT DEVELOPMENTS

On December 19, 2007, in an effort to “allow a larger number of public companies to benefit from the greater flexibility and efficiency in assessing the public securities markets . . . in a manner that is consistent with investor protection,” the Commission announced amendments to certain registration eligibility requirements, making short-form and shelf registration accessible to a larger number of companies. The amendments primarily relate to Form S-3 (“short-form”) registration, which is used by eligible companies to incorporate Exchange Act reports into Securities Act registration requirements. Prior to the amendments, a company was eligible to utilize short-form registration only if their non-affiliate equity market capitalization (“public float”) was equal to or greater than $75 million.

213. Model Rules of Prof’l Conduct R. 1.9(c)(1).
214. Model Rules of Prof’l Conduct R. 1.9(b)(1)-(2). In cases where the issuer chooses the underwriter’s counsel, presumably this would present little problem.
216. Jacob, supra note 95, at 52-53.
218. Id. Eligibility to utilize Form S-3 also enables an issuer to utilize shelf registration.
219. Id.
In April of 2006, the Commission Advisory Committee on Smaller Public Companies ("Committee") recommended that the criteria be loosened so a greater number of companies could benefit from short-form registration.\textsuperscript{220} Consequently, as of January 28, 2008, any company that has a class of stock listed and registered on a national securities exchange and has made proper Exchange Act periodic reporting for at least twelve months immediately preceding the filing of the registration statement is eligible to utilize short-form registration, as long as sales of securities in any public offering during the preceding twelve month period do not exceed one-third of the issuer's public float.\textsuperscript{221} The Commission estimates that 1,400 companies will be positively affected by the rule change.\textsuperscript{222}

The Commission imposed the one-third-of-float cap because "the greater the magnitude of the offering, the more likely it is that the transaction will be transformative to the issuer rather than routine in nature . . . [and] exceeding one-third of the value of an issuer's public float [is] generally of such significance to the issuer that the opportunity for . . . a greater window for underwriter due diligence [is] advisable."\textsuperscript{223} By this statement, it appears as though the Commission realizes this amendment will make a bad situation worse by admitting that the ability to utilize short-form registration in offerings of less than one-third of public float "may limit . . . underwriter involvement in the registration process . . . and may also reduce the time that participating underwriters have to apply their independent scrutiny and judgment to an issuer's . . . disclosure."\textsuperscript{224} The Commission, at least tacitly, appears willing to trade effective due diligence for issuer convenience. In fact, the Commission suggests that the securities exchanges themselves can assist in the underwriting function "because the exchanges' listing rules and procedures, as well as other requirements, provide an additional measure of protection for investors."\textsuperscript{225}

IX. SUGGESTIONS FOR CHANGE

As this Comment has shown, the securities underwriting and registration process has changed dramatically over the past seven decades. Technological and competitive forces have combined to shorten what once was a process measured in weeks to one not uncommonly measured in hours. The dynamics involved have changed dramatically as well. Issuers who once courted "trusted and respected" underwriters to lend an aura of respectability to their securities offering are now the ones being courted. Underwriters who once sought and relied on longstanding business relationships built on camaraderie and trust are now hawking their

\textsuperscript{220} Id.
\textsuperscript{221} Id. at 519-20.
\textsuperscript{222} Id. at 532.
\textsuperscript{223} Id. at 521.
\textsuperscript{224} Id. at 518-19.
\textsuperscript{225} Id. at 522.
services with price often the sole differentiator. Well-established lines of authority now frequently are blurred, with issuers hiring attorneys to represent underwriters. Investors, once at the mercy of underwriters and issuers for the information they deemed important, now instantly have access to all of the information they need to make an informed and educated decision. Despite these tremendous changes, the notion that “[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter” is one immovable force that has remained static throughout this constantly and rapidly evolving landscape. In other words, due diligence requirements have not changed. And that has to change.

Educators and practitioners alike long have agreed that the current expectations of underwriter due diligence no longer make sense. More than twenty years ago, Donald Langevoort wrote that “once technological or other structural changes in the market effectively expand the range of capital-raising options beyond traditional underwriting, investment bankers will no longer be gatekeepers. Their economic role thus altered, the justification for burdening them with due diligence responsibility is severely undercut.” More than a decade later, Professor John Coffee noted that “it is not clear that the underwriter today still performs the classic gatekeeping function . . . Many argue that serious due diligence efforts are simply not feasible within the time constraints of shelf registration.” Well into the electronic age, Frank Partnoy questioned “whether the underwriter’s ‘due diligence’ role is justified at all,” as “disinterested advance due diligence” had become the exception rather than the rule. In short, “Congress’s assumptions in 1933 and 1934 about registrants working with individual underwriters in a relatively leisurely atmosphere are at odds with today’s competition by multiple underwriters for high-speed transactions.”

A major flaw in the accountability theory (under which underwriters—as gatekeepers—have traditionally found their “power”) lies in the manner in which underwriters are rewarded and punished. Since most underwriters are paid based on a percentage of the per-share offering price, it follows that they get paid nothing if there is no offering. Like issuers, underwriters have a strong incentive to “close the deal.” However, the incentive to properly perform the gatekeeping role lies not only in the “carrot” of commissions, but also in the “stick” of statutory liability.

230. Partnoy, supra note 84, at 522.
232. See Cunningham, supra note 75, at 352-54.
The investing public is providing the carrot—through a built-in component of the offering price—and wielding the stick—through threat of liability—to the same entity, the underwriter. In many ways, this dual role of the underwriter makes little sense. As Warren Buffet remarked, “[i]f I’m going to pay $5 million to somebody if they give me advice and the deal goes through, then I think I probably ought to pay $5 million to somebody else whose advice I listen to who gets paid the $5 million only if the deal doesn’t go through.”233 It does not follow that these “somebodies” should be the same person.234 Critics argue that liability—the “stick”—may make gatekeepers especially risk-adverse and may lead to an exodus of highly-skilled professionals.235 “It follows that the advantages of penalties over rewards are less clear-cut for gatekeepers than for primary wrongdoers.”236 Nevertheless, the Commission continues to wield the stick of liability to motivate underwriter due diligence.

Despite such criticisms, the Commission and the courts generally adhere to the original positions of the Securities and Exchange Acts concerning due diligence expectations and liability exposure. The Southern District of New York noted in 2004 that “[t]he underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public.”237 What has evolved is an inefficient and uncomfortable patchwork of state-of-the-art technology, increased competitiveness, and old due diligence standards that has not only proved ineffective in addressing due diligence ramifications, but also has created new problems in its own right. Integrated disclosure and shelf registration have enabled issuers to meet increasingly-fleeting market windows, but necessarily have decreased the time underwriters have to perform due diligence. The use of underwriter's counsel has increased the competitiveness within the investment banking world and also has brought along its own baggage in the form of conflict-of-interest concerns. The January 2008 revisions to Form S-3 eligibility requirements provide a faster route to the markets for a greater number of “smaller” companies, but again at the expense of due diligence. The Commission appears to want an implausible, if not impossible, combination—the proverbial cake it can eat—in the form of speed and complete assurance. This approach is fundamentally flawed because it seeks to hold due diligence standards as a constant in a rapidly changing marketplace.

The Commission therefore should consider relaxing the due diligence standard for underwriters in at least some situations. One option would be to establish due diligence “tiers” based on the size and status of an

233. Id. at 354 (quoting Lawrence Cunningham, Conversations from the Warren Buffet Symposium, 19 Cardozo L. Rev. 719, 766-68 (1997)).
234. Cunningham, supra note 75, at 354.
236. Id. at 1679.
issuer. For example, the Commission might require that due diligence standards in an underwriting offering by a "well-known seasoned issuer" be held only to a recklessness standard. Such an issuer is far more likely to have made a vast majority of financial and operational information available to the general public at any time. Moreover, based on the "fraud on the market" theory, any negative information is built into the market price of the issuer's securities. This solution is really nothing more than an extrapolation of Rule 176, which implies that different issuers and offerings may require different due diligence.

Related is a "market-based" due diligence system, where an underwriter would "self-tailor" its own due diligence requirements based on the uniqueness of a transaction. This would allow an underwriter to bind itself to a particular set of due diligence requirements for each individual underwriting engagement. Over time, a due diligence marketplace would develop, offering different screening procedures, levels of accuracy, and prices. In an efficient market, purchasers, and not the government, would decide what due diligence exercises are necessary and how they should be enforced.

Another option is to allow an underwriter greater reliance on other experts, such as auditors, in establishing a due diligence defense. This would permit underwriters to "protect reputation and reduce liability risk by increasing the effectiveness of their fellow gatekeepers" and provide "sufficient flexibility . . . that would enable compensation systems to channel gains from effective gatekeeping to responsible partners." Such a system would allow underwriters to focus more on enabling the issuer, but not at the expense of the veracity and completeness of information available to investors. This argument was the basis of the underwriters' motion for summary judgment in WorldCom. The underwriters argued that they should be able to rely on the financial audits and comfort letters provided by the issuer's audit firm and had no reason to investigate unless they had grounds to doubt the accuracy of the information. Unfortunately, the court rejected this argument, noting that "underwriters' reliance on audited financial statements may not be blind . . . [and] where 'red flags' regarding the reliability of an audited financial statement emerge, mere reliance on an audit will not be sufficient to ward off liability." The underwriters' assertion was that an audited figure can never raise a "red flag" and trigger a duty of investigation.

238. Partnoy, supra note 84, at 541.
240. Id. at 952-53.
241. See id.
242. See id.
243. Cunningham, supra note 75, at 372.
244. Id. at 374.
246. Id. at 672.
247. Id. at 679.
Holding three parties (the issuer, the underwriter, and the auditor) responsible for the same piece of information is duplicative, unnecessary, and expensive. Justice Powell echoed this sentiment in a dissent from the denial of certiorari in *John Nuveen & Co.*,248 where he warned that “recognizing no distinction between the standards of care applicable under §§ 11 and 12(2), and particularly [ ] casting doubt upon the reasonableness of relying upon the expertise of certified public accountants”249 potentially “could affect adversely the efficiency of the Nation’s short-term financing markets.”250 Allowing underwriters to rely on experts appropriately would allocate resources by enabling market players to perform roles for which they are most efficient, while still providing due diligence protection to investors.

The Commission has taken the position that “[t]he underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public.”251 Imposing liability as an affirmative defense, rather than an affirmative requirement, almost seems at odds with this statement. In this vein, some commentators have suggested that Congress replace the affirmative due diligence defense with a “modified strict liability regime.”252 Under such a plan, underwriters would be held strictly liable for material misstatements and omissions in registration statements, but would be allowed to manage their risk through contract.253 Such a scheme would pass savings along to investors by removing the costs of adjudicating due diligence defenses from the securities markets.254 Underwriters would still engage in some due diligence (in most cases probably as much as they are able to now), issuers would still face liability, but competition again would foster motivation based on reputation.255

Many other solutions to the due diligence problem have been proposed over the years, and a discussion of each is beyond the scope of this Comment. What this Comment attempts to convey, however, is how important it is for something to be done. The current system apparently works only in the collective minds of the Commission.

**X. CONCLUSION**

The securities registration process is like a game—be it baseball, basketball, or football. The game has been around for many decades, but the way the game is played—and the rules under which it is played—have

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249. *Id.* at 1011.
250. *Id.* at 1005-06.
252. Partnoy, *supra* note 84, at 540. Interestingly, Congress considered a strict liability regime in 1933 before compromising on the due diligence affirmative defense. *Id.*
253. *Id.* at 546.
254. *Id.*
255. *Id.* at 547.
changed dramatically over the years. In fact, it is sometimes difficult to
tell that it is the same game at all. Unfortunately, because of these con-
stant changes, a major group of players in this game—the underwriters—
are at a decided disadvantage. Although other players frequently have
new equipment and get to play by new, advantageous rules, the under-
writers are stuck with the same old equipment and are subject to the
same old rules, even though the equipment is ineffective and the rules do
not make sense anymore. The underwriters cannot—indeed, will not—
continue to play this game forever. They cannot afford to change the
rules themselves, because the fines are too great if they do. Their only
real alternative is to put down their equipment, walk off the field, and
look for a better game. The problem is that this game really cannot be
played without them. It is time to give the underwriters some new equip-
ment and let them play by new rules. It is time to get the underwriters
back in the game.