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Fraud on the market
A relational investment approach

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Abstract

Regulators of securities markets across the globe uniformly impose strict liability on firms that raise capital by means of a misleading prospectus. But regulators are divided in their approach regarding the circulation of false information in the secondary market. Indeed, on one side of the Atlantic, we find England adhering to its conservative Common Law approach and on the other side, the United States with the broad liability embodied in the "Fraud on the Market" paradigm under Rule 10b-5.

Fraud on the Market (FOMA) has been one of the most popular topics of discussion among American legal scholars over the last two decades. The focus of scholarship has been placed mainly on the effect of FOMA on the efficiency and on the fairness of the American stock market.[1] This paper takes a different approach: it highlights and compares the effects of three liability regimes on corporate governance and, in particular, on the relational investment structure of a publicly held firm. Moreover, the paper shifts the focus of discussion from the effect of liability on a firm's incentives to the effect of the compensatory scheme of each regime on investor conduct.

The three liability regimes this paper examines are as follows:

The *traditional Common Law* regime, under which plaintiffs must demonstrate proximity, reliance, and causation;

The *reliance* regime, under which plaintiffs are required only to demonstrate reliance and causation; and

The *fraud on the market* regime, whereby plaintiffs prevail if they can establish causation.

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[1] See for example: J. C. Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" 70 Va. L. Rev. 717 (1984). Others have focused on the enormous litigation costs Rule 10b-5 generates: the dynamics of the class action process result in a flood of frivolous suits that are launched mainly against the more volatile firms and, therefore, discourage risk-taking. See J. A. Grundfest "Disimplying Private Rights of Action Under the Federal Securities Laws - The Commission's Authority" 107 Harv. L. Rev. 961 (1994); J. C. Alexander "Do the Merits Matter - A Study of settlement in Securities Class Action" 43 Stan. L. Rev. 497 (1991). Few scholars have stressed other effects of Rule 10b-5; see Macey & Miller, *infra* n. 32, and Marcel Kahan, *infra* n. 35.

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The first part of this paper examines the effect of liability on monitoring. In particular, I argue that the traditional Common Law regime manifests and fosters the monitoring role institutional investors play in England. The American deviation from the traditional rule, in the form of the Fraud on the Market regime, discourages such relational investment and encourages shareholder passivity.

The second part of the paper adopts an (almost) opposite agency model: whereas the first part treats the collective body of shareholders as principals concerned with their manager-agent performance, the second part treats the manager as the principal who solicits feedback from informed investors-agents. Whereas monitors are inspecting the managers' hidden actions, thereby diminishing the firm's agency costs, feedback providers are actually informing managers, thereby enabling the latter to run the firm more efficiently. I show that each liability regime provides a different set of incentives to investors and, therefore, facilitates the operation of a different feedback mechanism. © 2001 Elsevier Science Inc. All rights reserved.

Part one: the effect of liability on investor monitoring

1. Introduction

In this part of the paper, I distinguish between three types of players: (1) "**Monitors**," typically institutions that oversee management and take action against bad managers; (2) "**Informed Traders,**" whose trading decisions are based on the collection and analysis of public and private information; and (3) "**Liquidity Traders,**" who enter or exit the market according to their liquidity needs.[2] I show that each liability regime attracts and alienates different players to and from the market. Specifically, I show that FOMA pushes monitors out of the market, and thus it can supplement Mark Roe's list of American rules that impede shareholder activism.[3] The traditional Common Law regime, on the other hand, is shown to attract monitors, and thus it promotes the type of relational investment documented by Black & Coffee in Britain.[4]

In addition I show that the U.S. move from the traditional Common Law rule, first to the reliance, and thereafter, to the FOMA regime, may also have been a catalyst in the evolution of the most important monitoring device in the U.S., the hostile takeover. Whereas the Common Law regime dictates a "fair," open-card game, Fraud on the Market (and the reliance regime) impels contestants in this market to employ tricky stratagems.

[2] A. C. Kyle, "Continuous Auctions and Insider Trading" 53 Econometrica 1315 (1985).

[3] Mark J. Roe, Strong Managers, Weak Owners - The Political Roots of American Corporate Finance (1994). In this book, Mark Roe convincingly showed that shareholder passivity is not necessarily an inevitable product of free market forces. Instead, he suggested, it is an outgrowth of U.S. regulations, including, *inter alia*, the ban on bank ownership of stock, limitations on size of block owned by insurers and mutual funds, and proxy rules that curb the ability of institutional investors to join forces and influence the firm.

[4] See B. S. Black & J. C. Coffee, "Hail Britannia?: Institutional Investor Behavior Under Limited Regulation" (1994) 92 Mich. L. Rev. 1997.

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