CORPORATE ACCOUNTABILITY: IS IT TIME TO CHANGE THE APPROACH TO PROSPECTUS LIABILITY?

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ABSTRACT

Government has tried in recent years through legislation and regulatory efforts to provide investors with the assurances they need to have confidence in the integrity of the capital markets. Such confidence is necessary to protect the vitality of the economic system. However, in the area of prospectus liability, especially as this type of liability applies to closed-ended investment companies, the courts have gone in the opposite direction and permitted issuers to use exculpatory templates to cancel explicit representations contained in a prospectus. As a result, an important area of investor protection has been neglected.

INTRODUCTION

The capital markets have been directly and negatively impacted by a corporate culture characterized by corporate fraud, insider trading, and auditor and director negligence. For good or bad, the political system has taken it upon itself to respond to these problems. The passage of the "Sarbanes-Oxley Act of 2002" has been the first significant output [xxxii]of the legislative branch of government in this regard. On the executive branch side, U.S. and state attorneys have also been active through investigations and prosecutions of wrongdoers. The SEC, as the primary administrative enforcement agency, has predictably been engaged in this process as one would assume. But what about the Judiciary? Unfortunately, the federal courts in the last 10 years have not had a good track record of upholding standards or interpreting laws and regulations in such a way as to demand accountability from corporate officers, directors, auditors and other insiders. Arguably, the place where investor protection has been the most jeopardized has been in the area of prospectus liability.

PRESENT PROSPECTUS STANDARDS: FEDERAL LAW

Section 5 of the 1933 Securities Act as amended requires that a purchaser of a security must receive a qualifying final prospectus before or at the same time as a confirmation of the purchase of the security[2]. A prospectus under section 5 is assumed to include any communication that offers a security for sale or confirms the sale of a security to the investor[xxxiii]. The content of the prospectus is similar to that required for a registration statement. Section 10(b) of the Act does give the SEC the authority to permit the use of a prospectus which omits or summarizes some of the information required in Section 10(a) of the Act[xxxiv]. Pursuant to SEC Rule 430 the Commission allows the offering price and related information to be omitted from a prospectus prior to the effective date of the offering[xxxv]. A special legend is required to be printed in red on the face of the prospectus; hence these types of preliminary prospectuses are called "red herring" prospectuses.[xxxvi] Section 11 of the Act establishes a statutory basis for liability for a false registration statement[xxxvii]. It is, however, Section 12 of the Securities Act that makes it clear that the prospectus is a liability document. That Section provides:

"*Any person who offers or sells a security…by the use 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, in the light of the circumstances under which they are made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could have not have known, of such untruth or omission, shall be liable to the person purchasing such security from him.*"[xxxviii]

The full reach of liability is extended under Section 15 of the Act to apply to controlling persons as well[xxxix]. The form and content of the prospectus is laid out with a fair amount of elaboration in SEC Rules 420 to 432. The SEC rules, however, do not speak directly to the issue of liability.

Liability for the sale of securities can also be established under Section 10(b) of the Securities Exchange Act[xl] and SEC Rule 10(b) [xli].These provisions of the law contain broad antifraud rules applicable to any issuer of a security. Although

statutory law is dominant in Securities Law, it is wise to keep in mind that common law fraud can also be raised as a cause of action pursuant to the state's law relevant to the federal district in which the case is litigated.

JUDICIAL INTERPETATIONS

What has prospectus liability come to mean? While the statutes provide the usual broad and abstract rules, the answer lies with the courts. Unfortunately for investors, the approach of the courts has been less than investor-friendly on these issues. Perhaps, among the most influential cases has been **Olkey v. The Hyperion 1997 Term Trust, Inc**[xlii]. In Okley, the Second circuit was confronted with a group of relatively conservative investors who purchased a new issue of a "Term Trust". A Term Trust is a form of business trust which as a closed-ended fund invests with a specific time horizon on which the fund will attempt to return the issuance price per share (in this case $10.00) back to the investors at a specified date in the future. During the term of the trust income generated by the Trust will be paid periodically to the investors. Most of these types of trusts invest in debt securities of an investment grade. In the case of Hyperion, the trust purported to invest primarily in mortgage-backed and asset-backed securities as well as government and municipal debt instruments. Hence, the investors after reviewing the prospectus and issuance communication believed that they were investing in a fund with a low to moderate return, primarily in the form of dividends, but that had a commensurate low to moderate market and credit risk. In the prospectus, the issuers clearly stated that they intended to achieve this goal. Language in the prospectus stated :

"The Adviser believes that it will be able to manage the composition of the Trust's portfolio in such manner that any decreases in the value of securities as a result of changes in interest rates will be offset by increases in the value of other securities, whose value moves in the opposite direction in response to changes in interest rates, thereby avoiding the realization of capital losses which are not offset by capital gains over the life of the Trust"[xliii].

The prospectus also stated that:

"*The Trust's investment in IOs, when combined with other instruments in the Trust's portfolio, is expected to aid the Trust in its attempt to preserve capital. The values of IOs tend to increase in response to changes in interest rates when the values of these other Mortgage-Backed Securities and of Zero Coupon Securities are decreasing, and to decrease when the values of such other instruments are increasing. While the Adviser has no control over changes in levels of interest rates, it has designed the initial composition of the Trust's portfolio and will manage the portfolio, on an ongoing basis in an attempt to minimize the impact of changes in interest rates on the net asset value of the portfolio.*"[xliv]

Reviewing these representations, the plaintiffs believed that they were purchasing an income-oriented investment for all interest rate seasons. Based upon a principle of finance known as *"convexity"* the investors were led to the conclusion that the trust would achieve a convexity which at any given time was close to zero. Zero convexity occurs when changes in a security's market value decreases or increases to the same extent as changes in a rising or declining interest rate environment. By contrast, a security that increases in value in a rising interest rate environment to a greater extent than it decreases in value in a rising interest rate environment is said to have positive convexity. Negative convexity then would occur when a security increases in value in a declining interest rate environment to a greater extent than it decreases in value in a rising interest rate environment.

This hope proved to be a false one. Rather the Trust purchased large amounts of interest only strips (IO strips). IO strips are investments or what is sometimes called synthetic securities whereby an investment bank separates from a note or bond the right to receive interest payments only in lieu of the right of to receive both interest and principal at the due date or call date of the note or bond. IOs strips respond to interest rate fluctuations in opposite direction from a debt security held outright since there is an adverse relationship between the price and yield of debt securities. The result of this imbalance was that fund proved to have a convexity which was largely biased toward the positive. Unfortunately for the advisers and the investors, interest rates fell during the period following the issuance of the securities. The result of this fall on the leveraged funds utilizing this approach was a substantial decline in net asset value of the fund. As a result, the funds were rated by a leading financial weekly as the worse performing funds of its class and the investors, even after the payment of dividends included, experienced huge declines on their investments[xlv.] Hence, the investors brought a class action lawsuit under federal rules for securities fraud under the 33 and 34 Acts and under the common law.

In challenging their claim under federal rules 12(b) (6) and 9(b), the Defendants argued that the prospectus stated cautionary language which outlined these risks. The Defendants pointed to several warning statements in the prospectus. Among the warnings were the following:

"A significant decline in interest rates could lead to a significant decrease in the Trust's net income and dividends… The Trust may be unable to distribute at least $10.00 per share…on its termination date…market prices of securities may be more sensitive to changes in interest rates than traditional fixed income securities. While the Trust seeks to minimize the impact of such volatility on the new asset value of the Trust's assets, there can be no assurance it will achieve this result…"[xlvi]

The prospectus also included the usual warnings that "The market value of the Trust's portfolio…is dependent on market forces not in the control of the Adviser" and "The Trust may be unable to distribute to its shareholders at the end of the Trust's term an amount equal to at least $10.00 for each Share then outstanding."[xlvii] The warnings also included the standard "No assurance can be given that the Trust will achieve its investment objectives, and the Trust may return less that $10.00 per Share."[xlviii] While the Court acknowledged that this language was the usual boiler-plate caution, nevertheless they agreed to the dismissal of the action. The majority in **Okley** based this decision on several arguments. The majority argued that the Plaintiffs offered:

"*no serious rationale as to why a reasonable investor would consider the warnings too generic to be taken seriously and, at the same time, would find the sections discussing the opportunities and protections enticingly specific. The plaintiffs conveniently dismiss as boilerplate anything in the prospectuses that undermines their argument.*"[xlix]

The majority also stated that to show misrepresentation under the securities laws, the complaint must offer more than allegations that the portfolios failed. Quoting **Kramer v Time Warner, Inc.**,[l] the Court stated *"It is in the very nature of securities markets that even the most exhaustively researched predictions are fallible". The Court also cited established case law to the effect that Fraud by Hindsight alone will not sustain a case.*[li]

Subsequent court decisions have failed to reverse the ***Olkey*** precedent. Although at least one decision seems to suggest that an opposite result could occur. In ***Hunt v Alliance North America Government Income***[lii] the Court did permit Plaintiff to plead a cause of action based upon misrepresentation in a prospectus regarding the use of hedging techniques. In that decision the Court ruled the prospectuses did not warn of the risk to the investor and that a reasonable investor could have been misled and would have considered the availability of hedging devices important in deciding to purchase shares.[liii] The Court in ***Hunt*** seems to suggest that a prospectus must be read as a whole to determine whether reasonable investor would have been misled. The case did not, however, specifically reverse ***Okley*** and did not speak directly to application of liability per se.

ARGUMENT FOR A CHANGE

Since **Okley,** the law of prospectus liability appears to provide a large degree of protection to issuers using boiler plate cautionary language. Since all issuers will use such language, it has become nearly impossible for investors to ever seek liability on a prospectus, except, perhaps in the most egregious and overt circumstances. Was this what Congress intended in 1933 and are investors really protected under the current judicial interpretations of the Securities Acts? Clearly, they are not. It is wise to revisit the **Olkey** decision. In the dissent, Judge Newman, Chief Judge for the Second Circuit, argues that the majority opinion leaves much to desire. The issuers of the Hyperion prospectuses plainly gave the impression that they intended to invest in securities that possessed a convexity close to zero. However, as we have seen they did not follow this investment approach and the value of the trust and, therefore, the value of the share price were destroyed. Judge Newman argued that *"Investors in fixed-income securities or funds…seek rates of return above Treasury issues and accept the risk that unforeseen developments might cause their asset values to drop"*.[liv] However, in **Olkey** the investment managers had in *"fact bet heavily on rising interest rates and used investors' money to make that bet"* even though in the explicit language of the prospectus the issuer provided *"repeated assurances that the funds would be balanced"* and therefore, the investors were *"entitled…to believe that the funds would be so structured as to be relatively insulated from any significant rate movements"*.[lv]

We are, therefore, left with three alternate approaches to the resolution of this issue. They are as follows:

1. We can continue to follow the **Olkey** approach and permit issuers to use boiler

plate exculpatory clauses to eliminate their liability for investor losses dues to false and misleading statements in a prospectus;

2. We can follow the mixed signals in **Hunt** and provide an investor with a remedy if we can show that a review of the whole document would have mislead the investor; or
3. We can take the position that clear, expressed statements in a prospectus directly related to the risks therein and strategies employed by Advisers to manage those risks take priority over boiler plate language where such statements prove to be false and misleading.

In this day of the realization of the need to protect investors from those who would give them misleading information, it can be argued that the best interpretation of the prospectus liability laws would place a heavier emphasis on the explicit statements and assertions of the prospectus and in a conflict between explicit language directly communicating the details of the security (or in the case of a closed-ended fund, the anticipated approach of the investment manager), that direct assertions cannot be cancelled by standard boiler-plate exculpatory clauses or blanket risk warnings. Investors should be entitled to expect the security or fund to conform to a standard that a reasonable person would come to expect after a careful review of the prospectus. While the ***Hunt*** decision gives investors some faint hope, the reality is that such a judicial standard does not presently apply to the law of prospectus liability.

CONCLUSION

In the present investment climate where we have the destructive impact of corporate irresponsibility and fraud on the financial market and the global economy, should we continue to let the **Olkey** interpretation stand? **The Sarbanes-Oxley Act of 2002** does not focus on this question. But should it? While it is only one piece of the puzzle to protect investors, meaningful prospectus liability is an important and necessary piece. It can be argued that the present status of the law should be changed by legislation or by new judicial thinking on this point. It would clearly benefit investors if they could rely on that language of a prospectus that expressly and clearly states the investment approach and philosophy of a fund or derivative security, even if such language is contradicted by the typical exculpatory boiler plate language. In 2003, the SEC did issues new rules to compel Investment Companies to issue prospectuses which are investor-friendly and that provide the investor with an objective way by which to judge past performance of the investment fund. However, the new rules did nothing to address the issue of liability for future performance failures. Confidence in the markets is necessary. The prospect of liability is the primary private market response to insuring issuer honesty on this subject. Honesty within the investment and corporate community is, at the end of the day, the key to financial market integrity and honesty.

[xxxii] H.R.3763
[xxxiii] See generally, Securities Act of 1933, Section 5, 15 U.S.C. section 77e
[xxxiv] Securities Act of 1933, Section 5, 15 U.S.C. section 77e(b)(1)
[xxxv] Securities Act of 1933, Section 10(b) 15 U.S.C. section 77j(b)
[xxxvi] SEC Rule 430
[xxxvii] See generally, Securities Act of 1933, Section 11, 15 U.S.C. section 77k
[xxxviii] Securities Act of 1933, Section 12, 15 U.S.C. section 77l(a)(2)
[xxxix] Securities Act of 1933, Section 15, 15 U.S.C. section 77o
[xl] See generally, Securities Exchange Act of 1934, 15 U.S.C. section 78(j)(b)
[xli] SEC Rule10b-5, 17 C.F.R. section 240.10b-5
[xlii] 98 F.3d 2 (2d circuit 1996); cert, denied, 117 S. Ct. 2433 (1997).
[xliii] Prospectus for the 1997 Hyperion Term Trust, Inc., page 19
[xliv] Prospectus for the 1997 Hyperion Term Trust, Inc. page 4
[xlv] Olkey v. Hyperion 1999 Term Trust Inc., 98 F.3d 2, 11 (2d Circuit 1996), cert denied, 117 S.Ct. 2433 (1997).
[xlvi] Prospectus for the 1997 Hyperion Term Trust, Inc., pages 13 to 14.
[xlvii] Prospectus for the 1997 Hyperion Term Trust, Inc., page 9 and page 19.
[xlviii] Prospectus for the 1997 Hyperion Term Trust, Inc., page 2
[xlix] Olkey at 9
[l] 937 F. 2d 767, 776 (2d Circuit, 1991)
[li] Denny v. Barber, 576 F.2d. 465, 470 (2d circuit, 1978)
[lii] *Hunt v. Alliance North American Income Trust, Inc.,* 159 F.3d 723 (2nd circuit)
[liii] *Hunt*, 159 F.3d 723, 731
[liv] Olkey at 13
[lv] Olkey at 13

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